

**DEPARTMENT OF THE TREASURY****Internal Revenue Service****26 CFR Part 1**

[REG-130507-11]

RIN 1545-BK44

**Net Investment Income Tax**

**AGENCY:** Internal Revenue Service (IRS), Treasury.

**ACTION:** Notice of proposed rulemaking and notice of public hearing.

**SUMMARY:** This document contains proposed regulations that provide guidance under section 1411 of the Internal Revenue Code (Code). Section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010 added new section 1411 to the Code effective for taxable years beginning after December 31, 2012. The proposed regulations affect individuals, estates, and trusts. This document also contains a notice of a public hearing on these proposed regulations.

**DATES:** Written or electronic comments must be received by March 5, 2013.

**ADDRESSES:** Send submissions to: CC:PA:LPD:PR (REG-130507-11), Room 5203, Internal Revenue Service, P.O. Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-130507-11), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue NW., Washington, DC, or sent electronically, via the Federal eRulemaking portal at [www.regulations.gov](http://www.regulations.gov) (IRS REG-130507-11).

**FOR FURTHER INFORMATION CONTACT:** Concerning the proposed regulations, Michala Irons, (202) 622-3050, or David H. Kirk, (202) 622-3060; concerning submissions of comments, the hearing, and/or to be placed on the building access list to attend the hearing, Oluwafunmilayo (Funmi) Taylor, (202) 622-7180 (not toll-free numbers).

**SUPPLEMENTARY INFORMATION:****Paperwork Reduction Act**

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)). Comments on the collection of information should be sent to the Office of Management and Budget, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs,

Washington, DC 20503, with copies to the Internal Revenue Service, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by February 4, 2013. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

There are two collections of information in the proposed regulations. The first collection is in proposed § 1.1411-7(d) and the second collection is in proposed § 1.1411-10(g).

The information collected in proposed § 1.1411-7(d) is required by the IRS to verify the taxpayer's reported adjustment under section 1411(c)(4). This information will be used to determine whether the amount of tax has been reported and calculated correctly. The likely respondents are owners of interests in partnerships and S corporations.

*Estimated total annual reporting and/or recordkeeping burden:* 315,000 hours.

*Estimated average annual burden per respondent:* 5 hours.

*Estimated number of respondents:* 63,000.

*Estimated annual frequency of responses:* On occasion.

The collection of information in proposed § 1.1411-10(g) is necessary for the IRS to determine whether a taxpayer has made an election pursuant to proposed § 1.1411-10(g) and to determine whether the amount of tax has been reported and calculated correctly. The likely respondents are individuals, estates, and trusts.

*Estimated total annual reporting and/or recordkeeping burden:* 62,000 hours.

*Estimated average annual burden per respondent:* 4 hours.

*Estimated number of respondents:* 15,500.

*Estimated annual frequency of responses:* Other (one time).

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

Books or records relating to a collection of information must be retained as long as their contents may

become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103.

**Background**

Section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010 (Pub. L. 111-152, 124 Stat. 1029) added section 1411 to a new chapter 2A of subtitle A (Income Taxes) of the Code effective for taxable years beginning after December 31, 2012. Section 1411 imposes a 3.8 percent tax on certain individuals, estates, and trusts. See section 1411(a)(1) and (a)(2). The tax does not apply to a nonresident alien or to a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B). See section 1411(e).

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

In the case of an estate or trust, section 1411(a)(2) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of (A) the estate's or trust's undistributed net investment income, or (B) the excess (if any) of (i) the estate's or trust's 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.

Section 1402(a)(2) of the Health Care and Education Reconciliation Act of 2010 also amended section 6654 of the Code to provide that the tax imposed under chapter 2A (which includes

section 1411) is subject to the estimated tax provisions.

The tax imposed by section 1411 is not deductible in computing any tax imposed by subtitle A of the Code. See Joint Committee on Taxation, General Explanation of Tax Legislation Enacted in the 111th Congress (JCS–2–11) (March 24, 2011), at 364 (JCT 2011 Explanation).

Amounts collected under section 1411 are not designated for the Medicare Trust Fund. The Joint Committee on Taxation in 2011 stated that “[i]n the case of an individual, estate, or trust an unearned income Medicare contribution tax is imposed. No provision is made for the transfer of the tax imposed by this provision from the General Fund of the United States Treasury to any Trust Fund.” See JCT 2011 Explanation, at 363; see also Joint Committee on Taxation, Description of the Social Security Tax Base (JCS–36–11) (June 21, 2011), at 24.

Section 1411(c)(1) provides that net investment income means the excess (if any) of (A) the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the tax does not apply, (ii) other gross income derived from a trade or business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply; over (B) the deductions allowed by subtitle A which are properly allocable to such gross income or net gain.

Section 1411(c)(1)(A) defines net investment income, in part, by reference to trades or businesses described in section 1411(c)(2). A trade or business is described in section 1411(c)(2) if such trade or business is (A) a passive activity (within the meaning of section 469) with respect to the taxpayer, or (B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)).

Income on the investment of working capital is not treated as derived from a trade or business for purposes of section 1411(c)(1) and is subject to tax under section 1411. See section 1411(c)(3).

In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain or net loss which would be so taken into account by the transferor if all property of the partnership or S corporation were sold

at fair market value immediately before the disposition of such interest.

Net investment income does not include distributions from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b). Section 1411(c)(5).

Net investment income also does not include any item taken into account in determining self-employment income for a taxable year on which a tax is imposed by section 1401(b). Section 1411(c)(6).

## Explanation of Provisions

### 1. Overview of Proposed Regulations

Proposed § 1.1411–1 provides general operating rules applicable to section 1411. Proposed § 1.1411–2 provides specific rules applicable to individuals. Proposed § 1.1411–3 provides specific rules applicable to estates and trusts. Proposed § 1.1411–4 provides rules for defining net investment income. Proposed § 1.1411–5 provides rules for net investment income derived from trades or businesses that are passive activities or trading in financial instruments or commodities. Proposed § 1.1411–6 provides rules for gross income and net gain on the investment of working capital. Proposed § 1.1411–7 provides rules for dispositions of interests in partnerships and S corporations. Proposed § 1.1411–8 provides rules for distributions from certain qualified plans. Proposed § 1.1411–9 provides rules for items taken into account in determining self-employment income. Proposed § 1.1411–10 provides rules with respect to controlled foreign corporations and passive foreign investment companies. Finally, proposed § 1.469–11(b)(3)(iv) provides a regrouping “fresh start” under section 469 for certain taxpayers.

### 2. In General

Section 1411 (which constitutes chapter 2A of the Code) contains terms commonly used in Federal income taxation and cross-references certain provisions of chapter 1 such as sections 67(e), 469, 401(a), and 475(e)(2). However, other than these specific cross-references to provisions of chapter 1, and certain specific definitions set forth in section 1411, section 1411 does not provide definitions of its operative phrases or terminology. Moreover, there is no indication in the legislative history of section 1411 that Congress intended, in every event, that a term used in section 1411 would have the same meaning ascribed to it for other Federal income tax purposes (such as chapter 1). Accordingly, the definitional rules set forth in the proposed regulations are

designed to promote the fair administration of section 1411 while preventing circumvention of the purposes of the statute. One of the general purposes of section 1411 is to impose a tax on unearned income or investments of certain individuals, estates, and trusts.

Under these proposed regulations, except as otherwise provided, chapter 1 principles and rules apply in determining the tax under section 1411. Consistent with this general approach, except as otherwise provided in the proposed regulations, gain that is not recognized under chapter 1 for a taxable year is not recognized for that year for purposes of section 1411 (for example, gain deferred or excluded under section 453 (installment method), section 1031 (like-kind exchanges), section 1033 (involuntary conversions), or section 121 (sale of principal residence)). Deferral or disallowance provisions of chapter 1 used in determining adjusted gross income apply to the determination of net investment income (for example, section 163(d) (limitation on investment interest), section 265 (expenses and interest relating to tax-exempt income), section 465(a)(2) (at risk limitations), section 469(b) (passive activity loss limitations), section 704(d) (partner loss limitations), section 1212(b) (capital loss carryover limitations), or section 1366(d)(2) (S corporation shareholder loss limitations)). A deduction carried over to a taxable year by reason of section 163(d), section 465(a)(2), section 469(b), section 704(d), section 1212(b), or section 1366(d)(2) and allowed for that taxable year in determining adjusted gross income is also allowed for the determination of net investment income, whether or not the taxable year from which the deduction is carried precedes the effective date of section 1411.

However, the proposed regulations modify the chapter 1 rules in certain respects in order to prevent circumvention of the purposes of the statute. For example, substitute interest and dividends, which are included in gross income under chapter 1, are net investment income even though these amounts are not categorically “interest” and “dividends” under chapter 1. In addition, while an item of income that is specifically excluded from gross income under chapter 1 generally also is excluded from net investment income under section 1411 (for example, tax-exempt interest), distributions described in section 959(d) or section 1293(c), excess distributions under section 1291 that are dividends, and gains that are treated as excess distributions under section 1291 (which are discussed in

part 11.B of this preamble) are net investment income under chapter 2A.

Proposed § 1.1411–1(b) provides generally that all references to an individual's adjusted gross income shall be treated as references to adjusted gross income (as defined in section 62) and that all references to an estate's or trust's adjusted gross income shall be treated as references to adjusted gross income (as defined in section 67(e)). As provided in part 11 of this preamble, there may be adjustments to adjusted gross income as a result of investments in controlled foreign corporations and passive foreign investment companies.

The IRS will closely review transactions that manipulate a taxpayer's net investment income to reduce or eliminate the amount of tax imposed by section 1411. In appropriate circumstances, the IRS will challenge such transactions based on applicable statutes and judicial doctrines. Thus, for example, if an investment arrangement that in form gives rise to income that does not constitute net investment income is in substance properly treated for Federal tax purposes as the holding of securities by one party as agent for another, the arrangement will be taxed in accordance with its substance.

### 3. Application to Individuals

#### A. In General

Section 1411(a)(1) imposes a tax on individuals, but section 1411(e)(1) provides that section 1411 does not apply to a nonresident alien. The proposed regulations provide that the term *individual* for purposes of section 1411 is any natural person, except for natural persons who are nonresident aliens. Therefore, section 1411 applies to any citizen or resident of the United States (within the meaning of section 7701(a)(30)(A)).

The amount of the tax on individuals is equal to 3.8 percent of the lesser of two amounts: (A) An individual's net investment income for such taxable year, or (B) the excess (if any) of (i) the individual's modified adjusted gross income for such taxable year, over (ii) the threshold amount. For example, if an unmarried U.S. citizen has modified adjusted gross income (as defined in section 1411(d) and proposed § 1.1411–2(c)) of \$190,000, which includes \$50,000 of net investment income (as defined in section 1411(c)(1) and proposed § 1.1411–4), there is no tax imposed under section 1411 because the threshold amount for a single individual is \$200,000 (see section 1411(b)(3) and proposed § 1.1411–2(d)(1)(iii)). On the other hand, if that individual has

\$220,000, which includes net investment income of \$50,000, the individual has a section 1411 tax of \$760 (3.8 percent times \$20,000).

The proposed regulations also clarify the treatment of (1) grantor trusts (see proposed §§ 1.1411–2(a)(2)(ii), 1.1411–3(b)(5), and part 4.B.ii of this preamble), (2) certain bankruptcy estates (see proposed §§ 1.1411–2(a)(2)(iii), 1.1411–3(d)(1), and part 4.D of this preamble), and (3) bona fide residents of the U.S. territories (see proposed § 1.1411–2(a)(2)(iv) and part 3.C of this preamble).

#### B. Joint Returns in the Case of a Nonresident Alien Individual Married to a U.S. Citizen or Resident

Proposed § 1.1411–2(a)(2)(i) addresses certain joint returns filed by married individuals. Proposed § 1.1411–2(a)(2)(i)(A) provides that in the case of a U.S. citizen or resident who is married (as defined in section 7703) to a nonresident alien individual, the spouses will be treated as married filing separately for purposes of section 1411. For purposes of calculating the tax imposed under section 1411(a)(1), the U.S. citizen or resident spouse will be subject to the threshold amount in section 1411(b)(2) (\$125,000) for a married taxpayer filing a separate return, and the nonresident alien spouse will be exempt from section 1411 taxation under section 1411(e)(1). In accordance with the rules for married taxpayers filing separate returns, the U.S. citizen or resident spouse must determine his or her own net investment income and modified adjusted gross income.

In general, section 6013(a) provides that no joint return may be made by married taxpayers if either spouse is a nonresident alien at any time during a taxable year. Section 6013(g), however, generally permits a nonresident alien individual married to a citizen or resident of the United States to elect for purposes of chapter 1 and chapter 24 of the Code to be treated as a resident of the United States. Proposed § 1.1411–2(a)(2)(i)(B) provides that married taxpayers who file a joint Federal income tax return pursuant to a section 6013(g) election can also elect to be treated as making a section 6013(g) election for purposes of chapter 2A of the Code. For purposes of calculating the tax imposed under section 1411(a)(1), the effect of such an election is to include the combined income of the U.S. citizen or resident spouse and the nonresident spouse in the section 1411(a)(1) calculation and subject that income to the threshold amount in section 1411(b)(1) (\$250,000) for a

taxpayer filing a joint return. Proposed § 1.1411–2(a)(2)(i)(B)(2) provides procedural requirements for making this election.

#### C. Bona Fide Residents of U.S. Territories

Proposed § 1.1411–2(a)(2)(iv) provides guidance on the application of section 1411 to individuals who are bona fide residents (within the meaning of section 937(a)) of possessions of the United States (U.S. territories) (namely, American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the United States Virgin Islands). An individual who is a citizen, resident, or nonresident alien with respect to the United States may qualify as a bona fide resident of a U.S. territory.

The application of the tax under section 1411 to a bona fide resident of a U.S. territory depends on whether the U.S. territory has a mirror code system of taxation, meaning the income tax laws are generally identical to the Code (except for the substitution of the name of the relevant territory for the term "United States" where appropriate). Three of the five U.S. territories (Guam, the Northern Mariana Islands, and the United States Virgin Islands) have a mirror code.

Bona fide residents of U.S. territories that are mirror code jurisdictions have no income tax obligation (or related return filing requirement) with the United States provided, generally, that they properly report income and pay income tax to the tax administration of their respective U.S. territory. See generally sections 932, 934, and 935. Therefore, the tax imposed by section 1411(a) generally does not apply to bona fide residents of mirror code jurisdictions because they will not have an income tax liability to the United States if they fully comply with the tax laws of the relevant territory.

Bona fide residents of non-mirror code jurisdictions (American Samoa and Puerto Rico) generally exclude territory-source income from U.S. Federal gross income under sections 931 and 933, respectively. (American Samoa currently is the only territory to which section 931 applies because it is the only territory that has entered into an implementing agreement under sections 1271(b) and 1277(b) of the Tax Reform Act of 1986.) Although territory-source income is excluded, these bona fide residents are subject to U.S. Federal income taxation, and have a related income tax return filing requirement with the United States to the extent they have U.S.-source or other non-territory source income or income from amounts paid for services performed as an

employee of the United States or any agency thereof (collectively, U.S. reportable income). See section 931(a) and (d) and section 933. Furthermore, under section 876 and § 1.876-1, bona fide residents of non-mirror code jurisdictions who are nonresident aliens with respect to the United States are subject to net-basis U.S. taxation on U.S. reportable income under sections 1 and 55, rather than to gross-basis U.S. taxation with respect to U.S.-source income under sections 871 through 879 (provisions that otherwise generally apply to nonresident aliens with respect to U.S.-source income).

Therefore, the tax imposed under section 1411(a) is applicable to bona fide residents of non-mirror code jurisdictions if they have U.S. reportable income that gives rise to both net investment income and modified adjusted gross income exceeding the threshold amount in section 1411. However, section 1411(a) does not apply if such bona fide residents are nonresident alien individuals with respect to the United States because section 1411(e)(1) and proposed § 1.1411-2(a)(1) exclude from section 1411(a) all nonresident alien individuals, which would include bona fide residents of any U.S. territory. However, nonresident alien individuals who are bona fide residents of non-mirror code jurisdictions remain subject to taxation under chapter 1 of subtitle A pursuant to section 876.

#### D. Modified Adjusted Gross Income

For purposes of section 1411 and the regulations thereunder, the term *modified adjusted gross income* is defined in section 1411(d) and proposed § 1.1411-2(c)(1) as adjusted gross income increased by the excess of (1) the amount excluded from gross income under section 911(a)(1), over (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts excluded from gross income under section 911(a)(1). See part 11 of this preamble for additional discussion on adjustments to modified adjusted gross income with respect to the ownership of interests in controlled foreign corporations and passive foreign investment companies.

#### E. Threshold Amount

For purposes of section 1411(a)(1) and (b) and the regulations thereunder, the term *threshold amount* for an individual means (1) in the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), \$250,000, (2) in the case

of a married taxpayer (as defined in section 7703) filing a separate return, \$125,000, and (3) in any other case, \$200,000. For special rules regarding a nonresident alien individual married to U.S. citizen or resident, see proposed § 1.1411-2(a)(2)(i) and part 3.B of this preamble. For rules regarding certain bankruptcy estates, see proposed §§ 1.1411-2(a)(2)(iii), 1.1411-3(d)(1), and part 4.D of this preamble. The threshold amount is not indexed for inflation.

Under the proposed regulations, the threshold amount is generally not prorated in the case of a short taxable year of an individual. However, the proposed regulations provide a special rule in the case of an individual who has a short taxable year resulting from a change of annual accounting period. Under section 443(b)(1), a taxpayer that undergoes a change in annual accounting period under section 442 and has a short period must annualize its taxable income. The taxpayer's Federal income tax is the tax computed on the annualized taxable income by multiplying the taxable income for the short period by twelve and dividing the result by the number of months in the short period. Proposed § 1.1411-2(d)(2)(ii) provides that an individual taxpayer that has a short period resulting from a change of annual accounting period shall reduce the applicable threshold amount to an amount that bears the same ratio to the full threshold amount provided under section 1411(b) as the number of months in the short period bears to twelve.

#### 4. Application to Estates and Trusts

In general, section 1411(a)(2) imposes a tax of 3.8 percent on estates and trusts on the lesser of their undistributed net investment income or the excess of their adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year. Proposed § 1.1411-3 provides special rules for applying section 1411 to estates and trusts, including an estate or trust with a short taxable year resulting from the formation or termination of the estate or trust or a change in accounting period.

##### A. Trusts Subject to Section 1411

Because Congress did not provide a rule specifying the particular trusts subject to section 1411, the Treasury Department and the IRS have determined that section 1411 applies to ordinary trusts described in § 301.7701-4(a). The general rule set forth in proposed § 1.1411-3(a)(1)(i) (that 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) implements this approach. This rule excludes from the application of section 1411 business trusts described in § 301.7701-4(b), which are treated as business entities under § 301.7701-2 and as eligible entities for purposes of entity classification in § 301.7701-3. Accordingly, such trusts are not subject to section 1411 at the entity level.

In addition, the general rule excludes certain state law trusts that are subject to specific taxation regimes in chapter 1 other than part I of subchapter J. This exclusion is consistent with the exception in the entity classification regulations for entities where a specific provision of the Code provides for special treatment of that organization. See § 301.7701-1(b). Examples of these trusts include common trust funds taxed under section 584 and expressly not subject to taxation under chapter 1 (per section 584(b)) and designated settlement funds taxed under section 468B in lieu of any other taxation under subtitle A (per section 468B(b)(4)).

However, section 1411 does apply to trusts subject to the provisions of part I of subchapter J, even though such trusts may have special computational rules within those provisions. These trusts include pooled income funds described in section 642(c)(5), cemetery perpetual care funds described in section 642(i), and qualified funeral trusts described in section 685. Similarly, section 1411 applies to certain Alaska Native settlement trusts described in section 646 (if that provision is in effect after the effective date of section 1411). The Treasury Department and the IRS request comments as to whether there may be administrative reasons to exclude one or more of these types of trusts from section 1411.

##### B. Application to Specific Trusts

###### i. Tax-Exempt Trusts

Section 1411 is in subtitle A. As a result, section 1411 does not apply to any trust, fund, or other special account that is exempt from tax imposed under subtitle A. This exclusion applies even if such trust may be subject to tax under section 511 on its unrelated business taxable income (and even if the trust's unrelated business taxable income is comprised of net investment income). Accordingly, the proposed regulations provide that any account, fund, or trust that is exempt from taxation under subtitle A (for example, sections 501(a), 664(c)(1), 220(e)(1), 223(e)(1), 529(a), and 530(a)) is also exempt from section 1411.

Section 1411(e)(2) specifically excepts from the application of section 1411 a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B). See proposed § 1.1411-3(b)(1).

#### ii. Grantor Trusts

A grantor trust is a trust or any portion thereof that is treated as being owned by the grantor or another person under subpart E of subchapter J (see sections 671 through 679). The owner must compute the owner's taxable income and credits by including the items of income, deduction, and credit against the tax attributable to the trust or the portion thereof treated as being owned by the owner. Thus, a grantor trust's income is not taxed as trust income but instead is treated as being the income of (and taxable to) the owner. The same rule applies for purposes of section 1411, thereby providing a consistent application of the grantor trust rules. This approach is also consistent with the IRS's position that the application of section 671 is not limited to chapter 1 of subtitle A. See Notice 97-24 (1997-1 CB 409); see § 601.601(d)(2).

Proposed § 1.1411-3(b)(5) provides that the tax under section 1411 is not imposed on a grantor trust, but if a grantor or another person is treated as the owner of all or a portion of a trust under subpart E of part I of subchapter J of chapter 1 any items of income, deduction, or credit that are included in computing taxable income of such grantor or other person under section 671 shall be treated as if such items had been received or paid directly by the grantor or other person for purposes of calculating such person's net investment income.

#### iii. Electing Small Business Trusts (ESBTs)

Proposed § 1.1411-3(c)(1) provides special computational rules for ESBTs. For purposes of chapter 1, section 641(c)(1) provides that (A) the portion of any ESBT which consists of stock in one or more S corporations shall be treated as a separate trust, and (B) the amount of the tax imposed by chapter 1 on such separate trust shall be determined with certain modifications detailed in section 641(c)(2). Section 1.641(c)-1(a) provides that an ESBT is treated as two separate trusts for purposes of chapter 1.

The proposed regulations preserve the chapter 1 treatment of the ESBT as two separate trusts for computational purposes but consolidates the ESBT into a single trust for determining the adjusted gross income threshold in

section 1411(a)(2)(B)(ii). This rule applies a single section 1(e) threshold so as to not inequitably benefit ESBTs over other taxable trusts.

Proposed § 1.1411-3(c)(1)(ii) provides the method to determine the ESBT's section 1411 tax base. First, the ESBT will separately calculate the undistributed net investment income of the S portion and non-S portion in accordance with the general rules for trusts under chapter 1, and combine the undistributed net investment income of the S portion and the non-S portion. Second, the ESBT will determine its adjusted gross income, solely for purposes of section 1411, by adding the net income or net loss from the S portion to that of the non-S portion as a single item of income or loss. Finally, to determine whether the ESBT is subject to section 1411, and if so, the section 1411 tax base, the ESBT will compare the combined undistributed net investment income with the excess of its adjusted gross income over the section 1(e) threshold.

#### iv. Charitable Remainder Trusts

Proposed § 1.1411-3(c)(2) provides special computational rules for charitable remainder trusts. Although the trust itself is not subject to section 1411 as provided in proposed § 1.1411-3(b)(3), annuity and unitrust distributions may be net investment income to the non-charitable recipient beneficiary. Proposed § 1.1411-3(c)(2) provides special rules to maintain the character and distribution ordering rules of § 1.664-1(d) for purposes of section 1411. The Treasury Department and the IRS are proposing these rules to determine whether items of income allocated to annuity or unitrust payments constitute net investment income to the recipient beneficiary.

Proposed § 1.1411-3(c)(2)(i) provides that distributions from a charitable remainder trust to a beneficiary for a taxable year consist of net investment income in an amount equal to the lesser of the total amount of the distributions for that year, or the current and accumulated net investment income of the charitable remainder trust. For charitable remainder trusts with multiple annuity or unitrust beneficiaries, the trust shall apportion the net investment income among the beneficiaries based on their respective shares of the total annuity or unitrust amount paid by the trust for that taxable year.

Proposed § 1.1411-3(c)(2)(ii) defines the term *accumulated net investment income* as the total amount of net investment income received by a charitable remainder trust for all taxable

years beginning after December 31, 2012, less the total amount of net investment income distributed for all prior taxable years beginning after December 31, 2012.

Thus, under proposed § 1.1411-3(c)(2), current and accumulated net investment income of the trust is deemed to be distributed before amounts that are not items of net investment income for purposes of section 1411. This classification of income as net investment income or non-net investment income is separate from, and in addition to, the four tiers under section 664(b), which continue to apply.

The Treasury Department and the IRS considered an alternative method for determining the distributed amount of net investment income in which net investment income would be determined on a class-by-class basis within each of the § 1.664-1(d)(1) enumerated categories. Under this alternative method, trustees would need to account for additional classes of income within each category, consistent with § 1.664-1(d)(1)(i), for taxable years beginning after December 31, 2012. The alternative method would create a subclass system of net investment income and non-net investment income within each class and category of the section 664 framework. Although differentiating between net investment income and non-net investment income within each class and category might be considered more consistent with the structure created for charitable remainder trusts by section 664 and the corresponding regulations, the Treasury Department and the IRS believe that the recordkeeping and compliance burden that would be imposed on trustees by this alternative would outweigh the benefits.

#### C. Foreign Estates and Foreign Trusts

Section 1411 does not specifically address the treatment of foreign estates and foreign nongrantor trusts. See part 4.B.ii of this preamble for the rules that apply if the foreign trust is treated as owned by a grantor or another person under sections 671 through 679. The Treasury Department and the IRS believe that section 1411 should not apply to foreign estates and foreign trusts that have little or no connection to the United States (for example, if none of the beneficiaries is a United States person). Accordingly, proposed §§ 1.1411-3(d)(2)(i) and 1.1411-3(b)(6) provide, as a general rule, that foreign estates and foreign trusts are not subject to section 1411. The Treasury Department and the IRS believe, however, that net investment income of

a foreign estate or foreign trust should be subject to section 1411 to the extent such income is earned or accumulated for the benefit of, or distributed to, United States persons. The taxation of United States beneficiaries receiving current distributions of net investment income from a foreign estate or foreign nongrantor trust will be consistent with the general operation of subparts A through D of part I of subchapter J and will be subject to section 1411. See proposed §§ 1.1411-4(e) and 1.1411-3(e)(3).

Proposed §§ 1.1411-3(d)(2)(ii) and 1.1411-3(c)(3) reserve on the application of section 1411 to foreign estates and foreign trusts with United States beneficiaries. The Treasury Department and the IRS request comments on the application of section 1411 to net investment income of foreign estates and foreign trusts that is earned or accumulated for the benefit of United States beneficiaries, including whether section 1411 should be applied to the foreign estate or foreign trust, or to the United States beneficiaries upon an accumulation distribution. Regarding the application of section 1411 to the foreign estate or foreign trust, consideration is being given to whether the definition of a United States beneficiary should exclude contingent or future beneficiaries and to adoption of an exclusion from section 1411 for foreign pension funds that are treated as trusts for United States tax purposes. To the extent that the final regulations do not subject foreign estates or foreign trusts to tax under section 1411, the Treasury Department and IRS request comments on how section 1411 should apply to United States persons that receive accumulation distributions from foreign estates and foreign trusts, including the means by which to identify such distributions as net investment income.

#### D. Bankruptcy Estates

A bankruptcy estate of a debtor who is an individual is treated as an individual for purposes of computing the tax under section 1411. Section 1398 provides rules for the taxation of bankruptcy estates in chapter 7 and chapter 11 cases under the Bankruptcy Code in which the debtor is an individual. In these cases, the bankruptcy estate computes its tax in the same manner as an individual. Section 1398(c)(2) provides that the tax rate under section 1 for the bankruptcy estate is the same as that imposed on a married taxpayer filing separately, and section 1398(c)(3) provides that the bankruptcy estate is entitled to a standard deduction of a married

taxpayer filing separately. Therefore, consistent with section 1398, regardless of the actual marital status of the debtor, a bankruptcy estate of a debtor who is an individual is treated as a married taxpayer filing separately for purposes of the thresholds in section 1411(b), and therefore the threshold amount applicable to such a bankruptcy estate is \$125,000.

#### E. Calculation of Undistributed Net Investment Income

Under section 1411(a)(2), the tax under section 1411 is imposed on the lesser of (A) the undistributed net investment income of the estate or trust for such year, or (B) the excess (if any) of the adjusted gross income (as defined in section 67(e)) for the taxable year, over the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year. Thus, similar to the computation for individuals, it is the lesser of two amounts. Net investment income is defined in section 1411(c)(1) and proposed § 1.1411-4, and this same definition applies to individuals, estates, and trusts. Undistributed net investment income is a section 1411 term used solely for estates and trusts (and not individuals), and is not defined in section 1411. The proposed regulations conform the taxation of estates and trusts under section 1411 to the rules of part I of subchapter J to avoid double taxation of net investment income and the taxation of amounts distributed to charities.

The proposed regulations give effect to the provisions of subchapter J that treat an estate or trust as a conduit by reducing the estate's or trust's taxable income to take into account distributions to beneficiaries and the charitable deduction. The proposed regulations, accordingly, provide that undistributed net investment income of an estate or trust is its net investment income (as determined under proposed § 1.1411-4) reduced by the share of net investment income included in the deductions of the estate or trust under section 651 or section 661, and the share of net investment income allocated to the section 642(c) deduction of the estate or trust in accordance with § 1.642(c)-2(b) and the allocation and ordering rules under § 1.662(b)-2. The proposed regulations adopt the class system of income categorization, generally embodied in sections 651 through 663 and the regulations thereunder, to arrive at the trust's net investment income reduction in the case of distributions that are comprised of both net investment income and net excluded income items. For this purpose, the term excluded income

includes items that are not includible in net investment income by either specific exclusion under chapter 1 (for example, interest on state and local bonds under section 103(a)); specific exclusion contained in section 1411 (for example, section 1411(c)(5) or (6)) or the proposed regulations; or are not specifically included in section 1411(c)(1)(A) or elsewhere in the proposed regulations.

#### 5. Definition of Net Investment Income

Section 1411(c)(1) defines net investment income as the excess (if any) of (A) the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the tax does not apply, (ii) other gross income from trades or businesses to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply, over (B) deductions allowed by subtitle A which are properly allocable to such gross income or net gain.

If items of net investment income (including the properly allocable deductions) pass through to an individual, estate, or trust from a partnership or S corporation, the allocation of such items must be separately stated under section 702 or section 1366 and the regulations thereunder.

#### A. Gross Income Items Described in Section 1411(c)(1)(A)(i)

##### i. In General

The proposed regulations provide that net investment income includes, in part, gross income from interest, dividends, annuities, royalties, and rents. However, such income is excluded from net investment income if it is derived in the ordinary course of a trade or business not described in section 1411(c)(2). This exclusion is described in part 5.A.vi of this preamble.

##### ii. Interest and Dividends

###### (a) In General

Gross income from interest includes any item treated as interest for purposes of chapter 1, and includes substitute interest (as discussed in part 5.A.ii.(b) of this preamble).

Gross income from dividends includes any item treated as a dividend for purposes of chapter 1. This includes, but is not limited to, amounts treated as dividends pursuant to subchapter C that are included in gross income (including

constructive dividends); amounts treated as dividends under section 1248(a); amounts treated as dividends under § 1.367(b)–2(e)(2); and amounts treated as dividends under section 1368(c)(2). In addition, as discussed in part 5.A.ii.(b) and part 11 of this preamble, substitute dividends, distributions from previously taxed earnings and profits (within the meaning of section 959(d) or section 1293(c)), and certain excess distributions (within the meaning of section 1291(b)) are included in net investment income.

Gross income from notional principal contracts (within the meaning of § 1.446–3(c)) is not included in net investment income under section 1411(c)(1)(A)(i). However, if gross income from notional principal contracts is derived in a trade or business described in proposed § 1.1411–5, all of such gross income is included in net investment income under section 1411(c)(1)(A)(ii). In addition, gain on a disposition of a notional principal contract is included in net investment income under either section 1411(c)(1)(A)(ii) or section 1411(c)(1)(A)(iii) (see parts 5.B and 5.C of this preamble).

#### (b) Substitute Interest and Substitute Dividends

A substitute interest payment or a substitute dividend payment made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction is treated as an interest payment or dividend payment, as applicable, for purposes of section 1411, and thus as net investment income for purposes of proposed § 1.1411–4(a)(1)(i). If substitute interest and substitute dividend payments were not treated in this manner, the Treasury Department and the IRS believe that taxpayers could easily avoid the section 1411 tax with respect to interest or dividend income by lending their securities over a payment date. The Treasury Department and the IRS do not believe that Congress intended the imposition of the section 1411 tax to turn on transactional formalities that are so readily manipulated by well-advised taxpayers. This approach is consistent with other contexts in which substitute interest and dividend payments have been treated in the same manner as actual interest or dividend payments in order to preclude avoidance of tax. For example, regulations under sections 861, 871, and 881 treat substitute interest and dividend payments as having the same source and the same character as the actual interest or dividend payments for which they

substitute in order to preclude avoidance of nonresident withholding tax. See §§ 1.861–2(a)(7); 1.861–3(a)(6); 1.871–7(b)(2); and 1.881–2(b)(2).

In certain other contexts, substitute payments are not treated in the same manner as actual interest or dividend payments (for example, a substitute dividend payment is not eligible for the dividends received deduction or for the lower rate of tax applicable to qualified dividends under section 1(h)(11)). In those contexts, however, disparate treatment serves essentially the same purpose, that is, to preclude the avoidance of tax through the multiplication of tax benefits or tax exclusions. The Treasury Department and the IRS believe that it is appropriate to treat substitute payments in a manner that precludes their use to facilitate tax avoidance. Accordingly, these proposed regulations treat substitute interest and substitute dividends as interest and dividends for purposes of determining net investment income.

#### (c) Controlled Foreign Corporations and Passive Foreign Investment Companies

Special rules apply to a United States shareholder of a controlled foreign corporation or a United States person who owns stock in a passive foreign investment company. See part 11 of this preamble.

#### iii. Annuities

Gross income from annuities includes the amount received as an annuity under an annuity, endowment, or life insurance contract that is includible in gross income as a result of the application of section 72(a) and section 72(b), and an amount not received as an annuity under an annuity contract that is includible in gross income under section 72(e).

The Code does not define the term annuity. Section 72(a) provides that gross income includes any amount received as an annuity under an annuity, endowment, or life insurance contract. Section 72(b), however, excludes from gross income that part of an amount received as an annuity that bears the same ratio to that amount as the investment in the contract bears to the expected return under the contract (determined as of the annuity starting date).

Section 72(e) governs the treatment of amounts received under an annuity contract that are not received as an annuity (such as lump sum distributions or surrenders). Section 72(e)(2) provides in general that such amounts received on or after the annuity starting date are included in gross income, and that amounts received before the annuity

starting date are included in gross income to the extent allocable to income on the contract on an income-first basis.

Gain or loss from the sale of an annuity would be treated as net investment income for purposes of section 1411. To the extent the sales price of the annuity does not exceed its surrender value, the gain recognized would be treated as gross income described in section 1411(c)(1)(A)(i) and proposed § 1.1411–4(a)(1)(i). If the sales price of the annuity exceeds its surrender value, the seller would treat the gain equal to the difference between the basis in the annuity and the surrender value as gross income described in section 1411(c)(1)(A)(i) and proposed § 1.1411–4(a)(1)(i), and would treat the excess of the sales price over the surrender value as gain from the disposition of property under section 1411(c)(1)(A)(iii) and proposed § 1.1411–4(a)(1)(iii).

#### iv. Royalties

Gross income from royalties includes amounts received from mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, franchises, and other like property.

#### v. Rents

Gross income from rents includes amounts paid or to be paid principally for the use of (or the right to use) tangible property.

#### vi. Ordinary Course of a Trade or Business Exception

The items described in parts 5.A.ii through 5.A.v of this preamble are not included in net investment income by reason of section 1411(c)(1)(A)(i) if the item meets the ordinary course of a trade or business exception. See proposed § 1.1411–4(b). The ordinary course of a trade or business exception is a two-part test. First, the item must be “derived in” a trade or business not described in section 1411(c)(2). Second, if the item is derived in a trade or business not described in section 1411(c)(2), then such item must also be derived in the “ordinary course” of such trade or business. As explained in part 6 of this preamble, a trade or business described in section 1411(c)(2) is either a trade or business that is (A) a passive activity (within the meaning of section 469) with respect to the taxpayer, or (B) trading in financial instruments (as defined in proposed § 1.1411–5(c)(1)) or commodities (as defined in section 475(e)(2)).

## (a) Derived In

In order for an item of gross income described in section 1411(c)(1)(A)(i) to be excluded from section 1411 under the ordinary course of a trade or business exception, the income must be derived in a trade or business that is neither a passive activity with respect to the taxpayer (as described in section 1411(c)(2)(A) and the regulations thereunder) nor a trade or business of trading in financial instruments or commodities (as described in section 1411(c)(2)(B) and the regulations thereunder).

In the case of an individual who is engaged in the conduct of a trade or business directly (for example, a sole proprietor) or through ownership of an interest in an entity that is disregarded as an entity separate from the individual owner under § 301.7701-3, the determination of whether an item of gross income is derived in a trade or business described in section 1411(c)(2)(A) or (B) is made at the individual level. For example, if A, an individual, is engaged in a trade or business that is not described in section 1411(c)(2) and the trade or business has gross income (for example, royalties), such gross income is derived in A's trade or business, and therefore A meets the first part of the ordinary course of a trade or business exception. However, if A's trade or business is a passive activity with respect to A or if A's trade or business is trading in financial instruments or commodities, the ordinary course of a trade or business exception will be inapplicable because the income is derived in a trade or business described in section 1411(c)(2).

In the case of an individual, estate, or trust that owns an interest in a trade or business through one or more passthrough entities (a partnership or an S corporation), the determination of whether an item of gross income described in section 1411(c)(1)(A)(i) allocated to the individual, estate, or trust from the passthrough entity is derived in a trade or business described in section 1411(c)(2)(A) (a passive activity with respect to the taxpayer) or section 1411(c)(2)(B) (trading in financial instruments or commodities) is made in the following manner. The determination of whether the trade or business from which the income is derived is a passive activity with respect to the taxpayer is determined at the taxpayer (individual, estate, or trust) level in accordance with the general principles of section 469. For example, if A, an individual, owns an interest in PRS, a partnership, which is engaged in a trade or business, the determination of

whether PRS's trade or business is a passive activity with respect to A is made in accordance with section 469 and the regulations under that section. See part 6.B of this preamble for rules to determine whether a trade or business is a passive activity with respect to a taxpayer.

On the other hand, the determination of whether the trade or business from which the income is derived is a trade or business of trading in financial instruments or commodities is made at the passthrough entity level (the partnership or S corporation level). If the passthrough entity is engaged in a trade or business of trading in financial instruments or commodities, income from such trade or business retains its character as it passes from the entity to the taxpayer. Therefore, regardless of whether the individual is directly engaged in a trade or business or whether an intervening passthrough entity is engaged in a trade or business, such income will not qualify for the ordinary course of a trade or business exception in section 1411(c)(1)(A)(i) because such income is derived in a trade or business of trading in financial instruments or commodities (as described in section 1411(c)(2)(B)). See *Example 2* of proposed § 1.1411-4(b)(3).

Conversely, if the passthrough entity is not engaged in a trade or business, income allocated to an individual from such entity will not qualify for the ordinary course of a trade or business exception even if the individual or an intervening entity is engaged in a trade or business. For example, B, 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. Any income described in section 1411(c)(1)(A)(i) passed through from LTP (through UTP) to B will not be derived in a trade or business because LTP is not engaged in a trade or business. This characterization applies even though UTP is engaged in a trade or business and even if (1) B is engaged in a trade or business, (2) B provides services with respect to UTP's trade or business, and/or (3) B provides services to LTP. See *Example 1* of proposed § 1.1411-4(b)(3).

In addition, if the passthrough entity is not engaged in a trade or business and the passthrough entity has items of income described in section 1411(c)(1)(A)(i), the individual's status under section 469 is irrelevant. For example, C, an individual, owns an interest in PRS, a partnership that is not engaged in a trade or business and earns dividends and interest. C's distributive

share of dividends and interest from PRS will be subject to section 1411(c)(1)(A)(i) because they are not derived in a trade or business and therefore cannot be excluded under the ordinary course of a trade or business exception.

Similar rules regarding whether the trade or business is determined at the taxpayer level or the entity level apply in determining whether net gain is attributable to the disposition of property "held" in a trade or business subject to section 1411. See part 5.C of this preamble.

The interaction of the ordinary course of a trade or business exception and the trade or business rules under sections 1411(c)(2)(A) and 1411(c)(2)(B) can be illustrated in the following example. B, an individual, owns an interest in S, an S corporation, which is a bank. S earns interest in the ordinary course of its trade or business (which is not trading in financial instruments or commodities). Accordingly, the interest B earns through S is not derived in a trade or business described in section 1411(c)(2)(B). B will then have to determine if S's trade or business is a passive activity with respect to B. If B is passive with respect to S's banking business, then even though the interest was not subject to section 1411(c)(1)(A)(i) because of section 1411(c)(2)(B), B's pro rata share of S's interest is net investment income under section 1411(c)(1)(A)(ii) because of section 1411(c)(2)(A). See *Example 3* of proposed § 1.1411-4(b)(3).

## (b) Ordinary Course

Section 1411 does not define ordinary course of a trade or business, and the proposed regulations do not provide guidance on the meaning of ordinary course. However, other regulation sections and case law provide guidance on whether an item of gross income is derived in the ordinary course of a trade or business. See, for example, *Lilly v. Comm'r*, 343 U.S. 90, 93 (1953), *rev'g* 188 F.2d 269 (4th Cir. 1951), *aff'g* 14 T.C. 1066 (1950) (holding that expenses incurred regularly and arising from transactions that commonly or frequently occur in the type of business involved are "ordinary"); § 1.469-2T(c)(3)(ii) (providing rules for determining whether certain portfolio income is excluded from the definition of passive activity gross income).

## vii. Income From Employment

For purposes of section 1411, an employee is treated as engaged in the trade or business of being an employee. Therefore, regardless of whether such amounts are calculated by reference to

the items described in proposed § 1.1411-4(a), amounts paid by an employer to an employee that are treated as wages for purposes of section 3401 are not net investment income because such amounts are derived in the ordinary course of a trade or business to which section 1411 does not apply. For example, amounts paid to an employee under a nonqualified deferred compensation plan for such employee (or that otherwise become includible in income under section 409A, 457(f), 457A, or other Code section or tax doctrine) that include gross income from interest or other earnings are not treated as net investment income, regardless of whether such amounts are not subject to Federal Insurance Contributions Act tax due to the earlier application of section 3121(v)(2).

viii. Coordination With Portfolio Income Rules in Section 469

Because section 469 treats portfolio income (which includes, for example, gross income from interest and dividends) as not derived in the ordinary course of a trade or business, the ordinary course of a trade or business exception in section 1411(c)(1)(A)(i) does not apply to such income, and such income will be net investment income under proposed § 1.1411-4(a)(1)(i). The section 469 portfolio income rules are discussed in detail in part 6.B.i.(c).(1).(f) of this preamble.

B. Other Trade or Business Gross Income Described in Section 1411(c)(1)(A)(ii)

Net investment income also includes other gross income derived from a trade or business described in section 1411(c)(2). See section 1411(c)(1)(A)(ii). The trades or businesses described in section 1411(c)(2) are discussed in part 6 of this preamble.

For a trade or business described in section 1411(c)(2)(A), which is a trade or business that is a passive activity with respect to the taxpayer, section 1411(c)(1)(A)(ii) includes other gross income that is not gross income described in section 1411(c)(1)(A)(i) or net gain described in section 1411(c)(1)(A)(iii). Thus, if an item of gross income or net gain is subject to section 1411(c)(1)(A)(i) or (iii), it is generally not other gross income described in section 1411(c)(1)(A)(ii).

For a trade or business described in section 1411(c)(2)(B), which is a trade or business of trading in financial instruments or commodities, section 1411(c)(1)(A)(ii) includes all other gross income from such trade or business that is not gross income described in section

1411(c)(1)(A)(i). For example, any gain from marking to market under section 475(f) or section 1256 and any realized gain from the disposition of property held in the trade or business of trading in financial instruments or commodities is classified as other gross income subject to section 1411(c)(1)(A)(ii) (and not classified as net gain under section 1411(c)(1)(A)(iii)).

C. Net Gain Described in Section 1411(c)(1)(A)(iii)

Section 1411(c)(1)(A)(iii) states that net investment income includes net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business not described in section 1411(c)(2). See part 11 of this preamble for additional discussion on net investment income with respect to controlled foreign corporations and passive foreign investment companies.

i. Disposition

1. In General

The proposed regulations provide that net investment income includes net gain (to the extent taken into account in computing taxable income) attributable to the sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition (collectively, referred to as the disposition) of property other than property held in a trade or business not described in proposed § 1.1411-5. Except as otherwise provided, the income tax rules in chapter 1 generally will determine whether there has been a disposition of property under section 1411. For example, if a partner receives a distribution of money from a partnership in excess of the adjusted basis of the partner's interest in the partnership and recognizes gain under section 731(a), or if an S corporation shareholder receives a distribution of money from the S corporation in excess of the adjusted basis of the shareholder's stock in the corporation and recognizes gain under section 1368(b)(2), the gain is treated as gain from the sale or exchange of such partnership interest or S corporation stock for purposes of section 1411(c)(1)(A)(iii). As another example, if stock of an S corporation is sold and a section 338(h)(10) election is made, each shareholder's pro rata share of the deemed asset sale gain or loss may be taken into account in determining net investment income under section 1411(c)(1)(A)(iii). Furthermore, each shareholder may have additional gain or loss upon the

deemed liquidation of the S corporation resulting from the section 338(h)(10) election, which gain or loss will also generally be taken into account under section 1411(c)(1)(A)(iii) in determining net investment income. In addition, capital gain dividends from regulated investment companies and real estate investment trusts described in sections 852(b)(3)(C) and 857(b)(3)(C), respectively, and undistributed capital gains described in sections 852(b)(3)(D) and 857(b)(3)(D), are included in net investment income as net gain under section 1411(c)(1)(A)(iii), and not as dividend income under section 1411(c)(1)(A)(i).

2. Mark-to-Market Rules for Non-Traders

Under certain statutory or regulatory provisions, a non-trader may (or may be required to) mark assets to market. For example, under section 1256, a taxpayer is treated as selling a section 1256 contract for fair market value at the end of the taxable year, and the taxpayer includes in gross income any gain and, in certain cases, loss recognized as a result of the deemed sale. Similarly, as further discussed in part 11 of this preamble, under section 1296, a United States person that has made a mark-to-market election with respect to stock in a passive foreign investment company recognizes income at the close of each taxable year based on the difference between the fair market value of the passive foreign investment company stock and the person's adjusted basis in such stock (or is allowed a deduction equal to the lesser of the excess of the adjusted basis of such stock over its fair market value or the unreversed mark-to-market inclusions with respect to the passive foreign investment company stock). These proposed regulations treat amounts of gain or loss recognized as a result of marking to market as net investment income. For rules regarding section 1296, see part 11 of this preamble. For rules regarding traders who mark assets to market under sections 475 and 1256, see part 5.B of this preamble.

ii. Determination of Net Gain From Disposition

Except as otherwise expressly provided in the regulations, the income tax gain and loss recognition rules in chapter 1 apply for purposes of determining net gain under section 1411. Thus, for example, to the extent gain from a like-kind exchange is not recognized for income tax purposes under section 1031, it is not recognized for purposes of determining net investment income under section 1411.

Losses properly taken into account in determining net gain include all losses deductible under section 165, to the extent they are attributable to property that is either (1) not held in a trade or business, or (2) held in a trade or business described in proposed § 1.1411-5.

The amount of net gain on the disposition of an interest in a partnership or an S corporation taken into account for purposes of section 1411(c)(1)(A)(iii) may be adjusted in accordance with proposed § 1.1411-7 (relating to the special rule in section 1411(c)(4) for the dispositions of certain interests in partnerships or S corporations).

Because section 1411(c)(1)(A)(iii) uses the term net gain (which contemplates a positive number), the proposed regulations provide that the amount of net gain included in net investment income may not be less than zero. Although capital losses in excess of capital gains are not recognized for purposes of section 1411, losses allowable under section 1211(b)(1) and (2) are permitted to offset gain from the disposition of assets other than capital assets that are subject to section 1411.

#### iii. Exception for Property Held in a Trade or Business Not Described in Section 1411(c)(2)

Section 1411(c)(1)(A)(iii) generally applies if the property disposed of is either not held in a trade or business, or is held in a trade or business described in section 1411(c)(2) and proposed § 1.1411-5. See part 6 of this preamble for rules relating to trades or business subject to section 1411. However, if the property disposed of is “held” in a trade or business and such trade or business is not described in proposed § 1.1411-5, net investment income would not include gain attributable to such property.

The determination of whether property is “held” in a trade or business is determined in the same manner as whether gross income is “derived in” a trade or business for purposes of section 1411(c)(1)(A)(i). These rules are described in detail in part 5.A.vi of this preamble. Thus, for individuals directly engaged in a trade or business, the determination is made at the individual level. If an individual, estate, or trust holds an interest in a passthrough entity and such entity disposes of its property, the determination of whether property is held in a trade or business that is a passive activity is made at the taxpayer level (that is, the individual, estate, or trust level), and the determination of whether property is held in a trade or business of trading in financial

instruments or commodities is made at the entity level. For example, S, an S corporation, is engaged in trade or business, and A, an individual, owns stock in S. If S sells its Property 1 for a gain, the determination of whether A’s gain from the disposition of S’s Property 1 is subject to section 1411(c)(1)(A)(iii) depends on (1) whether S held Property 1 in its trade or business, and (2) if S held Property 1 in its trade or business, whether S’s trade or business is described in proposed § 1.1411-5. If S held Property 1 in its trade or business and S’s trade or business is neither a passive activity with respect to A nor trading in financial instruments or commodities with respect to S, net gain from the disposition of Property 1 will not be subject to section 1411(c)(1)(A)(iii).

#### D. Distributions From Trusts

The proposed regulations provide that 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 net investment income, with further computations provided in proposed § 1.1411-3(e).

#### E. Properly Allocable Deductions

The proposed regulations provide that in determining net investment income, items of gross income and net gain are reduced by properly allocable deductions. Principles applied in determining the amount and timing of a deduction for purposes of Federal income taxation generally apply for purposes of determining a deduction under section 1411. However, only amounts paid or incurred by a taxpayer to produce gross income or net gain described in proposed § 1.1411-4 may be deducted in determining net investment income.

Net investment income for any taxable year may not be less than zero. In addition, any otherwise allowable deductions not taken into account for section 1411 purposes may only be taken into account in another taxable year to the extent allowed for chapter 1 purposes (such as a carryforward of investment interest under section 163(d), a suspended passive activity loss that is allowed in a later year under section 469(b), or a capital loss carryforward under section 1212).

Section 469(g)(1) provides special rules for the treatment of suspended passive losses when the taxpayer disposes of its entire interest in any passive activity (or former passive activity) in a fully taxable transaction to

an unrelated party during the taxable year. The Treasury Department and the IRS request comments on whether the losses triggered under section 469(g)(1) upon the disposition should be considered taken into account in determining the taxpayer’s net gain on the disposition of the activity under section 1411(c)(1)(A)(iii) or whether the losses should be considered properly allocable deductions to gross income and net gain described in section 1411(c)(1)(A)(i) through (iii).

The proposed regulations provide that net investment income does not take into account a net operating loss deduction. While some of the deductions included in the computation of a net operating loss may be deductions described in proposed § 1.1411-4(f), the character of each of the various deduction items that comprise a net operating loss is generally not tracked for purposes of chapter 1 once the item becomes part of a net operating loss. Thus, when an item becomes part of a net operating loss that is carried to another year, it generally is no longer properly allocable to a specific type of income, such as gross income from interest. In addition, rules to determine the portion of a net operating loss deduction properly allocable to items of gross income or net gain subject to section 1411 would be unduly complex and not administrable. This result is similar to the result for self-employment income, where section 1402(a)(4) specifically provides that the deduction for net operating losses provided in section 172 shall not be allowed in determining net earnings from self-employment. In determining a taxpayer’s modified adjusted gross income (in the case of an individual) or adjusted gross income (in the case of an estate or trust), however, net operating losses continue to be taken into account. The Treasury Department and the IRS invite comments on this issue.

Gross income from rents or royalties may be reduced by deductions described in section 62(a)(4) that are allocable to such income. Net investment income also takes into account the deduction for penalties associated with the early withdrawal of savings described in section 62(a)(9).

In addition, the proposed regulations permit gross income from a trade or business described in proposed § 1.1411-5 that constitutes net investment income to be reduced by deductions described in section 62(a)(1) that are allocable to such income. However, the amount of deductions allowed under section 1411(c)(1)(B) may be reduced or eliminated by the application of the self-employment

income exception in section 1411(c)(6) and proposed § 1.1411-9.

As discussed in part 10 of this preamble, under section 1411(c)(6) and proposed § 1.1411-9(a), amounts taken into account in determining self-employment income are excluded from net investment income. Amounts not taken into account in determining self-employment income because they are excluded from net earnings from self-employment are not covered by the self-employment income exception in section 1411(c)(6), and thus may be net investment income. The application of section 1411(c)(6) and the general rule in proposed § 1.1411-9(a) to properly allocable deductions under section 1411(c)(1)(B) might produce an unintended result in the context of traders in financial instruments or commodities. In many cases, the gross income earned by a taxpayer engaged in the trade or business of trading financial instruments or commodities will be subject to section 1411 because the trading income is not taken into account in determining the taxpayer's self-employment income due to section 1402(a)(3)(A) (and in cases where the trader has made a section 475 election, due to the interaction of sections 475(f)(1)(D) and 1402(a)(3)(A)), and thus the self-employment income exception in section 1411(c)(6) does not apply to the income. However, the properly allocable deductions attributable to a trade or business of trading in financial instruments or commodities would be taken into account in determining the taxpayer's self-employment income (even though the gross income was not) and, absent an exception, would therefore not reduce the taxpayer's gross income under section 1411.

For example, assume A, an individual, is engaged in the trade or business of trading in commodities, and made an election under section 475(f)(2). A earns \$500,000 of gross income (which is subject to proposed § 1.1411-4(a)(1)(ii)), and A also incurs \$100,000 of expenses relating to the trading business. Under section 1402, none of the \$500,000 of gross income would be taken into account in determining A's self-employment income (as provided in sections 475(f)(1)(D) and 1402(a)(3)(A)), but all of the \$100,000 of expenses would be taken into account within the meaning of the general rule in proposed § 1.1411-9(a), even though there are no net earnings from self-employment and thus no self-employment income to reduce. Absent the exception described in proposed § 1.1411-9(b), the expenses also would not reduce the taxpayer's \$500,000 of gross income under section

1411 because the expenses were taken into account under section 1402 in determining the taxpayer's self-employment income and would therefore be excluded under section 1411(c)(6) and the general rule in proposed § 1.1411-9(a).

The Treasury Department and the IRS believe that a trader should be able to reduce gross income described in proposed § 1.1411-4(a)(1)(ii) by properly allocable deductions if the deductions did not actually reduce net earnings from self-employment, even after aggregating net earnings from self-employment from other trades or businesses. Therefore, proposed § 1.1411-9(b) provides a special rule for traders of financial instruments or commodities. If the trader has deductions that did not reduce the taxpayer's net earnings from self-employment (that is, excess deductions), even after aggregating net earnings from self-employment from other trades or businesses, such excess deductions are properly allocable deductions under section 1411(c)(1)(B), notwithstanding the exclusion in section 1411(c)(6). This trader exception and section 1411(c)(6) are also discussed in part 10 of this preamble.

The proposed regulations also provide that several itemized deductions are properly allocable deductions under section 1411. The proposed regulations provide that investment interest allowed as a deduction by reason of section 163(d)(1), investment expenses described in section 163(d)(4)(C), and taxes imposed on investment income that are described in section 164(a)(3) are deductible in determining net investment income. In the case of taxes imposed on both investment income and non-investment income, the proposed regulations provide that the portion of taxes properly allocable to investment income may be determined by taxpayers using any reasonable method. The proposed regulations further provide that allocating the deduction based on the ratio of investment income to total gross income is an example of a reasonable method.

Under the proposed regulations, properly allocable deductions that are itemized deductions subject to the 2-percent floor on miscellaneous itemized deductions under section 67 or subject to the overall limitation on itemized deductions under section 68 may be deducted in determining net investment income only to the extent that they are deductible for income tax purposes after the application of the 2-percent floor and the overall deduction limitation. Some deductions, such as investment expenses, are subject to limitation under

both sections 67 and 68, while other deductions, such as state taxes, are subject only to the limitation under section 68. It is necessary to apportion these deduction limitations between deductions properly allocable to net investment income and deductions that are not properly allocable to net investment income. The proposed regulations provide a method for apportioning these limitations to determine the amount of deductions allowed in computing net investment income after applying sections 67 and 68. This method first applies section 67 to all deductions subject to that limitation. The disallowance is applied proportionately to each deduction subject to section 67. The proposed regulations then apply a similar process to deductions subject to section 68.

Deductions for losses under section 165 are taken into account only in computing net gain. Therefore, because net gain in section 1411(c)(1)(A)(iii) cannot be less than zero, any excess of losses over gains are not allowable in the computation of net investment income. Accordingly, properly allocable deductions do not include deductions under section 165.

#### F. Income Inclusion From Tax-Exempt Trusts

Generally, a recipient of a distribution from a tax-exempt trust (other than non-charitable beneficiary of a charitable remainder trust as described in part 4.B.iv of this preamble) will not be liable for Federal income tax on the distribution because the distribution is tax-exempt income. Accordingly, the recipient (whether an individual, estate, or trust) will not be liable for tax under section 1411 regardless of whether the distributed amount is comprised of items of net investment income. However, there may be certain situations in which the recipient of a distribution from a tax-exempt trust is liable for Federal income tax on all or a part of the distributed amount. For example, a distribution from a qualified tuition program under section 529, a Coverdell education savings account, an Archer medical savings account (Archer MSA), or a health savings account (HSA) may be subject to Federal income tax if the distributed amounts are not used by the recipient for qualified expenses. In these situations, it is possible that a portion of the distribution may be comprised of items of net investment income generated by the trust corpus. However, in these cases, a recipient of a distribution from a tax-exempt trust will not be subject to tax under section 1411 on the distribution (even if the recipient

otherwise may be liable for Federal income tax on the distribution) because of the difficulty in determining whether the distributions from the corpus of the trust are gross income from items that may constitute net investment income (such as interest). Distributions from certain tax-exempt settlement funds covering Indian tribal governments also will not be subject to tax under section 1411, although income subsequently generated from distributed funds (for example, after deposit in an interest-bearing account) may be subject to section 1411.

#### 6. Section 1411 Trades or Businesses

Section 1411(c)(1)(A) defines net investment income, in part, by reference to trades or businesses described in section 1411(c)(2). The trades or businesses described in section 1411(c)(2) are (A) a passive activity (within the meaning of section 469) with respect to the taxpayer, and (B) trading in financial instruments or commodities (as defined in section 475(e)(2)).

##### A. In General

Section 1411's statutory language and legislative history do not provide a definition of trade or business. The most established definition of trade or business is found under section 162(a), which permits a deduction for all the ordinary and necessary expenses paid or incurred in carrying on a trade or business. The rules under section 162 for determining the existence of a trade or business are well-established, and there is a large body of case law and administrative guidance interpreting section 162's meaning of trade or business. The proposed regulations incorporate the rules under section 162 for determining whether an activity is a trade or business for purposes of section 1411 and the proposed regulations. The use of the section 162 definition of trade or business facilitates administration of section 1411 and should simplify taxpayer compliance. See parts 5.A.vi and 5.C of this preamble for rules relating to the determination of whether certain items of income are derived in the ordinary course of a trade or business and whether net gain is attributable to the disposition of property held in a trade or business, respectively.

##### B. Trade or Business That Is a Passive Activity With Respect to the Taxpayer

As described in part 6.A of this preamble, the statutory language in sections 1411(c)(1)(A) and 1411(c)(2)(A) is intended to take into account only gross income from and net gain

attributable to a passive activity (within the meaning of section 469) that involves the conduct of a trade or business (within the meaning of section 162). The definitions of trade or business and passive activity for section 1411 purposes are more restrictive than for section 469 purposes in two respects. First, section 469 and the regulations thereunder provide that a trade or business includes not only a trade or business (within the meaning of section 162), but also any activity conducted in anticipation of the commencement of a trade or business and any activity involving research or experimentation (within the meaning of section 174). See section 469(c)(5), §§ 1.469-1(e)(2), and 1.469-4(b)(1). Second, while section 469 defines passive activity as any trade or business in which the taxpayer does not materially participate, it also includes any rental activity in the definition of passive activity. See section 469(c)(1) and (2). The proposed regulations provide that the definition of trade or business for section 1411 purposes is limited to a trade or business within the meaning of section 162.

Due to the differences in the definitions for purposes of section 1411 and section 469, under the proposed regulations, in some cases gross income from activities that are passive activities under section 469 will not be taken into account for purposes of section 1411(c)(1)(A)(ii) because the gross income is derived from an activity that does not rise to the level of a trade or business (within the meaning of section 162). In such cases, the gross income will not be taken into account under section 1411 unless it is taken into account under section 1411(c)(1)(A)(i) or section 1411(c)(1)(A)(iii) and the proposed regulations. See *Example 1* of proposed § 1.1411-5(b)(2).

##### i. Passive Activities That Are Section 1411 Trades or Businesses

###### (a) In General

For purposes of section 1411(c)(2)(A) and the proposed regulations, the taxpayer must determine whether a section 162 trade or business in which the taxpayer owns an interest is a passive activity. Section 1411(c)(2)(A) provides that the term passive activity has the same meaning as section 469. Section 469(c)(1) provides that a passive activity is any activity that involves the conduct of any trade or business and in which the taxpayer does not materially participate. Section 469(c)(2) provides that, except as provided in section 469(c)(7), a passive activity also includes any rental activity (regardless

of whether the taxpayer materially participates in the rental activity). See also § 1.469-1T(e)(3)(ii). For rules regarding the treatment of working interests in oil or gas property, see section 469(c)(3).

###### (b) Application of Existing Section 469 Rules

Section 469 and the regulations thereunder provide rules for determining whether trade or business activities and certain rental activities are passive activities with respect to a taxpayer. Generally, these rules will also apply in determining whether a section 162 trade or business is a passive activity for purposes of section 1411(c)(2)(A). Examples of this principle are discussed in this preamble, but these examples are not meant to be an exhaustive list of the rules that apply.

##### (1) Material Participation

Section 469(h)(1) provides that a taxpayer shall be treated as materially participating in an activity only if the taxpayer is involved in the operations of the activity on a basis which is regular, continuous, and substantial. Section 1.469-5T provides additional guidance for individuals on the meaning of "material participation." The material participation rules of section 469 will apply for purposes of determining whether a taxpayer materially participates in a section 162 trade or business for purposes of determining whether such trade or business is described in section 1411(c)(2)(A).

##### (2) Real Estate Professionals

Section 469(c)(7) and § 1.469-9 provide special rules for certain individual taxpayers involved in the conduct of real property trades or businesses (real estate professionals). If a taxpayer meets the requirements to be a real estate professional in section 469(c)(7)(B), the taxpayer's interests in rental real estate are no longer subject to section 469(c)(2), and the rental real estate activities of the taxpayer will not be passive activities if the taxpayer materially participates in each of those activities. However, a taxpayer who qualifies as a real estate professional is not necessarily engaged in a trade or business (within the meaning of section 162) with respect to the rental real estate activities. If the rental real estate activities are section 162 trades or businesses, the rules in section 469(c)(7) and § 1.469-9 will apply in determining whether a rental real estate activity of a real estate professional is a passive activity for purposes of section 1411(c)(2)(A). However, if the rental real

estate activities of the real estate professional are not section 162 trades or businesses, the gross income from rents derived from such activity will not be excluded under section 1411(c)(1)(A)(i) by the ordinary course of a trade or business exception. The ordinary course of a trade or business exception is inapplicable because the rents are not derived from a trade or business and will therefore be subject to section 1411. The ordinary course of a trade or business exception is described in part 5.A.vi of this preamble.

### (3) Rental Activity Exceptions

Section 469(j)(8) and the regulations thereunder provide that a rental activity is any activity where payments are principally for the use of tangible property that is used or held for use by customers. Section 1.469-1T(e)(3)(ii) provides several exceptions to the definition of a rental activity. If a taxpayer's activity meets one of these exceptions, the activity is not a rental activity for purposes of section 469 (that is, it is no longer per se passive), and the activity will not be a passive activity if the taxpayer materially participates in that activity. These rental activity exceptions will also apply for determining whether the activity is a passive activity of a taxpayer for purposes of section 1411(c)(2)(A). However, a taxpayer who meets one of these exceptions is not necessarily engaged in a trade or business (within the meaning of section 162) with respect to the activity. In other words, even if the taxpayer meets one of the exceptions in § 1.469-1T(e)(3)(ii), if the taxpayer's activity is not a section 162 trade or business, gross income from rents from the activity will be subject to section 1411(c)(1)(A)(i) because the activity does not meet the ordinary course of a trade or business exception. The proposed regulations provide examples that illustrate the interaction of section 1411 and the section 469 rental activity exceptions. See *Examples 3 and 4* of proposed § 1.1411-5(b)(2).

### (4) Grouping Rules

Section 1.469-4 provides rules for defining an activity for purposes of applying the passive activity loss rules of section 469 (grouping rules). The grouping rules will apply in determining the scope of a taxpayer's trade or business in order to determine whether such trade or business is a passive activity for purposes of section 1411(c)(2)(A). However, a proper grouping under § 1.469-4(d)(1) (grouping rental activities with other trade or business activities) will not convert gross income from rents into

other gross income derived from a trade or business described in proposed § 1.1411-5(a)(1).

Section 1.469-4(e)(1) provides that, except as provided in §§ 1.469-4(e)(2) and 1.469-11, once a taxpayer has grouped activities, the taxpayer may not regroup those activities in subsequent taxable years. The Treasury Department and the IRS have determined on prior occasions that taxpayers should be given a "fresh start" to redetermine their groupings. The enactment of section 1411 may cause taxpayers to reconsider their previous grouping determinations, and therefore the Treasury Department and the IRS have determined that taxpayers should be given the opportunity to regroup. Thus, the proposed regulations provide that taxpayers may regroup their activities in the first taxable year beginning after December 31, 2013, in which the taxpayer meets the applicable income threshold in proposed § 1.1411-2(d) and has net investment income (as defined in proposed § 1.1411-4). The determination in the preceding sentence is made without regard to the effect of the regrouping. Taxpayers may regroup their activities in reliance on this proposed regulation for any taxable year that begins during 2013 if section 1411 would apply to such taxpayer in such taxable year. A taxpayer may only regroup activities once pursuant to § 1.469-11(b)(3)(iv)(A), and any such regrouping will apply to the taxable year for which the regrouping is done and all subsequent years.

The regrouping must comply with the existing requirements under § 1.469-4. For example, § 1.469-4(e) provides that taxpayers must comply with disclosure requirements that the Commissioner may prescribe with respect to both their original groupings and the addition and disposition of specific activities within those chosen groupings in subsequent taxable years. On January 25, 2010, the Treasury Department and the IRS published Revenue Procedure 2010-13 (2010-4 IRB 329), which requires taxpayers to report to the IRS their groupings and regroupings of activities and the addition of specific activities within their existing groupings of activities for purposes of section 469 and § 1.469-4. Thus, the disclosure requirements of § 1.469-4(e) and Revenue Procedure 2010-13 require taxpayers who regroup their activities pursuant to proposed § 1.469-11(b)(3)(iv) to report their regroupings to the IRS. See § 601.601(d)(2).

### (c) Special Rules for Certain Income From Passive Activities

Section 469 and the regulations thereunder provide several rules that restrict the ability of taxpayers to artificially generate passive income from certain types of passive activities. Some rules specifically recharacterize income from a passive activity as income not from a passive activity (income recharacterization rules). Other rules recharacterize the activity itself as being a non-passive activity (activity recharacterization rules).

#### (1) Income Recharacterization Rules

##### (I) Portfolio Income

Section 469(e)(1)(A)(i)(I) provides that in determining the income or loss from any activity there shall not be taken into account any gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business (portfolio income). Thus, items of net investment income in section 1411(c)(1)(A)(i) and proposed § 1.1411-4(a)(1)(i) that are portfolio income will, by definition, be included in section 1411 because these portfolio items are not derived in the ordinary course of a trade or business. In addition, § 1.469-7 provides an exception to the portfolio income rules for self-charged interest, which is treated as passive income, and therefore, the gross income from such interest would be gross income from interest subject to proposed § 1.1411-4(a)(1)(i).

Similarly, section 469(e)(1)(A)(ii) provides that gain or loss not derived in the ordinary course of a trade or business which is attributable to the disposition of property (I) producing portfolio income, or (II) held for investment, should not be taken into account in determining income from a passive activity. Thus, gain described in section 469(e)(1)(A)(ii) will be net investment income if (1) the gain is attributable to property held in a section 162 trade or business of trading in financial instruments or commodities, or (2) the gain is attributable to property not held in a section 162 trade or business. See part 5.C of this preamble.

##### (II) Working Capital

Section 469(e)(1)(B) provides special rules for return on working capital. Section 1411(c)(3) provides that rules similar to section 469(e)(1)(B) also apply for purposes of section 1411. Working capital is discussed in part 7 of this preamble.

## (III) Net Income Recharacterization Rules

The regulations under section 469 provide special rules that treat income from certain activities as not from a passive activity. See § 1.469–2T(f)(2) (special rule for significant participation); § 1.469–2T(f)(3) (rental of nondepreciable property); § 1.469–2T(f)(4) (net interest income from passive equity-financed lending activity); § 1.469–2(f)(5) (net income from certain property rented incidental to development activity); § 1.469–2(f)(6) (property rented to a nonpassive activity); § 1.469–2T(f)(7) (special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property). In most cases, these items will be subject to section 1411 if the item of income constitutes gross income from one of the items described in proposed § 1.1411–4(a)(1)(i) and the item of income is not derived in the ordinary course of a trade or business. For example, if a taxpayer has gross income from rents from an activity described in § 1.469–2(f)(6) that is not derived in the ordinary course of a trade or business, the gross income from rents will be subject to section 1411. The ordinary course of a trade or business exception is described in part 5.A.vi of this preamble.

## (IV) Substantially Appreciated Property

Section 1.469–2(c)(2)(iii)(A) generally provides that if an interest in property used in an activity is substantially appreciated at the time of its disposition, any gain from the disposition shall be treated as not from a passive activity. The recharacterized gain may be taken into account under section 1411(c)(1)(A)(iii) if the gain is attributable to the disposition of property.

## (2) Activity Recharacterization Rules

Section 1.469–1T(e)(6) provides that an activity of trading personal property for the account of owners of interests in the activity is not a passive activity (without regard to whether such activity is a trade or business activity). For this purpose, § 1.469–1T(e)(6)(ii) provides that the term *personal property* means personal property (within the meaning of section 1092(d), without regard to paragraph (3) thereof). Section 1092(d)(1) provides that personal property means any personal property of a type which is actively traded. While the gross income from or net gain attributable to an activity of trading or dealing in property will not be taken into account under section 1411(c)(2)(A)

by virtue of § 1.469–2T(c)(3)(ii)(D), such gross income or net gain nevertheless will be taken into account under section 1411(c)(2)(B) if the activity constitutes a section 162 trade or business of trading in financial instruments or commodities. Trading in financial instruments or commodities is discussed in part 6.C of this preamble.

## C. Trading in Financial Instruments or Commodities

## i. Distinguishing Between Dealers, Traders, and Investors

Determining whether trading in financial instruments or commodities rises to the level of a section 162 trade or business is a question of fact. *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *Estate of Yaeger v. Comm'r*, 889 F.2d 29, 33 (2d Cir. 1989). In general, section 475(c)(1) provides that the term *dealer in securities* means a taxpayer who (A) regularly purchases securities from or sells securities to customers in the ordinary course of a trade or business, or (B) regularly offers to enter into, assume, offset, assign, or otherwise terminate positions in securities with customers in the ordinary course of a trade or business. In contrast, a trader seeks profit from short-term market swings and receives income principally from selling on an exchange rather than from dividends, interest, or long-term appreciation. *Groetzing v. Comm'r*, 771 F.2d 269, 274–275 (7th Cir. 1985), *aff'd* 480 U.S. 23 (1987); *Moller v. United States*, 721 F.2d 810, 813 (Fed. Cir. 1983). A person will be a trader, and therefore engaged in a section 162 trade or business, if his or her trading is frequent and substantial, which has been rephrased as “frequent, regular, and continuous.” *Boatner v. Comm'r*, T.C. Memo. 1997–379, *aff'd in unpublished opinion* 164 F.3d 629 (9th Cir. 1998).

An investor is a person who purchases and sells securities with the principal purpose of realizing investment income in the form of interest, dividends, and gains from appreciation in value over a relatively long period of time (that is, long-term appreciation). The management of one’s own investments is not considered a section 162 trade or business no matter how extensive or substantial the investments might be. See *Higgins v. Comm'r*, 312 U.S. 212, 217 (1941); *King v. Comm'r*, 89 T.C. 445 (1987). Therefore, an investor is not considered to be engaged in a section 162 trade or business of investing.

For purposes of section 1411(c)(2)(B), in order to determine whether gross income is derived from a section 162

trade or business of trading in financial instruments or commodities, the gross income must be derived from an activity that would constitute trading for purposes of chapter 1. Therefore, a person that is a trader in commodities or a trader in financial instruments is engaged in a trade or business for purposes of section 1411(c)(2)(B). The Treasury Department and the IRS emphasize that the proposed regulations do not change the state of the law with respect to classification of traders, dealers, or investors for purposes of chapter 1.

## ii. Definition of Financial Instruments

Section 1411 does not define the term “financial instrument.” Section 731(c)(2)(C) provides a definition of financial instrument for purposes of section 731, and this existing statutory definition is used as a guideline for the section 1411 definition. The proposed regulations define the term *financial instrument* to include stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of an interest in any of the listed items. An evidence of an interest in any of these listed items includes, but is not limited to, short positions or partial units in any of these listed items.

## iii. Definition of Commodities

In accordance with the statutory language in section 1411(c)(2)(B), the proposed regulations provide that the term *commodities* has the same meaning as that provided in section 475(e)(2).

## 7. Working Capital Exception

Section 1411(c)(3) provides that a rule similar to the rule of section 469(e)(1)(B) applies for purposes of section 1411 (the working capital rule). Section 469(e)(1)(B) provides that, for purposes of determining whether income is treated as from a passive activity, any income or gain attributable to an investment of working capital shall be treated as not derived in the ordinary course of a trade or business.

The term working capital is not defined in either section 469 or section 1411, but it generally refers to capital set aside for use in and the future needs of a trade or business. Because the capital may not be necessary for the immediate conduct of the trade or business, the amounts are often invested by businesses in income-producing liquid assets such as savings accounts, certificates of deposit, money market accounts, short-term government and commercial bonds, and other similar investments. These investment assets

will usually produce portfolio-type income, such as interest. Under section 469(e)(1)(B), portfolio-type income generated by working capital is not derived in the ordinary course of a trade or business, and therefore, it is not treated as passive income. Under section 1411(c)(3), gross income from and net gain attributable to the investment of working capital is not derived in the ordinary course of a trade or business, and therefore such gross income and net gain is subject to section 1411.

A taxpayer may take into account the properly allocable deductions (related to losses or deductions properly allocable to the investment of such working capital) in determining net investment income. See part 5.E of this preamble regarding properly allocable deductions.

#### 8. Dispositions of Interests in Partnerships and S Corporations

In most cases, an interest in a partnership or S corporation is not property held in a trade or business. Therefore, gain or loss from the sale of a partnership interest or S corporation stock will be subject to section 1411(c)(1)(A)(iii). See also section 731(a) and section 1368(b)(2) (providing that the gain recognized when cash is distributed in excess of the adjusted basis of, as applicable, a partner's interest in a partnership or a shareholder's stock in an S corporation is treated as gain from the sale or exchange of such partnership interest or S corporation stock).

Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or S corporation, gain from such disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be so taken into account by the transferor under section 1411(c)(1)(A)(iii) if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest. Section 1411(c)(4)(B) applies a similar rule to a loss from a disposition.

For purposes of section 1411, Congress intended section 1411(c)(4) to put a transferor of an interest in a partnership or S corporation in a similar position as if the partnership or S corporation had disposed of all of its properties and the accompanying gain or loss from the disposition of such properties passed through to its owners (including the transferor). However, the gain or loss upon the sale of an interest in the entity and a sale of the entity's underlying properties will not always match. First, there may be disparities between the transferor's adjusted basis

in the partnership interest or S corporation stock and the transferor's share of the entity's adjusted basis in the underlying properties. See *Example 2* of proposed § 1.1411-7(e). Second, the sales price of the interest may not reflect the proportionate share of the underlying properties' fair market value with respect to the interest sold.

In order to achieve parity between an interest sale and an asset sale, section 1411(c)(4) must be applied on a property-by-property basis, which requires a determination of how the property was held in order to determine whether the gain or loss to the transferor from the hypothetical disposition of such property would have been gain or loss subject to section 1411(c)(1)(A)(iii). As described in proposed § 1.1411-4(a)(1)(iii) and proposed § 1.1411-4(d), section 1411(c)(1)(A)(iii) applies if the property disposed of is either not held in a trade or business, or held in a trade or business described in proposed § 1.1411-5. In other words, under the proposed regulations, the exception in section 1411(c)(4) is only applicable where the property is held in a trade or business not described in section 1411(c)(2). See JCT 2011 Explanation, at 364, fn. 976 (and accompanying text); Joint Committee on Taxation, Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act" (JCX-18-10) (Mar. 21, 2010), at 135 fn. 286 (and accompanying text) (JCT 2010 Explanation). This means that the exception in section 1411(c)(4) does not apply where (1) there is no trade or business, (2) the trade or business is a passive activity (within the meaning of proposed § 1.1411-5(a)(1)) with respect to the transferor, or (3) where the partnership or the S corporation is in the trade or business of trading in financial instruments or commodities (within the meaning of proposed § 1.1411-5(a)(2)), because in these cases there would be no change in the amount of net gain determined under proposed § 1.1411-4(a)(1)(iii) upon an asset sale under section 1411(c)(4). For example, if the transferor is passive with respect to the entity's trade or business, the application of the deemed asset sale rule under section 1411(c)(4), as described in part 8.A of this preamble, would not adjust the transferor's section 1411(c)(1)(A)(iii) gain on the disposition of the interest. See *Example 7* of proposed § 1.1411-7(e) for a situation involving the transferor of an interest in an S corporation with two trades or businesses, only one of which is described in proposed § 1.1411-5.

#### A. Mechanics of Section 1411(c)(4)

##### i. In General

The proposed regulations provide that, for purposes of section 1411(c)(4), a transferor computes the gain or loss from the sale of the underlying properties of the partnership or S corporation using a deemed asset sale method (Deemed Sale), and then determines if, based on the Deemed Sale, there is an adjustment (either positive or negative) to the transferor's gain or loss on the disposition of the partnership or S corporation interest for purposes of section 1411(c)(1)(A)(iii). An adjustment only occurs if the underlying property is used in a trade or business not described in proposed § 1.1411-5 (a positive adjustment reduces a loss on the disposition of the interest, and a negative adjustment reduces the gain on the disposition of the interest). Because the proposed regulations apply a Deemed Sale by the passthrough entity of all its assets for cash equal to the fair market value of the entity's properties, any gain or loss on the interest sale that is not reflected in the underlying properties of the passthrough entity (as the result of an inside-outside basis disparity) would not create an adjustment. This is illustrated in *Example 2* of proposed § 1.1411-7(e).

In developing the Deemed Sale, the Treasury Department and the IRS considered existing hypothetical transactions, such as the hypothetical transaction to determine a transferee's basis adjustment under section 743(b). See § 1.743-1. The proposed regulations provide that the Deemed Sale under section 1411(c)(4) applies, in part, rules similar to § 1.743-1(d)(2). However, the Treasury Department and the IRS recognize that the Deemed Sale may impose an administrative burden on owners of partnerships and S corporations in certain circumstances. The Treasury Department and the IRS request comments on other methods that would implement the provisions of section 1411(c)(4) without imposing an undue burden on taxpayers. In addition, the IRS and the Treasury Department request comments on how to determine a partner's interest in section 1411 assets upon a distribution in which gain is recognized pursuant to section 731.

##### ii. Deemed Sale

The first step of the Deemed Sale is a hypothetical disposition of all the entity's properties (including goodwill) in a fully taxable transaction for cash equal to the fair market value of the entity's properties immediately before the disposition of the interest.

The second step of the Deemed Sale is to compute the gain or loss on each of the entity's properties (including goodwill). The calculation of gain or loss is determined by comparing the fair market value of each property with such property's adjusted basis. The gain or loss from each property must be computed separately.

The third step of the Deemed Sale is to allocate the gain or loss from each property determined in the second step to the transferor. In the case of a partnership, the amount of gain or loss allocated to the transferor must take into account the allocations provided in the partnership agreement and any allocations required by sections 704(b) and 704(c) (and the regulations thereunder), as well as basis adjustments under section 743 with respect to the transferor. In the case of an S corporation, the amount of gain or loss allocated to the transferor is determined under section 1366(a), and the allocation should not take into account any reduction in the transferor's distributive share in section 1366(f)(2) resulting from the hypothetical imposition of tax under section 1374 as a result of the Deemed Sale.

The fourth step of the Deemed Sale is to determine whether the amount of gain or loss allocated to the transferor with respect to each property under the Deemed Sale would have been taken into account in determining the transferor's net gain under section 1411(c)(1)(A)(iii) if it were an actual disposition. If the entity's property is either held in a trade or business described in section 1411(c)(2) with respect to the partnership, the S corporation, or the transferor, or is not held in a trade or business, there will be no adjustment under section 1411(c)(4) with respect to that property. However, if the property is held in a trade or business not described in section 1411(c)(2), there is an adjustment under section 1411(c)(4) calculated in the following manner. First, the transferor's gains or losses from such property (or properties) are aggregated to create a net gain (which will be treated as a negative adjustment) or a net loss (which will be treated as a positive adjustment). Second, based on the adjustment calculated and subject to certain limitations, the transferor then must adjust the gain or loss from the disposition of the partnership or S corporation interest determined in section 1411(c)(1)(A)(iii) (without regard to section 1411(c)(4)) by the positive or negative adjustment.

For example, if in the Deemed Sale the transferor would have been allocated a net gain from property held

in a trade or business not described in section 1411(c)(2) (thus, a negative adjustment) and the transferor had a gain on the disposition of the interest, then the gain on the disposition of the interest will be reduced for purposes of determining net investment income. However, in a situation in which a transferor has a gain (determined without regard to section 1411(c)(4)) from the disposition of the partnership or S corporation interest, a negative adjustment cannot result in the transferor having a loss on the disposition of the partnership or S corporation interest for purposes of section 1411(c)(1)(A)(iii), and a positive adjustment is not taken into account. For example, if a transferor has a \$100,000 gain on the disposition of S corporation stock, the section 1411(c)(4) adjustment cannot result in a gain for section 1411 purposes greater than \$100,000, and cannot result in a loss for section 1411 purposes. See *Example 3* of proposed § 1.1411-7(e). Similarly, in a situation where a transferor has a loss (determined without regard to section 1411(c)(4)) from the disposition of the partnership or S corporation interest, a positive adjustment cannot result in the transferor having a gain on the disposition of the partnership or S corporation interest for purposes of section 1411(c)(1)(A)(iii), and a negative adjustment is not taken into account. For example, if a transferor has a \$50,000 loss on the disposition of S corporation stock, the section 1411(c)(4) adjustment cannot result in a loss for section 1411 purposes greater than \$50,000, and cannot result in a gain for section 1411 purposes.

The proposed regulations provide a special rule for property held in more than one trade or business during the twelve-month period ending on the date of the disposition. In such case, the fair market value and the adjusted basis of such property must be allocated among the trades or businesses on a basis that reasonably reflects the use of the property. This allocation rule is illustrated in *Example 7* of proposed § 1.1411-7(e).

The proposed regulations provide rules to determine the treatment of gain or loss from goodwill for purposes of section 1411(c)(4). If the entity is engaged in one trade or business, the entire gain or loss on the goodwill will be treated as gain or loss from the disposition of property held for use in that trade or business, and no portion of such gain or loss will be treated as attributable property not held for use in the trade or business. If the entity is engaged in more than one trade or business, the gain or loss on the

goodwill is allocated between the trades or businesses based on the relative fair market value of the property (excluding cash) held for use in each trade or business. For example, if the entity has total assets with a fair market value of \$110,000 (consisting of assets of \$10,000 not held in any trade or business, \$15,000 of assets held for use in Business 1, \$45,000 of assets held for use in Business 2, \$10,000 of cash, and goodwill of \$30,000), and if the gain on the goodwill is \$20,000, \$5,000 of such gain is allocated to Business 1 and the remaining \$15,000 gain is allocated to Business 2. See *Example 8* of proposed § 1.1411-7(e).

## B. Special Situations

### i. Interaction of Section 1411(c)(4) and Section 338(h)(10) Election

In the case of a disposition of stock in an S corporation with respect to which a section 338(h)(10) election is made, section 1411(c)(4) is inapplicable to the deemed asset sale and liquidation transactions that result from the section 338(h)(10) election. Under section 338(h)(10), the sale of the S corporation stock is treated as an actual asset sale by the S corporation. Section 1411(c)(4) is inapplicable to such an asset sale. In the deemed liquidation of the former S corporation, section 1411(c)(4) is also inapplicable to the shareholders because the underlying character of the gain or loss in the assets at the former S corporation level is already fully taken into account in the deemed asset sale.

### ii. Installment Sales

In the case of a disposition of a partnership or S corporation interest in an installment sale transaction to which section 453 applies, proposed § 1.1411-7(b)(1)(i) provides that the adjustment to net gain will be calculated in the year of the disposition. However, under proposed § 1.1411-4(a)(1)(iii), the gain and any applicable adjustment are deferred and recognized proportionally pursuant to section 453.

In the event that the year of the disposition of the interest occurs before the effective date of section 1411, the adjustment under section 1411(c)(4) and proposed § 1.1411-7(c) will not be applicable. However, the proposed regulations allow taxpayers to elect into the rules of proposed § 1.1411-7 if they receive installment sale payments attributable to a disposition of an interest in a partnership or S corporation that occurred before the effective date of section 1411. This election allows taxpayers that sell their interests in installment sales before the effective date of section 1411 to be

treated similarly with taxpayers that sell their interests after the effective date. In submitting the required statement of adjustment (described in proposed § 1.1411-7(d)), this election will require the taxpayer to have the information (such as basis and fair market value of each property) as of the date of disposition.

### iii. Sale by a Qualified Subchapter S Trust (QSST)

If an election is made pursuant to section 1361(d)(2), a QSST can be an eligible shareholder of an S corporation. Section 1.1361-1(j)(8) provides rules for coordinating the QSST rules and the grantor trust rules, and provides that the income beneficiary of the QSST is treated as the owner, for purposes of section 678(a), of that portion of the trust that consists of the stock of the S corporation for which the QSST election was made. However, solely for purposes of this rule, an income beneficiary who is a deemed section 678 owner only by reason of section 1361(d)(1) will not be treated as the owner of the S corporation stock in determining and attributing the Federal income tax consequences of a disposition of the stock by the QSST. Therefore, if the QSST sells some (or all) of its S corporation stock, any gain or loss recognized on the sale will be that of the trust, not the income beneficiary. (On the other hand, the disposition is treated as a disposition by the income beneficiary for purposes of applying sections 465 and 469 to the income beneficiary of a QSST.)

The proposed regulations do not address whether special rules are needed to coordinate the QSST rules regarding dispositions of stock in an S corporation in § 1.1361-1(j)(8) and section 1411(c)(4). The Treasury Department and the IRS request comments on whether special coordination rules are necessary.

### C. Required Statements

Any transferor making an adjustment under proposed § 1.1411-7(c)(5) must attach a statement to the transferor's return for the year of disposition. The statement must include: (1) A description of the disposed-of interest; (2) the name and taxpayer identification number of the entity disposed of; (3) the fair market value of each property of the entity; (4) the entity's adjusted basis in each property; (5) the transferor's allocable share of gain or loss with respect to each property of the entity; (6) information regarding whether the property was held in a trade or business not described in section 1411(c)(2); (7) the amount of the section 1411(c)(1)(A)(iii) gain on the disposition

of the interest; and (8) the computation of the adjustment under proposed § 1.1411-7(c)(5).

In cases involving partnerships without a section 754 election in effect (or where there is no mandatory section 743 adjustment) and S corporations, the transferor may not have access to the information that is necessary to make the adjustment and to file the required statements. The Treasury Department and the IRS request comments on how a transferor may acquire the required information in these cases.

### 9. Exception for Distributions From Qualified Plans

Section 1411(c)(5) provides that net investment income does not include any distribution from the following plans or arrangements:

- (1) A qualified pension, stock bonus, or profit-sharing plan under section 401(a);
- (2) A qualified annuity plan under section 403(a);
- (3) A tax-sheltered annuity under section 403(b);
- (4) An individual retirement account (IRA) under section 408;
- (5) A Roth IRA under section 408A; or
- (6) A deferred compensation plan of a State and local government or a tax-exempt organization under section 457(b).

These proposed regulations provide rules relating to whether an amount is a distribution from a plan within the meaning of section 1411(c)(5) and, thus, exempt from net investment income. First, the proposed regulations provide that, for purposes of section 1411, any amount actually distributed from a qualified plan or arrangement is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. The proposed regulations provide examples of actual distributions, including a rollover to an eligible retirement plan within the meaning of section 402(c)(8)(B), a distribution of a plan offset amount within the meaning of Q&A-13(b) of § 1.72(p)-1, and corrective distributions from a qualified plan or arrangement to maintain its tax-favored status. The term "corrective distribution" includes any of the following distributions: (1) A distribution of excess deferrals as described in § 1.402(g)-1(e)(3); (2) for purposes of section 408 IRAs, a distribution of excess contributions as described in § 1.408-4(c); (3) for purposes of section 408A Roth IRAs, a distribution of excess contributions as described in Q&A-1(d) of § 1.408A-6; and (4) for purposes of eligible section 457(b) plans, a distribution of excess

deferrals as described in § 1.457-4(e)(2) through (4).

Second, the proposed regulations provide that, for purposes of section 1411, amounts that are deemed distributions under the Code for purposes of income tax are distributions for purposes of section 1411(c)(5), even if these distributions are not treated as actual distributions for purposes of the qualification requirements under section 401(a). Examples of deemed distributions include conversions to a Roth IRA described in section 408A and deemed distributions under section 72(p).

Third, any amount that is not treated as a distribution, but is otherwise includible in gross income pursuant to a rule relating to amounts held in a qualified plan or arrangement, is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. For example, any income of the trust of a qualified plan or arrangement that is applied to purchase a participant's life insurance coverage (the P.S. 58 costs) is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income.

While distributions from qualified plans or arrangements are not includible in net investment income, as defined in section 1411(c)(1), distributions from a qualified plan or arrangement that are includible in gross income under chapter 1 are taken into account in determining the taxpayer's modified adjusted gross income or adjusted gross income for purposes of calculating the amount subject to tax under section 1411(a)(1)(B) or (a)(2)(B).

### 10. Exception for Items Subject to Self-Employment Tax

Section 1411(c)(6) provides that net investment income shall not include any item taken into account in determining self-employment income for such taxable year on which a tax is imposed by section 1401(b). Section 1401(b) imposes a Medicare tax on the self-employment income of individuals equal to a specified percentage (2.9 percent) of the amount of the self-employment income for such taxable year and an Additional Medicare Tax for taxable years beginning after December 31, 2012, equal to 0.9 percent of self-employment income in excess of certain threshold amounts. Section 1402(b) provides that the term *self-employment income* generally means the net earnings from self-employment (defined under section 1402(a)) derived by an individual except that such term shall not include the net earnings from self-employment if such net earnings for

the taxable year are less than \$400. Section 1402(a) generally defines the term *net earnings from self-employment* as the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed which are attributable to such trade or business, plus his distributive share (whether or not distributed) of income or loss described in section 702(a)(8) from any trade or business carried on by a partnership of which he is a member. Section 1402(a)(1) through (17) includes exceptions from the definition of net earnings from self-employment as well as other special rules.

The JCT 2011 and 2010 Explanations state that net investment income does not include “amounts subject to SECA [Self-Employment Contribution Act] tax.” JCT 2011 Explanation, at 365; JCT 2010 Explanation, at 135. Therefore, the proposed regulations provide that for purposes of section 1411(c)(6), “items taken into account” in determining self-employment income means income included and deductions allowed in determining net earnings from self-employment under section 1402(a) for purposes of determining self-employment income under section 1402(b), but does not include amounts excepted from net earnings from self-employment under section 1402(a)(1) through (17). In addition, proposed § 1.1411–9(b) provides a special rule for properly allocable deductions (as defined in proposed § 1.1411–4(f)(2)(ii)) in the case of a taxpayer engaged in the trade or business of trading in financial instruments or commodities (as defined in proposed § 1.1411–5(a)(2)). This exception provides that deductions described in proposed § 1.1411–4(f)(2)(ii) that do not reduce a taxpayer’s net earnings from self-employment (after aggregating the net earnings from self-employment from all of the taxpayer’s trades or business) are not considered taken into account for purposes of section 1411(c)(6) and may be considered in determining the taxpayer’s net investment income under section 1411. Generally, this exception will apply if the taxpayer is engaged in a trade or business of trading in financial instruments or commodities and does not have any net earnings from self-employment or the deductions from trading exceed the taxpayer’s net earnings from self-employment.

#### 11. Controlled Foreign Corporations and Passive Foreign Investment Companies

As noted in part 5 of this preamble, section 1411(c)(1) provides that net investment income includes dividends and net gain (to the extent taken into

account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply. Accordingly, income with respect to investments in foreign corporations generally is included in the calculation of net investment income for section 1411 purposes. Specifically, dividends and gains derived with respect to the stock of a controlled foreign corporation (within the meaning of section 957(a)) (CFC) or a passive foreign investment company (within the meaning of section 1297(a)) (PFIC) are taken into account in computing net investment income.

#### A. CFC or PFIC Amounts Derived From a Trade or Business Described in Proposed § 1.1411–5

The special rules described in proposed § 1.1411–10 do not apply to income derived from a trade or business described in section 1411(c)(2) and proposed § 1.1411–5 because such income is included in net investment income under section 1411(c)(1)(A)(ii) and proposed § 1.1411–4(a)(1)(ii). Thus, an amount included in gross income under section 1296(a) that is also income derived from a trade or business described in section 1411(c)(2) and proposed § 1.1411–5 is net investment income within the meaning of section 1411(c)(1)(A)(ii) and proposed § 1.1411–4(a)(1)(ii). Similarly, amounts included in income under sections 951(a) and 1293(a) that are derived from a trade or business described in section 1411(c)(2) and proposed § 1.1411–5, and therefore fall within section 1411(c)(1)(A)(ii) and proposed § 1.1411–4(a)(1)(ii), are taken into account for purposes of section 1411 when they are taken into account for purposes of chapter 1, and accordingly, the modifications described in this part of the preamble are not necessary.

#### B. Net Investment Income

Under subpart F of the Code, a United States shareholder (as defined in section 951(b)) of a CFC is required to include certain amounts in income currently under section 951(a) (section 951 inclusions). Section 951 inclusions are not treated as dividends unless expressly provided for in the Code, and therefore are not within any of the categories of income items that comprise net investment income (unless the amount is derived from a trade or business to which the tax applies as provided in section 1411(c)(1)(A)(ii) and proposed § 1.1411–4(a)(1)(ii)). See *Rodriguez v. Comm’r*, 137 T.C. 174 (2011). Similarly, a United States person owning shares in a PFIC also is required

to include amounts in income currently under section 1293(a) (section 1293 inclusions) if the person makes a qualified electing fund (QEF) election under section 1295 with respect to the PFIC. Section 1293 inclusions also are not treated as dividends unless expressly provided for in the Code, and, therefore, also are not taken into account for purposes of calculating net investment income (unless the amount is derived from a trade or business to which the tax applies as provided in section 1411(c)(1)(A)(ii) and proposed § 1.1411–4(a)(1)(ii)).

The subpart F and PFIC regimes provide rules that prevent amounts that have been included in income under sections 951 and 1293 by a United States person from being subject to tax again when there is an actual distribution from the foreign corporation. Specifically, section 959(d) provides that distributions from a CFC that are excluded from gross income for purposes of chapter 1 under section 959(a) (earnings and profits attributable to section 951 inclusions) are treated for chapter 1 purposes as distributions that are not dividends. Similarly, section 1293(c) provides that distributions paid out of earnings and profits of a PFIC that are attributable to section 1293 inclusions are treated for chapter 1 purposes as distributions that are not dividends. However, in the absence of these special rules, which expressly apply for chapter 1 purposes and are intended to reflect that the relevant CFC or PFIC earnings have already been taxed for chapter 1 purposes, the actual distributions would be taxable as dividends under general Code rules applicable to corporations and their shareholders. Moreover, as is the case with dividends, such actual distributions reduce the earnings and profits of the relevant CFC or PFIC. Accordingly, the proposed regulations reflect the premise that a distribution of earnings and profits that previously were taxed pursuant to section 951(a) or section 1293(a), and which is not a dividend for chapter 1 purposes under section 959(d) or section 1293(c), remains a dividend for chapter 2A purposes, and therefore constitutes gross income from dividends for purposes of section 1411(c)(1)(A)(i) and proposed § 1.1411–4(a)(1)(i).

Nevertheless, in light of the effective date of section 1411 and the administrative burdens that would be imposed if taxpayers were required to reconstruct the tax basis of their CFC or QEF stock (and any intermediate entities) to eliminate the basis adjustments (described in this part 11) associated with pre-effective date

income inclusions under sections 951(a) and 1293(a), the proposed regulations provide a limit on the treatment of distributions of previously taxed earnings and profits of a CFC or QEF as dividends for section 1411 purposes. Specifically, under the proposed regulations, such treatment would apply only with respect to distributions of earnings and profits that previously were taxed pursuant to section 951(a) or section 1293(a) in a taxable year beginning after December 31, 2012. For purposes of determining whether a distribution is attributable to earnings and profits that previously were taxed pursuant to section 951(a) or section 1293(a) in a taxable year beginning after December 31, 2012 (and thus is treated as a dividend for section 1411 purposes), a distribution of earnings and profits that previously were taxed pursuant to section 951(a) or section 1293(a) will be considered attributable first to such earnings and profits, if any, derived from the current taxable year, and then from taxable years beginning with the most recent prior taxable year. In the case of a distribution from a CFC, such determination shall be made without regard to whether the earnings and profits are described in section 959(c)(1) or section 959(c)(2). Thus, this classification of distributions as net investment income or non-net investment income is separate from, and in addition to, the allocation of distributions to previously taxed earnings and profits that are described in sections 959(c)(1) and 959(c)(2).

Accordingly, absent an election under proposed § 1.1411-10(g) (described in part 11.F of this preamble), the timing of income derived from an investment in a CFC or a QEF may be different for chapter 1 and chapter 2A purposes. Taxpayers will not include section 951 inclusions or section 1293 inclusions in net investment income, but generally will take distributions that are not treated as dividends for chapter 1 purposes under section 959(d) or section 1293(c) into account for purposes of determining net investment income under section 1411(c)(1)(A)(i) and proposed § 1.1411-4(a)(1)(i).

Including an amount in income only for purposes of chapter 1 or chapter 2A however, requires special rules to calculate and administer the tax imposed by section 1411. For example, because the rules governing previously taxed income under chapter 1 require basis adjustments to the stock of the CFC or QEF, a United States person will be required to compute its tax basis in the stock (as well as its basis in intermediate entities through which it holds the CFC or QEF stock) differently

for chapter 1 and chapter 2A purposes. As described in detail in part 11.F of this preamble, however, the proposed regulations seek to minimize complexity arising from the different treatment under chapter 1 and chapter 2A by providing an election that, if made, results in consistent treatment for chapter 1 and chapter 2A purposes with respect to stock of CFCs and QEFs. See proposed § 1.1411-10(g).

To the extent that a disposition of stock of a CFC or QEF gives rise to net gain under section 1411(c)(1)(A)(iii), such amount is included in net investment income. In the absence of an election under proposed § 1.1411-10(g), the basis increases provided in sections 961(a) and 1293(d) that apply for chapter 1 purposes for amounts included in gross income for chapter 1 purposes under sections 951(a) and 1293(a) in taxable years beginning after December 31, 2012, do not apply to the calculation of gain or loss for purposes of section 1411. Similarly, in the absence of an election, the basis decreases provided in sections 961(b) and 1293(d) that apply for chapter 1 purposes do not apply to the extent that such decreases are attributable to a distribution of post-effective date earnings and profits that is treated as a dividend for chapter 2A purposes.

In certain circumstances, section 1248 may apply for chapter 1 purposes to recharacterize all or a portion of gain recognized on the disposition of stock of a foreign corporation as dividend income. Section 1248 also may apply to determine whether any portion of the gain calculated for section 1411 purposes should be recharacterized as a dividend. If no election is made pursuant to proposed § 1.1411-10(g), the proposed regulations provide that sections 1248(d)(1) and 1248(d)(6) (relating to amounts excluded from earnings and profits for purposes of determining the amount of gain recharacterized as a dividend under section 1248) generally do not apply because the earnings and profits of the foreign corporation are not attributable to any amount previously taxed for purposes of section 1411. However, the proposed regulations provide that sections 1248(d)(1) and 1248(d)(6) do apply for purposes of section 1411 to the extent the earnings and profits of the foreign corporation are attributable to an amount that was included in chapter 1 income in a taxable year that began prior to December 31, 2012 (the effective date of section 1411).

Proposed § 1.1411-10 also provides special rules that apply to a United States shareholder of a PFIC who is subject to the tax and interest charge

applicable to excess distributions under section 1291. The proposed regulations provide that the calculation of net investment income includes any distribution of earnings and profits by a PFIC that constitutes a dividend within the meaning section 316(a), or any gain from a disposition of PFIC stock, even though all or a portion of the dividend or gain may be treated as an excess distribution and allocated to prior taxable years for purposes of computing the additional amount of tax imposed under section 1291(a)(1)(C) (and hence may not be taxed as a dividend or gain for chapter 1 purposes).

In addition, the proposed regulations provide rules applicable to a United States person that has elected to mark to market its PFIC stock under section 1296. In such case, amounts that are included in gross income under section 1296(a)(1) and, correspondingly, amounts allowable as a deduction under section 1296(a)(2) are taken into account under section 1411(c)(1)(A)(iii) and proposed § 1.1411-4(a)(1)(iii) in computing net gain for purposes of section 1411.

Section 1411(c)(1)(B) provides that, in determining net investment income, items of gross income and net gain are reduced by properly allocable deductions. In the absence of an election under proposed § 1.1411-10(g), differences may occur in the timing of income derived with respect to CFCs and QEFs for chapter 1 and chapter 2A purposes. Consequently, the determination of properly allocable deductions with respect to sections 959(d) and 1293(c) dividend distributions may require special rules. For example, certain itemized deductions related to items of net investment income described in proposed § 1.1411-10(c) (such as the investment interest deduction) may require special rules to determine when these deductions are properly allocable deductions for purposes of section 1411. The Treasury Department and the IRS request comments on whether guidance is necessary to determine the deductions that are properly allocable to items of net investment income described in proposed § 1.1411-10(c) if the election under proposed § 1.1411-10(g) is not made.

#### C. Modified Adjusted Gross Income

Because of the different timing under chapter 1 and chapter 2A for including certain income from investments in CFCs and PFICs, the proposed regulations contain rules coordinating these provisions with the determination of the calculation of the section 1411 tax, which is based, in part, in section

1411(a)(1)(B) on an individual's modified adjusted gross income. Absent an election under proposed § 1.1411–10(g), the proposed regulations provide that an individual who owns stock in a CFC or a QEF must increase or decrease modified adjusted gross income (as defined in proposed § 1.1411–2(c)) in certain circumstances. For example, proposed § 1.1411–10(e) provides that modified adjusted gross income is increased by any section 959(d) or section 1293(c) distributions that are dividends for chapter 2A purposes. In order to avoid subjecting the same amount of income to tax twice under section 1411, section 951 inclusions and section 1293 inclusions are excluded from modified adjusted gross income under proposed § 1.1411–10(e)(1)(iii) for purposes of section 1411. In addition, modified adjusted gross income is adjusted to take into account the amount of gain or loss attributable to a disposition of stock of a CFC or QEF for section 1411 purposes, which may differ from the amount of gain or loss calculated for chapter 1 purposes. For purposes of section 1411, in the absence of an election under proposed § 1.1411–10(g), gain or loss is determined without taking into account basis increases under sections 961(a) and 1293(d) that are included in the calculation of basis for purposes of chapter 1 with respect to amounts included in gross income for chapter 1 purposes under sections 951(a) and 1293(a) in taxable years beginning after December 31, 2012. In addition, gain or loss is determined without taking into account basis decreases under sections 961(a) and 1293(d) that are included in the calculation of basis for purposes of chapter 1 to the extent the decreases are attributable to a distribution of earnings and profits that is treated as a dividend for chapter 2A purposes.

Modified adjusted gross income is also adjusted with respect to interests in PFICs that are subject to tax under section 1291. Specifically, the proposed regulations provide that modified adjusted gross income for section 1411 purposes is increased by the amount of any excess distribution (within the meaning of section 1291(b)) to the extent the distribution constitutes a dividend under section 316(a) and is not otherwise included in income for chapter 1 purposes under section 1291(a)(1)(B), and by any gain treated as an excess distribution under section 1291(a)(2) to the extent not otherwise included in income for chapter 1 purposes under section 1291(a)(1)(B).

#### D. Special Rules Where Stock Is Held by Partnerships or S Corporations

The proposed regulations provide rules that apply to an individual, estate, or trust that owns stock of a CFC or QEF through a domestic partnership or S corporation. Because of the different timing rules under chapter 1 and chapter 2A and the fact that partnerships and S corporations are passthrough entities, the proposed regulations provide rules on the determination for section 1411 purposes of (1) the partner's or shareholder's outside basis in his interest, and (2) the partnership's or S corporation's adjusted basis in its CFC or QEF stock. The Treasury Department and the IRS believe that the partnership or S corporation will need to separately state, in addition to a partner's distributive share of the amounts included in the partnership's income under section 951(a) or section 1293(a), a partner's distributive share of any distributions of previously taxed earnings and profits of a CFC or QEF received by the partnership or S corporation that are dividends for purposes of chapter 2A. The Treasury Department and the IRS request comments on appropriate ways to determine a partner's distributive share of a distribution of previously taxed earnings and profits given the purpose of section 1411.

The Treasury Department and the IRS request comments on improving the administrability of these provisions, including the reporting of CFC or QEF amounts through domestic partnerships or S corporations. In addition, the Treasury Department and the IRS request comments on the determination of a partner's basis adjustment under section 743 for purposes of section 1411 when the partnership holds stock in a CFC or QEF.

#### E. Conforming Rules for Estates and Trusts

The proposed regulations also provide conforming rules for estates, trusts, and their beneficiaries. Proposed § 1.1411–10(c)(5), (e)(2), and (f) coordinate the rules relating to the computation of net investment income and any associated gross income or decrease to adjusted gross income with the distributable net income regime and other general operating rules governing the income taxation of estates and trusts contained in Subchapter J and proposed § 1.1411–3. The Treasury Department and the IRS request comments on the interaction of subchapter J and the PFIC rules in order to address consistency issues between chapter 1 and chapter 2A.

#### F. Election

As described in parts 11.B through 11.E of this preamble, certain adjustments, including adjustments to modified adjusted gross income for purposes of section 1411, are necessary with respect to inclusions under sections 951 and 1293. The Treasury Department and the IRS recognize that these rules may create an additional administrative burden for certain taxpayers. Thus, proposed § 1.1411–10(g) allows individuals, estates, and trusts to make an election to include inclusions under sections 951 and 1293 in net investment income in the same manner and in the same taxable year as such amounts are included in income for chapter 1 purposes. If an individual, estate, or trust makes the election, any section 959(d) or section 1293(c) distributions that are not treated as dividends for chapter 1 purposes are not treated as dividends for section 1411 purposes, and thus would not be included in net investment income for section 1411 purposes. Moreover, the separate computation of basis for section 1411 purposes would not be required, and thus distributions under sections 959(d) and 1293(c) would decrease the taxpayer's basis in its CFC or PFIC stock, and inclusions under sections 951 and 1293 would increase the taxpayer's basis in its CFC or PFIC stock, in the same manner as the taxpayer's basis is adjusted for chapter 1 purposes.

An individual, estate, or trust that wants to make the election generally must do so for the first taxable year beginning after December 31, 2013, during which (1) the individual, estate, or trust owns an interest in a CFC or PFIC, and (2) the individual, estate, or trust is subject to tax under section 1411 or would be subject to tax under section 1411 if the election under proposed § 1.1411–10(g) is made. In addition, the election may be made for a taxable year that begins before January 1, 2014. The determination of whether an individual, estate, or trust is subject to tax under section 1411 for a taxable year is based on whether the individual's modified adjusted gross, or the estate's or trust's adjusted gross income, exceeds the applicable threshold set forth in § 1.1411–2(d) or § 1.1411–3(a)(1)(ii)(B)(2), regardless of whether the individual, estate, or trust has an income inclusion under section 951(a) or section 1293(a), or receives a distribution of previously taxed income with respect to any CFC or QEF in that taxable year. For example, if in 2014, a single individual acquires an interest in a QEF, has a QEF inclusion of \$5,000,

and has modified adjusted gross income of \$150,000, the individual would not have to make an election for 2014 because section 1411 is not applicable. If, in 2015, the individual has modified adjusted gross income in excess of \$200,000, and the individual would like to take QEF inclusions into account for purposes of section 1411 in the same manner and in the same taxable year as such amounts are taken into account for chapter 1 purposes, the individual must make the election for 2015 in the time and manner described in proposed § 1.1411-10(g).

Once an election is made, it applies to all interests in CFCs and PFICs, including CFCs and PFICs that subsequently are acquired by the electing taxpayer. The election cannot be revoked, except with the Commissioner's consent.

The Treasury Department and the IRS request comments on this election, including the conditions under which an automatic extension of time to make the election should be permitted.

#### 12. Taxpayer Reliance on Proposed Regulations

These regulations are proposed to be effective for taxable years beginning after December 31, 2013, except that § 1.1411-3(c)(2) is proposed to apply to taxable years beginning after December 31, 2012. The Treasury Department and IRS intend to finalize regulations under section 1411 in 2013. Taxpayers are reminded that section 1411 is effective for taxable years beginning after December 31, 2012. Taxpayers may rely on these proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations. To the extent these proposed regulations provide taxpayers with the ability to make an election, taxpayers may make the election, including regroupings described in § 1.469-11(b)(3)(iv), provided that the election is made in the manner described in the applicable provision. Any election made in reliance on these proposed regulations will be in effect for the year of the election, and will remain in effect for subsequent taxable years. However, if final regulations provide for the same or a similar election, taxpayers who opt not to make an election in reliance on these proposed regulations will not be precluded from making that election pursuant to the final regulations.

#### Proposed Effective Date

These regulations are proposed to be effective for taxable years beginning after December 31, 2013, except that § 1.1411-3(c)(2) is proposed to apply to

taxable years beginning after December 31, 2012.

#### Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to the proposed regulations. Pursuant to the Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6), it is hereby certified that the proposed regulations will not have a significant economic impact on a substantial number of small entities. The applicability of the proposed regulations are limited to individuals, estates, and trusts, which are not small entities as defined by the RFA (5 U.S.C. 601). Accordingly, the RFA does not apply. Therefore, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, the proposed regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

#### Comments and Public Hearing

Before the proposed regulations are adopted as final regulations, consideration will be given to any written comments (a signed original and eight (8) copies) or electronic comments that are submitted timely to the IRS. The Treasury Department and the IRS request comments on all aspects of the proposed rules. All comments will be available for public inspection and copying.

A public hearing has been scheduled for Tuesday, April 2, 2013, beginning at 10:00 a.m. in the Auditorium, Internal Revenue Building, 1111 Constitution Avenue NW., Washington, DC. Due to building security procedures, visitors must enter at the Constitution Avenue entrance. In addition, all visitors must present photo identification to enter the building. Because of access restrictions, visitors will not be admitted beyond the immediate entrance area more than 30 minutes before the hearing starts. For information about having your name placed on the building access list to attend the hearing, see the **FOR FURTHER INFORMATION CONTACT** section of this preamble.

The rules of 26 CFR 601.601(a)(3) apply to the hearing. Persons who wish to present oral comments at the hearing must submit electronic or written comments by March 5, 2013, and an

outline of the topics to be discussed and the time to be devoted to each topic (signed original and eight (8) copies) by March 5, 2013. A period of 10 minutes will be allotted to each person for making comments. An agenda showing the scheduling of the speakers will be prepared after the deadline for receiving outlines has passed. Copies of the agenda will be available free of charge at the hearing.

#### Drafting Information

The principal authors of the proposed regulations are Michala Irons and David H. Kirk, IRS Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

#### List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

#### Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

#### PART 1—INCOME TAXES

**Paragraph 1.** The authority citation for part 1 continues to read in part as follows:

**Authority:** 26 U.S.C. 7805 \* \* \*

**Par 2.** Section 1.469-0 is amended by adding the following entries to the table of contents:

#### § 1.469-0 Table of contents.

\* \* \* \* \*

§ 1.469-11 *Effective date and transition rules.*

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(iv) Regrouping for taxpayers subject to section 1411.

(A) In general.

(B) Effective/applicability date.

\* \* \* \* \*

**Par 3.** Section 1.469-11 is amended by adding paragraph (b)(3)(iv) to read as follows:

#### § 1.469-11 Effective date and transition rules.

\* \* \* \* \*

(b) \* \* \*

(3) \* \* \*

(iv) *Regrouping for taxpayers subject to section 1411—(A) In general.* If an individual, estate, or trust has net investment income (as defined in § 1.1411-4) and such individual's (as defined in § 1.1411-2(a)) modified adjusted gross income (as defined in § 1.1411-2(c)) exceeds 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 exceeds the amount described in section 1411(a)(2)(B)(ii) and § 1.1411-3(a)(1)(ii)(B)(2), such individual, estate, or trust may, in the first taxable year beginning after December 31, 2013, in which section 1411 would apply to such taxpayer, regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year. For this purpose, the determination whether section 1411 would apply is made without regard to the effect of regrouping. A taxpayer that is an individual, estate, or trust may regroup its activities for any taxable year that begins during 2013, if section 1411 would apply to such taxpayer for such year. A taxpayer may regroup activities only once pursuant to this paragraph (b)(3)(iv), and a regrouping made pursuant to this paragraph will apply to the taxable year for which the regrouping is done and all subsequent years.

(B) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013.

\* \* \* \* \*

**Par. 4.** Sections 1.1411-0 through 1.1411-10 are added to read as follows:

**§ 1.1411-0 Table of contents.**

*§ 1.1411-1 General rules.*

- (a) General rule.
- (b) Adjusted gross income.
- (c) Effective/applicability date.

*§ 1.1411-2 Application to individuals.*

- (a) Individual defined.
- (1) Individuals to whom tax applies.
- (2) Special rules.
- (i) Joint returns in the case of a nonresident alien individual married to a U.S. citizen or resident.

- (A) Default treatment.
- (B) Taxpayer election.

- (1) Effect of election.

(2) Procedural requirements for making election.

- (ii) Grantor trusts.
- (iii) Bankruptcy estates.
- (iv) Bona fide residents of U.S. territories.

- (A) Applicability.

(B) Coordination with exception for nonresident aliens.

- (C) Definitions.

- (1) Bona fide resident.

- (2) U.S. territory.

- (b) Calculation of tax.

- (1) In general.

- (2) Example.

- (c) Modified adjusted gross income.

- (1) General rule.

(2) Rules with respect to controlled foreign corporations and passive foreign investment companies.

- (d) Threshold amount.

- (1) In general.

(2) Taxable year of less than twelve months.

- (i) General rule.

- (ii) Change of annual accounting period.

- (e) Effective/applicability date.

*§ 1.1411-3 Application to estates and trusts.*

- (a) Estates and trusts to which tax applies.

- (1) In general.

- (i) General application.

- (ii) Calculation of tax.

(2) Taxable year of less than twelve months.

- (i) General rule.

- (ii) Change of annual accounting period.

(3) Rules with respect to controlled foreign corporations and passive foreign investment companies.

- (b) Exception for certain trusts.

- (c) Application to specific trusts.

- (1) Electing small business trusts (ESBTs).

- (i) General application.

- (ii) Computation of tax.

- (A) Step one.

- (B) Step two.

- (C) Step three.

(2) Special rules for charitable remainder trusts.

(i) Treatment of annuity or unitrust distributions.

(ii) Apportionment between multiple beneficiaries.

(iii) Accumulated net investment income.

(3) Certain foreign trusts with United States beneficiaries. [Reserved]

- (d) Application to specific estates.

- (1) Bankruptcy estates.

- (2) Foreign estates.

- (i) General rule.

(ii) Certain foreign estates with United States beneficiaries. [Reserved]

(e) Calculation of undistributed net investment income.

- (1) In general.

- (2) Undistributed net investment income.

(3) Distributions of net investment income to beneficiaries.

(4) Deduction for amounts paid or permanently set aside for a charitable purpose.

- (5) Excluded income.

- (f) Examples.

- (g) Effective/applicability date.

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

- (a) In general.

(b) Ordinary course of a trade or business exception.

(c) Other gross income from a trade or business described in § 1.1411-5.

- (1) Passive activity.

(2) Trading in financial instruments or commodities.

- (d) Net gain.

- (1) Definition of disposition.

- (2) Limitation.

(3) Net gain attributable to the disposition of property.

- (i) In general.

(ii) Exception for gain or loss attributable to property held in a trade or business not described in § 1.1411-5.

- (A) General rule.

(B) Special rules for determining whether property is held in a trade or business.

- (C) Example.

(iii) Adjustments to gain or loss attributable to the disposition of interests in a partnership or S corporation.

- (e) Distributions from estates and trusts.

- (f) Properly allocable deductions.

- (1) General rule.

- (i) In general.

- (ii) Limitations and carryovers.

(2) Properly allocable deductions described in section 62.

(i) Deductions allocable to gross income from rents and royalties.

(ii) Deductions allocable to gross income from trades or businesses described in § 1.1411-5.

(iii) Penalty on early withdrawal of savings.

(3) Properly allocable deductions described in section 63(d).

- (i) In general.

- (A) Investment interest expense.

- (B) Investment expenses.

- (C) Taxes described in section 164(a)(3).

(ii) Application of limitations under sections 67 and 68.

- (A) Deductions subject to section 67.

- (B) Deductions subject to section 68.

- (4) Loss deductions.

(g) Special rules for controlled foreign corporations and passive foreign investment companies.

- (h) Examples.

- (i) Effective/applicability date.

*§ 1.1411-5 Trades and businesses to which tax applies.*

- (a) In general.

- (b) Passive activity.

- (1) In general.

- (2) Examples.

(c) Trading in financial instruments or commodities.

- (1) Definition of financial instruments.

- (2) Definition of commodities.

- (d) Effective/applicability date.

*§ 1.1411-6 Income on investment of working capital subject to tax.*

- (a) General rule.

- (b) Example.

- (c) Effective/applicability date.

*§ 1.1411-7 Exception for dispositions of interests in partnerships and S corporations.*

- (a) In general.

- (1) General application.

- (2) Interests to which exception applies.

- (i) In general.

- (ii) Nonapplication.

- (b) Special rules.

- (1) Installment sales.

(i) Installment sales after the effective date of section 1411.

(ii) Installment sales prior to the effective date of section 1411.

- (2) Sale of an interest by a Qualified

Subchapter S Trust. [Reserved]

- (c) Deemed sale.

- (1) In general.

- (2) Step one: Deemed sale of properties.

- (3) Step two: Determination of gain or loss.

- (4) Step three: Allocation of gain or loss.

- (5) Step four: Adjustment to gain or loss.

- (i) In general.

- (ii) Special rules.

(A) Property used in more than one trade or business.

- (B) Goodwill attributable to property.

- (iii) Negative adjustment.

- (A) General rule.

- (B) Limitations.



purposes of section 1411. See § 1.1411-2(d)(1)(ii).

(iv) *Bona fide residents of U.S. territories*—(A) *Applicability*. An individual who is a bona fide resident of a U.S. territory is subject to the tax imposed by section 1411(a)(1) only if the individual is required to file an income tax return with the United States upon application of section 931, 932, 933, or 935 and the regulations thereunder. With respect to an individual described in this paragraph (a)(2)(iv)(A), the amount excluded from gross income under section 931 or 933 and any deduction properly allocable or chargeable against amounts excluded from gross income under section 931 or 933, respectively, is not taken into account in computing modified adjusted gross income under paragraph (c) of this section or net investment income under § 1.1411-4.

(B) *Coordination with exception for nonresident aliens*. An individual who is both a bona fide resident of a U.S. territory and a nonresident alien individual with respect to the United States is not subject to taxation under section 1411(a)(1).

(C) *Definitions*. For purposes of this section—

(1) *Bona fide resident*. The term *bona fide resident* has the meaning provided under section 937(a).

(2) *U.S. territory*. The term *U.S. territory* means American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the United States Virgin Islands.

(b) *Calculation of tax*—(1) *In general*. In the case of an individual described in paragraph (a)(1) of this section, the tax imposed by section 1411(a)(1) for each taxable year is equal to 3.8 percent of the lesser of—

(i) Net investment income (as defined in § 1.1411-4) for such taxable year; or

(ii) The excess (if any) of—

(A) The modified adjusted gross income (as defined in paragraph (c) of this section) for such taxable year; over

(B) The threshold amount (as defined in paragraph (d) of this section).

(2) **Example**. During Year 1 (a taxable year in which section 1411 is in effect), A, an unmarried U.S. citizen, has modified adjusted gross income (as defined in paragraph (c) of this section) of \$190,000, which includes \$50,000 of net investment income (as defined in § 1.1411-4). A has a zero tax imposed under section 1411 because the threshold amount for a single individual is \$200,000 (as provided in paragraph (d)(1)(iii) of this section). If during Year 2, A has modified adjusted gross income of \$220,000, which includes \$50,000 of net investment income, then the individual has a section 1411 tax of \$760 (3.8 percent multiplied by \$20,000).

(c) *Modified adjusted gross income*—(1) *General rule*. For purposes of section 1411, the term *modified adjusted gross income* means adjusted gross income increased by the excess of—

(i) The amount excluded from gross income under section 911(a)(1); over

(ii) The amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts described in paragraph (c)(1)(i) of this section.

(2) *Rules with respect to controlled foreign corporations and passive foreign investment companies*. Additional rules in § 1.1411-10(e)(1) apply to an individual that is a United States shareholder of a controlled foreign corporation (within the meaning of section 957(a)) or that is a United States person that directly or indirectly owns an interest in a passive foreign investment company (within the meaning of section 1297(a)).

(d) *Threshold amount*—(1) *In general*. The term *threshold amount* means—

(i) In the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), \$250,000;

(ii) In the case of a married taxpayer (as defined in section 7703) filing a separate return, \$125,000; and

(iii) In any other case, \$200,000.

(2) *Taxable year of less than twelve months*—(i) *General rule*. In the case of an individual who has a taxable year consisting of less than twelve months (short taxable year), the threshold amount under paragraph (d)(1) of this section is not reduced or prorated. For example, in the case of an unmarried decedent who dies on June 1, the threshold amount is \$200,000 for the decedent's short taxable year that begins on January 1 and ends on June 1.

(ii) *Change of annual accounting period*. Notwithstanding paragraph (d)(2)(i) of this section, an individual who has a short taxable year resulting from a change of annual accounting period shall reduce the threshold amount to an amount that bears the same ratio to the full threshold amount provided under paragraph (d)(1) of this section as the number of months in the short taxable year bears to twelve.

(e) *Effective/applicability date*. This section applies to taxable years beginning after December 31, 2013.

### § 1.1411-3 Application to estates and trusts.

(a) *Estates and trusts to which tax applies*—(1) *In general*—(i) *General application*. Section 1411 and the regulations thereunder apply 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 Internal Revenue Code, unless specifically exempted by paragraph (b) of this section.

(ii) *Calculation of tax*. The tax imposed by section 1411(a)(2) for each taxable year is equal to 3.8 percent of the lesser of—

(A) The estate's or trust's undistributed net investment income for such taxable year; or

(B) The excess (if any) of—

(1) The estate's or trust's adjusted gross income (as defined in section 67(e) and adjusted by § 1.1411-10(e)(2), if applicable) for such taxable year; over

(2) The dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

(2) *Taxable year of less than twelve months*—(i) *General rule*. In the case of an estate or trust that has a taxable year consisting of less than twelve months (short taxable year), the dollar amount described in paragraph (a)(1)(ii)(B)(2) of this section is not reduced or prorated.

(ii) *Change of annual accounting period*. Notwithstanding paragraph (a)(2)(i) of this section, an estate or trust that has a short taxable year resulting from a change of annual accounting period (but not from an individual's death) shall reduce the dollar amount described in paragraph (a)(1)(ii)(B)(2) of this section to an amount that bears the same ratio to that dollar amount as the number of months in the short taxable year bears to twelve.

(3) *Rules with respect to controlled foreign corporations and passive foreign investment companies*. Additional rules in § 1.1411-10 apply to an estate or trust that holds an interest in a controlled foreign corporation (within the meaning of section 957(a)) or a passive foreign investment (within the meaning of section 1297(a)).

(b) *Exception for certain trusts*. The following trusts are not subject to the tax imposed by section 1411:

(1) A trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B).

(2) A trust exempt from tax under section 501.

(3) A charitable remainder trust described in section 664. However, see paragraph (c)(2) of this section for special rules regarding the treatment of annuity or unitrust distributions from such trust to persons subject to tax under section 1411.

(4) Any other trust, fund, or account that is statutorily exempt from taxes imposed in subtitle A. For example, see sections 220(e)(1), 223(e)(1), 529(a), and 530(a).

(5) A trust, or a portion thereof, that is treated as a grantor trust under subpart E of part I of subchapter J of chapter 1. However, in the case of any such trust or portion thereof, each item of income or deduction that is included in computing taxable income of a grantor or another person under section 671 shall be treated as if it had been received by, or paid directly to, the grantor or other person for purposes of calculating such person's net investment income.

(6) Except to the extent provided in paragraph (c)(3) of this section, a foreign trust (as defined in section 7701(a)(31)(B) and § 301.7701-7(a)(2)).

(c) *Application to specific trusts*—(1) *Electing small business trusts (ESBTs)*—(i) *General application.* The S portion and non-S portion (as defined in § 1.641(c)-1(b)(2) and (3), respectively) of a trust that has made an ESBT election under section 1361(e)(3) and § 1.1361-1(m)(2) shall be treated as separate trusts for purposes of the computation of undistributed net investment income in the manner described in paragraph (e) of this section, but shall be treated as a single trust for purposes of determining the amount subject to tax under section 1411. If a grantor or another person is treated as the owner of a portion of the ESBT, the items of income and deduction attributable to the grantor portion (as defined in § 1.641(c)-1(b)(1)) shall be included in the grantor's calculation of net investment income and shall not be included in the ESBT's computation of tax described in paragraph (c)(1)(ii) of this section.

(ii) *Computation of tax.* This paragraph (c)(1)(ii) provides the method for an ESBT to compute the tax under section 1411. See *Example 3* in paragraph (f) of this section.

(A) *Step one:* The S portion and non-S portion shall compute each portion's undistributed net investment income as separate trusts in the manner described in paragraph (e) of this section and then combine these amounts to calculate the ESBT's undistributed net investment income.

(B) *Step two:* The ESBT will calculate its adjusted gross income (as defined in paragraph (a)(1)(ii)(B)(1) of this section). The ESBT's adjusted gross income is the non-S portion's adjusted gross income, increased or decreased by the net income or net loss of the S portion, after taking into account all deductions, carryovers, and loss limitations applicable to the S portion, as a single item of ordinary income (or ordinary loss).

(C) *Step three:* The ESBT will pay tax on the lesser of—

(1) The ESBT's total undistributed net investment income; or

(2) The excess of the ESBT's adjusted gross income (as calculated in paragraph (c)(1)(ii)(B) of this section) over the dollar amount at which the highest tax bracket in section 1(e) begins for the taxable year.

(2) *Special rules for charitable remainder trusts*—(i) *Treatment of annuity or unitrust distributions.* The net investment income of the beneficiary attributable to the beneficiary's annuity or unitrust distribution from a charitable remainder trust shall include an amount equal to the lesser of—

(A) The total amount of the distributions for that year; or

(B) The current and accumulated net investment income of the charitable remainder trust.

(ii) *Apportionment between multiple beneficiaries.* In the case of a charitable remainder trust with more than one annuity or unitrust beneficiary, the net investment income shall be apportioned among such beneficiaries based on their respective shares of the total annuity or unitrust amount paid by the charitable remainder trust for that taxable year.

(iii) *Accumulated net investment income.* The accumulated net investment income of a charitable remainder trust is the total amount of net investment income received by a charitable remainder trust for all taxable years that begin after December 31, 2012, less the total amount of net investment income distributed for all prior taxable years of the trust that begin after December 31, 2012.

(3) *Certain foreign trusts with United States beneficiaries.* [Reserved]

(d) *Application to specific estates*—(1) *Bankruptcy estates.* A bankruptcy estate in which the debtor is an individual is treated as a married taxpayer filing a separate return for purposes of section 1411. See §§ 1.1411-2(a)(2)(iii) and 1.1411-2(d)(1)(ii).

(2) *Foreign estates*—(i) *General rule.* Except to the extent provided in paragraph (d)(2)(ii) of this section, the tax imposed by section 1411 does not apply to a foreign estate (as defined in section 7701(a)(31)(A)).

(ii) *Certain foreign estates with United States beneficiaries.* [Reserved]

(e) *Calculation of undistributed net investment income*—(1) *In general.* This paragraph (e)(1) provides special rules for the computation of certain deductions and for the allocation of net investment income between an estate or trust and its beneficiaries. Generally, an estate's or trust's net investment income (as defined in § 1.1411-4) is calculated in the same manner as that of an

individual. See § 1.1411-10(c) for special rules regarding controlled foreign corporations, passive foreign investment companies, and estates and trusts holding interests in such entities.

(2) *Undistributed net investment income.* An estate's or trust's undistributed net investment income is the estate's or trust's net investment income determined under § 1.1411-4 reduced by distributions of net investment income to beneficiaries and deductions under section 642(c) in the manner described in paragraphs (e)(3) and (e)(4) of this section.

(3) *Distributions of net investment income to beneficiaries.* (i) In computing the estate's or trust's undistributed net investment income, net investment income shall be reduced by distributions of net investment income made to beneficiaries. The deduction allowed under this paragraph (e)(3) is limited to the lesser of the amount deductible to the estate or trust under section 651 or section 661, as applicable, or the net investment income of the estate or trust. In the case of a deduction under section 651 or section 661 that consists of both net investment income and excluded income (as defined in paragraph (e)(5) of this section), the distribution must be allocated between net investment income and excluded income in a manner similar to § 1.661(b)-1 as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. See § 1.661(c)-1 and *Example 1* in paragraph (f) of this section.

(ii) If one or more items of net investment income comprise all or part of a distribution for which a deduction is allowed under paragraph (e)(3)(i) of this section, such items retain their character as net investment income under section 652(b) or section 662(b), as applicable, for purposes of computing net investment income of the recipient of the distribution who is subject to tax under section 1411. The provisions of this paragraph (e)(3)(ii) also apply to distributions to United States beneficiaries of current year income described in section 652 or section 662 from foreign nongrantor trusts.

(4) *Deduction for amounts paid or permanently set aside for a charitable purpose.* In computing the estate's or trust's undistributed net investment income, the estate or trust shall be allowed a deduction for amounts of net investment income that are allocated to amounts allowable under section 642(c). In the case of an estate or trust that has items of income consisting of both net investment income and excluded

income (as defined in paragraph (e)(5) of this section), the allowable deduction under this paragraph (e)(4) must be allocated between net investment income and excluded income in accordance with § 1.642(c)-2(b) as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. For an estate or trust with deductions under both sections 642(c) and 661, see § 1.662(b)-2 and *Example 2* in paragraph (f) of this section.

(5) *Excluded income.* The term *excluded income* means—

- (i) Items of income excluded from gross income in chapter 1;
- (ii) Items of income not included in net investment income, as determined under § 1.1411-4; and
- (iii) Items of gross income and net gain specifically excluded by section 1411, the regulations thereunder, or other guidance published in the Internal Revenue Bulletin. See §§ 1.1411-7, -8, and -9.

(f) *Examples.* In each example, unless otherwise indicated, the taxpayer uses a calendar taxable year, the taxpayer is not a foreign trust, and Year 1 is a taxable year in which section 1411 is in effect:

*Example 1. Calculation of undistributed net investment income (with no deduction under section 642(c)).* (i) In Year 1, Trust has dividend income of \$15,000, interest income of \$10,000, capital gain of \$5,000, and \$60,000 of taxable income relating to a distribution from an individual retirement account (as defined under section 408). Trust has no expenses. Trust distributes \$10,000 of its current year trust accounting income to A, a beneficiary of Trust. For trust accounting purposes, \$25,000 of the distribution from the individual retirement account is attributable to income. Trust allocates the remaining \$35,000 of taxable income from the individual retirement account and the \$5,000 of capital gain to principal, and therefore these amounts do not enter into the calculation of Trust's distributable net income for Year 1.

(ii) Trust's distributable net income is \$50,000 (\$15,000 in dividends plus \$10,000 in interest plus \$25,000 of taxable income from an individual retirement account), from which the \$10,000 distribution to A is paid. Trust's deduction under section 661 is \$10,000. Under § 1.662(b)-1, the deduction reduces each class of income comprising distributable net income on a proportional basis. The \$10,000 distribution equals 20 percent of distributable net income (\$10,000 divided by \$50,000). Therefore, the distribution consists of dividend income of \$3,000, interest income of \$2,000, and ordinary income attributable to the individual retirement account of \$5,000. Because the \$5,000 of capital gain allocated to principal for trust accounting purposes did not enter into distributable net income, no portion of that amount is included in the

\$10,000 distribution, nor does it qualify for the deduction under section 661.

(iii) Trust's net investment income is \$30,000 (\$15,000 in dividends plus \$10,000 in interest plus \$5,000 in capital gain). Trust's \$60,000 of taxable income attributable to the individual retirement account is excluded income (within the meaning of paragraph (e)(5) of this section) because it is excluded from net investment income under § 1.1411-8. Trust's undistributed net investment income under paragraph (e)(2) of this section is \$25,000, which is Trust's net investment income (\$30,000) less the amount of dividend income (\$3,000) and interest income (\$2,000) distributed to A. The \$25,000 of undistributed net investment income is comprised of the capital gain allocated to principal (\$5,000), the remaining undistributed dividend income (\$12,000), and the remaining undistributed interest income (\$8,000).

(iv) Under paragraph (e)(3) of this section and pursuant to § 1.1411-4(a)(1), A's net investment income includes dividend income of \$3,000 and interest income of \$2,000, but does not include the \$5,000 of ordinary income attributable to the individual retirement account because it is excluded from net investment income under § 1.1411-8.

*Example 2. Calculation of undistributed net investment income (with deduction under section 642(c)).* (i) Same facts as *Example 1*, except Trust is required to distribute \$30,000 to A. In addition, Trust has a \$10,000 deduction under section 642(c) (deduction for amounts paid for a charitable purpose). Trust also makes an additional discretionary distribution of \$10,000 to B, a beneficiary of Trust. As in *Example 1*, Trust's net investment income is \$30,000 (\$15,000 in dividends plus \$10,000 in interest plus \$5,000 in capital gain). In accordance with §§ 1.661(b)-2 and 1.662(b)-2, the items of income must be allocated between the mandatory distribution to A, the discretionary distribution to B, and the \$10,000 distribution to a charity.

(ii) For purposes of the mandatory distribution to A, Trust's distributable net income is \$50,000. See § 1.662(b)-2, *Example 1*(b). Trust's deduction under section 661 for the distribution to A is \$30,000. Under § 1.662(b)-1, the deduction reduces each class of income comprising distributable net income on a proportional basis. The \$30,000 distribution equals 60 percent of distributable net income (\$30,000 divided by \$50,000). Therefore, the distribution consists of dividend income of \$9,000, interest income of \$6,000, and ordinary income attributable to the individual retirement account of \$15,000. A's mandatory distribution thus consists of \$15,000 of net investment income and \$15,000 of excluded income.

(iii) Trust's remaining distributable net income is \$20,000. Trust's remaining undistributed net investment income is \$15,000. The \$10,000 deduction under section 642(c) is allocated in the same manner as the distribution to A, where the \$10,000 distribution equals 20 percent of distributable net income (\$10,000 divided by \$50,000). For purposes of determining

undistributed net investment income, Trust's net investment income is reduced by \$5,000 under paragraph (e)(4) of this section (dividend income of \$3,000, interest income of \$2,000, but with no reduction for amounts attributable to the individual retirement account of \$5,000).

(iv) With respect to the discretionary distribution to B, Trust's remaining distributable net income is \$10,000. Trust's remaining undistributed net investment income is \$10,000. Trust's deduction under section 661 for the distribution to B is \$10,000. The \$10,000 distribution equals 20 percent of distributable net income (\$10,000 divided by \$50,000). Therefore, the distribution consists of dividend income of \$3,000, interest income of \$2,000, and ordinary income attributable to the individual retirement account of \$5,000. B's distribution consists of \$5,000 of net investment income and \$5,000 of excluded income.

(v) Trust's undistributed net investment income is \$5,000 after taking into account distribution deductions and section 642(c) in accordance with paragraphs (e)(3) and (e)(4) of this section, respectively. To arrive at Trust's undistributed net investment income of \$5,000, Trust's net investment income of \$30,000 is reduced by \$15,000 of the mandatory distribution to A, \$5,000 of the section 642(c) deduction, and \$5,000 of the discretionary distribution to B.

*Example 3. Calculation of an ESBT's tax for purposes of section 1411.* (i) In Year 1, the non-S portion of Trust, an ESBT, has dividend income of \$15,000, interest income of \$10,000, and capital gain of \$5,000. Trust's S portion has net rental income of \$21,000 and a capital loss of \$7,000. The Trustee's annual fee of \$1,000 is allocated 60 percent to the non-S portion and 40 percent to the S portion. Trust makes a distribution from income to a single beneficiary of \$9,000.

(ii) *Step one.* (A) Trust must compute the undistributed net investment income for the S portion and non-S portion in the manner described in paragraph (c)(1) of this section.

The undistributed net investment income for the S portion is \$20,600 and is determined as follows:

Net Rental Income .....	\$21,000
Trustee Annual Fee .....	(400)
<hr/>	
Total S portion undistributed net investment income .....	20,600

(B) No portion of the capital loss is allowed because, pursuant to § 1.1411-4(d)(2), net gain cannot be less than zero and excess capital losses are not properly allocable deductions under § 1.1411-4(f). See *Example 1* of § 1.1411-4(h). In addition, pursuant to § 1.641(c)-1(i), no portion of the \$9,000 distribution is allocable to the S portion.

The undistributed net investment income for the non-S portion is \$20,400 and is determined as follows:

Dividend Income .....	\$15,000
Interest Income .....	10,000
Capital Gain .....	5,000
Trustee Annual Fee .....	(600)
Distributable net income distribution .....	(9,000)
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Total non-S portion undistributed net investment income .....	20,400
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(C) Trust will combine the undistributed net investment income of the S portion and non-S portion from (ii)(A) and (B) to arrive at Trust's combined undistributed net investment income.

S portion's undistributed net investment income .....	\$20,600
Non-S portion's undistributed net investment income .....	20,400

Combined undistributed net investment income .....	41,000
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(iii) *Step two.* (A) The ESBT will calculate its adjusted gross income. Pursuant to paragraph (c)(1)(ii)(B) of this section, the ESBT's adjusted gross income is the non-S portion's adjusted gross income increased or decreased by the net income or net loss of the S portion.

(B) The adjusted gross income for the ESBT is \$38,000 and is determined as follows:

Dividend Income .....	\$15,000
Interest Income .....	10,000
Capital Gain .....	5,000
Trustee Annual Fee .....	(600)
Distributable net income distribution .....	(9,000)
S Portion Income (see (iii)(C)) ....	17,600

Adjusted gross income .....	38,000
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(C) The S portion's single item of ordinary income used in the ESBT's adjusted gross income calculation is \$17,600. This item of income is determined by starting with net rental income of \$21,000 and reducing it—

(1) By the S portion's \$400 share of the annual trustee fee; and

(2) As allowed by section 1211(b)(1), \$3,000 of the \$7,000 capital loss.

(iv) *Step three.* Trust will pay tax on the lesser of—

(A) The combined undistributed net investment income (\$41,000 calculated in (ii)(C)); or

(B) The excess of adjusted gross income (\$38,000 calculated in (iii)(B)) over the dollar amount at which the highest tax bracket in section 1(e) applicable to a trust begins for the taxable year.

(g) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013, except that paragraph (c)(2) of this section shall apply to taxable years of charitable remainder trusts that begin after December 31, 2012.

#### § 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, rents, substitute interest payments, and substitute dividend payments, 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)(3)(ii)(A) 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 level.

(2) In the case of an individual, estate, or trust that owns an interest in a trade or business through one or more passthrough entities for Federal tax purposes (for example, through a partnership or S corporation), 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).

*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. Entity engaged in trading in financial instruments.* B, 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 B. In addition, B is not directly engaged in a trade or business of trading in financial instruments or commodities. PRS earns interest of \$50,000, and B'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 B's \$25,000 distributive share of the interest is net investment income under paragraph (a)(1)(i) of this section.

*Example 3. Application of ordinary course of a trade or business exception.* C, 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 C. S earns \$100,000 of interest in the ordinary course of its trade or business, of which \$5,000 is C's pro rata share. 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 C (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 C'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—(1) Passive activity.* For a trade or business described in § 1.1411-5(a)(1), paragraph (a)(1)(ii) of this section includes other gross income 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. Thus, for a trade or business described in § 1.1411-5(a)(1), if an item of gross income or net gain is subject to paragraph (a)(1)(i) or (iii) of this section, it is generally not other gross income described in paragraph (a)(1)(ii) of this section.

(2) *Trading in financial instruments or commodities.* For a trade or business described in § 1.1411-5(a)(2), paragraph (a)(1)(ii) of this section includes all other gross income that is not gross income described in paragraph (a)(1)(i) of this section. For example, any gain from marking to market under section 475(f) or section 1256 and any realized gain from the disposition of

property held in the trade or business is classified as other gross income subject to paragraph (a)(1)(ii) of this section (and not classified as net gain under 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.

(2) *Limitation*. The calculation of net gain shall 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) *In general*. 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). Net gain shall include gain or loss attributable to the disposition of property from the investment of working capital. See § 1.1411–6.

(ii) *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 shall 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. See § 1.1411–7 for rules relating to dispositions of interests in partnerships or S corporations.

(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 level.

(3) In the case of an individual, estate, or trust that owns an interest in a trade or business through one or more passthrough entities for Federal tax purposes (for example, through a partnership or S corporation), 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) *Example. 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, but 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)(3)(ii)(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).

(iii) *Adjustments to gain or loss attributable to the disposition of interests in a partnership or S corporation*. Net gain shall be adjusted as provided in § 1.1411–7 in the case of the disposition of an interest in a partnership or S corporation.

(e) *Distributions from estates and trusts*. 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 paragraph (a)(1)(i) and (ii) of this section or net gain attributable to items described 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).

(f) *Properly allocable deductions*—(1) *General rule*—(i) *In general*. Unless specifically stated otherwise, only properly allocable deductions described in this paragraph (f) may be taken into account in determining net investment income.

(ii) *Limitations and carryovers*. Deductions allowed under this paragraph (f) shall not exceed the total amount of gross income and net gain described in paragraph (a)(1) of this

section. Any deductions described in this paragraph (f) in excess of such gross income and net gain shall not be taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1. However, in no event will a net operating loss deduction allowed under section 172 be taken into account in determining net investment income for any taxable year. See *Example 3* of paragraph (h) of this section.

(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 (and that therefore constitute net investment income) shall be 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 shall be 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*. Net investment income shall take into account deductions described in section 62(a)(9).

(3) *Properly allocable deductions described in section 63(d)*—(i) *In general*. Net investment income shall take into account the following itemized deductions:

(A) *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) shall be treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year.

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

(C) *Taxes described in section 164(a)(3)*. In the case of taxes that are deductible under section 164(a)(3) and imposed on both gross income (including net gain) described in § 1.1411–4(a)(1) and gross income (as defined under section 61(a)) that is not described in § 1.1411–4(a)(1), the portion of the deduction that is properly allocable to gross income (including net gain) described in § 1.1411–4(a)(1) may be determined by taxpayers using any reasonable method. For purposes of the prior sentence, 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 gross income (as defined under section 61(a)) is an example of a reasonable method.

(ii) *Application of limitations under sections 67 and 68.* Any deductions described in this paragraph (f)(3) 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 is applied before section 68. The amounts that may be deducted in determining net investment income after the application of sections 67 and 68 shall be determined as described in paragraph (f)(3)(ii)(A) and (B) of this section.

(A) *Deductions subject to section 67.* The amount of miscellaneous itemized deductions tentatively deductible in determining net investment income after applying section 67 (but before applying section 68) is determined by multiplying a taxpayer's miscellaneous itemized deductions otherwise allowable under this paragraph (f)(3) by a fraction. The numerator of the fraction is the total miscellaneous itemized deductions allowed after the application of section 67, but before the application of section 68. The denominator of the fraction is the total miscellaneous itemized deductions before the application of sections 67 and 68. See *Example 6* of paragraph (h) of this section.

(B) *Deductions subject to section 68.* The amount of itemized deductions allowed in determining net investment income after applying sections 67 and 68 is determined by multiplying a taxpayer's itemized deductions otherwise allowable under this paragraph (f)(3), after the application of section 67, by a fraction. The numerator of the fraction is the total itemized deductions allowed after the application of sections 67 and 68. The denominator of the fraction is the total itemized deductions allowed after the application of section 68. For this purpose, the term itemized deductions does not include any deduction described in section 68(c).

(4) *Loss deductions.* Deductions allowed under this paragraph (f) do not include losses described in section 165, whether described in section 62 or section 63(d). Losses deductible under section 165 are deductible only in determining net gain under paragraph

(d) of this section, and only to the extent of gains.

(g) *Special rules for controlled foreign corporations and passive foreign investment companies.* 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 (within the meaning of section 957(a)) or that is a United States person that directly or indirectly owns an interest in passive foreign investment companies (within the meaning of section 1297(a)).

(h) *Examples.* The following examples illustrate the provisions of this section. In each example, unless otherwise indicated, the taxpayer uses a calendar taxable year, the taxpayer is a U.S. citizen, and Year 1 is a taxable year 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. However, because net gain may not be less than zero, A may not 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 172 net operating loss deduction.* (i) In Year 1, A, an unmarried individual, has the following items of income and deduction: \$60,000 in wages, \$20,000 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), \$70,000 in loss from his sole proprietorship (which is not a trade or business described in § 1.1411-5), and \$30,000 in trading activity expense deductions. As a result, for income tax purposes A sustains a section 172(c) net operating loss of \$20,000. A makes an election under section 172(b)(3) to waive the carryback period for this net operating loss.

(ii) For purposes of section 1411, A's net investment income for Year 1 is the excess (if any) of the \$20,000 in gross income from the trading activity over the \$30,000 deduction for the trading activity expenses. Net investment income cannot be less than zero for a taxable year. Therefore, A's net investment income for Year 1 is \$0.

(iii) For Year 2, A has \$200,000 of wages, \$100,000 of gross income from the trading activity, \$80,000 of income from his sole proprietorship, and \$10,000 in trading activity expense deductions. For income tax purposes, A's \$20,000 net operating loss carryover from Year 1 will be allowed as a deduction. In addition, under § 1.1411-2(c), A's Year 1 \$20,000 net operating loss will be allowed as a deduction in computing A's Year 2 modified adjusted gross income.

(iv) For purposes of section 1411, A's \$20,000 net operating loss carryover from Year 1 is not allowed in computing A's Year 2 net investment income. As a result, A's Year 2 net investment income is \$90,000 (\$100,000 gross income from the trading activity minus the \$10,000 of trading activity expenses).

*Example 4. Section 121(a) exclusion.* (i) In Year 1, A, an unmarried individual, sells a house that he has owned and used as his principal residence for five years and realizes \$200,000 in gain. In addition to the gain realized from the sale of his 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 his principal residence from his 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 his principal residence from his Year 1 gross income and, consequently, net investment income. In determining A's Year 1 net gain under paragraph (a)(1)(iii) of this section, A reduces the \$7,000 capital gain by the \$5,000 capital loss carryover allowed under section 1211(b).

*Example 5. Section 163(d) limitation.* (i) 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. 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.

(ii) 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.

*Example 6. Sections 67 and 68 limitations on itemized deductions.* (i) 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 .....	80,000
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, \$20,000 is properly allocable to net investment income and \$100,000 is not properly allocable to net investment income.

(ii) A's 2-percent floor under section 67 is \$40,000 (2 percent 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 percent of the excess of \$2,000,000 adjusted gross income over the \$200,000 limitation threshold).

(iii)(A) 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).

(B) The amount of the deduction allowed for investment expenses after the application of section 67 is computed as follows:

$$\$70,000 \times \frac{\$60,000}{\$100,000} = \$42,000$$

(C) The amount of the deduction allowed for job-related expenses after the application of section 67 is computed as follows:

$$\$30,000 \times \frac{\$60,000}{\$100,000} = \$18,000$$

(iv)(A) Under section 68, the \$80,000 deduction for the investment interest expense is not subject to the section 68 limitation on itemized deductions.

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

Investment expenses .....	\$42,000
Job-related expenses .....	18,000
State income tax .....	120,000
Deductions subject to section 68 .....	180,000

(C) 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 paragraph (ii) of this *Example 6*).

(D) The amount of the investment expense deduction allowed after the application of section 68 is determined as follows:

$$\$42,000 \times \frac{\$126,000}{\$180,000} = \$29,400$$

(E) The amount of the state income tax deduction allowed after the application of

section 68 and properly allocable to net investment income is determined as follows:

$$\$20,000 \times \frac{\$126,000}{\$180,000} = \$14,000$$

(F) The itemized deductions allowed after applying sections 67 and 68 and properly allocable to A's net investment income are the following:

Investment interest expense .....	\$80,000
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Investment expenses .....	29,400
State income taxes .....	14,000
Itemized deductions properly allocable to net investment income .....	123,400

(G) The amount of the state income tax deduction allowed after the application of section 68 and not properly allocable to net investment income is determined as follows:

$$\$100,000 \times \frac{\$126,000}{\$180,000} = \$70,000$$

(H) The job-related expenses deduction and \$70,000 of the state income tax deduction are not properly allocable deductions for purposes of section 1411.

*Example 7. 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 he 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 B 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.

(i) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013.

#### **§ 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 (within the meaning of section 162), 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 (within the meaning of section 162); and

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

(2) *Examples.* The following examples illustrate the principles of paragraph (b)(1) of this section and the ordinary course of a trade or business exception in § 1.1411-4(b). In each example,

unless otherwise indicated, the taxpayer uses a calendar taxable year, the taxpayer is a U.S. citizen, and Year 1 is a taxable year in which section 1411 is in effect:

*Example 1. Rental activity.* A, an unmarried individual, rents a commercial building to B for \$50,000 in Year 1. A's rental activity does not involve the conduct of a section 162 trade or business, but under section 469(c)(2), A's rental activity is a passive activity. Because paragraph (b)(1)(i) of this section is not satisfied, A's rental income of \$50,000 is not derived from a trade or business described in paragraph (b)(1) of this section. However, A's rental income of \$50,000 will still constitute gross income from rents within the meaning of § 1.1411-4(a)(1)(i) because § 1.1411-4(a)(1)(i) does not require a trade or business.

*Example 2. Application of grouping rules under section 469.* In Year 1, A, an unmarried individual, owns an interest in PRS, a partnership for Federal income tax purposes. PRS is engaged in two activities, X and Y, which constitute trades or businesses (within the meaning of section 162), and neither of which constitute trading in financial instruments or commodities (within the meaning of paragraph (a)(2) of this section). Pursuant to § 1.469-4, A has properly grouped X and Y (the grouped activity). A participates in X for more than 500 hours during Year 1 and would be treated as materially participating in the activity within the meaning of § 1.469-5T(a)(1). A only participates in Y for 50 hours during Year 1, and, but for the grouping of the two activities together, A would not be treated as materially participating in Y within the meaning of § 1.469-5T(a). However, pursuant to §§ 1.469-4 and 1.469-5T(a)(1), A materially participates in the grouped activity, and therefore, for purposes of paragraph (b)(1)(ii) of this section, neither X nor Y is a passive activity with respect to A. Accordingly, with respect to A, neither X nor Y is a trade or business described in paragraph (b)(1) of this section.

*Example 3. Application of the rental activity exceptions.* B, an unmarried individual, is a partner in PRS, which is engaged in an equipment leasing activity. The average period of customer use of the equipment is seven days or less (and therefore meets the exception in § 1.469-1T(e)(3)(ii)(A)). B materially participates in the equipment leasing activity (within the meaning of § 1.469-5T(a)). The equipment leasing activity constitutes a trade or business within the meaning of section 162. In Year 1, B has modified adjusted gross income (as defined in § 1.1411-2(c)) of \$300,000, all of which is derived from PRS. All of the income from PRS is derived in the ordinary course of the equipment leasing activity, and all of PRS's property is held in the equipment leasing activity. Of B's allocable share of income from PRS, \$275,000 constitutes gross income from rents (within

the meaning of § 1.1411-4(a)(1)(i)). While \$275,000 of the gross income from the equipment leasing activity meets the definition of rents in § 1.1411-4(a)(1)(i), the activity meets one of the exceptions to rental activity in § 1.469-1T(e)(3)(ii) and B materially participates in the activity. Therefore, the trade or business is not a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section, and because the rents are derived in the ordinary course of a trade or business not described in paragraph (a) of this section, the ordinary course of a trade or business exception in § 1.1411-4(b) applies, which means that the rents are not subject to § 1.1411-4(a)(1)(i). Furthermore, because the equipment leasing trade or business is not a trade or business described in paragraph (a)(1) or (a)(2) of this section, the \$25,000 of other gross income is not subject to § 1.1411-4(a)(1)(ii). Finally, gain or loss from the sale of the property held in the equipment leasing activity will not be subject to § 1.1411-4(a)(1)(iii) because although it is attributable to a trade or business, it is not a trade or business to which the section 1411 tax applies.

*Example 4. Application of section 469 and other gross income under § 1.1411-4(a)(1)(ii).* Same facts as *Example 3*, except B does not materially participate in the equipment leasing trade or business and therefore the trade or business is a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Accordingly, the \$275,000 of gross income from rents is subject to § 1.1411-4(a)(1)(i) because the rents are derived from a trade or business described in paragraph (a)(1) of this section (that is, the ordinary course of a trade or business exception in § 1.1411-4(b) is inapplicable). Furthermore, the \$25,000 of other gross income from the equipment leasing trade or business is subject to § 1.1411-4(a)(1)(ii) because the gross income is derived from a trade or business described in paragraph (a)(1) of this section. Finally, gain or loss from the sale of the property used in the equipment leasing trade or business is subject to § 1.1411-4(a)(1)(iii) because the trade or business is a passive activity with respect to B, as described in paragraph (b)(1)(ii) of this section.

*Example 5. Application of the portfolio income rule and section 469.* C, an unmarried individual, is a partner in PRS, a partnership engaged in a trade or business (within the meaning of section 162) that does not involve a rental activity. C does not materially participate in PRS within the meaning of § 1.469-5T(a), and therefore the trade or business of PRS is a passive activity with respect to C for purposes of paragraph (a)(1) of this section. C's \$500,000 allocable share of PRS's income consists of \$450,000 of gross income from a trade or business and \$50,000 of gross income from dividends and interest (within the meaning of § 1.1411-4(a)(1)(i)) that is not derived in the ordinary course of the trade or business of PRS. Thus, under

section 469(e)(1)(A)(i)(I) and the regulations thereunder, C's allocable share of gross income from dividends and interest consists of portfolio income. Therefore, C's \$500,000 allocable share of PRS's income is subject to section 1411. C's \$50,000 allocable share of PRS's income from dividends and interest is subject to § 1.1411-4(a)(1)(i) because the share is gross income from dividends and interest that is not derived in the ordinary course of a trade or business (that is, the ordinary course of a trade or business exception in § 1.1411-4(b) is inapplicable). C's \$450,000 allocable share of PRS's income is subject to § 1.1411-4(a)(1)(ii) because it is gross income from a trade or business that is a passive activity.

(c) *Trading in financial instruments or commodities*—(1) *Definition of financial instruments*. For purposes of section 1411 and the regulations thereunder, the term *financial instruments* includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of an interest in any of the items described in this paragraph (c)(1). An evidence of an interest in any of the items described in this paragraph (c)(1) includes, but is not limited to, short positions or partial units in any of the items described in this paragraph (c)(1).

(2) *Definition of commodities*. For purposes of section 1411 and the regulations thereunder, the term *commodities* refers to items described in section 475(e)(2).

(d) *Effective/applicability date*. This section applies to taxable years beginning after December 31, 2013.

#### **§ 1.1411-6 Income on investment of working capital subject to tax.**

(a) *General rule*. For purposes of section 1411, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business, and any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business. In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in § 1.469-2T(c)(3)(iii) apply. See § 1.1411-4(f) for rules regarding properly allocable deductions with respect to an investment of working capital; § 1.1411-7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

(b) *Example*. A, an unmarried individual, operates a restaurant, which is a section 162 trade or business but is not a trade or business described in § 1.1411-5(a)(1) with

respect to A. A owns and conducts the restaurant business through S, an S corporation wholly-owned by A. S is able to pay all of the restaurant's current obligations with cash flow generated by the restaurant. S utilizes an interest-bearing checking account at a local bank to make daily deposits of cash receipts generated by the restaurant, and also to pay the recurring ordinary and necessary business expenses of the restaurant. The average daily balance of the checking account is approximately \$2,500, but at any given time the balance may be significantly more or less than this amount depending on the short-term cash flow needs of the business. In addition, S has set aside \$20,000 for the potential future needs of the business in case the daily cash flow into and from the checking account becomes insufficient to pay the restaurant's recurring business expenses. S does not currently need to spend or use the \$20,000 capital to conduct the restaurant business, and S deposits and maintains the \$20,000 in an interest-bearing savings account at a local bank. Both the \$2,500 average daily balance of the checking account and the \$20,000 savings account balance constitute working capital and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts and allocated to A under section 1366 will be subject to tax under § 1.1411-4(a)(1)(i).

(c) *Effective/applicability date*. This section applies to taxable years beginning after December 31, 2013.

#### **§ 1.1411-7 Exception for dispositions of interests in partnerships and S corporations.**

(a) *In general*—(1) *General application*. In the case of a disposition of an interest in a partnership or S corporation described in paragraph (a)(2) of this section, the gain or loss from such disposition taken into account under § 1.1411-4(a)(1)(iii) shall be adjusted in accordance with paragraph (c) of this section. The adjustment reflects the net gain or net loss that would have been taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest (a deemed sale).

(2) *Interests to which exception applies*—(i) *In general*. The adjustment provided by this section applies only to dispositions of interests in partnerships or S corporations if—

(A) The partnership or S corporation is engaged in one or more trades or businesses (within the meaning of section 162), and at least one of its trades or businesses is not described in § 1.1411-5(a)(2) (trading in financial instruments or commodities); and

(B) With respect to the partnership or S corporation interest disposed of, the transferor is engaged in at least one trade or business that is not described in § 1.1411-5(a)(1) (passive activity with respect to the transferor).

(ii) *Nonapplication*. This section does not apply to the disposition of stock in an S corporation if an election under section 338(h)(10) is made.

(b) *Special rules*—(1) *Installment sales*—(i) *Installment sales on or after the effective date of section 1411*. In the case of a disposition of an interest in a partnership or S corporation in an installment sale to which section 453 applies, any adjustment to net gain under this section is determined in the year of disposition and shall be taken into account in the same proportion of the total gain as is taken into account under section 453.

(ii) *Installment sales prior to the effective date of section 1411*. In the case of a disposition before the effective date of section 1411 of an interest in a partnership or S corporation in an installment sale to which section 453 applies, taxpayers that want to make an irrevocable election to have this section apply must file the computational statement required by paragraph (d) of this section with the taxpayer's original or amended return for the first taxable year beginning after December 31, 2013, in which the taxpayer is subject to tax under section 1411. The determination of whether the taxpayer is subject to tax under section 1411 is made without regard to the effect of the election. In addition, a taxpayer may make an irrevocable election to have this section apply for a taxable year that begins before January 1, 2014, by filing the computational statement required by paragraph (d) of this section with the taxpayer's original or amended return for the taxable year. If the election is made under this section, the taxpayer shall calculate the gain or loss adjustment under this section and such adjustment shall be taken into account under § 1.1411-4(a)(1)(iii).

(2) *Sale of an interest by a Qualified Subchapter S Trust*. [Reserved]

(c) *Deemed sale*—(1) *In general*. In the case of a disposition of an interest in a partnership or S corporation described in paragraph (a)(2)(i) of this section, the amount of gain or loss from such disposition taken into account for purposes of § 1.1411-4(a)(1)(iii) must be adjusted in accordance with this paragraph (c).

(2) *Step one: deemed sale of properties*. The partnership or S corporation is deemed to dispose of all of the entity's properties in a fully taxable transaction (in a manner similar

to § 1.743-1(d)(2)) for cash equal to the fair market value of the entity's properties immediately before the disposition of the partnership or S corporation interest.

(3) *Step two: determination of gain or loss.* The partnership or S corporation determines the amount of gain or loss attributable to each property by comparing the fair market value of each property with the adjusted basis of each property. The gain or loss for each property must be treated as a separate item.

(4) *Step three: allocation of gain or loss.* Applying the rules of chapter 1, the partnership or S corporation determines the amount of gain or loss for each property that is allocable to the interest disposed of by the transferor. An allocation of gain or loss to a transferor partner must comply with the requirements in sections 704(b) and 704(c) and the regulations thereunder, and basis adjustments under section 743 with respect to the transferor must be taken into account. In the case of an S corporation, the amount of gain or loss allocated to the transferor is determined under section 1366(a), and the allocation should not take into account any reduction in the transferor's distributive share in section 1366(f)(2) resulting from the hypothetical imposition of tax under section 1374 as a result of the deemed sale. See § 1.460-4(k)(3)(v)(B) for a rule relating to the computation of income or loss that would be allocated to the transferor from a contract accounted for under a long-term contract method of accounting as a result of the deemed sale of properties.

(5) *Step four: adjustment to gain or loss—(i) In general.* If the amount of gain or loss allocable to the transferor in paragraph (c)(4) of this section is attributable to property held (as modified by paragraph (c)(5)(ii) of this section, if applicable) in a trade or business not described in § 1.1411-5(a), such gain or loss is aggregated to create a net gain (which results in a negative adjustment) or a net loss (which results in a positive adjustment). Then, in accordance with paragraph (c)(5)(iii) or (iv) of this section, the transferor must adjust the transferor's gain or loss from the disposition of the partnership or S corporation interest as determined in § 1.1411-4(a)(1)(iii) (without application of this section).

(ii) *Special rules—(A) Property used in more than one trade or business.* In the case of the disposition of a partnership or S corporation interest in which property of the partnership or S corporation is held in more than one trade or business during the twelve-

month period ending on the date of the disposition, the fair market value and the adjusted basis of such property must be allocated among such trades or businesses on a basis that reasonably reflects the use of such property during such twelve-month period. See *Example 7* of paragraph (e) of this section regarding multiple trades or businesses.

(B) *Goodwill attributable to property.* If the transferor is allocated gain or loss from goodwill in the deemed sale under paragraph (c)(4) of this section and if the entity is engaged in a trade or business, the transferor shall treat such gain or loss as gain or loss from the disposition of property held in that trade or business. If the entity is engaged in more than one trade or business, the transferor's gain or loss from goodwill will be attributable to the entity's trades or businesses based on the relative fair market value of the property (other than cash) held in each trade or business. See *Example 8* of paragraph (e) of this section.

(iii) *Negative adjustment—(A) General rule.* Subject to the limitations described in paragraph (c)(5)(iii)(B) of this section, if the amount determined under paragraph (c)(5)(i) of this section is a net gain, a negative adjustment of such amount shall be taken into account in computing the amount of the transferor's net gain in § 1.1411-4(a)(1)(iii).

(B) *Limitations.* If the transferor has a gain (determined without regard to section 1411(c)(4) and this paragraph (c)) from the disposition of the partnership or S corporation interest, the negative adjustment taken into account is limited to the amount of the gain (determined without regard to section 1411(c)(4) and this paragraph (c)). If the transferor has a loss (determined without regard to section 1411(c)(4) and this paragraph (c)) from the disposition of the partnership or S corporation interest, the negative adjustment shall not be taken into account.

(iv) *Positive adjustment—(A) General rule.* Subject to the limitations described in paragraph (c)(5)(iv)(B) of this section, if the amount determined under paragraph (c)(5)(i) of this section is a net loss, a positive adjustment of such amount shall be taken into account in computing the amount of the transferor's net gain in § 1.1411-4(a)(1)(iii).

(B) *Limitations.* If the transferor has a loss (determined without regard to section 1411(c)(4) and this paragraph (c)) from the disposition of the partnership or S corporation interest, the positive adjustment taken into account is limited to the amount of the

loss (determined without regard to section 1411(c)(4) and this paragraph (c)). If the transferor has a gain (determined without regard to section 1411(c)(4) and this paragraph (c)) from the disposition of the partnership or S corporation interest, the positive adjustment shall not be taken into account.

(d) *Required statement of adjustment.* Any transferor making an adjustment under paragraph (c) of this section must attach a statement to the transferor's return for the year of disposition. The statement must include—

(1) A description of the disposed-of interest;

(2) The name and taxpayer identification number of the entity disposed of;

(3) The fair market value of each property of the entity;

(4) The entity's adjusted basis in each property;

(5) The transferor's allocable share of gain or loss with respect to each property of the entity;

(6) Information regarding whether the property was held in (or attributable to) a trade or business not described in § 1.1411-5;

(7) The amount of the net gain under § 1.1411-4(a)(1)(iii) on the disposition of the interest; and

(8) The computation of the adjustment under paragraph (c) of this section.

(e) *Examples.* The following examples illustrate the principles of this section. In each example, unless otherwise indicated, the taxpayer uses a calendar taxable year, the taxpayer is a U.S. citizen, the partnership (PRS) or S corporation (S) is not engaged in a trade or business of trading in financial instruments or commodities (as defined in § 1.1411-5(a)(2)), and Year 1 is a taxable year in which section 1411 is in effect:

*Example 1. Basic application.* (i) *Facts.* Individuals A and B are shareholders of S Corporation (S). A owns 75 percent of the stock in S, and B owns 25 percent of the stock in S. During Year 1, S is engaged in a single trade or business. With respect to S's trade or business, A is not engaged in a trade or business described in § 1.1411-5(a)(1), and B is engaged in a trade or business described in § 1.1411-5(a)(1). S has three properties (1, 2, and 3) held exclusively in S's trade or business that have an aggregate fair market value of \$120,000. On September 1 of Year 1, A and B sell their S stock to C for the fair market value of S's properties (that is, A sells for \$90,000 and B sells for \$30,000). At the time of the disposition, A's adjusted basis in his S stock is \$75,000, and B's adjusted basis in his S stock is \$25,000. S's properties have the following adjusted bases and fair market values immediately before the disposition:

Property	Adjusted basis	Fair market value
1 .....	\$10,000	\$50,000
2 .....	70,000	30,000
3 .....	20,000	40,000

(ii) *Calculation of net gain under § 1.1411-4(a)(1)(iii)*. On the stock sale to C, A recognizes a gain of \$15,000 (\$90,000 minus \$75,000), which is subject to § 1.1411-4(a)(1)(iii), and B recognizes a gain of \$5,000 (\$30,000 minus \$25,000), which is subject to § 1.1411-4(a)(1)(iii).

(iii) *Application of section 1411(c)(4)—(A) In general*. Section 1411(c)(4) is applicable to A because with respect to S's trade or business, A is not engaged in a trade or business described in § 1.1411-5(a)(1). On the other hand, with respect to B, S's trade or business is described in § 1.1411-5(a)(1) because it is a passive trade or business with respect to B within the meaning of § 1.1411-5(a)(1). Accordingly, section 1411(c)(4) is inapplicable to B, and B may not make any adjustment to his \$5,000 gain upon the stock disposition.

(B) *Deemed sale—(1) Step one: deemed sale of properties*. Upon a hypothetical disposition of S's properties for cash equal to fair market value, S would receive \$50,000 for Property 1, \$30,000 for Property 2, and \$40,000 for Property 3.

(2) *Step two: determination of gain or loss*. The determination of gain or loss on the deemed sale of S's properties is as follows:

Property	Adjusted basis	Fair market value	Gain or loss
1 .....	\$10,000	\$50,000	\$40,000
2 .....	70,000	30,000	(40,000)
3 .....	20,000	40,000	20,000

(3) *Step three: allocation of gain or loss*. Under section 1366, A is allocated \$30,000 gain from Property 1, \$30,000 loss from Property 2, and \$15,000 gain from Property 3.

(4) *Step four: adjustment to net gain*. Because all three properties are held in S's trade or business, A must make an adjustment under paragraph (c)(5) of this section to the amount of net gain determined under § 1.1411-4(a)(1)(iii). The gain or loss on each of the three properties are added together (\$30,000 minus \$30,000 plus \$15,000), resulting in a negative adjustment of \$15,000. Under paragraph (c)(5) of this section, A's gain of \$15,000 on the disposition of the interest under § 1.1411-4(a)(1)(iii) is reduced by \$15,000, and A has zero gain with respect to the stock disposition for purposes of § 1.1411-4(a)(1)(iii).

*Example 2. Inside-outside basis disparity.* (i) *Facts*. Same facts as *Example 1*, except that A's adjusted basis in his S stock is \$70,000.

(ii) *Analysis*. On the stock sale to C, A recognizes a gain of \$20,000 (\$90,000 minus \$70,000), which is subject to § 1.1411-4(a)(1)(iii). The deemed sale would result in a negative adjustment of \$15,000 (\$30,000 minus \$30,000 plus \$15,000). Under paragraph (c)(5) of this section, A's net gain

of \$20,000 on the disposition of the interest under § 1.1411-4(a)(1)(iii) is reduced by \$15,000, and A has \$5,000 net gain with respect to the stock disposition for purposes of § 1.1411-4(a)(1)(iii).

*Example 3. Limitation of adjustment.* (i) *Facts*. Same facts as *Example 1*, except that A's adjusted basis in his S stock is \$80,000.

(ii) *Analysis*. On the stock sale to C, A recognizes a gain of \$10,000 (\$90,000 minus \$80,000), which is subject to § 1.1411-4(a)(1)(iii). The deemed sale would result in a negative adjustment of \$15,000 (\$30,000 minus \$30,000 plus \$15,000). Under paragraph (c)(5) of this section, A's net gain of \$10,000 on the disposition of the interest under § 1.1411-4(a)(1)(iii) is reduced by the negative adjustment, but the negative adjustment under § 1.1411-7(c)(5)(iii)(B) is limited to \$10,000 (the amount of A's gain determined without regard to § 1.1411-7). As a result, A has zero net gain with respect to the stock disposition for purposes of § 1.1411-4(a)(1)(iii).

*Example 4. Loss on disposition.* (i) *Facts*. Same facts as *Example 1*, except that (A) A's adjusted basis in his stock is \$105,000, (B) Property 3 has an adjusted basis of \$60,000 and fair market value of \$10,000, and (C) A sells his interest for \$67,500.

(ii) *Analysis*. On the stock sale to C, A recognizes a loss of \$37,500 (\$67,500 minus \$105,000), which is subject to § 1.1411-4(a)(1)(iii). In the deemed sale, A would be allocated \$30,000 gain from Property 1, \$30,000 loss from Property 2, and \$37,500 loss from Property 3. The deemed sale would result in a positive adjustment of \$37,500 (\$30,000 minus \$30,000 minus \$37,500). Under paragraph (c)(5) of this section, A's loss of \$37,500 on the disposition of the interest under § 1.1411-4(a)(1)(iii) is increased by the positive adjustment of \$37,500, and A has zero loss with respect to the stock disposition for purposes of § 1.1411-4(a)(1)(iii).

*Example 5. Property not held in trade or business.* (i) *Facts*. Same facts as *Example 1*, except that S owns a fourth property (adjusted basis of \$20,000 and fair market value of \$100,000) that is not held in S's trade or business and only A sells his S stock to C for A's proportionate share of the fair market value of S's properties. At the time of the disposition, A's adjusted basis in his S stock is \$90,000.

(ii) *Calculation of net gain under § 1.1411-4(a)(1)(iii)*. On the stock sale to C, A recognizes a gain of \$75,000 (\$165,000 minus \$90,000), which is subject to § 1.1411-4(a)(1)(iii).

(iii) *Application of section 1411(c)(4)—(A) In general*. Section 1411(c)(4) is applicable to A because S's trade or business is not a trade or business described in § 1.1411-5(a)(1) with respect to A.

(B) *Deemed sale—(1) Step one: deemed sale of properties*. Upon a hypothetical disposition of S's properties for cash equal to fair market value, S would receive \$50,000 for Property 1, \$30,000 for Property 2, \$40,000 for Property 3, and \$100,000 for Property 4.

(2) *Step two: determination of gain or loss*. The determination of gain or loss on the deemed sale of S's properties is as follows:

Property	Adjusted basis	Fair market value	Gain or loss
1 .....	\$10,000	\$50,000	\$40,000
2 .....	70,000	30,000	(40,000)
3 .....	20,000	40,000	20,000
4 .....	20,000	100,000	80,000

(3) *Step three: allocation of gain or loss*. Under section 1366, A is allocated \$30,000 gain from Property 1, \$30,000 loss from Property 2, \$15,000 gain from Property 3, and \$60,000 gain from Property 4.

(4) *Step four: adjustment to net gain*. Because S's trade or business is not a trade or business described in § 1.1411-5(a)(1) with respect to A, A must make an adjustment under paragraph (c)(5) of this section to the amount of gain determined under § 1.1411-4(a)(1)(iii). Because Property 4 is not held in S's trade or business, A's \$60,000 gain from Property 4 is not taken into account under paragraph (c)(5) of this section. The gain or loss on Property 1, Property 2, and Property 3 are added together (\$30,000 minus \$30,000 plus \$15,000), resulting in a negative adjustment of \$15,000. Under paragraph (c)(5) of this section, A's net gain of \$75,000 under § 1.1411-4(a)(1)(iii) on the disposition of the interest is reduced by \$15,000, and A has \$60,000 net gain with respect to the stock disposition for purposes of § 1.1411-4(a)(1)(iii).

*Example 6. Calculation of gain in general.* (i) *Facts*. D and E are equal partners in PRS, a partnership, and PRS's partnership agreement provides that allocations are 50 percent to D and 50 percent to E. PRS is engaged in a single trade or business. D contributed Property 1 with an adjusted basis of \$100,000 and a fair market value of \$200,000 at the time of the contribution. E contributed Property 2 with an adjusted basis of \$120,000 and a fair market value of \$200,000 at the time of the contribution. PRS is engaged in a single trade or business in which both Property 1 and Property 2 are used. PRS's trade or business is not a trade or business described in § 1.1411-5(a)(1) with respect to D. On November 1 of Year 1, D sells his interest in PRS to F for \$320,000, which is based on the fair market value of PRS's properties. At the time of the sale, D has an adjusted basis in his partnership interest of \$100,000 and the properties of PRS have the following adjusted bases and fair market values:

Property	Adjusted basis	Fair market value
1 .....	\$100,000	\$240,000
2 .....	120,000	400,000

(ii) *Calculation of net gain under § 1.1411-4(a)(1)(iii)*. D recognizes \$220,000 (\$320,000 minus \$100,000) of gain on the sale of his partnership interest to F, and such gain is subject to § 1.1411-4(a)(1)(iii).

(iii) *Application of section 1411(c)(4)—(A) In general*. Section 1411(c)(4) is applicable to D because PRS's trade or business is not a trade or business described in § 1.1411-5(a)(1) with respect to A.

(B) *Deemed sale—(1) Step one: deemed sale of properties*. Upon a hypothetical

disposition of PRS's properties for cash equal to fair market value, PRS would receive \$240,000 for Property 1 and \$400,000 for Property 2.

(2) *Step two: determination of PRS's gain or loss.* The determination of gain or loss on the deemed sale of PRS's properties is as follows:

Property	Adjusted basis	Fair market value	Gain or loss
1 .....	\$100,000	\$240,000	\$140,000
2 .....	120,000	400,000	280,000

(3) *Step three: allocation of gain or loss.*

Pursuant to section 704(c), D is allocated \$120,000 gain from the deemed sale of Property 1 and \$100,000 gain from the deemed sale of Property 2.

(4) *Step four: adjustment to net gain.*

Because both properties are used in PRS's in trade or business, D must make an adjustment under paragraph (c)(5)(i) of this section to the amount of net gain determined under § 1.1411-4(a)(1)(iii). The total gain allocated to D in the deemed sale is \$220,000 (\$120,000 plus \$100,000), resulting in a negative adjustment of \$220,000. Under paragraph (c)(5) of this section, D's net gain of \$220,000 under § 1.1411-4(a)(1)(iii) on the disposition of the interest is reduced by \$220,000, and D has zero net gain with respect to the partnership interest disposition for purposes of § 1.1411-4(a)(1)(iii).

*Example 7. Multiple trades or businesses.*

(i) *Facts.* Individuals A and B are shareholders of an S corporation (S). A owns 50 percent of the stock in S. During Year 2, S is engaged in two trades or businesses (Business X and Business Y). With respect to Business X, A is not engaged in a trade or business described in § 1.1411-5(a)(1), but with respect to Business Y, A is engaged in a trade or business is described in § 1.1411-5(a)(1). S has five properties. Property 1 and Property 2 are held exclusively in Business X, and Property 3 and Property 4 are held exclusively in Business Y. Property 5 is used half of the time in Business X and the rest of the time in Business Y. On December 1 of Year 2, A sells his S stock to C for A's proportionate share of the fair market value of S's properties. At the time of the disposition, A's adjusted basis in his S stock is \$110,000. S's properties have the following adjusted bases and fair market values immediately before the disposition:

Property	Adjusted basis	Fair market value
1 .....	\$10,000	\$30,000
2 .....	70,000	30,000
3 .....	20,000	40,000
4 .....	20,000	100,000
5 .....	100,000	120,000

(ii) *Calculation of gain under § 1.1411-4(a)(1)(iii).* On the stock sale to C, A recognizes a gain of \$50,000 (\$160,000 minus \$110,000), which is subject to § 1.1411-4(a)(1)(iii).

(iii) *Application of section 1411(c)(4)—(A) In general.* Section 1411(c)(4) is applicable to A. However, any adjustment will only relate

to property held in Business X and not to property held in Business Y (because Business Y is a trade or business described in § 1.1411-5(a)(1) with respect to A).

(B) *Deemed sale—(1) Step one: deemed sale of properties.* Upon a hypothetical disposition of S's properties for cash equal to fair market value, S would receive \$30,000 for Property 1, \$30,000 for Property 2, \$40,000 for Property 3, \$100,000 for Property 4, and \$120,000 for Property 5.

(2) *Step two: determination of gain or loss.* The determination of gain or loss on the deemed sale of S's properties is as follows:

Property	Adjusted basis	Fair market value	Gain or loss
1 .....	\$10,000	\$30,000	\$20,000
2 .....	70,000	30,000	(40,000)
3 .....	20,000	40,000	20,000
4 .....	20,000	100,000	80,000
5 .....	100,000	120,000	20,000

(3) *Step three: allocation of gain or loss.*

Under section 1366, A is allocated \$10,000 gain from Property 1, \$20,000 loss from Property 2, \$10,000 gain from Property 3, \$40,000 gain from Property 4, and \$10,000 gain from Property 5.

(4) *Step four: adjustment to net gain.* A must make an adjustment under paragraph (c)(5) of this section to the amount of net gain determined under § 1.1411-4(a)(1)(iii), but only with respect to the gain or loss on the properties used in Business X (that is, Property 1, Property 2, and a portion of Property 5). Because Property 5 is used 50 percent of the time in Business X, under paragraph (c)(5)(ii)(A) of this section, 50 percent of the gain would be attributable to Business X (and A's share would be \$5,000). The gain or loss on Property 1, Property 2, and Property 5 are added together (\$10,000 minus \$20,000 plus \$5,000), and results in a positive adjustment of \$5,000. Under paragraph (c)(5)(iv)(B) of this section, because A had a gain of \$50,000 on the stock disposition, A does not take the positive adjustment of \$5,000 into account and A has a \$50,000 gain for purposes of § 1.1411-4(a)(1)(iii).

*Example 8. Goodwill and multiple trades or businesses.*

(i) *Facts.* Individuals A and B are shareholders of an S corporation (S). A owns 50 percent of the stock in S. During Year 2, S is engaged in two trades or businesses (Business X and Business Y). With respect to Business X, A is not engaged in a trade or business described in § 1.1411-5(a)(1), but with respect to Business Y, A is engaged in a trade or business described in § 1.1411-5(a)(1). In addition to cash and goodwill, S has five properties. Property 1 and Property 2 are used exclusively in Business X. Property 3 is not held for use in either Business X or Business Y. Property 4 and Property 5 are used exclusively in Business Y. On June 1 of Year 2, A sells his S stock to C for A's proportionate share of the fair market value of S's properties. At the time of the disposition, A's adjusted basis in his S stock is \$30,000. S's properties have the following adjusted basis and fair market value immediately before the disposition:

Property	Adjusted basis	Fair market value
1 .....	\$5,000	\$10,000
2 .....	5,000	5,000
3 .....	0	10,000
4 .....	20,000	30,000
5 .....	10,000	15,000
Cash .....	10,000	10,000
Goodwill .....	10,000	30,000

(ii) *Calculation of gain under § 1.1411-4(a)(1)(iii).* On the stock sale to C, A recognizes a gain of \$25,000 (\$55,000 minus \$30,000), which is subject to § 1.1411-4(a)(1)(iii).

(iii) *Application of section 1411(c)(4)—(A) In general.* Section 1411(c)(4) is applicable to A. However, any adjustment will only relate to property used in Business X and not to property used in Business Y (because Business Y is a trade or business described in § 1.1411-5(a)(1) with respect to A).

(B) *Deemed sale—(1) Step one: deemed sale of properties.* Upon a hypothetical disposition of S's properties for cash equal to fair market value, S would receive \$10,000 for Property 1, \$5,000 for Property 2, \$10,000 for Property 3, \$30,000 for Property 4, \$15,000 for Property 5, \$10,000 for the cash, and \$30,000 for goodwill.

(2) *Step two: determination of gain or loss.* The determination of gain or loss on the deemed sale of S's properties is as follows:

Property	Adjusted basis	Fair market value	Gain or loss
1 .....	\$5,000	\$10,000	5,000
2 .....	5,000	5,000	0
3 .....	0	10,000	10,000
4 .....	20,000	30,000	10,000
5 .....	10,000	15,000	5,000
Cash ...	10,000	10,000	0
Goodwill ...	10,000	30,000	20,000

(3) *Step three: allocation of gain or loss.*

Under section 1366, A is allocated a \$25,000 gain (\$2,500 gain from Property 1, \$0 gain from Property 2, \$5,000 gain from Property 3, \$5,000 gain from Property 4, \$2,500 gain from Property 5, \$0 from cash, and \$10,000 from goodwill).

(4) *Step four: adjustment to net gain.* A must make an adjustment under paragraph (c)(5) of this section to the amount of net gain determined under § 1.1411-4(a)(1)(iii), but only with respect to the gain or loss on the properties used in Business X (that is, Property 1, Property 2, and a portion of the goodwill). Under paragraph (c)(5)(ii)(B) of this section, the goodwill is allocated to Business X and Business Y based on the relative fair market value of the property (other than cash) held for use in each trade or business. For this purpose, the fair market value of the property held for use in Business X is \$15,000, and the fair market value of the property held for use in Business Y is \$45,000. Therefore, 25 percent of A's gain on the goodwill is attributable to Business X (or \$2,500). A's share of the gain on Property 1, Property 2, and goodwill are added together (\$2,500 plus zero plus \$2,500), which results in a negative adjustment of \$5,000. Under

paragraph (c)(5) of this section, A takes into account the negative adjustment of \$5,000, and A has a \$20,000 gain (\$25,000 minus \$5,000 adjustment) for purposes of § 1.1411-4(a)(1)(iii).

(f) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013.

**§ 1.1411-8 Exception for distributions from qualified plans.**

(a) *General rule.* Net investment income (as defined in § 1.1411-4) does not include any distribution from a qualified plan or arrangement. For this purpose, the term qualified plan or arrangement means any plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b).

(b) *Rules relating to distributions.* This paragraph (b) provides rules for purposes of paragraph (a) of this section. For purposes of section 1411(c)(5) and this section, a distribution means the following:

(1) *Actual distributions.* Any amount actually distributed from a qualified plan or arrangement, as defined in paragraph (a) of this section, is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. Examples include a rollover to an eligible retirement plan within the meaning of section 402(c)(8)(B), a distribution of a plan loan offset amount within the meaning of Q&A-13(b) of § 1.72(p)-1, and certain corrective distributions under the Internal Revenue Code.

(2) *Amounts treated as distributed.* Any amount that is treated as distributed from a qualified plan or arrangement under the Internal Revenue Code for purposes of income tax is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. Examples include a conversion to a Roth IRA described in section 408A and a deemed distribution under section 72(p).

(3) *Amounts includible in gross income.* Any amount that is not treated as a distribution but is otherwise includible in gross income pursuant to a rule relating to amounts held in a qualified plan or arrangement described in paragraph (a) of this section is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. For example, any income of the trust of a qualified plan or arrangement that is applied to purchase a participant's life insurance coverage (the P.S. 58 costs) is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income.

(c) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013.

**§ 1.1411-9 Exception for self-employment income.**

(a) *General rule.* Except as provided in paragraph (b) of this section, net investment income (as defined in § 1.1411-4) does not include any item taken into account in determining self-employment income that is subject to tax under section 1401(b) for such taxable year. For purposes of section 1411(c)(6) and this section, *taken into account* means income included and deductions allowed in determining net earnings from self-employment. However, amounts excepted in determining net earnings from self-employment under section 1402(a)(1)-(17), and thus excluded from self-employment income under section 1402(b), are not taken into account in determining self-employment income and thus may be included in net investment income if such amounts are described in § 1.1411-4. Except as provided in paragraph (b) of this section, if net earnings from self-employment consist of income or loss from more than one trade or business, all items taken into account in determining the net earnings from self-employment with respect to these trades or businesses (see § 1.1402(a)-2(c)) are considered taken into account in determining the amount of self-employment income that is subject to tax under section 1401(b) and therefore not included in net investment income.

(b) *Special rule for traders.* In the case of gross income described in § 1.1411-4(a)(1)(ii) derived from a trade or business of trading in financial instruments or commodities (as described in § 1.1411-5(a)(2)), the deductions described in § 1.1411-4(f)(2)(ii) properly allocable to the taxpayer's trade or business of trading in financial instruments or commodities are taken into account in determining the taxpayer's self-employment income only to the extent that such deductions reduce the taxpayer's net earnings from self-employment (after aggregating under § 1.1402(a)-2(c) the net earnings from self-employment from any trade or business carried on by the taxpayer as an individual or as a member of a partnership). Any deductions described in § 1.1411-4(f)(2)(ii) that exceed the amount of net earnings from self-employment, in the aggregate (if applicable), shall be allowed in determining the taxpayer's net investment income under section 1411 and the regulations thereunder.

(c) *Examples.* The following examples illustrate the provisions of this section:

*Example 1. Exclusion from self-employment income.* A is a general partner in PRS, a partnership carrying on a trade or business that is not a trade or business of trading in financial instruments or commodities (within the meaning of § 1.1411-5(a)(2)). During Year 1, A's distributive share from PRS is \$1 million, \$300,000 of which is attributable to the gain on the sale of PRS's capital assets. Section 1402(a)(3)(A) provides an exclusion from net earnings from self-employment for any gain or loss from the sale or exchange of a capital asset. For Year 1, A has \$700,000 self-employment income subject to self-employment tax. This \$700,000 subject to self-employment tax is not included as part of net investment income. However, the \$300,000 attributable to the gain on PRS's sale of a capital asset is excluded from net earnings from self-employment and self-employment income and thus is not covered by the exception in section 1411(c)(6). The \$300,000 attributable to the gain on PRS's sale of a capital asset is included as part of net investment income if the other requirements of section 1411 are satisfied.

*Example 2. Two trades or businesses.* B is an individual engaged in two trades or businesses, Business X and Business Y, neither of which is the trade or business of trading in financial instruments or commodities (as described in § 1.1411-5(a)(2)). B carries on Business X as a sole proprietor and B is also a general partner in a partnership that carries on Business Y. During Year 1, B had net earnings from self-employment consisting of the aggregate of a \$50,000 loss (that is, after application of the exclusions under section 1402(a)(1)-(17)) from Business X that is attributable to passive activities, and \$70,000 in income (after application of the exclusions under section 1402(a)(1)-(17)) from B's distributive share from the partnership from carrying on Business Y. Thus, B's net earnings from self-employment in Year 1 are \$20,000. For Year 1, all of B's income, deductions, gains, and losses from Business X and distributive share from the partnership carrying on Business Y, other than those amounts excluded due to application of section 1402(a)(1)-(17), are taken into account in determining B's net earnings from self-employment and self-employment income for such taxable year. Accordingly, in calculating B's net investment income (as defined in § 1.1411-4) for Year 1, the items of income, loss, gain, and deduction that comprise B's \$50,000 loss attributable to Business X (after application of the exclusions under section 1402(a)(1)-(17)), and the items of income, loss, gain, and deduction that comprise B's \$70,000 distributable share attributable to B's general partnership interest (after application of the exclusions under section 1402(a)(1)-(17)), are not considered. Rather, only items of income, loss, gain, and deduction from the two separate businesses that were excluded from the calculation of B's net earnings from self-employment income due to the application of the exclusions under section 1402(a)(1)-(17), such as any capital gains and losses excluded under section 1402(a)(3), are considered for

purposes of calculating B's net investment income for Year 1 in connection with these two trades or businesses.

*Example 3. Special rule for trader with single trade or business.* D is an individual engaged in the trade or business of trading in commodities (as described in § 1.1411-5(a)(2)). D made an election under section 475(f)(2). D derives \$400,000 of gross income described in § 1.1411-4(a)(1)(ii) and \$150,000 of expenses described in § 1.1411-4(f)(2)(ii) from carrying on the trade or business. Pursuant to sections 475(f)(1)(D) and 1402(a)(3)(A), none of the gross income is taken into account in determining D's net earnings from self-employment and self-employment income, and therefore, under paragraph (a) of this section, the \$400,000 of gross income is not covered by the exception in section 1411(c)(6). Under paragraph (b) of this section and § 1.1411-4(f)(2)(ii), because the \$150,000 of deductions did not reduce D's net earnings from self-employment (because D had \$0 net earnings from self-employment), for purposes of section 1411(c)(6), the \$150,000 of deductions are not taken into account in determining D's net earnings from self-employment and self-employment income, and therefore the \$150,000 of deductions may reduce D's gross income of \$400,000 for purposes of section 1411.

*Example 4. Special rule for trader with multiple trades or businesses.* E is an individual engaged in two trades or businesses, Business X (which is not a trade or business of trading in financial instruments or commodities) and Business Y (which is a trade or business of trading in financial instruments or commodities (as described in § 1.1411-5(a)(2))). E has made an election under section 475(f) with respect to Business Y. During Year 1, E had net earnings from self-employment from Business X of \$35,000. During Year 1, E also had \$300,000 of gross income described in § 1.1411-4(a)(1)(ii) and \$75,000 of expenses described in § 1.1411-4(f)(2)(ii) from Business Y. E's \$300,000 of gross income from Business Y is excluded from net earnings from self-employment and self-employment income pursuant to sections 475(f)(1)(D) and 1402(a)(3)(A). E's \$75,000 of deductions from Business Y reduce E's \$35,000 of net earnings from self-employment from Business X to \$0. Pursuant to paragraph (b) of this section and § 1.1411-4(f)(2)(ii), the remaining \$40,000 of deductions from Business Y are taken into account in determining E's net investment income (by reducing E's gross income of \$300,000 from Business Y to \$260,000) for purposes of section 1411.

(d) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013.

#### **§ 1.1411-10 Controlled foreign corporations and passive foreign investment companies.**

(a) *In general.* This section provides rules that apply to an individual, estate, or trust that is a United States shareholder (within the meaning of section 951(b)) of a controlled foreign

corporation (within the meaning of section 957(a)), or that is a United States person that directly or indirectly owns an interest in a passive foreign investment company (within the meaning of section 1297(a)). In addition, this section provides rules that apply to an individual, estate, or trust that owns an interest in a domestic partnership or an S corporation that either is a United States shareholder of a controlled foreign corporation or that has made an election under section 1295 to treat a passive foreign investment company as a qualified electing fund.

(b) *Amounts derived from a trade or business described in § 1.1411-5.* An amount included in gross income under section 951(a) or section 1293(a) that is income derived from a trade or business described in section 1411(c)(2) and § 1.1411-5 is taken into account as net investment income under section 1411(c)(1)(A)(ii) and § 1.1411-4(a)(1)(ii) for purposes of section 1411 when it is taken into account for purposes of chapter 1, and the rules in paragraphs (c) through (g) of this section do not apply to such amounts. For purposes of section 1411, an amount included in gross income under section 1296(a) that is also income derived from a trade or business described in section 1411(c)(2) and § 1.1411-5 is net investment income within the meaning of section 1411(c)(1)(A)(ii) and § 1.1411-4(a)(1)(ii), and the rules in paragraphs (c) through (f) of this section do not apply to such amount.

(c) *Calculation of net investment income—(1) In general.* For purposes of section 1411 and the regulations thereunder, *net investment income* means net investment income as defined in § 1.1411-4, adjusted pursuant to the rules described in this paragraph (c).

(2) *Dividends.* For purposes of section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i), net investment income is calculated by taking into account the amount of dividends described in this paragraph (c)(2).

(i) *Distributions of previously taxed earnings and profits.* If no election is made pursuant to paragraph (g) of this section, a distribution of earnings and profits that is not treated as a dividend for chapter 1 purposes under section 959(d) or section 1293(c) is a dividend for purposes of section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i) if the distribution is attributable to amounts that are or have been included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) in a taxable year beginning after December 31, 2012. For this purpose, distributions of earnings and profits attributable to amounts that

are or have been included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) shall be considered first attributable to such earnings and profits, if any, derived from the current taxable year, and then from prior taxable years beginning with the most recent prior taxable year. With respect to such distributions from controlled foreign corporations, a distribution shall be attributable first to earnings and profits derived from the current taxable year and then from prior taxable years beginning with the most recent prior taxable year, without regard to whether the earnings and profits are described in section 959(c)(1) or section 959(c)(2).

(ii) *Excess distributions constituting dividends.* To the extent an excess distribution within the meaning of section 1291(b) constitutes a dividend within the meaning of section 316(a), the amount is included in net investment income for purposes of section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i).

(3) *Net gain.* For purposes of section 1411(c)(1)(A)(iii) and § 1.1411-4(a)(1)(iii), the rules in this paragraph (c)(3) apply in determining net gain attributable to the disposition of property.

(i) *Gains treated as excess distributions.* Gains treated as excess distributions under section 1291(a)(2) are included in determining net gain attributable to the disposition of property for purposes of section 1411(c)(1)(A)(iii) and § 1.1411-4(a)(1)(iii).

(ii) *Inclusions and deductions with respect to section 1296 mark to market elections.* Amounts included in gross income under section 1296(a)(1) and amounts allowed as a deduction under section 1296(a)(2) are taken into account in determining net gain attributable to the disposition of property for purposes of section 1411(c)(1)(A)(iii) and § 1.1411-4(a)(1)(iii).

(iii) *Gain or loss attributable to the disposition of stock of controlled foreign corporations and qualified electing funds.* If no election is made pursuant to paragraph (g) of this section, for purposes of calculating net gain in §§ 1.1411-4(a)(1)(iii) and 1.1411-4(d)(3) attributable to the direct or indirect disposition of stock of a controlled foreign corporation or qualified electing fund (including for purposes of determining gain or loss on the direct or indirect disposition of stock of a controlled foreign corporation or a qualified electing fund by a domestic partnership or S corporation), basis shall be determined in accordance with

the provisions of paragraph (d) of this section.

(iv) *Gain or loss attributable to the disposition of interests in domestic partnerships or S corporations that own directly or indirectly stock of controlled foreign corporations or qualified electing funds.* If no election is made pursuant to paragraph (g) of this section, for purposes of calculating net gain in §§ 1.1411-4(a)(1)(iii) and 1.1411-4(d)(3) attributable to the disposition of an interest in a domestic partnership or S corporation that directly or indirectly owns stock of a controlled foreign corporation or a qualified electing fund, basis shall be determined in accordance with the provisions of paragraph (d) of this section.

(4) *Application of section 1248.* If no election is made pursuant to paragraph (g) of this section, for purposes of section 1411 and § 1.1411-4:

(i) For purposes of determining the gain recognized on the sale or exchange of a foreign corporation for section 1248(a) purposes, basis is determined in accordance with the provisions of paragraph (d) of this section; and

(ii) Section 1248(a) applies without regard to the exclusion for certain earnings and profits under section 1248(d)(1) and (d)(6), except that such exclusions will apply with respect to the earnings and profits of a foreign corporation that are attributable to amounts previously included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) in a taxable year beginning before December 31, 2012, and that have not yet been distributed. For this purpose, the determination of whether earnings and profits attributable to amounts previously taxed in a taxable year beginning before December 31, 2012, have been distributed shall be determined based on the rules described in paragraph (c)(2)(i) of this section.

(5) *Amounts distributed by an estate or trust.* Net investment income of a beneficiary of an estate or trust includes the beneficiary's share of distributable net income, as described in sections 652 and 662 and as modified by paragraph (f) of this section, to the extent that the beneficiary's share of distributable net income includes items that, if they had been received directly by the beneficiary, would have been described in this paragraph (c).

(d) *Conforming basis adjustments—(1) Basis adjustments under sections 961 and 1293—(i) Stock held by individuals, estates, or trusts.* If no election is made by an individual, estate or trust pursuant to paragraph (g) of this section:

(A) The basis increases made by the individual, estate or trust pursuant to

sections 961(a) and 1293(d) for amounts included in gross income for chapter 1 purposes under sections 951(a) and 1293(a) in taxable years beginning after December 31, 2012, are not taken into account for purposes of section 1411; and

(B) The basis decreases made by the individual, estate or trust pursuant to sections 961(b) and 1293(d) attributable to distributions treated as dividends for purposes of section 1411 under paragraph (c)(2)(i) of this section are not taken into account for purposes of section 1411.

(ii) *Stock held by domestic partnerships or S corporations.* If an individual, estate, or trust is a shareholder of an S corporation, or if an individual, estate, or trust directly, or through one or more tiers of passthrough entities (including an S corporation), owns an interest in a domestic partnership, the domestic partnership or S corporation, as the case may be, will not take into account for purposes of section 1411 the basis increases made by the domestic partnership or S corporation pursuant to sections 961(a) and 1293(d) for amounts included in gross income for chapter 1 purposes under sections 951(a) and 1293(a) for taxable years beginning after December 31, 2012, and the basis decreases made by the domestic partnership or S corporation pursuant to sections 961(b) and 1293(d) attributable to amounts that are treated as dividends for section 1411 purposes under paragraph (c)(2)(i) of this section (the section 1411 recalculated basis). If the domestic partnership or S corporation disposes of its stock of a controlled foreign corporation or qualified electing fund, the section 1411 recalculated basis will be used to determine the distributive share or pro rata share of the gain or loss for section 1411 purposes for partners or shareholders that do not make an election pursuant to paragraph (g) of this section. If a partner or shareholder makes an election pursuant to paragraph (g) of this section, the partner's distributive share or the shareholder's pro rata share of the gain or loss for section 1411 purposes is the same as the distributive share or pro rata share of the gain or loss calculated for chapter 1 purposes. See *Example 6* of paragraph (h) of this section.

(2) *Special rules for partners that own interests in domestic partnerships that own directly or indirectly stock of controlled foreign corporations or qualified electing funds.* If no election is made by a partner pursuant to paragraph (g) of this section, the basis increases provided in section

705(a)(1)(A) to that partner for chapter 1 purposes that are attributable to amounts that a domestic partnership included in gross income under section 951(a) or section 1293(a) for a taxable year beginning after December 31, 2012, are not taken into account for purposes of section 1411. In such case, the partner's adjusted basis in the partnership interest is increased by the distributions to the partnership from the controlled foreign corporation or qualified electing fund that are treated as dividends for purposes of section 1411 under paragraph (c)(2)(i) of this section. The amount of the basis increase is calculated based on the partner's share of the distribution received by the domestic partnership. Similar rules apply when the stock of the controlled foreign corporation or qualified electing fund is held in a tiered partnership structure. For purposes of determining net investment income under section 1411 and the regulations thereunder, the partner's adjusted basis in the partnership interest as calculated under this paragraph (d)(2) shall be used to determine all tax consequences related to tax basis (for example, loss limitation rules and the characterization of partnership distributions).

(3) *Special rules for S corporation shareholders that own interests in S corporations that own directly or indirectly stock of controlled foreign corporations or qualified electing funds.* If no election is made by a shareholder pursuant to paragraph (g) of this section, the basis increases provided in section 1367(a)(1)(A) to the shareholder for chapter 1 purposes that are attributable to amounts that an S corporation included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) for taxable years beginning after December 31, 2012, are not taken into account for purposes of section 1411. In such case, the shareholder's adjusted basis of stock in the S corporation is increased by the distributions to the S corporation from the controlled foreign corporation or qualified electing fund that are treated as dividends for purposes of section 1411 under paragraph (c)(2)(i) of this section. The amount of the basis increase is calculated based on the shareholder's pro rata share of the distribution received by the S corporation. Similar rules apply when the S corporation holds an interest in a controlled foreign corporation or qualified electing fund through a partnership. For purposes of determining net investment income under section 1411 and the regulations thereunder, the shareholder's adjusted

basis in the stock of the S corporation as calculated under this paragraph (d)(3) shall be used to determine all tax consequences related to tax basis (for example, loss limitation rules and the characterization of S corporation distributions).

(e) *Conforming adjustments to modified adjusted gross income and adjusted gross income*—(1) *Individuals*. Solely for purposes of section 1411(a)(1)(B)(i) and the regulations thereunder, the term *modified adjusted gross income* means modified adjusted gross income as defined in § 1.1411–2(c)(1)—

(i) Increased by amounts included in net investment income under paragraphs (c)(2)(i), (c)(2)(ii), (c)(3)(i), and (c)(5) of this section that are not otherwise included in gross income for chapter 1 purposes;

(ii) Increased or decreased, as applicable, by the difference between the amount calculated with respect to a disposition under paragraphs (c)(3)(iii) and (c)(3)(iv) of this section and the amount of the gain or loss attributable to the relevant disposition as calculated for chapter 1 purposes; and

(iii) Decreased by any amount included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) if no election is made pursuant to paragraph (g) of this section.

(2) *Estates and trusts*. Solely for purposes of section 1411(a)(2)(B)(i) and the regulations thereunder, the term *adjusted gross income* means adjusted gross income as defined in § 1.1411–3(a)(1)(ii)(B)(1) adjusted by the following amounts to the extent those amounts are not distributed by the estate or trust—

(i) Increased by amounts included in net investment income under paragraphs (c)(2)(i), (c)(2)(ii), (c)(3)(i), and (c)(5) of this section that are not otherwise included in gross income for chapter 1 purposes;

(ii) Increased or decreased, as applicable, by the difference between the amount calculated with respect to a disposition under paragraphs (c)(3)(iii) and (c)(3)(iv) of this section and the amount of the gain or loss attributable to the relevant disposition as calculated for chapter 1 purposes; and

(iii) Decreased by any amount included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) if no election is made pursuant to paragraph (g) of this section.

(f) *Application to estates and trusts*. All of the items described in paragraph (c) of this section shall be included in the net investment income of an estate or trust or its beneficiaries. The amounts described in paragraphs (e)(2)(i),

(e)(2)(ii), and (e)(2)(iii) of this section, regardless of whether the estate or trust receives those amounts directly or indirectly through another estate or trust, shall increase or decrease, as applicable, the estate's or trust's distributable net income. The estate or trust, or the beneficiaries thereof, shall take such amounts into account in a manner reasonably consistent with the general operating rules for estates and trusts in § 1.1411–3 and subchapter J in computing the undistributed net investment income of the estate or trust and the net investment income of the beneficiaries.

(g) *Election with respect to controlled foreign corporations and qualified electing funds*—(1) *In general*. An individual, estate, or trust may make an election under this paragraph (g) with respect to all interests in controlled foreign corporations and qualified electing funds held directly or indirectly by the individual, estate, or trust (other than as provided in paragraph (b) of this section) in the year of the election or acquired in subsequent years. The election, if made, for an estate or trust shall be made by the fiduciary of that estate or trust. If the election is made, amounts included in gross income under section 951(a) or section 1293(a)(1)(A) in taxable years beginning with the year for which the election is made are treated as net investment income for purposes of § 1.1411–4(a)(1)(i), and amounts included in gross income under section 1293(a)(1)(B) in taxable years beginning with the year for which the election is made are taken into account in calculating net gain attributable to the disposition of property under § 1.1411–4(a)(1)(iii).

(2) *Revocation of election*. An election under paragraph (g) of this section may only be revoked if the Commissioner, in the Commissioner's discretion, consents to the individual's, estate's, or trust's request to revoke the election.

(3) *Time and manner for making election*. Except as otherwise provided in this paragraph (g)(3), an individual, estate, or trust that wants to make the election under this paragraph (g) must make the election for the first taxable year beginning after December 31, 2013, during which the individual, estate, or trust directly or indirectly holds stock of a controlled foreign corporation or qualified electing fund and the individual, estate, or trust is subject to tax under section 1411 or would be subject to tax under section 1411 if the election were made with respect to the stock of the controlled foreign corporation or qualified electing fund. In addition, an individual, estate, or trust may make an election under this

paragraph (g)(3) for a taxable year that begins before January 1, 2014. In all cases, the election must be made in the manner prescribed by the Secretary on or before the due date, determined with regard to any extension of time, for filing the individual's, estate's, or trust's income tax return for the taxable year for which the election is made. Further, in all cases, once made, the election applies to the taxable year for which it is made and all subsequent years unless revoked pursuant to paragraph (g)(2) of this section.

(h) *Examples*. The following examples illustrate the rules of this section. In each example, unless otherwise indicated, the individuals, the foreign corporation (FC), the qualified electing fund (QEF), and the partnership (PRS) use a calendar taxable year. Further, the gross income or gain with respect to an interest in FC is not derived in a trade or business described in § 1.1411–5.

*Example 1.* (i) *Facts*. A, a U.S. citizen, is the sole shareholder of FC, a controlled foreign corporation (within the meaning of section 957). A is a United States shareholder (within the meaning of section 951(b)) with respect to FC. On December 31, 2012, A's basis in the stock of FC for chapter 1 purposes is \$500,000, which includes an increase to basis under section 961(a) of \$40,000. The amount of FC's earnings and profits that are described in section 959(c)(2) is \$40,000, the amount of FC's earnings and profits that are described in section 959(c)(3) is \$20,000, and FC does not have any earnings and profits that are described in section 959(c)(1). No election is made pursuant to paragraph (g) of this section. During 2013, A does not include any amounts in income under section 951(a) with respect to FC, A does not receive any distributions from FC, and there is no change in the amount of FC's earnings and profits. In 2014, A includes \$10,000 in gross income for chapter 1 purposes under section 951(a)(1)(A) with respect to FC. As a result, A's basis in the stock of FC for chapter 1 purposes increases by \$10,000 to \$510,000 pursuant to section 961(a). During 2015, FC distributes \$30,000 to A, which is not treated as a dividend for purposes of chapter 1 under section 959(d). As a result, A's basis in the stock of FC for chapter 1 purposes is decreased by \$30,000 to \$480,000 pursuant to section 961(b).

(ii) *Results for section 1411 purposes*. In 2014, A does not include the \$10,000 section 951(a) income inclusion in A's net investment income under section 1411(c)(1)(A)(i) and § 1.1411–4(a)(1)(i). Pursuant to paragraph (e)(1)(iii) of this section, A decreases A's modified adjusted gross income for section 1411 purposes by \$10,000 in 2014, and pursuant to paragraph (d)(1)(i) of this section, A's adjusted basis is not increased by \$10,000 and remains at \$500,000. In 2015, pursuant to paragraph (c)(2)(i) of this section, A includes \$10,000 of the distribution of previously taxed earnings and profits as a dividend for purposes of

determining A's net investment income because \$10,000 of the \$30,000 distribution is attributable to amounts that A included in gross income for chapter 1 purposes under section 951(a) in a tax year that began after December 31, 2012. Pursuant to paragraph (e)(1)(i) of this section, A increases A's modified adjusted gross income for section 1411 purposes by \$10,000 in 2015. Under paragraph (d)(1)(i) of this section, A's adjusted basis is not decreased by the \$10,000 that is treated as a dividend for section 1411 purposes, and thus, A's adjusted basis in FC for section 1411 purposes is decreased under section 961 only by \$20,000 to \$480,000.

**Example 2.** (i) *Facts.* Same facts as *Example 1.* In addition, during 2016, A includes \$15,000 in gross income for chapter 1 purposes under section 951(a)(1)(A) with respect to FC. As a result, A's basis in the stock of FC for chapter 1 purposes increases by \$15,000 to \$495,000 pursuant to section 961(a). During 2017, A sells all of A's shares of FC for \$550,000 and, prior to the application of section 1248, recognizes \$55,000 (\$550,000 minus \$495,000) of long-term capital gain for chapter 1 purposes. For purposes of calculating the amount included in income as a dividend pursuant to section 1248(a) for chapter 1 purposes, the earnings and profits of FC attributable to A's shares in FC which were accumulated after December 31, 1962 and during the period which A held the stock while FC was a controlled foreign corporation is \$55,000, \$35,000 of which is excluded pursuant to section 1248(d)(1). Therefore, after the application of section 1248, for chapter 1 purposes, upon the sale of the FC stock, A recognizes \$35,000 of long-term capital gain and a \$20,000 dividend.

(ii) *Results for section 1411 purposes.* (A) In 2016, A does not include the \$15,000 section 951(a)(1)(A) income inclusion in A's net investment income under section 1411(c)(1)(A)(i) and § 1411(c)(1)(A)(i). Pursuant to paragraph (e)(1)(ii) of this section, A decreases A's modified adjusted gross income for section 1411 purposes by \$15,000, and, pursuant to paragraph (d)(1)(i) of this section, A's adjusted basis remains at \$480,000.

(B) During 2017, prior to the application of section 1248, A recognizes \$70,000 (\$550,000 minus \$480,000) of gain for section 1411 purposes. Pursuant to paragraph (c)(4) of this section, for section 1411 purposes, section 1248(a) applies to the gain on the sale of FC calculated for section 1411 purposes (\$70,000) and section 1248(d)(1) does not apply, except with respect to the \$20,000 of earnings and profits of FC that are attributable to amounts previously included in income for chapter 1 purposes under section 951 for a taxable year beginning before December 31, 2012. Accordingly, for purposes of calculating the amount of income includible as a dividend under section 1248(a), A has \$55,000 of earnings and profits, \$20,000 of which is excluded pursuant to section 1248(d)(1). Therefore, after the application of section 1248, for section 1411 purposes A has \$35,000 of long term capital gain and a \$35,000 dividend. For purposes of calculating net investment income in 2016, A includes \$35,000 as a

dividend under section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i) and \$35,000 as a gain under section 1411(c)(1)(A)(iii) and § 1.1411-4(a)(1)(iii).

**Example 3.** (i) *Facts.* Same facts as *Example 2*, except that A timely makes an election pursuant to paragraph (g) of this section for 2014 (and thus for all subsequent years).

(ii) *Results for section 1411 purposes.* A does not have any adjustments to A's modified adjusted gross income for section 1411 purposes for 2014, 2015, 2016 or 2017 because the election under paragraph (g) of this section was timely made. Pursuant to paragraph (g)(1) of this section, for purposes of calculating A's net investment income in 2014, the \$10,000 that A included in income for chapter 1 purposes under section 951(a) is net investment income for purposes of section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i). A has no amount of net investment income with respect to FC in 2015. Pursuant to paragraph (g)(1) of this section, for purposes of calculating A's net investment income in 2016, the \$15,000 that A included in income for chapter 1 purposes under section 951(a) is net investment income for purposes of section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i). For purposes of calculating A's net investment income in 2017, the amount of gain on the disposition of the FC shares is the same as the amount calculated for chapter 1 purposes. Applying section 1248, A includes \$35,000 as a gain under section 1411(c)(1)(A)(iii) and § 1.1411-4(a)(1)(iii), and \$20,000 as a dividend under section 1411(c)(1)(A)(i) and § 1.1411-4(a)(1)(i).

**Example 4.** *Domestic partnership holding QEF stock.* (i) *Facts.* (A) C, a U.S. citizen, owns a 50 percent interest in PRS, a domestic partnership. D, a U.S. citizen, and E, a U.S. citizen, each own a 25 percent interest in PRS. All allocations of partnership income and losses are pro rata based on ownership interests. PRS owns an interest in QEF, a foreign corporation that is a passive foreign investment company (within the meaning of section 1297(a)). PRS, a United States person, made an election under section 1295 with respect to QEF applicable to the first year of its holding period in QEF. As of December 31, 2012, for chapter 1 purposes, C's basis in his partnership interest is \$100,000, D's basis in his partnership interest is \$50,000, E's basis in his partnership interest is \$50,000, and PRS's adjusted basis in its QEF stock is \$80,000, which includes an increase in basis under section 1293(d) of \$40,000. As of December 31, 2012, the amount of QEF's earnings that have been included in income by PRS under section 1293(a), but have not been distributed by QEF, is \$40,000. PRS also has cash of \$60,000 and domestic C corporation stock with an adjusted basis of \$60,000. During 2013, PRS does not include any amounts in income under section 1293(a) with respect to QEF, PRS does not receive any distributions from QEF, and there are no adjustments to the basis of C, D, or E in their interests in PRS.

(B) During 2014, PRS has income of \$40,000 under section 1293(a) with respect to QEF and has no other partnership income. C makes an election under paragraph (g) of this

section, and D and E do not make an election under paragraph (g) of this section.

(C) During 2015, QEF distributes \$60,000 to PRS. PRS has no income for the year.

(ii) *Results for 2014.* (A) For chapter 1 purposes, as a result of the \$40,000 income inclusion under section 1293(a), PRS's basis in its QEF stock is increased by \$40,000 under section 1293(d)(1) to \$120,000. Under § 1.1293-1(c)(1) and section 702, C's, D's, and E's distributive shares of the section 1293(a) income inclusion are \$20,000, \$10,000, and \$10,000, respectively. Under section 705(a)(1)(A), C increases his adjusted basis in his partnership interest by \$20,000 to \$120,000, and D and E each increase his adjusted basis in his partnership interest by \$10,000 to \$60,000.

(B) For section 1411 purposes, pursuant to paragraph (d)(1)(ii) of this section, PRS's basis in QEF is not increased by the \$40,000 income inclusion (it remains at \$80,000). Because C made an election under paragraph (g) of this section, C has net investment income of \$20,000 as a result of the income inclusion, and his adjusted basis in his interest in PRS is increased by \$20,000 to \$120,000. C does not make any adjustments to his modified adjusted gross income. Because D and E did not make an election under paragraph (g) of this section, D and E do not have net investment income with respect to the income inclusion, and pursuant to paragraph (d)(2) of this section, they do not increase their adjusted bases in their interests in PRS (each remains at \$50,000). Pursuant to paragraph (e)(1)(ii) of this section, D and E each reduce their modified adjusted gross income by \$10,000.

(iii) *Results for 2015.* (A) For chapter 1 purposes, the distribution of \$60,000 from QEF to PRS is not a dividend under section 1293(c), and PRS decreases its basis in QEF by \$60,000 under section 1293(d)(2) to \$60,000.

(B) Pursuant to paragraph (c)(2)(i) of this section, \$40,000 of the distribution is a dividend for section 1411 purposes because PRS included \$40,000 in gross income for chapter 1 purposes under section 1293(a) in a tax year that began after December 31, 2012. For section 1411 purposes, pursuant to paragraph (d)(1)(ii) of this section, section 1293(d) will not apply to reduce PRS's basis in QEF to the extent of the \$40,000 of the distribution that is treated as a dividend under paragraph (c)(2)(i) of this section. Thus, PRS's basis in QEF is decreased only by \$20,000 for purposes of section 1411 and is \$60,000. The \$40,000 distribution of previously taxed earnings and profits that is treated as a dividend for section 1411 purposes is allocated \$20,000 to C, \$10,000 to D, and \$10,000 to E. Because C made an election under paragraph (g) of this section, C has zero net investment income as a result of the distribution of previously taxed amounts of \$20,000, his adjusted basis in his interest in PRS remains at \$120,000, and he does not make any adjustments to his modified adjusted gross income. Because D and E did not make an election under paragraph (g) of this section, pursuant to paragraph (c)(2)(i) of this section, D and E each has \$10,000 of net investment income as a result of the distribution by QEF, and

pursuant to paragraph (d)(2) of this section, D and E each increases his adjusted basis in PRS by \$10,000 to \$60,000. Pursuant to paragraph (e)(1)(i) of this section, D and E each increases his modified adjusted gross income by \$10,000.

*Example 5. Sale of partnership interest.* (i) *Facts.* Same facts as *Example 4*. In addition, in 2016, D sells his entire interest in PRS to F for \$100,000.

(ii) *Results for 2016.* For chapter 1 purposes, D has a gain of \$40,000 (\$100,000 minus \$60,000). For section 1411 purposes, D has a gain of \$40,000 (\$100,000 minus \$60,000), and thus, has net investment income of \$40,000. No adjustments to modified adjusted gross income are necessary under paragraph (e) of this section.

*Example 6. Domestic partnership's sale of QEF stock.* (i) *Facts.* Same facts as *Example 4*. In addition, in 2016 PRS has income of \$60,000 under section 1293(a) with respect to QEF, and in 2017, PRS sells its entire interest in QEF for \$170,000.

(ii) *Results for 2016.* (A) For chapter 1 purposes, as a result of the \$60,000 income inclusion under section 1293(a), PRS's basis in its QEF stock is increased by \$60,000 under section 1293(d)(1) to \$120,000. Under § 1.1293-1(c)(1) and section 702, C's, D's, and E's distributive shares of the section 1293(a) income inclusion are \$30,000, \$15,000, and

\$15,000 respectively. Under section 705(a)(1)(A), C increases his adjusted basis in his partnership interest by \$30,000 to \$150,000, and D and E each increases his adjusted basis in his partnership interest by \$15,000 to \$75,000.

(B) For section 1411 purposes, pursuant to paragraph (d)(1)(ii) of this section, PRS's basis in QEF is not increased by the \$60,000 income inclusion (it remains at \$60,000). Because C made an election under paragraph (g) of this section, C has net investment income of \$30,000 as a result of the income inclusion, and his adjusted basis in his interest in PRS is increased by \$30,000 to \$150,000. C does not make any adjustments to his modified adjusted gross income. Because D and E did not make an election under paragraph (g) of this section, D and E do not have net investment income with respect to the income inclusion, and pursuant to paragraph (d)(2) of this section, they do not increase their adjusted bases in their interests in PRS (each remains at \$60,000). Pursuant to paragraph (e)(1)(ii) of this section, D and E each reduce their modified adjusted gross income by \$15,000.

(iii) *Results for 2017.* (A) For chapter 1 purposes, PRS has a gain of \$50,000 (\$170,000 minus \$120,000), which is allocated 50 percent (\$25,000) to C, 25

percent (\$12,500) to D, and 25 percent (\$12,500) to E.

(B) Based on PRS's basis in the stock of QEF for section 1411 purposes, PRS has a gain for section 1411 purposes of \$110,000 (\$170,000 minus \$60,000), which in the absence of a partner election under paragraph (g) of this section, would result in gain of \$55,000 to C, \$27,500 to D, and \$27,500 to E. However, pursuant to paragraph (d)(1)(ii) of this section, because C made an election under paragraph (g) of this section, C's gain for section 1411 purposes is the same as his gain for chapter 1 purposes (\$25,000). Because neither D nor E made an election under paragraph (g) of this section, D and E each have a gain of \$27,500 and therefore net investment income of \$27,500. Pursuant to paragraph (e)(1)(ii) of this section, D and E each increase their modified adjusted gross income by \$15,000.

(i) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013.

**Steven T. Miller,**

*Deputy Commissioner for Services and Enforcement.*

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