FEDERAL REGISTER

Vol. 78 Monday,
No. 231 December 2, 2013

Part V

Department of the Treasury

Internal Revenue Service

26 CFR Parts 1 and 602

Net Investment Income Tax; Final and Proposed Rules

DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Parts 1 and 602

[TD 9644]

RIN 1545–BK44

Net Investment Income Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

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

DATES: *Effective Date:* These regulations are effective on December 2, 2013.

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

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

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

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

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

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

Background

I. In General

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

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

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

Public comments on the 2012 proposed regulations identified two issues that the IRS and the Treasury Department will study further and on which the IRS and the Treasury Department request additional comments. Those issues, the treatment of accumulation distributions from foreign trusts and material participation of estates and trusts, are discussed in parts 4.D and 4.F of this preamble, respectively. Comments on those issues should be submitted in writing by March 3, 2014, and can be mailed to the Office of Associate Chief Counsel (Passthroughs and Special Industries), Re: REG–130507–11—Estates/Trusts, CC:PSI:B02, Room 5011, 1111 Constitution Avenue NW., Washington, DC 20224. All comments received will be available for public inspection at *www.regulations.gov* (IRS REG–130507–11).

II. Statutory Provisions

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

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

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 1.1411–3 of the final regulations provides guidance on the computation of the net investment income tax for estates and trusts.

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 that are properly allocable to such gross income or net gain. Sections 1.1411–4 and 1.1411–10 of the final regulations provide guidance on the calculation of net investment income under section 1411(c)(1).

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)). Section 1.1411–5 of the final regulations provides guidance on the trades or businesses described in section 1411(c)(2).

Section 1411(c)(3) provides that 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. Section 1.1411–6 of the final regulations provides guidance on working capital under 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 that 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. Section 1.1411–7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.

Section 1411(c)(5) provides that 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 1.1411–8 of the final regulations provides guidance on distributions from qualified plans under section 1411(c)(5).

Section 1411(c)(6) provides that 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 1.1411–9 of the final regulations provides guidance regarding self-employment income under section 1411(c)(6).

Summary of Comments and Explanation of Provisions

The Treasury Department and the IRS received numerous written and electronic comments regarding the proposed regulations. The comments included requests for clarification and recommendations relating to: (1) the calculation of net investment income; (2) the treatment of several special types of trusts; (3) the interaction between various aspects of section 469 and the regulations thereunder with the calculation of net investment income; (4) the method of gain calculation regarding a sale of an interest in a partnership or S corporation; and (5) multiple areas where the proposed regulations could be simplified. After consideration of all of the comments, the proposed regulations are adopted as amended by this Treasury decision. In general, the final regulations follow the approach of the proposed regulations with some modifications in response to comments and questions that have arisen with respect to the application of the proposed regulations. This preamble describes comments received by the Treasury Department and the IRS on the most significant issues.

1. Comments of General Applicability

A. Confirmation in the Regulation Text of Certain Statements Made in the Preamble

The Treasury Department and the IRS received a number of comments noting that some of the rules set forth in the preamble were not contained in the regulation text itself. In response to these comments, the final regulations provide additional guidance within the regulation text. For example, § 1.1411–1(d) of the final regulations contains additional guidance related to various definitions applicable to multiple sections of the regulations, which had appeared only in the preamble to the proposed regulations. In addition, the final regulations contain supplemental clarifications and examples.

In addition, one commentator stated that the preamble to the proposed regulations acknowledges that certain types of income may not be subject to tax under section 1411, even if such income is not explicitly excepted from the tax under section 1411(c)(1)(A)(i) or (c)(1)(A)(iii), or is earned in a trade or business that is not a passive activity or in a trade or business of trading in financial instruments or commodities. Multiple commentators suggested that the final regulations confirm that there are types of income that are not included in net investment income. One commentator suggested the best way to illustrate principles of income that is not net investment income is inclusion of one or more examples of income not subject to tax under section 1411. Another commentator requested that the final regulations include a non-exhaustive list of items of income that are not net investment income.

The final regulations do not provide a list of income or deduction items that are excluded from the calculation of net investment income. However, the final regulations provide, in certain instances, additional guidance on items of income that are or are not included in net investment income. For example, pursuant to one comment asking whether distributions from foreign pension plans are included in net investment income, the definition of ‘‘annuity’’ in § 1.1411–1(d) of the final regulations clarifies that the term annuities, as used in section 1411(c) and § 1.1411–4, does not include amounts paid in consideration for services rendered even if such amounts are subject to the rules of section 72. This is consistent with United States income tax treaties that prescribe one set of rules for ‘‘annuities’’ that are not paid in exchange for services, but another set of rules for pension distributions paid in the form of an annuity. See, for example, paragraphs 1 and 3 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) of the 2006 United States Model Income Tax Convention. In addition, the final regulations provide examples of items excluded from net investment income in § 1.1411–1(d)(4).

Furthermore, these final regulations, as with the notice of proposed rulemaking, re-confirm the application of chapter 1 provisions in the absence of special rules for purposes of the net investment income tax. The Treasury Department and the IRS may issue other guidance in the future, as necessary, to address the treatment of particular income items whose treatment is not apparent from the general rules of section 1411 and these final regulations or from chapter 1.

B. Section 1411 and Estimated Taxes

Two commentators stated that, because many investors do not know until the end of the year if a passthrough investment will generate net investment income for that year, the Treasury Department and the IRS should not penalize taxpayers for failure to include net investment income in their calculation of estimated tax payments. One commentator suggested that the estimated tax calculation fully exempt the tax imposed by section 1411. Another commentator urged the Treasury Department and the IRS to grant penalty relief for failure to pay the appropriate estimated tax payments due to the impact of section 1411.

Section 1402(a)(2) of the HCERA 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. To assist taxpayers with their compliance obligations for taxable years beginning after December 31, 2012, the notice of proposed rulemaking extended reliance upon the proposed regulations for this first taxable year in which section 1411 was in effect. Although the Treasury Department and IRS recognize that the actual tax liability of a taxpayer may not be known at the time that an estimated tax payment is due, a similar issue is present for chapter 1 purposes. Moreover, taxpayers subject to estimated tax payments may not be subject to a penalty under certain circumstances. See section 6654(b). After consideration of these comments, the Treasury Department and IRS decline to extend penalty relief.

C. Availability of Tax Credits To Reduce Section 1411 Tax

The Treasury Department and the IRS received comments asking whether foreign income, war profits, and excess profits taxes (''foreign income taxes'') are allowed under sections 27(a) and 901 as a credit against the section 1411 tax. Under the express language of sections 27(a) and 901(a), foreign income taxes are not creditable against United States taxes other than those imposed by chapter 1 of the Code. Section 1.1411–1(e) of the final regulations clarifies that amounts that are allowed as credits only against the tax imposed by chapter 1 of the Code, including credits for foreign income taxes, may not be credited against the section 1411 tax, which is imposed by chapter 2A of the Code. This limitation is similar to the limitation applicable to a number of other credits that are allowed only against the tax imposed by chapter 1 of the Code. See, for example, section 38.

The Treasury Department and the IRS also received comments asking whether United States income tax treaties may provide an independent basis to credit foreign income taxes against the section 1411 tax. The Treasury Department and the IRS do not believe that these regulations are an appropriate vehicle for guidance with respect to specific treaties. An analysis of each United States income tax treaty would be required to determine whether the United States would have an obligation under that treaty to provide a credit against the section 1411 tax for foreign income taxes paid to the other country. If, however, a United States income tax treaty contains language similar to that in paragraph 2 of Article 23 (Relief from Double Taxation) of the 2006 United States Model Income Tax Convention, which refers to the limitations of United States law (which include sections 27(a) and 901), then such treaty would not provide an independent basis for a credit against the section 1411 tax.

2. Comments Regarding Regrouping Under Section 469

Section 1.469–4(e)(1) provides that, except as provided in §§ 1.469–4(e)(2) and 1.469–11, after a taxpayer has grouped activities, the taxpayer may not regroup those activities in subsequent taxable years. The preamble to the proposed regulations acknowledged that the enactment of section 1411 may cause taxpayers to reconsider their previous grouping determinations.

The proposed regulations provided taxpayers an opportunity to regroup their activities in the first taxable year beginning after December 31, 2012, in which: (1) the taxpayer met the applicable income threshold under section 1411, and (2) had net investment income. The determination in the preceding sentence was to be made without regard to the effect of the regrouping. Pursuant to proposed § 1.469–11(b)(3)(iv)(A), a taxpayer may regroup his or her activities once, and any such regrouping applies to the taxable year for which the regrouping is made and all subsequent years. Furthermore, the disclosure requirements of § 1.469–4(e) and Revenue Procedure 2010–13 (2010–1 CB 329) require taxpayers who regroup their activities pursuant to proposed § 1.469–11(b)(3)(iv) to report their regroupings to the IRS.

The Treasury Department and the IRS received several comments regarding proposed amendments to § 1.469–11(b)(3)(iv). One commentator suggested that all individuals, trusts, and estates—regardless of whether they have net investment income or modified adjusted gross income above the threshold—be permitted a ''fresh start'' with respect to their section 469 groupings. The commentator stated that restricting the fresh start only to taxpayers subject to section 1411 places lower income taxpayers at a disadvantage. In addition, multiple commentators recommended that S corporations and partnerships be permitted to change their groupings in light of the application of section 1411 for any tax year that begins during 2013 or 2014. These commentators acknowledged that section 1411 does not apply to partnerships and S corporations directly, but stated that the Treasury Department and the IRS have regulatory authority to allow these entities to change the groupings reported to their owners and that the disclosure required under Revenue Procedure 2010–13 may operate to improve tax administration in this complex area.

Multiple commentators suggested that, in the case of a failure to make regrouping elections in 2013 or 2014, the final regulations should allow taxpayers to make their regrouping election on an amended return. These commentators noted that denying regrouping on an amended return where there is an adjustment to income after a return has been filed may be unfair.

The final regulations retain the requirement that regrouping under § 1.469–11(b)(3)(iv) may occur only during the first taxable year beginning after December 31, 2012, in which (1) the taxpayer meets the applicable income threshold under section 1411, and (2) has net investment income. The Treasury Department and the IRS believe that the interaction between section 1411 and section 469 justifies the section 1411 regrouping rule, and that, if a taxpayer does not have a section 1411 tax liability, the reason for allowing the regrouping does not apply. The Treasury Department and the IRS acknowledge that, in the case of regrouping elections by partnerships and S corporations, one commentator's implied assertion is correct that imposition of section 1411 on a passthrough entity's owner(s) is the same change in law that precipitated the proposed regulation's allowance of regrouping in the first instance. However, if the Treasury Department and the IRS were to expand the scope of the regulations to allow regrouping by partnerships and S corporations, then taxpayers with no tax liability under section 1411 indirectly would be allowed to regroup. Accordingly, the final regulations do not adopt this suggestion.

However, after considering the comments, the Treasury Department and the IRS agree with the commentators' concerns regarding the potential unfairness to taxpayers who become subject to section 1411 after adjustments to, for example, income or deduction items after an original return has been filed. Therefore, the final regulations allow a taxpayer to regroup under § 1.469–11(b)(3)(iv) on an amended return, but only if the taxpayer was not subject to section 1411 on his or her original return (or previously amended return), and if, because of a change to the original return, the taxpayer owed tax under section 1411 for that taxable year. This rule applies equally to changes to modified adjusted gross income or net investment income upon an IRS examination. However, if a taxpayer regroups on an original return (or previously amended return) under these rules, and then subsequently determines that the taxpayer is not subject to section 1411 in that year, such regrouping is void in that year and all subsequent years until a valid regrouping is done. The voiding of the regrouping may cause additional changes to the taxpayer's current year return and may warrant corrections to future year returns to restore the taxpayer's original groupings. The final regulations contain two exceptions to such voided elections. First, the final regulations allow a taxpayer to adopt the voided grouping in a subsequent year without filing an amended return if the taxpayer is subject to section 1411 in such year. Second, if the taxpayer is subject to section 1411 in a subsequent year, the taxpayer may file an amended return to regroup in a manner that differs from the previous year's voided regrouping. The final regulations provide four new examples on the amended return regrouping rules. Furthermore, § 1.1411–2(a)(2)(iii) of the final section 1411 regulations also contains a similar rule applicable to section 6013(g) elections.

3. Comments Regarding the Application of Section 1411 to Individuals

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 provided that the term *individual* for purposes of section 1411 is any natural person, except for natural persons who are nonresident aliens. The final regulations retain this position.

A. Dual Resident Individuals

During the consideration of comments concerning the application of section 1411 to foreign individuals, the Treasury Department and the IRS considered how section 1411 applies to a dual-resident individual, within the meaning of § 301.7701(b)–7(a)(1), who determines that he or she is a resident of a foreign country for tax purposes pursuant to an income tax treaty between the United States and that foreign country and claims benefits of the treaty as a nonresident of the United States. Consistent with § 301.7701(b)–7(a)(1), which provides that such an individual will be treated as a nonresident alien of the United States for purposes of computing that individual's United States income tax liability, the final regulations provide that the individual is treated as a nonresident for purposes of section 1411.

B. Dual-Status Individuals

The Treasury Department and the IRS also considered how section 1411 should apply to a dual-status individual who is a resident of the United States for part of the year and a nonresident for the other part of the year. The Treasury Department and the IRS believe that a dual-status resident should be subject to section 1411 only with respect to the portion of the year during which the individual is a United States resident, and the final regulations clarify this. However, consistent with the rule for taxable years of less than 12 months in § 1.1411–2(d)(2), the threshold amount under § 1.1411–2(d)(1) is not reduced or prorated for a dual-status resident. The Treasury Department and the IRS may reconsider this rule if taxpayers are applying it inappropriately.

C. Section 6013(h) Elections

During the consideration of comments concerning the application of section 1411 to foreign individuals, the Treasury Department and the IRS considered whether the final regulations should provide an election with respect to section 6013(h) that is similar to the election that § 1.1411–2(a)(2)(i)(B) of the proposed regulations provided for section 6013(g). Section 6013(h) allows a dual-status individual who is a nonresident alien at the beginning of any taxable year but at the close of such taxable year is a United States resident, and who is married to a United States citizen or resident, to make a joint election with his or her spouse to be treated as a United States resident for purposes of chapters 1 and 24 for such taxable year. The Treasury Department and the IRS believe that such an election is appropriate. Accordingly, § 1.1411–2(a)(2)(iv)(B) of the final regulations provides that a dual-status individual who makes a section 6013(h) election with his or her spouse for purposes of chapters 1 and 24 also may make a section 6013(h) election for purposes of chapter 2A. 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 United States citizen or resident spouse and the dual-status spouse in the section 1411(a)(1) calculation and subject the income of both spouses to the $250,000 threshold amount in section 1411(b)(1) for taxpayers filing a joint return. Section 1.1411–2(a)(2)(iv)(B)(*2*) of the final regulations provides procedural requirements for making this election.

If the spouses do not make a section 6013(h) election for purposes of chapter 2A (whether or not they make the election for purposes of chapters 1 and 24), the final regulations require each spouse to determine his or her own net investment income and modified adjusted gross income (MAGI), and subjects each spouse to the $125,000 threshold amount for spouses filing separately. Consistent with the rule for taxable years of less than 12 months in § 1.1411–2(d)(2), the threshold amount under § 1.1411–2(d)(1) is not reduced or prorated in the case of the dual-status resident spouse for the portion of the year that he or she is treated as a United States resident. The Treasury Department and the IRS may reconsider this rule if taxpayers are applying it inappropriately.

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

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

A. Exclusion of Certain Estates and Trusts From the Application of Section 1411

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

i. Pooled Income Funds (PIFs)

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

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

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

ii. Cemetery Perpetual Care Funds

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

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

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

iii. Electing Alaska Native Settlement Trusts (ANSTs)

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

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

Commentators further explained that the statutory framework for the taxation of ANSTs reflects important policy considerations relating to the beneficiaries of ANSTs, which were expressed in the Congressional findings and declaration of policy in the Alaska Native Claims Settlement Act (Public Law 92–203, 85 Stat. 688) (''ANCSA''). See 43 U.S.C. 1601. The commentators said that those policies include the following: Alaska Natives have long been recognized as being among the poorest inhabitants of our nation, with poverty rates significantly higher than the national average; ANSTs are not vehicles wealthy individuals might use to avoid the reach of section 1411 by employing a trust to reinvest investment income rather than making distributions; rather, ANSTs are entities created to provide for ''the real economic and social needs of Natives'' by making distributions and/or reinvesting trust income to grow the trust to better provide for the future needs of its beneficiaries.

The Treasury Department and the IRS agree with the commentators that ANSTs should not be subject to section 1411, and that this exclusion is consistent with the chapter 1 taxation of these entities at the lowest individual tax rate. Therefore, the final regulations modify § 1.1411–3(b)(1) to exclude from section 1411 all ANSTs that have made an election under section 646.

iv. Qualified Funeral Trusts (QFTs) Taxable Under Section 685

One commentator stated that it was illogical for section 1411 to apply to QFTs because Congress intended to impose section 1411 on ''private trusts,'' which high-income individuals often establish as vehicles for the management and intergenerational transfer of wealth. Another commentator stated that there is no administrative reason why QFTs should not be treated the same as other trusts for purposes of section 1411.

Three commentators noted that a QFT's regular tax liability is calculated on a per-contract basis and then consolidated into a single return. Specifically, section 685(c) provides that the tax imposed on the QFT is calculated by treating each beneficiary's interest in his or her contract as a separate trust. The commentators stated that, because the individual contracts are generally under $10,000, the annual investment income on them likewise is generally well under $10,000. Thus, as a practical matter, the commentators believed that QFTs would not incur this tax (due to the investment income on each contract being below the section 1411(a)(2)(B)(ii) threshold amount).

The final regulations do not exclude QFTs from the application of the net investment income tax. However, the final regulations do confirm that the calculation of the section 1411 tax will be consistent with the taxation of QFTs in chapter 1. As a result, § 1.1411–3(b)(2)(i) of the final regulations provides that the section 1411 is applied to the QFT by treating each beneficiary's interest in that beneficiary's contract as a separate trust.

v. Charitable Purpose Estates

Section 1411(e)(2) and proposed § 1.1411–3(b)(1) exclude 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) (referred to as ''Charitable Purpose Trusts''). The final regulations retain this rule in § 1.1411–3(b)(1).

One commentator pointed out that proposed § 1.1411–3(d) does not have an exclusion comparable to proposed § 1.1411–3(b)(1) to exempt an estate all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B) (referred to as ''Charitable Purpose Estates''). The commentator noted that, although Charitable Purpose Trusts are statutorily exempt from the net investment income tax, Charitable Purpose Estates are subject to section 1411 but may achieve the same result through the use of the charitable deduction in section 642(c). Thus, through the operation of provisions outside of section 1411, it is expected that Charitable Purpose Estates typically will not have a section 1411 tax liability.

The commentator also pointed out that a Charitable Purpose Estate's need to rely on the section 642(c) deduction to achieve this result (and thus, this inconsistency between Charitable Purpose Trusts and Charitable Purpose Estates) could have an inadvertent and adverse impact on both Charitable Purpose Estates and Charitable Purpose Trusts for chapter 1 purposes—specifically, on their decision to make an election under section 645 (a ''645 Election''). Section 645 was enacted to eliminate the differences in income tax treatment between the disposition of a decedent's property by will (through an estate) and by a revocable trust (that becomes irrevocable on the decedent's death). See H.R. Rep. No. 148, 105th Cong., 1st Sess. 618 (1997).

Assuming a wholly-charitable disposition by a decedent, the commentator stated that a trustee of the decedent's formerly revocable trust and the executor of the related estate would normally join in a 645 Election to minimize the cost and burden of administration and to achieve consistency in the income tax treatment of the estate and trust. However, unless an estate and trust have the same exemption from section 1411, the trustees of a Charitable Purpose Trust may be reluctant to join in an otherwise useful election.

The Treasury Department and the IRS agree with the commentator's recommendation. Given that, whether under section 1411(e)(2) or section 642(c), no section 1411 tax is imposed on a wholly charitable trust or estate, respectively, the Treasury Department and the IRS believe it is consistent with the Congressional intent of both section 1411 and section 645 to treat both types of entities as exempt from section 1411. Accordingly, § 1.1411–3(b)(1) of the final regulations excludes from the application of section 1411 an estate in which all of the unexpired interests are devoted to one or more of the purposes described in section 170(c)(2)(B).

B. Application of Section 1411 To Electing Small Business Trusts (ESBTs)

The proposed regulations preserved the chapter 1 treatment of the ESBT as two separate trusts for computational purposes but consolidated the ESBT into a single trust for determining the adjusted gross income threshold in section 1411(a)(2)(B)(ii). This is consistent with the chapter 1 treatment of ESBTs, which are entitled to only a single personal exemption, rather than one per ESBT portion, notwithstanding the fact that the income for each portion is computed separately. Moreover, this rule in the proposed regulations put ESBTs on the same footing as other taxable trusts by applying a single section 1(e) threshold to ESBTs similar to other taxable trusts. Proposed § 1.1411–3(c)(1)(ii) described the method to determine the ESBT's section 1411 tax base. First, the ESBT separately calculates 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 then combines the undistributed net investment income of the S portion and the non-S portion. Second, the ESBT determines its adjusted gross income, solely for purposes of section 1411, by adding the net income or net loss from the S portion to the adjusted gross income of the non-S portion as a single item of income or loss. Finally, to determine whether the ESBT is subject to section 1411, the ESBT compares the combined undistributed net investment income with the excess of its adjusted gross income over the section 1(e) threshold.

One commentator challenged the authority of the Treasury Department and the IRS to issue regulations that require the use of chapter 1's separate trust treatment of the S portion and non-S portion of an ESBT for purposes of section 1411. The commentator also stated that the lack of any mention of ESBTs in section 1411 or its legislative history means that there is no regulatory authority for the treatment of an ESBT as detailed in the proposed regulations.

The preamble to the proposed regulations stated, in relevant part, that ''[s]ection 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, the preamble also stated that ''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).'' The Treasury Department and the IRS believe that the ESBT regulations under section 1411, which generally conform to the chapter 1 framework but with certain modifications needed for section 1411 compliance purposes, fall well within the general regulatory authority pursuant to section 7805.

Two other commentators addressed the inability to offset net investment income losses (capital, ordinary, and/or passive) from one portion of the ESBT with net investment income from the other portion. The commentators recommended that, if one portion has income or a net capital gain and the other has a net capital loss, the ESBT should be able to offset one against the other in the same manner as a non-ESBT nongrantor trust. Both commentators focused on the annual calculation of net investment income, but neither addressed the potential problems from allowing income and losses to offset: (1) loss duplication in carryover years (because loss would offset gain across portions in year 1 and also be a carryover to year 2 within the originating portion), or (2) differences in loss carryforwards for purposes of chapters 1 and 2A.

The Treasury Department and the IRS agree with the commentators' observations that the method of consolidation in the proposed regulations, in certain instances, may put ESBTs at a computational disadvantage, from a section 1411 perspective, to similarly situated nongrantor trusts in the case of netting of income and losses. However, this computational disadvantage exists with regard to the tax imposed under chapter 1, and the rules regarding ESBTs (and the final regulations generally) adopt chapter 1 principles. The Treasury Department and the IRS believe a full integration of the S portion and non-S portion into a single trust for purposes of section 1411 is administratively burdensome to both taxpayers and the IRS because it would cause the section 1411 calculations to deviate significantly from the calculations for purposes of chapter 1, resulting in the need for additional rules to address the computational differences and treatment of separate carryover regimes. For example, a full integration of the S and non-S portion would allow passive income and passive losses from each portion to offset each other, which would result in different loss carryforwards for regular tax and section 1411 purposes. A similar outcome would occur if capital gains and losses could offset between the portions in a manner inconsistent with chapter 1. Therefore, the final regulations retain the calculation of an ESBT's undistributed net investment income and modified adjusted gross income without change, but have relocated the operative ESBT rules to § 1.1411–3(c).

One commentator recommended that the final regulations clarify that, when an ESBT disposes of S corporation stock, the rules under §§ 1.641(c)–1(d)(3) and 1.1361–1(m)(5)(ii) that permit the use of the installment method on the sale or disposition of stock in an S corporation by an ESBT, also should apply for purposes of section 1411. The Treasury Department and the IRS believe that the general administrative principles enumerated in § 1.1411–1(a) accomplish this result for section 1411 purposes. Accordingly, a special rule within § 1.1411–3(c) is not necessary to achieve what the commentator requested.

C. Application of Section 1411 to Charitable Remainder Trusts (CRTs)

The proposed regulations provided special computational rules for the classification of the income of and the distributions from charitable remainder trusts, solely for section 1411 purposes. Proposed § 1.1411–3(c)(2)(i) provided that distributions from a CRT 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 CRT. Proposed § 1.1411–3(c)(2)(iii) defined the term *accumulated net investment income* (ANII) as the total amount of net investment income received by a CRT 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.

The Treasury Department and the IRS acknowledged in the preamble to the proposed regulations that the classification of income as net investment income or non-net investment income would be separate from, and in addition to, the four tiers under section 664(b), which would continue to apply for chapter 1 purposes. The Treasury Department and the IRS also stated in the preamble that they considered an alternative method for determining the distributed amount of net investment income under which net investment income would be determined on a class-by-class basis within each of the § 1.664–1(d)(1) enumerated categories. The Treasury Department and the IRS acknowledged that, although differentiating between net investment income and non-net investment income within each class and category might be more consistent with the structure created for CRTs by section 664 and the corresponding regulations, the Treasury Department and the IRS were concerned that the apparent recordkeeping and compliance burden on trustees would outweigh the benefits of this alternative.

Multiple commentators asked that the final regulations follow the existing rules under section 664 that create subclasses in each category of income as the tax rates on certain types of income are changed from time to time. They said that CRT trustees are already maintaining the appropriate records and are familiar with the existing rules, so compliance would be less complicated than under the new system described in the proposed regulations. Some of the commentators suggested that the final regulations allow the trustee to elect between the method described in the proposed regulations and the existing rules under section 664.

Section 1.1411–3(d)(2) of the final regulations adopts the commentators' request to categorize and distribute net investment income based on the existing section 664 category and class system. The provisions of § 1.1411–3(d)(2), as discussed in this preamble, will apply to taxable years of CRTs that begin after December 31, 2012, provided however that, for CRTs that relied on the proposed regulations for returns filed before the publication of these final regulations in the **Federal Register**, the CRT and its beneficiary (as applicable) do not have to amend their returns to comply with rules set forth in these final regulations. For such a CRT, when transitioning from the method in the proposed regulations to the method in these final regulations, the CRT may use any reasonable method to allocate the remaining undistributed net investment income for that year to the categories and classes under section 664.

The final regulations retain the concept of ANII. ANII is defined 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. The final regulations apply the section 664 category and class system to ANII by providing that the Federal income tax rate applicable to an item of ANII, for purposes of allocating that item of ANII to the appropriate class within a category of income as described in § 1.664–1(d)(1), is the sum of the income tax rate imposed on that item under chapter 1 and the rate of the tax imposed under section 1411. Thus, if a charitable remainder trust has both excluded income (such as income received by the trust prior to January 1, 2013, or other income received after December 31, 2012, but excluded from net investment income) and ANII in an income category, such excluded income and ANII will constitute separate classes of income for purposes of § 1.664–1(d)(1)(i)(b).

The Treasury Department and the IRS believe special rules are necessary to apply the section 664 category and class system contained in § 1.664–1(d) to certain distributions made to charitable remainder trusts that own interests in CFCs and PFICs not making the § 1.1411–10(g) election to account for the difference between the income inclusion for chapter 1 and for section 1411 purposes. Accordingly, the final regulations reserve paragraph § 1.1411–3(d)(2)(ii) for special rules in this case. The companion notice of proposed rulemaking (REG–130843–13) contains special rules relating to CFCs and PFICs and are proposed to be effective for tax years beginning after December 31, 2013.

The final regulations reserve paragraph § 1.1411–3(d)(3) for rules allowing the CRT to elect between the simplified method contained in the proposed regulations and the section 664 method contained in these final regulations. The companion notice of proposed rulemaking (REG–130843–13) provides rules to enable a CRT to choose between the simplified method described in the proposed regulations (with the modification noted in the companion notice) and the existing rules under section 664. The rules contained in the companion proposed regulation are proposed to be effective for taxable years beginning after December 31, 2012.

D. Application of Section 1411 to Foreign Estates and Trusts

Section 1411 does not address specifically the treatment of foreign estates and foreign nongrantor trusts. Proposed §§ 1.1411–3(d)(2)(i) and 1.1411–3(b)(6) provided, as a general rule, that foreign estates and foreign trusts are not subject to section 1411.

i. Foreign Estates

The proposed regulations requested comments as to whether section 1411 should apply to foreign estates with United States beneficiaries. The Treasury Department and the IRS received several comments recommending that the section 1411 tax not apply to foreign estates, even those with United States beneficiaries, as there is little potential abuse in this context. Although some commentators recommended providing special rules for foreign estates with United States beneficiaries, the Treasury Department and the IRS continue to believe that section 1411 should not apply to foreign estates that often have little or no connection to the United States. Accordingly, § 1.1411–3(b)(1)(ix) of the final regulations provides that the section 1411 tax does not apply to foreign estates. This rule, however, does not exempt United States beneficiaries of foreign estates from the application of section 1411 to distributions from foreign estates. The taxation under section 1411 of United States beneficiaries receiving distributions of net investment income from a foreign estate 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 §§ 1.1411–3(e)(3)(ii) and 1.1411–4(e)(1).

ii. Foreign Trusts

The preamble to proposed § 1.1411–3(c)(3) requested comments on the application of section 1411 to net investment income of foreign trusts that is earned or accumulated for the benefit of United States beneficiaries, including whether section 1411 should apply to the foreign trust, or to the United States beneficiaries upon an accumulation distribution. Commentators recommended that section 1411 should not apply to foreign trusts that accumulate income for the benefit of United States beneficiaries, but rather, that United States beneficiaries should be subject to section 1411 upon the receipt of an accumulation distribution from a foreign trust.

The Treasury Department and the IRS agree that section 1411 should apply to United States beneficiaries that receive distributions of accumulated net investment income from a foreign trust rather than to the foreign trust itself. The Treasury Department and the IRS continue to study how section 1411 should apply to accumulation distributions from foreign trusts to United States beneficiaries and intend to issue subsequent guidance on this issue. Pending the issuance of such guidance, section 1411 will not apply to distributions of accumulated income from a foreign trust to United States beneficiary. Therefore, § 1.1411–4(e)(1)(ii) of the final regulations is reserved.

The Treasury Department and the IRS request additional comments concerning this issue, including recommendations on methods by which to identify accumulation distributions as net investment income. In particular, the Treasury Department and the IRS are interested in possible methods by which to determine the ''additional tax'' imposed under section 667(b) when the distribution is ''thrown back'' to the relevant past tax year, possible methods by which to identify and exclude the ''additional tax'' imposed under section 667(b) from years prior to the effective date of section 1411, whether a default rule similar to that contained in Notice 97–34 may be a viable approach for section 1411 purposes, and other specific technical recommendations (accompanied by numerical examples, if possible) for applying section 1411 to accumulation distributions.

E. Calculation of Undistributed Net Investment Income

The proposed regulations provided 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 net investment income included in the distribution to beneficiaries deductible by the estate or trust under section 651 or section 661, and by the net investment income for which the estate or trust was entitled to a section 642(c) deduction, in each case as computed in accordance with § 1.642(c)–2 and the allocation and ordering rules under § 1.662(b)–2. The proposed regulations adopted 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. Section 1.1411–3(e) of the final regulations retain this approach.

Proposed § 1.1411–3(f) provided examples of the calculation of undistributed net investment income. One commentator noted that *Example 1* and *Example 2* of the proposed regulations contain incorrect computations of distributable net income, which consequently causes an incorrect calculation of undistributed net investment income. The final regulations correct the computational error in these examples.

Some commentators recommended that the final regulations allow fiduciaries to reconsider a previous decision to include capital gains in the distributable net income (DNI) of an estate or trust. Section 1.643(a)–3(b)(1) provides that a fiduciary may allocate capital gains between corpus and DNI as long as such decision is a reasonable and impartial exercise of discretion and part of a consistent practice over time. In general, the commentators noted that, because section 1411 causes many capital gains to be included in net investment income, an estate or trust that does not include capital gains in DNI causes such net investment income to be retained in the estate or trust and thus, because of the low income threshold applicable to estates and trusts, to be subjected to the section 1411 tax more readily than if it had been distributed. The commentators note that, when a fiduciary considers whether capital gains are to be treated as part of DNI pursuant to section 643, as part of its duty to the trust or estate and its beneficiaries, a fiduciary takes into account any tax that would be imposed, including any tax imposed pursuant to section 1411. If the tax imposed by section 1411 had existed in the year that an existing trust or estate had first incurred capital gains, the fiduciary may have exercised its discretion differently. The commentators request that the final regulations allow a fiduciary a ''fresh start'' to determine whether capital gains are to be treated as part of DNI.

The final regulations do not adopt this suggestion. A fiduciary's decision regarding the inclusion of capital gains in DNI is comparable to other elections under chapter 1 that only indirectly impact the computation of net investment income. In addition, the potential for fluctuations in the effective tax rate on capital gains is a factor that is foreseeable by fiduciaries making these elections.

F. Material Participation of Estates & Trusts

Several commentators noted that the enactment of section 1411 has created an additional and compelling reason for the need to determine how an estate or a trust materially participates in an activity. An estate's or a trust's income or gain from a trade or business activity in which the entity materially participates does not constitute income from a passive activity under section 469 or section 1411. One commentator noted that, in the case of estates or trusts that have not incurred losses from a passive activity, those estates and trusts previously have not had to characterize either losses or income under section 469.

Commentators stated that the legislative history of section 469 suggests that only a fiduciary's participation should control in determining whether an estate or a trust materially participates in a trade or business activity. In certain situations, case law has concluded that the participation of beneficiaries and employees also should be considered. One commentator noted that case law and IRS guidance conflict, leaving taxpayers with uncertainty in determining the material participation of a trust.

A number of commentators requested that the Treasury Department and the IRS provide guidance on material participation of estates and trusts. However, the commentators acknowledged that guidance on material participation would apply under both sections 469 and 1411, and consequently suggested the initiation of a guidance project to propose the rules for which § 1.469–5T(g) has been reserved.

The Treasury Department and the IRS believe that the commentators have raised valid concerns. The Treasury Department and the IRS considered whether the scope of these regulations should be broadened to include guidance on q2material participation of estates and trusts. The Treasury Department and the IRS, however, believe that this guidance would be addressed more appropriately in the section 469 regulations. Further, because the issues inherent in drafting administrable rules under section 469 regarding the material participation of estates and trusts are very complex, the Treasury Department and the IRS believe that addressing material participation of trusts and estates at this time would significantly delay the finalization of these regulations. However, the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date. The Treasury Department and the IRS welcome any comments concerning this issue, including recommendations on the scope of any such guidance and on specific approaches to the issue.

5. Comments Regarding the Calculation 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 that are properly allocable to such gross income or net gain. Section 1.1411–4 of the proposed regulations provided guidance on the calculation of net investment income. The final regulations retain the general structure of proposed § 1.1411–4 with some modifications as discussed in this part.

A. Interaction With Section 469

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. The preamble to the proposed regulations provided a summary of the section 469 rules applicable for purposes of section 1411. The preamble identified certain aspects of the section 469 regulations that would apply for section 1411 purposes (such as the various types of recharacterization rules), and other areas where certain section 469 rules were not applicable for purposes of section 1411 (for example, the scope of a passive activity under section 469 is broader than the section 1411(c)(2)(A) definition of passive activity).

The preamble to the proposed regulations identified a series of section 469 rules that recharacterize income from a passive activity as income not from a passive activity (income recharacterization rules). Commentators requested the final regulations clarify the interaction between certain aspects of the income recharacterization rules and items of gross income included in section 1411(c)(1)(A). One such income recharacterization involves section 469(e)'s definition of portfolio income versus working capital. The comments regarding portfolio income are discussed in this part of the preamble and comments regarding working capital are discussed in part 7 of this preamble. Part 6 discusses comments regarding the net income recharacterization rules.

B. Gross Income Items Described in Section 1411(c)(1)(a)(i)

i. Portfolio Income

The Treasury Department and the IRS received several comments regarding the interaction between section 1411(c)(1)(A)(i) and the portfolio income items described in section 469(e)(1)(A) and the regulations thereunder. One commentator suggested that the final regulations cross reference the definition of portfolio income so that items included in portfolio income for section 469 purposes are net investment income under section 1411(c)(1)(A)(i).

In general, section 469(e)(1)(A)(i)(I) defines portfolio income as interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. The Treasury Department and the IRS recognize that this definition is similar to section 1411(c)(1)(A)(i). However, pursuant to the specific grant of authority to promulgate regulations under section 469 provided to the Treasury Department and the IRS in section 469(l), § 1.469–2T(c)(3) expands the definition of portfolio income to include, for example, income from controlled foreign corporations and qualified electing funds.

Furthermore, § 1.469–1T(d)(1) provides that the characterization of items of income or deduction as passive activity gross income (within the meaning of § 1.469–2T(c)) does not affect the treatment of any item of income or gain under any provision of the Code other than section 469.

Therefore, the characterization of certain types of income, gain, loss, and deduction as portfolio income under § 1.469–2T(c)(3) is expressly limited to the section 469 context. While many of the provisions of section 469 impact the classification of income, gain, loss, and deduction for net investment income purposes within section 1411, such interaction with section 469 is generally limited to the determination of whether those items are attributable to a passive activity within the meaning of section 1411(c)(2)(A). Accordingly, because the scope of portfolio income as defined in the regulations under section 469 does not match the scope of net investment income items in section 1411(c)(1)(A)(i), the final regulations do not adopt this recommendation.

ii. Definition of ''Derived in the Ordinary Course of a Trade or Business''

The preamble to the proposed regulations stated that 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, such item must be derived in the ''ordinary course'' of such trade or business. The preamble to the proposed regulations provided that a trade or business refers to a trade or business within the meaning of section 162 but the phrase was not defined in the proposed regulations. The proposed regulations did not provide guidance on the meaning of ''ordinary course.''

a. Definition of a Trade or Business

Several commentators requested guidance concerning the meaning of ''trade or business.'' Commentators suggested that the regulations include references to relevant case law and administrative guidance. A commentator requested that the regulations expand upon existing guidance by including bright-line examples of what constitutes a trade or business to aid taxpayers in determining if income is derived in the ordinary course of a trade or business and thus is excluded from net investment income.

As noted in part 6.A. of the preamble to the proposed regulations, the rules under section 162 have long existed as guidance for determining the existence of a trade or business and are applied in many circumstances. Whether an activity constitutes a trade or business for purposes of section 162 is generally a factual question. For example, in *Higgins* v. *Commissioner,* 312 U.S. 212 (1941), the Supreme Court stated that the determination of ''whether the activities of a taxpayer are 'carrying on a trade or business' requires an examination of the facts in each case.'' 312 U.S. at 217. Except for certain clarifications made in response to the proposed regulations, further guidance concerning the definition of trade or business is beyond the scope of these regulations.

In response to these commentators, § 1.1411–1(d) of the final regulations provides that the term *trade or business,* when used in section 1411 and the final regulations, describes a trade or business within the meaning of section 162. The section 162 reference incorporates case law and administrative guidance applicable to section 162.

One commentator noted that determining whether income is earned in a section 162 trade or business under a separate entity approach, as reflected in proposed § 1.1411–4(b), will yield unexpected results that are inconsistent with section 162. For purposes of determining whether income is earned under section 162, the commentator noted that § 1.183–1(d) provides that activities are determined and their section 162 trade or business status is evaluated by aggregating undertakings in any reasonable manner determined by the taxpayer.

The Treasury Department and the IRS do not believe that the determination of a trade or business under section 162 mandates the use of the definition of ''activity'' within the meaning of § 1.183–1(d). Section 183 disallows expenses in excess of income attributable to activities not engaged in for profit. Section 1.183–1(a) provides that section 162 and section 212 activities are not subject to section 183 limitations. The definition of activity within § 1.183–1(d) allows taxpayers latitude to combine different activities into a single activity to establish that the taxpayer is engaged in an activity for profit, and thus is not subject to the section 183 limitation. However, once the taxpayer determines that section 183 is not applicable, the taxpayer then must determine whether the activity is a section 162 trade or business or a section 212 for-profit activity. Furthermore, different definitions of ''activity'' can be found in sections 465 and 469. Therefore, the Treasury Department and the IRS do not believe that determining whether a trade or business exists using the activity determinations of Code provisions unrelated to section 162 is appropriate.

The Treasury Department and the IRS received multiple comments regarding the determination of a trade or business within the context of rental real estate. Specifically, commentators stated that *Example 1* of proposed § 1.1411–5(b)(2) is inconsistent with existing case law regarding the definition of a trade or business of rental real estate. Commentators cited cases such as *Fackler* v. *Commissioner,* 45 BTA 708 (1941), aff'd, 133 F.2d 509 (6th Cir. 1943); *Hazard* v. *Commissioner,* 7 T.C. 372 (1946); and *Lagreide* v. *Commissioner,* 23 T.C. 508 (1954), for the proposition that the activities of a single property can rise to the level of a trade or business.

The Treasury Department and the IRS agree with commentators that, in certain circumstances, the rental of a single property may require regular and continuous involvement such that the rental activity is a trade or business within the meaning of section 162. However, the Treasury Department and the IRS do not believe that the rental of a single piece of property rises to the level of a trade or business in every case as a matter of law. For example, § 1.212–1(h) provides that the rental of real property is an example of a for-profit activity under section 212 and not a trade or business.

Within the scope of a section 162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease). Therefore, due to the large number of factual combinations that exist in determining whether a rental activity rises to the level of a section 162 trade or business, bright-line definitions are impractical and would be imprecise. The same is true wherever the section 162 trade or business standard is used and is not unique to section 1411. The Treasury Department and the IRS decline to provide guidance on the meaning of trade or business solely within the context of section 1411. However, the Treasury Department and the IRS have modified *Example 1* in § 1.1411–5(b)(3) to explicitly state that the rental property in question is not a trade or business under applicable section 162 standards.

In cases where other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted in these final regulations, the IRS will closely scrutinize situations where taxpayers take the position that an activity is a trade or business for purposes of section 1411, but not a trade or business for such other provisions. For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of section 1411, the IRS will take into account the facts and circumstances surrounding the taxpayer's determination of a trade or business for other purposes, such as whether the taxpayer complies with any information reporting requirements for the rental activity imposed by section 6041.

b. Definition of ''Derived in the Ordinary Course''

Section 1411 does not define the phrase ''derived in the ordinary course'' within the context of a trade or business. The preamble to the proposed regulations stated that 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 and specifically referenced § 1.469–2T(c)(3)(ii) as an example.

The Treasury Department and the IRS received comments regarding the meaning of the phrase ''derived in the ordinary course'' within the context of section 1411(c)(1)(A)(i) and proposed § 1.1411–4(b).

Within the context of section 469, income from interest, dividends, royalties, and annuities is classified as portfolio income unless such income is derived in the ordinary course of a trade or business. Section 1.469–2T(c)(3)(ii)(A) through (c)(3)(ii)(G), which implements section 469(e)(1)(B), identifies several situations where interest, dividends, royalties, or annuities are derived in the ordinary course of a trade or business, and therefore are not portfolio income. If the interest, dividends, royalties, or annuities do not fall into one of these situations, then they constitute working capital because they are not derived in the ordinary course of a trade or business. If the assets that generate the interest, dividends, royalties, and annuities are not held in a trade or business, however, then the classification of the income as working capital by reference to § 1.469–2T(c)(3)(ii) is irrelevant.

Proposed § 1.1411–6 defined working capital by reference to section 469(e)(1)(B) and § 1.469–2T(c)(3)(ii). The definition of working capital in § 1.1411–6(a) of the final regulations continues to reference § 1.469–2T(c)(3)(ii). If a trade or business receives interest, dividends, royalties, or annuities, and the income is working capital under § 1.1411–6(a), then it is not derived in the ordinary course of a trade or business for purposes of section 1411(c)(1)(A)(i) and § 1.1411–4(b). Conversely, if a trade or business receives interest, dividends, royalties, or annuities, and the income is not working capital under § 1.1411–6(a) because it falls within one of the situations in § 1.469–2T(c)(3)(ii), then such income is derived in the ordinary course of a trade or business for both section 469 and section 1411(c)(1)(A)(i) and § 1.1411–4(b). As a result of the interaction between § 1.1411–6(a) and § 1.469–2T(c)(3)(ii), the Treasury Department and the IRS do not believe that any special rules are necessary within § 1.1411–4(b) defining ''derived in the ordinary course'' or, conversely, ''working capital'' with respect to section 1411(c)(1)(A)(i) income other than rents. In the case of rents, which are not covered by § 1.469–2T(c)(3), case law will provide guidance on whether rents are derived in the ordinary course of a trade or business. Additional public comments pertaining to the definition of working capital are discussed in part 7 of this preamble.

iii. Income From Annuities

The preamble of the proposed regulations provided that 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 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.

The preamble to the proposed regulations provided that gain or loss from the sale of an annuity is treated as net investment income for purposes of section 1411. To the extent the sales price of an annuity does not exceed its surrender value, the gain recognized is treated as gross income described in section 1411(c)(1)(A)(i) and § 1.1411–4(a)(1)(i). If the sales price of the annuity exceeds its surrender value, the seller treats 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 § 1.1411–4(a)(1)(i), and treats 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 § 1.1411–4(a)(1)(iii). The final regulations generally retain this approach.

One commentator stated that the definition of the term ''annuity'' provided in the preamble of the proposed regulations is too expansive. The commentator requested that the final regulations clarify that only items of income for which a taxpayer is liable under section 72(a) are subject to the net investment income tax. The final regulations do not adopt the requested change. The principles and rules under chapter 1 of the Code generally apply, where appropriate, in interpreting the statutory language of section 1411. Section 1411(c)(1)(A)(i) provides that net investment income includes ''gross income from . . . annuities.'' Amounts received as an annuity under an annuity contract are includible in gross income under section 72(a) and section 72(b). However, there are other types of distributions from annuity contracts that are includible in gross income under section 72(e). Such amounts may include, for example, dividends received from an annuity contract. See section 72(e)(1)(B). We believe it is appropriate to apply these same rules in determining what constitutes gross income from annuities for purposes of section 1411. Therefore, amounts received under annuity contracts that are includible in income under section 72(a), (b), and (e) are subject to the net investment income tax.

One commentator requested that the final regulations clarify that net investment income from charitable gift annuities established post-2012 will be spread over the annuitant's life expectancy, similar to other items of income, pursuant to § 1.1011–2(c), Example 8. The commentator also requested that the final regulations clarify that the income recognized and distributed from charitable gift annuities established prior to 2013 is not subject to the net investment income tax. The commentator asked that the final regulation extend the benefit afforded to CRTs with regard to pre-2013 gifts to pre-2013 funded charitable gift annuities.

Charitable gift annuities, like installment sales and other tax deferral transactions, defer the recognition of income to a future year. Charitable gift annuities share more characteristics with installment sales than with CRTs. In the case of installment sales, amounts received in taxable years beginning after December 31, 2012, on installment sales made prior to the effective date of section 1411 are included in net investment income, unless an exception applies. See § 1.1411–4(d)(4)(i)(C), *Example 2.* A CRT, as defined in section 664, must provide for the distribution of a specified payment, at least annually, to one or more persons (at least one of which is a noncharitable beneficiary). Upon the termination of the noncharitable interest or interests, the remainder must either be held in continuing trust for charitable purposes or be paid to or for the use of one or more organizations described in section 170(c). During its operation, a CRT is a tax-exempt entity. Unlike charitable gift annuities, the Federal income tax character of the income received by a CRT's annuity or unitrust beneficiary is dependant on the Federal income tax character of the income received by the CRT in the year of distribution and, in many cases, income received in year(s) prior to the distribution. In the case of charitable gift annuities, the amount and character of the income paid to the annuity recipient generally is known at the inception of the annuity. Furthermore, the amount and character of the income paid to the annuity recipient is not dependent on the charity's use (or sale) of the property exchanged for the annuity. The section 1411 policy reason behind the exclusion of pre-2013 accumulated income within a CRT from net investment income is that the character is passed through from the CRT to the recipient, and pre-2013 income is not net investment income. Because the character of the distribution to the recipient of a charitable gift annuity is not dependent on its character in the hands of the payor, the final regulations do not adopt the requested change.

B. Gross Income Items 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). For a trade or business described in section 1411(c)(2)(A), that is, a trade or business that is a passive activity with respect to the taxpayer, proposed § 1.1411–4(c) provided that section 1411(c)(1)(A)(ii) includes other gross income that is not included in section 1411(c)(1)(A)(i) or section 1411(c)(1)(A)(iii). For a trade or business described in section 1411(c)(2)(B), that is, a trade or business of trading in financial instruments or commodities (a "trading business"), proposed § 1.1411–4(c) provided that section 1411(c)(1)(A)(ii) includes all other gross income from such trade or business that is not included in section 1411(c)(1)(A)(i). See part 5.b.ii.a of this preamble for a discussion of the definition of a trade or business for purpose of section 1411.

The Treasury Department and the IRS received a number of comments regarding the proper treatment of gains and losses from a trade or business of trading in financial instruments or commodities described in section 1411(c)(2)(B). For chapter 1 purposes, a taxpayer engaged in a trading business combines gains and losses from trading activities to arrive at a net amount of gain or loss from the trading business. Under proposed § 1.1411–4(c)(2), all gross income from a trading business is included in net investment income under section 1411(c)(1)(A)(ii), except for interest, dividends, rents, royalties, and annuities included in net investment income under section 1411(c)(1)(A)(i). Under proposed § 1.1411–4(f)(4), section 165 losses are taken into account under section 1411(c)(1)(A)(iii) and are subject to a limit on net losses. Commentators interpreted these proposed regulations to mean that all gains from the trading activities of a trading business are included in net investment income under section 1411(c)(1)(A)(ii), while the offsetting trading losses would be under section 1411(c)(1)(A)(iii). As a result, the section 1411(c)(1)(A)(iii) loss limitation would prevent a trading business from netting the gains and losses for purposes of the net investment income tax. Multiple commentators recommended that trading losses generated by a trading business should be allocated to the same category as trading gains. Some commentators recommended that proposed § 1.1411–4(f)(4) not apply to trading gains, which would allow trading losses to offset trading gains under section 1411(c)(1)(A)(ii). Other commentators recommended that trading gains should be included in net investment income under section 1411(c)(1)(A)(iii) rather than under section 1411(c)(1)(A)(ii).

The Treasury Department and the IRS agree that trading gains and losses should be assigned to the same category of net investment income. Because section 1411(c)(2)(B) does not distinguish between a trader who has made a section 475(f) mark-to-market election (a "section 475 trader") and a trader who has not made a section 475(f) mark-to-market election (a "non-section 475 trader"), aligning gains and losses from a trading business requires rules that apply equally to a section 475 trader and to a non-section 475 trader. Chapter 1, however, provides different timing and character rules for the two types of traders. For a section 475 trader, all securities and commodities held in a trading business are marked to market on the last day of the tax year, both realized and mark-to-market gains or losses have ordinary character, and any net trading loss may be used to offset other income under chapter 1. In contrast, a non-section 475 trader generally does not mark securities and commodities to market, gains and losses recognized from trading are capital in character, and any net trading loss would be subject to chapter 1 capital loss limitations. One possible solution is to assign the trading gains and losses from both section 475 traders and non-section 475 traders to section 1411(c)(1)(A)(ii), which would permit a non-section 475 trader to use net trading losses to offset other net investment income. Another possible solution is to assign the trading gains and losses from both section 475 traders and non-section 475 traders to section 1411(c)(1)(A)(iii), thereby making a section 475 trader subject to the loss limitations of that section. Under either scenario, some traders would be treated differently for purposes of section 1411 and chapter 1. This would have required those traders to maintain a separate set of books and records specifically to comply with section 1411.

To minimize the inconsistencies between chapter 1 and section 1411 for traders, the final regulations assign all trading gains and trading losses to section 1411(c)(1)(A)(iii). The final regulations also permit a taxpayer to deduct excess losses from the trading business of a section 475 trader from other categories of income. Part 5.C of this preamble describes the treatment of those excess losses. Section 1.1411–4(c) of the final regulations provides that gross income from a trading business is included in net investment income under section 1411(c)(1)(A)(ii) only to the extent that income is not included in section 1411(c)(1)(A)(i) or (c)(1)(A)(iii). This change aligns the categorization of income between section 1411(c)(1)(A)(i), (c)(1)(A)(ii), and (c)(1)(A)(iii) in a manner consistent with income from a passive activity trade or business described in section

1411(c)(2)(A). As a result, the final regulations now categorize gross gains from the disposition of property associated with a trading business as net investment income under section 1411(c)(1)(A)(iii), which may be offset by losses from trading dispositions. However, see part 5.C of this preamble for a discussion of additional changes relative to section 1411(c)(1)(A)(iii) and section 1411(c)(1)(B) that impact the calculation of net investment income for items of gain and loss attributable to a trading business.

C. Calculation of Net Gain in Section 1411(c)(1)(a)(iii)

The proposed regulations provided 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 section 1411(c)(2). The proposed regulations provided that, because section 1411(c)(1)(A)(iii) uses the term ''net gain'' and not the term ''net gain or loss,'' the amount of net gain included in net investment income may not be less than zero. However, the proposed regulations also provided that losses allowable under section 1211(b)(1) and (b)(2) are permitted to offset gain from the disposition of assets other than capital assets that are subject to section 1411.

i. Overall Limits on Losses

Several commentators suggested that, instead of limiting net gain to zero, losses in excess of gains should offset other net investment income in order to reflect the true economic net investment income for any given year. One commentator acknowledged that the position taken by the proposed regulations appears consistent with the statutory definition of net investment income because section 1411(c)(1)(A)(iii) appears to preclude the possibility of a net loss. Another commentator observed that the proposed regulations place excessive stress on the word ''gain'' in section 1411(c)(1)(A)(iii), and insufficient stress on the word ''net.'' Stressing the word ''gain'' prevents a taxpayer from deducting a $3,000 capital loss limit against other investment income (such as interest). Another commentator stated that, because chapter 1 imposes significant constraints on deducting capital losses against non-capital income (such as the prohibition on carrybacks of such losses for individuals), and imposes a variety of limitations on deducting ordinary losses under section 165, including losses that become section 165 deductions through the operation of other provisions such as section 475, 988, or 1231, there does not appear to be any reason to impose additional limitations on those deductions for section 1411 purposes. A number of commentators recommended that losses in excess of gains be allowed as a properly allocable deduction that may offset other net investment income from section 1411(c)(1)(A)(i) or (c)(1)(A)(ii). Some commentators suggested that section 1411(c)(1)(B) properly allocable deductions include any capital losses allowed for chapter 1 purposes. Several other commentators suggested that there should be no limit imposed on losses, capital or ordinary.

Section 1.1411–4(d)(2) of the final regulations retains the overall limitation of the proposed regulations on allowable losses that the calculation of net gain within section 1411(c)(1)(A)(iii) cannot be less than zero. The Treasury Department and the IRS believe that provision follows the statutory language of section 1411(c)(1)(A)(iii). However, § 1.1411–4(f)(4) of the final regulations provides that losses described in section 165, whether described in section 62 or section 63(d), are allowed as a properly allocable deduction to the extent such losses exceed the amount of gain described in section 61(a)(3) and are not taken into account in computing net gain by reason of § 1.1411–4(d). Thus, although § 1.1411–4(d)(2) imposes an overall limitation on net gain included in net investment income by reason of section 1411(c)(1)(A)(iii), § 1.1411–4(f)(4) allows losses in excess of gains as a properly allocable deduction to the extent the losses would be allowable in computing taxable income under chapter 1. Losses are first applied to calculate net gain under § 1.1411–4(d), and then § 1.1411–4(f)(4) applies to the excess losses. This ordering rule prevents taxpayers from deducting the same loss twice: first in calculating net gain under § 1.1411–4(d), and then again in § 1.1411–4(f)(4). As a result, final § 1.1411–4(f)(4) allows, as a properly allocable deduction, the $3,000 capital loss ($1,500 in the case of an individual filing as married filing separately) allowed by section 1211(b) in all cases. Furthermore, a taxpayer, such as a section 475 trader, that has ordinary losses in excess of ordinary gains and net capital gains, may claim those excess losses as a § 1.1411–4(f)(4) properly allocable deduction.

Furthermore, the final regulations retain the definition of disposition as the sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition of property.

A commentator suggested that section 1411 does not apply to a deemed sale resulting from section 877A. Section 877A(a)(1) provides, in relevant part, that ''For purposes of this subtitle, all property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value.'' The Treasury Department and the IRS believe that any gain taken into account in computing a covered expatriate's taxable income is also included in net investment income because the operative provision of section 877A(a)(1) treats the property as sold for purposes of subtitle A, which includes section 1411. Accordingly, the final regulations clarify that a deemed sale under section 877A, which applies for purposes of subtitle A, is a disposition of property subject to section 1411.

ii. Treatment of Certain Capital Loss Carryforwards

The proposed regulations provided, and the final regulations retain, the provision that except as otherwise expressly provided in regulations, the income tax gain and loss recognition rules in chapter 1 apply for purposes of determining net gain 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. Therefore, under the proposed regulations, net gain took into account capital losses carried over from prior years by reason of section 1212(b)(1) (including years preceding the effective date of section 1411). The final regulations retain this position.

The Treasury Department and the IRS received several comments and inquiries regarding the treatment of capital loss carryforwards. The final regulations reserve paragraph § 1.1411–4(d)(4)(iii) for special rules that the Treasury Department and the IRS believe are necessary to properly address capital loss carryforwards. The companion notice of proposed rulemaking (REG–130843–13) contains an explanation of the proposed rule and the proposed regulation text.

D. Properly Allocable Deductions Described in Section 1411(C)(1)(b)

Section 1411(c)(1)(B) provides that net investment income includes deductions allowed by subtitle A that are properly allocable to gross income or net gain described in section 1411(c)(1)(A). Section 1.1411–4(f)(1)(i) of the proposed regulations provided that ''[u]nless specifically stated otherwise, only properly allocable deductions described in this paragraph (f) may be taken into account in determining net investment income.'' Specifically, proposed § 1.1411–4(f)(3) provided that properly allocable deductions include: (A) investment interest expense, (B) investment expenses described in section 163(d)(4)(C), and (C) state, local, and foreign income taxes described in section 164(a)(3). The Treasury Department and the IRS intend this rule to limit the deductions against net investment income to those specifically enumerated in paragraph (f).

One commentator recommended that the final regulations provide that the phrase ''properly allocable deductions'' comprise all of the chapter 1 deductions that are allowed against chapter 1 gross income from rent, dividends, royalties, annuities and interest, other gross income derived from a trade or business, and net gains attributable to the disposition of property other than property held in a trade or business.

The Treasury Department and the IRS believe the recommended language would permit taxpayers to argue that they can take deductions that have no direct relation to net investment income, and it would lead to uncertainty and to disputes between taxpayers and the IRS over what constitutes properly allocable deductions. However, the Treasury Department and the IRS acknowledge that flexibility is needed within § 1.1411–4(f) so that future changes in law or circumstances can be more easily integrated into the regulations. Although the cross-references in § 1.1411–4(f)(2) to deductions described in section 62(a) provide section 1411(c)(1)(B) flexibility to automatically take into account additions or changes to chapter 1 deductions attributable to trades or business, rents, and royalties, these regulations would have to be amended to expand properly allocable deductions in the event of such changes not captured by section 62(a)(1) or 62(a)(4). To strike a balance between the intent of the proposed rule (to provide a specific list of deductions to limit uncertainty and controversy) and the recognized value of future flexibility inherent in the commentators' recommendation, § 1.1411–4(f)(6) of the final regulations allows the Treasury Department and the IRS to publish additional guidance in the Internal Revenue Bulletin that expands the list of properly allocable deductions.

i. Inclusion of Additional Properly Allocable Deductions

Commentators requested that properly allocable deductions also include amounts described in sections 72(b)(3), 642(h), 691(b), 691(c), 1341, and 7518 (c)(1)(A).

Section 72(b)(3) allows a deduction for unrecovered basis in an annuity when an annuitant dies with unrecovered basis in the annuity contract. Section 72(b)(3) allows the deduction on the decedent's final income tax return. The Treasury Department and the IRS believe that, because an annuity contract would have produced income subject to tax under section 1411 had the annuitant continued living, it is appropriate to allow the deduction under section 72(b)(3) in calculating the net investment income for the decedent's final taxable year. Accordingly, § 1.1411–4(f)(3)(iv) of the final regulations provides that the section 72(b)(3) deduction for unrecovered annuity basis is a properly allocable deduction.

Section 642(h) provides ''[i]f on the termination of an estate or trust, the estate or trust has (1) a net operating loss carryover under section 172 or a capital loss carryover under section 1212, or (2) for the last taxable year of the estate or trust deductions (other than the deductions allowed under subsections (b) or (c)) in excess of gross income for such year, then such carryover or such excess shall be allowed as a deduction . . . to the beneficiaries succeeding to the property of the estate or trust.''

Section 691(b) provides that an estate (or successor to property) may take deductions described in section 162, 163, 164, 212, or 611 in respect of a decedent, which are not properly allowable to the decedent in the taxable period prior to or in which falls the date of the decedent's death (these items are often referred to as Deductions in Respect of a Decedent, or ''DRD''). Section 691(b) is the statutory mechanism that allows a deduction to the estate (or other successor to property) because, under the normal accounting rules, the decedent would have been entitled to the deduction but failed to live long enough to take it. The section 691(b) listing of deductions is an exclusive list. If a deduction is not listed (such as suspended capital losses), then it is not deductible under this provision.

The Treasury Department and the IRS believe that it is appropriate to provide a special rule that allows a beneficiary to succeed to the deductions of a terminating estate or trust in the same fashion as that provided by section 642(h) for chapter 1 purposes. In addition, the Treasury Department and the IRS believe that it is appropriate to provide a special rule that allows for deductions described in section 691(b) to be claimed by an estate or a successor to the estate. However, to limit the deductions to those that would have been deductible had the predecessor been able to deduct the expenses, the scope of allowable deductions under these special rules is limited to only those deductions allowed under § 1.1411–4(f), and only to the extent that the terminating estate or trust has negative net investment income upon termination.

Section 691(c) allows a deduction for estate taxes imposed on items of income that are Income in Respect of a Decedent (IRD) under section 691(a). The section 691(c) deduction allowed for estate tax attributable to IRD that is ordinary income must be claimed as an itemized deduction, and not as a deduction from gross income in arriving at adjusted gross income (AGI), because it is not among the deductions listed in section 62. However, the section 691(c) deduction is not subject to the 2-percent floor under section 67.

In the case of IRD that is capital gain, section 691(c)(4) provides that ''[f]or purposes of section 1(h), 1201, 1202, and 1211, the amount taken into account with respect to any item described in subsection (a)(1) shall be reduced (but not below zero) by the amount of the deduction allowable under paragraph (1) of this subsection with respect to such item.''

Net investment income may include items of IRD (such as annuities and outstanding installment sale payments) that may carry with it a deduction under section 691(c) for chapter 1 purposes. Therefore, the Treasury Department and the IRS believe it is consistent with the general principles of section 691 also to allow the section 691(c) deduction to reduce net investment income. Section 1.1411–4(f)(3)(v) of the final regulations provides that the deduction described in section 691(c) is a properly allocable deduction, except to the extent that the section 691(c) deduction is taken into account in determining net gain (within the meaning of § 1.1411–4(d)) by reason of section 691(c)(4).

Generally, section 1341 applies if: (1) a taxpayer included an item in gross income in a prior taxable year because it appeared that the taxpayer had a claim of right to the item, and (2) a deduction is allowable for the repayment of the item in a later taxable year under some provision of the Code other than section 1341 because it is established that the taxpayer did not have a right to the item. If section 1341 applies, a taxpayer's tax liability for the year of repayment (or the taxable year in which the obligation to make repayment otherwise gives rise to a deduction) is based on the lesser of: (A) the tax for the taxable year, computed with a deduction of the repayment amount (''section 1341 deduction amount''), or (B) the tax for the year of repayment computed without the repayment deduction, less the decrease in tax imposed by chapter 1 in the prior taxable year(s) that would result solely from the exclusion of the restored item from gross income in the prior taxable year(s) (''section 1341 credit amount''). The section 1341 credit amount is intended to compensate the taxpayer for the tax paid in the year of income inclusion (for example, if the tax rates were higher in the year of inclusion).

One commentator recommended that the final regulations contain certain provisions similar to section 1341 to the extent that section 1341 would apply for chapter 1 in a particular year. The commentator noted that, because some types of income that might be restored under section 1341 might have been subjected to tax under section 1411 when included in a prior year, it would be equitable for the section 1411 regulations to contain a mechanism similar to section 1341 to allow a deduction under section 1411(c)(1)(B) for repayment of the income in a later year.

To the extent that a deduction is allowable under a provision of chapter 1 that specifically is allowed under section 1411(c)(1)(B) and § 1.1411–4(f), that amount also would be a deduction for section 1411 purposes in the year of the repayment (or the taxable year in which the obligation to make repayment otherwise gives rise to a deduction). For example, if the repayment constituted a section 165 loss that was a properly allocable deduction, then that deduction also would be available for section 1411 purposes.

However, if the section 1341 credit amount produces a lower tax for the repayment year when compared to the section 1341 deduction amount, section 1341(b)(3) denies the taxpayer a deduction in the year of repayment in favor of the alternative credit for the tax cost. In this instance, the deduction is not allowed by subtitle A (which includes chapter 1, chapter 2, and chapter 2A) in the recovery year, and therefore would not be a properly allocable deduction under section 1411(c)(1)(B) and § 1.1411–4(f). Therefore, the final regulations do not incorporate this recommendation.

One commentator recommended that the final regulations include amounts deposited in capital construction funds described in section 7518 as a properly allocable deduction under section 1411(c)(1)(B). Section 7518(c)(1)(A), which is in chapter 77 of subtitle F of the Code, provides that taxable income is reduced by certain amounts described in section 7518(a)(1)(A) that a taxpayer deposits into the fund. The final regulations do not adopt this recommendation. Section 1411(c)(1)(B) provides that net investment income includes deductions allowed by subtitle A that are properly allocable to such gross income or net gain described in section 1411(c)(1)(A). The reduction in taxable income provided by section 7518(c)(1)(A) is not a deduction allowed by subtitle A of the Code. Therefore, these deductible amounts are outside of the scope of section 1411(c)(1)(B).

Section 1.1411–4(f) of the final regulations also provides that properly allocable deductions include amounts described in section 212(3). Section 212(3) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in connection with the determination, collection, or refund of any tax. Section 1.212–1(l) provides, in relevant part, that expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of tax returns or in connection with any proceedings involved in determining or contesting a tax liability are deductible. Section 1.1411–4(f)(3)(vi) of the final regulations provides that amounts described in section 212(3) and § 1.212–1(l) that are allocable to net investment income using any reasonable method are properly allocable deductions.

Section 1.1411–4(f) also includes two additional properly allocable deductions attributable to investments in certain types of debt instruments. In the case of a contingent payment debt instrument, the holder may receive a payment that is less than the corresponding projected payment determined under the noncontingent bond method, resulting in a negative adjustment under § 1.1275–4(b)(6). In general, a holder treats a negative adjustment as a reduction in interest income otherwise includible for the taxable year and, if there is any excess, as an ordinary loss for the taxable year to the extent of prior interest inclusions. The loss, in effect, reverses the holder's prior interest over-inclusions on the debt instrument. One commentator recommended that the final regulations provide that a holder's negative adjustment treated as an ordinary loss under § 1.1275–4(b)(6) be a properly allocable deduction. The final regulations adopt this recommendation and treat the loss as a properly allocable deduction because it accurately reflects the taxpayer's economic net investment income attributable to the debt instrument and is otherwise allowed by chapter 1. The final regulations also provide a similar rule for a deflation adjustment on an inflation-indexed debt instrument subject to § 1.1275–7.

If a taxpayer purchases a taxable debt instrument at a premium, the taxpayer can elect under section 171 to amortize the bond premium. In general, the amount of amortizable bond premium for a period offsets the interest income allocable to the period and the taxpayer includes the net amount of interest in taxable income. In certain circumstances, however, the taxpayer is entitled to deduct all or a portion of the bond premium under section 171(a)(1). For example, if an electing taxpayer acquires a Treasury bill at a premium and holds the bill until maturity, the taxpayer can deduct the premium at maturity under section 171(a)(1). See § 1.171–2T(a)(4)(i)(C). In these circumstances, the final regulations provide that a deduction under section 171(a)(1) is a properly allocable deduction.

ii. Deduction for Income Taxes Described in Section 164(a)(3)

The Treasury Department and the IRS received comments on multiple aspects of proposed § 1.1411–4(f)(3)(i)(C), which pertains to itemized deductions for state and local, and foreign income, war profits, and excess profits taxes described in section 164(a)(3) (''section 164(a)(3) taxes''). Proposed § 1.1411–4(f)(3)(i)(C) provided that income 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 provided that the portion of taxes properly allocable to investment income may be determined by taxpayers using any reasonable method. The proposed regulations further provided that allocating the deduction based on the ratio of investment income to total gross income is an example of a reasonable method.

Commentators recommended that the final regulations provide additional examples of reasonable methods of allocation of taxes between net investment income and non-net investment income. One commentator recommended that the final regulations provide that state income tax reported on the state income tax return, rather than the actual state income tax payments made during the year, should be used in calculating a trust or estate's deduction under proposed § 1.1411–4(f)(3)(i)(C) for taxes under section 164(a)(3). One commentator requested alignment between the reasonable method of allocating section 164(a)(3) taxes in proposed § 1.1411–4(f)(3)(i)(C) with the existing allocation rules in chapter 1 for estates and trusts. One commentator stated that the proposed method of allocation creates a problem because a trust or estate deducts state and local taxes for DNI purposes in a different manner. Another commentator recommended that the final regulations follow the long-standing state and local tax allocation rules of § 1.652(b)–3(b).

The final regulations generally retain the position of the proposed regulations. Although the regulations provide an example of a reasonable method of allocation, it is not the only reasonable method. The final regulations do not provide other examples of generally applicable reasonable allocation methods because the Treasury Department and the IRS believe that providing multiple examples of reasonable methods may lead to taxpayers to incorrectly conclude that the methods listed are the only acceptable methods. Therefore, the Treasury Department and the IRS believe that the final regulations allow taxpayers flexibility to determine a method of allocation that best applies to their specific facts. The final regulations do provide, however, that for estates and trusts, an allocation between classes of income under § 1.652(b)–3 is a reasonable allocation.

Several commentators suggested that foreign taxes should be a properly allocable deduction under section 1411(c)(1)(B), without reference to any election made by the taxpayer for chapter 1 purposes. Another commentator, however, suggested that the final regulations confirm that foreign taxes included in the foreign tax credit computation are not taxes included in section 164(a)(3) and, therefore, would not be allowed as a deduction allocable to net investment income. Section 1.1411–4(f)(3)(iii) of the final regulations provides that foreign income, war profits, and excess profits taxes may be allowable as deductions in determining net investment income only if the taxpayer does not choose to take any foreign tax credits under section 901 with respect to the same taxable year. This rule is consistent with the limitation in section 275(a)(4) on deductibility of those taxes.

Several commentators requested that the final regulations address the proper treatment of refunds of taxes deductible under section 164(a)(3). In response to this request, § 1.1411–4(g)(2) of the final regulations provides guidance on refunds and recoveries of amounts deducted under section 1411(c)(1)(B) and § 1.1411–4 in prior taxable years. In general, the final regulations provide that the recovery or refund of a previously deducted item shall reduce the total amount of properly allocable deductions in the year of the recovery. The final regulations first determine the recovered amount without regard to the application of the tax benefit rule in section 111 for chapter 1 purposes. For example, if a taxpayer receives a refund of state income taxes from a prior year, such a refund would be included in the taxpayer's gross income. However, if the taxpayer was subject to the alternative minimum tax in the year of the payment, the taxpayer may not have received any tax benefit under chapter 1, and therefore section 111 may exclude some, or all, of the refund from gross income. However, the deductibility of state income taxes for section 1411 purposes is independent of the deductibility of the taxes for alternative minimum tax purposes. Therefore, the applicability of the recovery rule in § 1.1411–4(g)(2) is determined without regard to whether the recovered amount was excluded from gross income by reason of section 111.

The final regulations contain two exceptions to the general rule. The two exceptions apply the tax benefit rule of section 111 within the section 1411 system, and therefore operate independently of the application of section 111 for chapter 1 purposes. First, properly allocable deductions are not reduced in the year of the recovery if the amount deducted in the prior year did not reduce the amount of section 1411 liability. For example, the receipt in 2014 of a refund of income taxes paid in 2012 would not reduce a taxpayer's section 1411(c)(1)(B) deduction because section 1411 was not in effect in 2012 and thus the 2012 taxes were not properly allocable to net investment income. Second, properly allocable deductions are not reduced in the year of the recovery if the amount deducted in the prior year is included in net investment income by reason of section 1411(c)(1)(A). For example, a reimbursement of a deduction from a passive activity trade or business that is gross income for chapter 1 purposes is included as gross income from a passive activity under section 1411(c)(1)(A)(ii). Therefore, the recovery is already reflected in the recovery year's net investment income calculation.

In addition, § 1.1411–4(g)(2) of the final regulations provides a special rule in the case of a recovery of a deduction that was allocated between net investment income and non-net investment income (such as section 164(a)(3) taxes). The final regulations provide that the amount taken into account under the recovery rule is based on the ratio used to allocate the item in the year of the deduction. For example, if a taxpayer allocated 45 percent of its total section 164(a)(3) taxes to net investment income in the year of the deduction, 45 percent of the recovery of such taxes will reduce the total amount of properly allocable deductions in the year of the recovery even though the taxpayer's allocation of section 164(a)(3) taxes to net investment income in the year of recovery may be, for example, 30 percent.

iii. Treatment of Estate and Trust Administration Expenses

Several commentators requested that the final regulations explicitly provide that section 1411(c)(1)(B) properly allocable deductions include fiduciary commissions, legal and accounting fees, and other estate and trust administration expenses. Subject to the limitations pursuant to section 67(e), the final regulations adopt this comment by amending proposed § 1.1411–4(f)(3) to provide that properly allocable deductions include amounts described in § 1.212–1(i) (allowing a deduction for reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation) to the extent they are allocable to net investment income. The final regulations require that estates and trusts apportion any § 1.212–1(i) expenses between net investment income and excluded income using any reasonable method.

iv. Limitations on Properly Allocable Deductions

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 to the overall limitation on itemized deductions under section 68 are deducted in determining net investment income only to the extent that they are deductible for income tax purposes after the application of both limitations. The proposed regulations provided 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 the 2-percent floor. 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.

One commentator argued that applying general limitations on deductions under sections 67 and 68 is inconsistent with congressional intent, and that it may cause ''taxable'' net investment income to exceed ''economic'' net investment income. The commentator recommended that the final regulations allow the full amount of properly allocable itemized deductions to offset income items comprising net investment income without regard to the limitations imposed under sections 67 and 68.

Section 1411(c)(1)(B) provides that only those deductions that are allowed under subtitle A and properly allocable to component items of net investment income are deducted in determining net investment income. Sections 67 and 68 limit the amount of certain itemized deductions in determining taxable income for purposes of subtitle A and, therefore, also apply to limit the amount of those itemized deductions in determining net investment income. Accordingly, properly allocable deductions that are subject to section 67 or 68 are deducted in determining net investment income only to the extent that they are deductible after the application of the limitations.

Another commentator agreed that the limitations on itemized deductions under sections 67 and 68 should apply for section 1411 purposes, but suggested that these limitations only reduce the amount of properly allocable itemized deductions if such deductions exceed the aggregate amount of the deductions, whether properly allocable or not, that would be allowed after application of these limitations. In other words, the commentator requested an ordering approach to the section 67 and 68 limitations, instead of the pro-rata approach in the proposed regulations. Both the commentator's recommendation and the proposed regulation method are reasonable interpretations of section 1411(c)(1)(B), accordingly, the final regulations adopt the commentator's recommendation.

Under § 1.1411–4(f)(7) of the final regulations, the amount of miscellaneous itemized deductions allowed under section 67 in determining net investment income (but before the application of section 68) is the lesser of: (1) the amount of miscellaneous itemized deductions before applying section 67 that are properly allocable to net investment income, or (2) the amount of all miscellaneous itemized deductions allowed after the application of section 67. The amount of itemized deductions subject to limitation under section 68 that are deducted in determining net investment income is the lesser of: (1) the amount of such deductions that are properly allocable to net investment income allowed after the application of section 67 but before the application of section 68, or (2) the amount of all deductions allowed after the application of section 68.

v. Treatment of Properly Allocable Deductions in Excess of Investment Income

Proposed § 1.1411–4(f)(1)(ii) provided that any deductions described in § 1.1411–4(f) in excess of gross income and net gain are not taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1. Many commentators recommended that the final regulations provide that negative net investment income (when section 1411(c)(1)(B) deductions exceed section 1411(c)(1)(A) income) be carried over and become a section 1411(c)(1)(B) deduction in the subsequent year.

The final regulations do not adopt this recommendation. Section 1411(c)(1)(B) provides that, in order for a deduction to be allowed, it must be: (1) allowed by subtitle A, and (2) be properly allocable to section 1411(c)(1)(A) income. Section 1411(c)(1)(B) only allows deductions allowed by other Code sections; it does not establish a basis for a deduction that does not exist elsewhere in the Code. However, as discussed in the following part of this preamble, the final regulations do permit deductions of net operating losses otherwise allowed by subtitle A that are properly allocable to section 1411(c)(1)(A) income.

vi. Net Operating Losses as a Properly Allocable Deduction

Proposed § 1.1411–4(f)(1)(ii) provided that, in no event, will a net operating loss (NOL) deduction allowed under section 172 be taken into account in determining net investment income for any taxable year. The proposed regulations requested comments on whether a deduction should be allowed for an NOL in determining net investment income. Several commentators argued that, for purposes of section 1411(c)(1)(B), at least some portion of an NOL deduction should be a deduction properly allocable to gross income included in net investment income and therefore allowed in determining net investment income. Three commentators recommended that taxpayers be allowed to keep track of the portions of an NOL attributable to investment income for the loss year. One commentator recommended that the IRS adopt a simple rule for determining a portion of an NOL that is attributable to a ''net investment loss'' for a loss year (for example, using a ratio of the portion of the loss attributable to ''net investment loss'' to the NOL) and allow taxpayers to take a prorated portion of the NOL deduction into account in determining net investment income for a taxable year to which the NOL is carried.

The final regulations adopt a modified version of the commentator's approach in § 1.1411–4(f)(2)(iv) and (h). Because NOLs are computed and carried over year-by-year, a separate ratio must be determined for each year. Thus, the final regulations provide that taxpayers may deduct a portion of an NOL deduction in determining their net investment income. The portion of an NOL deduction for a taxable year that may be deducted for section 1411 purposes is calculated by first determining the applicable portion of the NOL for each loss year. The applicable portion of the NOL is the lesser of: (1) the amount of the NOL for the loss year that the taxpayer would have incurred if only items of gross income that are used to determine net investment income and only properly allocable deductions were taken into account in determining the NOL in accordance with section 172(c) and (d), or (2) the amount of the taxpayer's NOL for the loss year. Next, the amount of the NOL carried from each loss year and deducted in the taxable year is multiplied by a fraction. The numerator of this fraction is the applicable portion of the NOL for the loss year as determined above. The denominator of the fraction is the total NOL for the loss year. A separate fraction is determined for each loss year. The result of this multiplication is the amount of the NOL deduction from the loss year that is allowed as a section 1411(c)(1)(B) deduction in the taxable year, referred to as the *section 1411 NOL* amount. The sum of the section 1411 NOL amounts for each NOL carried to and deducted in the taxable year, referred to as the total section 1411 NOL amount, is the amount of the NOL deduction for the taxable year that is properly allocable to net investment income.

E. Calculation of Net Investment Income in Special Situations

Section 1411(c)(1)(A)(i) provides that net investment income does not include (among other things) items of interest, dividend, annuity, royalty or rent derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer within the meaning of section 469. Section 1411(c)(1)(A)(iii) provides that net investment income does not include (among other things) gain or loss from the disposition of property used in a trade or business that is not a passive activity of the taxpayer. In general, section 469 and the regulations thereunder provide four ways for an item of income to be nonpassive—grouping, activity recharacterization, income recharacterization, and material participation.

In the case of certain types of net investment income, such as rent and interest, commentators recommended that the final regulations exclude certain nonpassive net income, gain, or loss and self-charged interest from net investment income. Other commentators recommended that the final regulations provide a deduction that offsets the income.

As discussed in part 5.D.v. of this preamble, section 1411(c)(1)(B) only allows deductions allowed by other Code sections; it does not establish a basis for a deduction that does not exist elsewhere in the Code. Therefore, the Treasury Department and the IRS do not adopt the recommendation that the final regulations contain an offsetting deduction (or a reversal of a net loss item) that is subject to section 1411. Nevertheless, the Treasury Department and the IRS recognize that in some cases it is appropriate to exclude certain nonpassive items of income from net investment income. Accordingly, in the limited and specific situations described in this part of the preamble, the final regulations deem a particular item of income to be ''derived in the ordinary course of a trade or business'' for purposes of section 1411(c)(1)(A) and therefore excluded from net investment income. However, the Treasury Department and the IRS emphasize that these specific rules contained in these final regulations are for section 1411 purposes only, and thus taxpayers should not draw any inference regarding the treatment of these items for any purpose other than section 1411. See § 1.1411–1(c).

i. Treatment of Self-Charged Interest

Commentators noted that, under the proposed regulations, a taxpayer who is not engaged in the trade or business of lending would have net investment income when it receives interest income attributable to a loan made to a passthrough entity in which it materially participates because the offsetting interest expense allocable to the taxpayer from the nonpassive activity would not be a properly allocable deduction under section 1411(c)(1)(B) and § 1.1411–4(f). An analogous situation was identified during the 1986 enactment of section 469, which resulted in the promulgation of the self-charged interest rules in § 1.469–7.

In response to these comments, the final regulations include a special rule that addresses self-charged interest. The special rule provides that, in the case of self-charged interest received from a nonpassive entity, the amount of interest income excluded from net investment income will be the taxpayer's allocable share of the nonpassive deduction. The rule cross-references the self charged interest rule of § 1.469–7 for the operative mechanics. The mathematical result of the special rule is to exclude an amount of interest income from net investment income that is equal to the amount of interest income that would have been considered passive income under § 1.469–7 if the nonpassive activity was considered passive activity. However, the special rule contains an exception. The special rule will not apply to a situation where the interest deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

ii. Treatment of Certain Nonpassive Rental Activities

With regard to grouping and recharacterizations, commentators recommended that the final regulations clarify that determining whether income is net investment income should be based solely on its recharacterized or grouped status as nonpassive under section 469 and the regulations thereunder. Although the Treasury Department and the IRS recognize the administrative simplicity of this rule, the Treasury Department and the IRS believe that this rule is too broad as it would 'deem' certain items to be derived in a trade or business when it is unlikely that a section 162 trade or business is present. For example, see §§ 1.469–1T(e)(3)(ii)(D) (rental of property incidental to an investment activity) and 1.469–2T(f)(3) (rental of nondepreciable property). Therefore, the final regulations do not adopt this broad approach.

Another option advanced by some commentators is a special rule for self-charged rents similar to § 1.469–7 pertaining to self-charged interest. However, a proposed rule for self-charged rents would be more complex than the rule for self-charged interest because the amount of the net investment income exclusion must take into account the deductions allowed (depreciation, taxes, interest, etc.) that are not present in self-charged interest. A self-charged rent rule would have to exclude from gross income rents in the same way as self-charged interest, and would also exclude a share of the deductions attributable to earning the income. In addition, a rule based on § 1.469–7 would cover only rents within the context of section 1411(c)(1)(A)(i) and would not provide relief from the inclusion of the gain upon the sale of the property from net investment income. Accordingly, the final regulations do not adopt this recommendation.

However, the Treasury Department and the IRS appreciate the concerns raised by the commentators. Therefore, the final regulations provide special rules for self-charged rental income. The final regulations provide that, in the case of rental income that is treated as nonpassive by reason of § 1.469–2(f)(6) (which generally recharacterizes what otherwise would be passive rental income from a taxpayer's property as nonpassive when the taxpayer rents the property for use in an activity in which the taxpayer materially participates) or because the rental activity is properly grouped with a trade or business activity under § 1.469–4(d)(1) and the grouped activity is a nonpassive activity, the gross rental income is deemed to be derived in the ordinary course of a trade or business. Furthermore, in both of these instances, the final regulations provide that any gain or loss from the assets associated with that rental activity that are treated as nonpassive gain or loss will also be treated as gain or loss attributable to the disposition of property held in a nonpassive trade or business.

iii. Treatment of Section 469(c)(7) Real Estate Professionals

With regard to real estate professionals, many commentators recommended that the final regulations provide that, if a real estate professional materially participates in his or her rental real estate activities, then the rental income should be excluded from net investment income. The general theory behind the commentators' recommendation was that such rental income must be derived in the ordinary course of a trade or business because a taxpayer that qualifies as a real estate professional under section 469 is necessarily engaged in a real property trade or business. In certain situations, the Treasury Department and the IRS agree that some real estate professionals derive rental income in the ordinary course of the real property trade or business. However, for several reasons, the Treasury Department and the IRS do not believe that every real estate professional is necessarily engaged in the trade or business of rental real estate.

Section 469(c)(7)(C) provides 11 types of activities that constitute a real property trade or business. Only a few of the 11 enumerated activities may be relevant in determining whether rents are derived in the ordinary course of a trade or business, such as the activities of ''rental'' and ''leasing.'' Some of the other enumerated items have little, if any, relation to rental activities. For example, an individual engaged in real property construction could satisfy the two tests enumerated in section 469(c)(7)(B) to qualify as a real estate professional, but the construction activities may not have any relation to whether the individual's rental income is derived in the ordinary course of a trade or business. In addition, the scope of activities that a taxpayer may consider in determining whether a real property trade or business exists is broader than the definition of a trade or business for section 1411 purposes. Section 1.469–9(b)(1) states ''[a] trade or business is any trade or business determined by treating the types of activities in § 1.469–4(b)(1) as if they involved the conduct of a trade or business, and any interest in rental real estate, including any interest in rental real estate that gives rise to deductions under section 212.'' Therefore, under § 1.469–9(b)(1), individuals may establish real estate professional status by combining non-trade or business activities (such as multiple section 212 rental activities) for determining a taxpayer's real property trade or business. Because the analysis under section 469(c)(7) and the regulations thereunder to determine whether a taxpayer is a real estate professional differs from the analysis to determine whether rental income is derived in the ordinary course of a trade or business under section 1411(c)(1)(A)(i), the use of a taxpayer's real estate professional status as a proxy to determine whether rental income is derived in the ordinary course of a trade or business is not appropriate.

Once an individual establishes real estate professional status, that status only allows the taxpayer to treat rental real estate activities as nonpassive if the taxpayer satisfies at least one of the tests for material participation in § 1.469–5T in the rental real estate activities. The status as a real estate professional alone does not establish that those rental real estate activities rise to the level of a trade or business within the meaning of section 162. Section 1.469–5T(a) provides seven tests to establish material participation. However, not all of the material participation tests provide conclusive evidence that a taxpayer is regularly, continuously, and substantially involved in a rental trade or business within the meaning of section 162. For example, a real estate broker that satisfies the section 469(c)(7) real estate professional requirements by reason of hours devoted to brokerage could classify his or her real property rental activity as nonpassive by satisfying § 1.469–5T(a)(2). Under this test, the taxpayer needs to establish only that the taxpayer's participation in the activity was substantially all of the activity (taking into account all other persons involved in the activity) to establish material participation. As a result, and similar to the case of establishing real estate trade or business, the Treasury Department and the IRS believe that reliance on the § 1.469–5T material participation tests as a proxy to establish regular, continuous, and substantial activity within the meaning of section 162 for section 1411 purposes is not appropriate.

The final regulations do, however, provide a safe harbor test for certain real estate professionals in § 1.1411–4(g)(7). The safe harbor test provides that, if a real estate professional (within the meaning of section 469(c)(7)) participates in rental real estate activities for more than 500 hours per year, the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. Alternatively, if the taxpayer has participated in rental real estate activities for more than 500 hours per year in five of the last ten taxable years (one or more of which may be taxable years prior to the effective date of section 1411), then the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. The safe harbor test also provides that, if the hour requirements are met, the real property is considered as used in a trade or business for purposes of calculating net gain under section 1411(c)(1)(A)(iii). The Treasury Department and the IRS recognize that some real estate professionals with substantial rental activities may derive such rental income in the ordinary course of a trade or business, even though they fail to satisfy the 500 hour requirement in the safe harbor test. As a result, the final regulations specifically provide that such failure will not preclude a taxpayer from establishing that such gross rental income and gain or loss from the disposition of real property, as applicable, is not included in net investment income.

iv. Treatment of Former Passive Activities

Losses disallowed by section 469 stem from (1) expenses incurred in the passive activity or (2) a sale of a portion of the passive activity or property used in the activity, in excess of passive income from any source. Section 1.469–1T(f)(2)(i) and (ii) require taxpayers to trace disallowed losses back to the activities giving rise to the losses and to further trace the losses allocated to a particular activity back to the deductions from the activity giving rise to the net loss. When a taxpayer disposes of a partial interest in a passive activity or disposes of assets used within a passive activity, any losses realized from the disposition are treated as arising from the passive activity and are allocated to that activity. Sections 469(b), (g), and § 1.469–1(f)(4) provide that, generally, passive losses that are disallowed in the current year carry forward to the succeeding tax year and remain suspended until the taxpayer has sufficient passive income to offset those losses or otherwise disposes of the entire activity in a fully taxable transaction with an unrelated party.

In cases where a taxpayer materially participates in an activity that was formerly a passive activity, the deductions produced by the activity in the current year are not subject to section 469. However, the carryover (or ''suspended'') passive losses incurred in prior years when the activity was a passive activity remain disallowed passive losses subject to carryover. Section 469(f)(1)(A) allows the suspended passive losses when the former passive activity produces current-year net income (even though that income is technically from a nonpassive activity). To the extent the taxpayer has passive losses allocable to a former passive activity in excess of the current year nonpassive income from that activity (the section 469(f)(1)(A) amount), section 469(f)(1)(C) allows excess passive losses to offset net passive income from other passive activities of the taxpayer. Any suspended passive losses not allowed by section 469(f)(1)(A) or (C) remain suspended and are carried over to the following year.

Section 469 does not alter the character or nature of the items that make up the suspended passive loss. If the suspended losses are attributable to operating deductions in excess of operating income, such suspended losses retain that character as deductions described in section 62(a)(1) or 62(a)(4) when ultimately allowed by section 469. To the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character as section 165 losses when they are ultimately allowed by section 469.

If a taxpayer materially participates in a former passive trade or business activity, the gross income produced by that activity (and associated section 1411(c)(1)(B) properly allocable deductions) in the current year generally would not be net investment income because the activity is no longer a trade or business that is a passive activity within the meaning of section 469. However, in the case of rental income not derived in the ordinary course of a trade or business, a classification of the rental income as nonpassive for purposes of section 469 will not result automatically in the exclusion of such rental income and associated deductions from net investment income. Furthermore, it is possible that a section 469 former passive activity may still generate net investment income on its disposition to the extent the gain is included in section 1411(c)(1)(A)(iii) and not entirely excluded by, for example, section 1411(c)(4).

Suspended losses that are allowed by reason of section 469(f)(1)(A) or (C) may constitute properly allocable deductions under section 1411(c)(1)(B) and § 1.1411–4(f)(2) (to the extent those losses would be described in section 62(a)(1) or 62(a)(4)) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) and § 1.1411–4(d) (to the extent those losses would be described in section 62(a)(3) in the year they are allowed, depending on the underlying character and origin of such losses). The treatment of excess suspended losses of a former passive activity upon a fully taxable disposition is discussed in the next section of this preamble.

The final regulations clarify, for section 1411 purposes, the treatment of income, deductions, gains, losses, and the use of suspended losses from former passive activities. The Treasury Department and the IRS considered three alternatives. One approach is the complete disallowance of all suspended losses once the activity is no longer a passive activity (in other words, becomes a former passive activity or a nonpassive activity). The rationale behind this approach is that the income from the activity would not be includable in net investment income, thus the suspended losses become irrelevant. Another approach is the unrestricted allowance of all suspended losses in the year in which they are allowed by section 469(f), regardless of whether the nonpassive income is included in net investment income. The rationale behind this approach is that the losses were generated during a period when the activity was a passive activity, and if such losses were allowed in full, they would have potentially reduced net investment income, and therefore the losses should continue to retain their character as net investment income deductions. The third approach is a hybrid approach that allows suspended losses from former passive activities in calculation of net investment income (as properly allocable deductions under section 1411(c)(1)(B) or in section 1411(c)(1)(A)(iii) in the case of losses) but only to the extent of the nonpassive income from such former passive activity that is included in net investment income in that year. The final regulations adopt this hybrid approach.

For example, in the case of a former passive trade or business activity with suspended losses of $10,000 that generates $3,000 of net nonpassive income, section 469(c)(1)(A) allows $3,000 of the $10,000 suspended loss to offset the nonpassive income in the current year. Since the gross nonpassive income is not included in section 1411(c)(1)(A)(ii) (or in section 1411(c)(1)(A)(iii) in the case of gains from the disposition of property in such trade or business), none of the deductions and losses associated with such income are properly allocable deductions under section 1411(c)(1)(B) (or in section 1411(c)(1)(A)(iii) in the case of losses from the disposition of property in such trade or business). Thus, under the facts of this example, the final regulations provide that the $3,000 is not a properly allocable deduction (or a loss included in section 1411(c)(1)(A)(iii)). However, to the extent that the remaining suspended passive loss deduction of $7,000 is allowed by section 469(f)(1)(C) to offset other net passive activity income (which is included in net investment income by reason of section 1411(c)(1)(A) less deductions allowed by section 1411(c)(1)(B)), such amounts are considered properly allocable deductions under section 1411(c)(1)(B), or as a loss included in section 1411(c)(1)(A)(iii), as appropriate.

v. Treatment of Losses and Deductions Described in Section 469(g)(1)

Section 469(g)(1) provides, in relevant part, that if all gain or loss realized on a disposition is recognized, the excess of any loss from that activity for such taxable year (determined after the application of section 469(b)), over any net income or gain for that taxable year from all other passive activities (determined after the application of section 469(b)), shall be treated as a loss which is not from a passive activity. The preamble to the proposed regulations requested comments on ''whether the losses triggered under section 469(g)(1) upon the disposition should be 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).'' Because section 469(g)(1) provides that the allowed loss is treated as a loss ''which is not from a passive activity,'' there is a question whether this language prevents the allowed losses from being treated as ''properly allocable deductions'' from passive activities for purposes of section 1411.

Commentators recommended that losses allowed under section 469(g) be taken into account in computing net gain under section 1411(c)(1)(A)(iii), and that any net loss in section 1411(c)(1)(A)(iii) resulting from the use of such losses should be treated as a properly allocable deduction under section 1411(c)(1)(B). One commentator suggested that, to the extent a taxpayer has a net loss under section 1411(c)(1)(A)(iii) that is attributable to the allowed loss under section 469(g), the excess section 469(g) loss should continue to be suspended and carried forward to offset future gain resulting from the disposition of other passive assets subject to inclusion in section 1411(c)(1)(A)(iii).

The final regulations provide that section 469(g) losses, which are treated as losses from a nonpassive activity, are taken into account for net investment income purposes in the same manner in which they are taken into account for chapter 1 purposes. As discussed in the context of section 469(f), section 469 does not alter the character or nature of the suspended passive loss. If the suspended losses allowed as a current year deduction by reason of section 469(g)(1) are attributable to operating deductions in excess of operating income, such suspended losses retain that character as, in most cases, deductions described in section 62(a)(1) or 62(a)(4). However, to the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character when they are ultimately allowed by section 469. Therefore, losses that are allowed by reason of section 469(g) may constitute properly allocable deductions under section 1411(c)(1)(B) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) in the year they are allowed, depending on the underlying character and origin of such losses. The recommendations proposed by the commentators depart from the general operating principles in chapter 1 and add additional complexity. Therefore, the final regulations do not adopt the positions advanced by commentators that section 469(g)(1) suspended losses should offset the gain first, then be allowed as a properly allocable deduction or that it should continue to be suspended and carried forward.

Furthermore, section 469(g)(1) losses that are allowed by reason of a fully taxable disposition of a former passive activity are also fully taken into account for net investment income. As a result of the ordering rules in sections 469(f)(1) and (g)(1), any nonpassive gain realized on the disposition that causes passive losses to be allowed would be excluded from net investment income under the general former passive activity rules discussed in part 5.E.iv of this preamble. However, to the extent that any of the nonpassive gain is included in net investment income (for example, a portion of the gain remaining after the application of section 1411(c)(4)), the final regulations allow the same amount of suspended losses described in section 469(f)(1)(A) to be included in net investment income to offset the gain. The section 469(g)(1) losses allowed by reason of the disposition of the former passive activity are allowed in full because they relate to a period of time when the activity was a passive activity and represent true economic losses from a passive activity that do not materially differ from other section 469(g)(1) losses from non-former passive activities.

F. Other Comments Relating to the Calculation of Net Investment Income

The Treasury Department and the IRS received comments requesting that these final regulations address the treatment for section 1411 purposes of section 707(c) guaranteed payments for capital, section 736 payments to retiring or deceased partners, Real Estate Mortgage Investment Conduits (REMICs), and certain notional principal contracts. After consideration of these comments, the Treasury Department and the IRS believe that it is appropriate to address the treatment of these payments in regulations. However, because such guidance was not included in the proposed regulations, these items are addressed in a companion notice of proposed rulemaking (REG–130843–13) relating to the Net Investment Income Tax.

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. Passive Activities

The preamble to the proposed regulations stated that ''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 that involves the conduct of a trade or business.'' The preamble to the proposed regulations acknowledged that, due to the differences in the definitions for purposes of section 1411 and section 469, gross income from some 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).

The Treasury Department and the IRS have received several comments and inquiries regarding the consequences of the income recharacterization rules. The regulations under section 469 provide special rules that treat income from certain passive 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 addition, the preamble to the proposed regulations highlighted a special gain recharacterization rule in § 1.469–2(c)(2)(iii) applicable to gains attributable to the disposition of substantially appreciated property formerly used in a nonpassive activity.

In order for these section 469 recharacterization rules to apply, the income or gain subject to recharacterization must be passive activity income under the general section 469 operating rules. If the income is nonpassive by reason of some other provision of section 469 (such as a taxpayer materially participating in the activity), the recharacterization rules are not applicable because there is no passive income to recharacterize.

In general, commentators had different opinions regarding the treatment under section 1411(c)(1) of income that is recharacterized under the rules in section 469. In the case of income from a passive activity trade or business, some commentators stated that net investment income does not include any amount of income or gain that is recharacterized as ''not from a passive activity,'' either because it satisfies the ordinary course exception (derived in the ordinary course of a trade or business not described in section 1411(c)(2)) in section 1411(c)(1)(A)(i) or (iii), or because such income is not income within the scope of section 1411(c)(1)(A)(ii). Other commentators stated that such nonpassive income qualifies as net investment income under section 1411(c)(1)(A) because the activity's status as a passive activity trade or business described in section 1411(c)(2)(A) is unchanged, despite section 469's recharacterization of a portion of the income or gain to income ''not from a passive activity.''

Another commentator recommended that the final regulations not apply a single rule to all income recharacterization situations because the underlying section 469 rationale differs for each one. The commentator stated that the various income recharacterization rules do not recharacterize all the income and gains in the same way. In the case of income recharacterizations covered by §§ 1.469–2T(f)(3), 1.469–2T(f)(4), and 1.469–2T(f)(7), such income is further characterized as portfolio income (within the meaning of section 469(e)(1)(A)) by § 1.469–2T(f)(10). In the case of the recharacterization of gains under § 1.469–2(c)(2)(iii), the characterization of the gain as portfolio income is determined under § 1.469–2(c)(2)(iii)(F) based on whether the property was held in an investment activity before it was used in a passive activity. The commentator recommended that the final regulations distinguish recharacterized income treated as portfolio income from recharacterized income not treated as portfolio income.

Section 1.1411–5(b)(2) of the final regulations provides clarification regarding the interaction between the net income recharacterization rules under section 469 and the section 1411 rules. For purposes of section 1411, the final regulations generally follow the section 469 characterization of the income and gain, particularly the treatment of the items as portfolio income. Section 1.1411–5(b)(2) of the final regulations provides that, to the extent that income or gain from a trade or business is subject to a net income recharacterization rule described in §§ 1.469–2T(f)(2), § 1.469–2(f)(5), or § 1.469–2(f)(6), the gross income or gain treated as ''not from a passive activity'' will not be considered derived from a trade or business described in section 1411(c)(2)(A). In addition, any gain recharacterized as ''not from a passive activity'' by reason of § 1.469–2(c)(2)(iii) is not derived from a trade or business described in section 1411(c)(2)(A) if the gain does not constitute portfolio income under § 1.469–2(c)(2)(iii)(F). In the case of recharacterization rules covered by § 1.469–2T(f)(10) and § 1.469–2(c)(2)(iii)(F), the underlying trade or business remains a passive activity within the meaning of section 1411(c)(1)(A) and § 1.1411–5(a)(1).

B. Trading in Financial Instruments or Commodities

The proposed regulations provided that, for purposes of section 1411(c)(2)(B), 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. Section 1.1411–5(c)(1) of the proposed regulations defined 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.

Two comments were received regarding the definition of a financial instrument in the proposed regulations. One commentator asked for explicit language that financial instruments that are used in a trade or business and produce foreign currency gain are exempt from section 1411. The same commentator requested that the proposed definition of a financial instrument be narrowed so that it would exclude ''non-financial instruments,'' such as contracts that reference electricity or weather. Another commentator suggested that the term ''stock'' in the definition of a financial instrument be replaced with the phrase ''security as defined in section 2(a)(1) of the Securities Act of 1933'' to broaden the scope of the definition.

With respect to the first comment, foreign currency gain or loss that otherwise is not subject to the Self-Employment Contribution Act is appropriately treated as net investment income. Regarding the definition of a financial instrument, the Treasury Department and the IRS believe that Congress chose that term to capture a broader class of instruments than the securities described in section 475. The suggestion to limit the definition of a ''financial instrument'' to exclude a derivative that is referenced to non-financial information, such as electricity or weather, would not be consistent with the intention to include in net investment income the income from all types of investment property. With respect to the second comment, there is no indication that Congress intended the definition of the term ''financial instrument'' to be coextensive with the definition of the term ''security'' used by the SEC, as evidenced by the fact that section 1411(c)(2)(B) uses the term ''financial instrument,'' not ''security.'' Accordingly, after consideration of both comments, neither suggestion was adopted in the final regulations.

7. Comments Regarding Working Capital

Section 1411(c)(3) provides that a rule similar to the rule of section 469(e)(1)(B) (the working capital rule) applies for purposes of section 1411. 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 is treated as not derived in the ordinary course of a trade or business. Section 1.469–2T(c)(3)(iii) provides an exception to the portfolio income characterization rule for items that are derived in the ordinary course of a trade or business. Section 1.1411–6(a) of the proposed regulations provided that, for purposes of section 1411(c)(3), working capital and the income generated therefrom will be determined under principles similar to those described in § 1.469–2T(c)(3)(ii).

Several commentators noted that the proposed regulations lack an adequate definition of ''working capital'' for purposes of section 1411. One commentator stated that the application of section 1411 is too restrictive because it taxes all working capital as income not derived in the ordinary course of business. Another commentator noted that the regulations should clearly define what property is considered working capital, particularly where capital is invested in a trade or business that either does not rise to the level of a trade or business under section 1411(c)(2)(A) or a trading business described in section 1411(c)(2)(B) that generates nonpassive income. One commentator noted that the cross-reference to working capital in section 469 does not account for the different purposes of the two statutory schemes. Commentators also stated that, if the final regulations do not elaborate on the definition of working capital, taxpayers must speculate where the dividing line is between active business assets and working capital.

Several commentators requested that the final regulations include a more comprehensive definition of working capital. One commentator recommended that proposed § 1.1411–6 be withdrawn and replaced with industry-specific guidelines for a safe harbor. Another commentator suggested the final regulations exclude income generated from liquid, short-term investments, such as interest-bearing bank accounts, from the definition of working capital and further exclude a reasonable amount of working capital.

The specific cross-reference in section 1411(c)(3) to section 469(e)(1)(B) indicates Congress' intent that the definition of working capital in § 1.1411–6 be consistent with the rules in section 469(e)(1)(B) and § 1.469–2T(c)(3)(ii). Accordingly, the proposed regulations intentionally aligned the section 1411 treatment of working capital with the section 469 rules. In addition, the rule in the proposed regulations avoids complexity that divergent definitions would have on tax administration and compliance. The Treasury Department and the IRS appreciate that certain businesses require different amounts of working capital based on their industries or general business practices, but the Treasury Department and the IRS do not believe that the promulgation of working capital definitions based on industry-specific characteristics would be administrable. Further, if the rules on working capital were materially different for section 469 and section 1411 purposes, such items would have to be reevaluated annually and would require detailed accounting and reporting burdens for both the IRS and taxpayers. As a result, the final regulations retain the provisions in proposed § 1.1411–6 without change. However, see part 5.A.ii.(b) of this preamble for a discussion of changes to the proposed regulations regarding items derived in the ordinary course of a trade or business.

8. Comments Regarding the Calculation of Gain or Loss Attributable to the Disposition of Interests in Partnerships and S Corporations

The proposed regulations described the method for adjusting a transferor's gain or loss from the disposition of a partnership interest or S corporation stock based on the entity's ownership of assets that are nonpassive with respect to the transferor. Under that method, a transferor first computes its gain (or loss) on disposition of its interest in the entity, and then reduces that gain (or loss) by the amount of nonpassive gain (or loss) that would have been allocated to the transferor upon a hypothetical sale of all of the entity's assets for fair market value immediately before the transfer.

Several commentators questioned the proposed regulations' methodology for adjusting a transferor's gain or loss on the disposition of its partnership interest or S corporation stock. These commentators noted that section 1411(c)(4) requires that gain (or loss) from such dispositions be taken into account under section 1411(c)(1)(A)(iii) ''only to the extent of the net gain [or loss] which would be 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.'' The commentators suggested that section 1411(c)(4) therefore includes gain/loss from the disposition of a partnership interest or S corporation stock only to the extent of the transferor's share of gain/loss from the entity's passive assets. Thus, under the commentator's approach, the amount of gain or loss included in section 1411(c)(A)(iii) is the lesser of a taxpayer's gain on the disposition of the interest or the taxpayer's share of gain or loss on the deemed sale of the entity's assets that would be included in calculating the taxpayer's net investment income. Commentators also discussed the complexity of the proposed regulations, stating that the regulations imposed a high compliance burden, including requiring a transferor to obtain information from the entity regarding valuation and tax basis.

After considering these comments, the Department of Treasury and the IRS are withdrawing the proposed regulations that address this issue and are issuing new proposed regulations under § 1.1411–7 adopting the commentators' suggestion, which are being published contemporaneously with these final regulations (REG–130843–13).

9. Comments Regarding the Exclusion of Certain Income under Section 1411(c)(5)

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).

Section 1.1411–8(a) of the proposed regulations provided 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 final regulations generally retain the rules in the proposed regulations relating to whether an amount is a distribution from a plan within the meaning of section 1411(c)(5) and, thus, excluded from net investment income. In addition, the final regulations retain the rule that, for purposes of section 1411, amounts that are deemed distributions under the Code for income tax purposes 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). The final regulations also retain the rule in the proposed regulations that any amount that is not treated as a distribution for purposes of the qualification requirements under the Code, 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.

One commentator asked for clarification on the application of section 1411 to employer securities. The commentator specifically asked for clarification on whether section 1411 applies to dividends on employer securities held by an employee stock ownership plan (as defined in section 4975(e)(7) of the Code) that are paid directly to plan participants. A–3 of § 1.404(k)–1T provides that a deductible dividend under section 404(k) that is paid directly to a plan participant or beneficiary is treated as a distribution under the plan for purposes of sections 72, 401, and 402 of the Code. The final regulations clarify that any dividend that is deductible under section 404(k) and is paid in cash directly to a plan participant or beneficiary is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. This rule does not apply to amounts paid as a dividend after the employer securities have been distributed from a qualified plan. Those amounts paid as dividends are included in net investment income.

The commentator also asked for clarification on whether section 1411 applies to the net unrealized appreciation realized on a disposition of employer securities that occurs after the securities were distributed from a qualified plan. Section 402(e)(4) provides that the net unrealized appreciation in employer securities that are distributed from a qualified plan is excluded from gross income in the year of the distribution in certain circumstances. In the case of a lump-sum distribution (within the meaning of section 402(e)(4)(D)), the net unrealized appreciation in the employer securities distributed is excluded from gross income. In the case of any other distribution (other than a distribution that is not currently taxable under the rollover rules), the net unrealized appreciation in the employer securities distributed is generally excluded from gross income only to the extent that it is attributable to after-tax employee contributions. Net unrealized appreciation is defined in § 1.402(a)–1(b)(2)(i) as the excess of the market value of employer securities at the time of distribution over the cost or other basis of such securities to the trust. The final regulations clarify that any such net unrealized appreciation in employer securities that is realized in a disposition of those employer securities is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. The regulations also provide that any appreciation in value that occurs subsequent to the distribution of the employer securities from a qualified plan is included in net investment income when realized.

10. Comments Regarding the Interaction between Section 1411 and Self-Employment Tax

Section 1411(c)(6) provides that net investment income does not include items taken into account in determining self-employment income for such taxable year on which a tax is imposed by section 1401(b). Several commentators, in considering the interaction of self-employment tax and section 1411, suggested that the regulations clarify that a taxpayer who is fully employed by a limited liability company (LLC) or a limited liability partnership (LLP) materially participates in that entity, and, therefore, the taxpayer's distributive share of income from the LLC or LLP is self-employment income for which a tax is imposed by section 1401. The final regulations do not adopt this suggestion because the imposition of self-employment taxes on LLC members and partners of an LLP is outside the scope of these regulations.

Proposed § 1.1411–9(b) provided a special rule for traders; specifically 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. One commentator suggested that this rule be amended to provide that a taxpayer can elect whether properly allocable deductions related to the taxpayer's trade or business of trading in financial instruments or commodities reduce net earnings from self-employment. The expenses of a trader maintaining a trade or business of trading in financial instruments or commodities are taken into account for purposes of determining self-employment income. Thus, such expenses, but for the special rule in § 1.1411–9(b), could not be used to reduce net investment income. The Treasury Department and the IRS believe that a trader should be able to reduce net investment income by amounts not used to reduce net earnings from self-employment income. Thus, the special rule is an exception under section 1411 for the benefit of taxpayers. The special rule was not intended to alter the result under the self-employment tax provisions. Accordingly, the final regulations do not adopt the commentator's suggestion.

11. Comments Regarding the Section 1411 Treatment of Controlled Foreign Corporations and Passive Foreign Investment Companies

A. Income Derived From a Trade or Business Described in Section 1411(c)(2)

Pursuant to section 1411(c)(1)(A)(ii), gross income derived from a trade or business described in section 1411(c)(2) is net investment income. A trade or business is described in section 1411(c)(2) if it is a passive activity (within the meaning of section 469) with respect to the taxpayer or a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)). Proposed § 1.1411–10(b), which applies to certain owners of controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs), provides that the special rules in proposed § 1.1411–10 do not apply to income derived by those taxpayers from a trade or business described in section 1411(c)(2) and § 1.1411–5. Instead, such income is included in net investment income under section 1411(c)(1)(A)(ii) and § 1.1411–4(a)(1)(ii).

A commentator asked if the determination of whether income is ''derived from'' a trade or business described in section 1411(c)(2) for § 1.1411–10(b) purposes is made by reference to the trade or business of the CFC or the PFIC, or the trade or business of the taxpayer (or passthrough entity in which the taxpayer invests) that holds the CFC or PFIC. The commentator noted that the rules in proposed § 1.1411–4(b) provided guidance on determining whether income is derived in a trade or business for purposes of section 1411(c)(1)(A)(ii). However, the commentator stated that the rule in proposed § 1.1411–10(b) may be of limited applicability if the rules in § 1.1411–4(b) apply for purposes of proposed § 1.1411–10(b). Section 1.1411–10(b)(1) of these final regulations clarifies that the trade or business determination for purposes of § 1.1411–10(b) is made pursuant to the rules set forth in § 1.1411–4(b)(2), which provide that the determination is either based on the taxpayer's trade or business or the trade or business of the passthrough entity in which the taxpayer invests.

Commentators also recommended that guidance be provided regarding the application of § 1.1411–10(b) to income derived from a trade or business that is a passive activity within the meaning of section 469 because of a concern that taxpayers may not be treated as engaged in a passive activity with respect to a CFC or qualified electing fund (QEF). Although theoretically the definition of ''passive activity'' under section 469 could include holding an interest in a CFC or PFIC, the commentators pointed out that amounts included in income under sections 951(a) (section 951 inclusions) and 1293(a) (section 1293 inclusions) are excluded from the definition of ''passive income'' for section 469 purposes, and, instead, are treated as portfolio income under § 1.469–2T(c)(3)(i)(A). The commentators stated that the exclusion of these items from ''passive income'' may mean that income derived from CFCs and QEFs would never be treated as income derived from a ''passive activity.'' In such a case, § 1.1411–10(b) would never apply to a section 951 inclusion or section 1293 inclusion even if the inclusion was derived from a CFC or QEF held in a trade or business that is a passive activity. After consideration of the comments, the Treasury Department and the IRS do not believe that the final regulations need to be clarified in order for § 1.1411–10(b) to apply to a taxpayer that holds a CFC or QEF in a trade or business that is a passive activity with respect to the taxpayer. Section 1411(c)(2)(A) and the regulations promulgated thereunder cross-reference section 469 solely for purposes of defining ''passive activity.'' Section 1.1411–10 does not cross-reference the section 469(e) rules, which provide guidance on whether income is treated as income from a passive activity, or the rule in § 1.469–2T(c)(3)(i)(A), which addresses portfolio income. In addition, § 1.469–1T(d)(1) provides that the characterization of items of income as passive activity gross income (within the meaning of § 1.469–2T(c)) applies only for purposes of section 469. The rule in § 1.1411–10(b) does not incorporate the section 469 rules on portfolio income, and, thus, applies to income derived by a taxpayer from a CFC or QEF that is held in a trade or business that is a passive activity within the meaning of section 469.

The Treasury Department and the IRS also received a comment that addressed the application of the rules in § 1.1411–10(b) when a taxpayer holds a CFC or PFIC in connection with a trade or business described in section 1411(c)(2) in some, but not all, years. The commentator explained that the trade or business determination is made on an annual basis, which creates the potential for taxpayers to alternate between being subject to the rules in § 1.1411–10(b) and the other applicable rules in § 1.1411–10 on an annual basis. As a result, when a taxpayer does not make an election under § 1.1411–10(g), a taxpayer could either be subject to double taxation under section 1411, or could avoid tax under section 1411, depending on the facts and circumstances. The commentator suggested that the trade or business determination that was in effect in the year in which the taxpayer acquired an interest in a CFC or PFIC should apply to all years in which the taxpayer holds the CFC or PFIC. Although the Treasury Department and the IRS do not adopt the commentator's suggested approach, the final regulations coordinate the application of the rules in § 1.1411–10 when a taxpayer's trade or business determination, either as a trader or for passive activity purposes, causes the taxpayer to alternate between being subject to § 1.1411–10(b) and the other applicable rules in § 1.1411–10, to eliminate both the possibility of double taxation and the avoidance of taxation.

B. Income derived from CFCs and QEFs

In general, the proposed regulations provided that distributions of previously taxed earnings and profits attributable to section 951 inclusions and section 1293 inclusions are dividends for purposes of section 1411, absent an election under § 1.1411–10(g). If a taxpayer made the § 1.1411–10(g) election, the proposed regulations provided that section 951 inclusions and section 1293 inclusions (rather than the distributions of previously taxed earnings and profits) are treated as dividends for purposes of section 1411.

Commentators recommended that the Treasury Department and the IRS revise the final regulations to treat section 951 inclusions and section 1293 inclusions as dividends for purposes of section 1411 (without regard to any election by the taxpayer), rather than treating the distributions of previously taxed earnings and profits attributable to section 951 inclusions or section 1293 inclusions (that were included in chapter 1 income in a taxable year beginning after December 31, 2012) as dividends. The commentators stated that the rules in the proposed regulations applicable to CFCs and QEFs when an election under § 1.1411–10(g) is not in effect are unduly complicated and impose significant administrative burdens on taxpayers. A commentator also recommended modifying the regulations to generally impose section 1411 when section 951 inclusions and section 1293 inclusions are taxed for purposes of chapter 1, and permit taxpayers to elect to defer such tax until the distribution of the earnings and profits that previously were taxed pursuant to sections 951(a) or 1293(a) (in a taxable year beginning after December 31, 2012).

As set forth in the preamble to the proposed regulations, section 951 inclusions and section 1293 inclusions are not treated as dividends except when expressly provided for in the Code. See *Rodriguez* v. *Commissioner,* 137 T.C. 174 (2011), *aff'd.* 722 F.3d 306 (5th Cir. 2013). Accordingly, the Treasury Department and the IRS do not adopt the commentators' recommendations to treat section 951 inclusions and section 1293 inclusions as dividends for purposes of section 1411. For the same reason, the Treasury Department and the IRS do not adopt the recommendation to provide a default rule that would treat section 951 inclusions and section 1293 inclusions as subject to section 1411 when the inclusions are taken into account for purposes of chapter 1, unless the taxpayer affirmatively elected to defer taxation under section 1411 until the distribution of earnings and profits related to the inclusions.

The Treasury Department and the IRS also received a comment that recommended the application of a look-through approach for determining whether income derived with respect to a CFC or QEF is included in net investment income. Pursuant to a look-through approach, taxpayers would determine whether section 1411 applied to a section 951 inclusion or section 1293 inclusion by analyzing the income earned directly by the CFC or QEF that gave rise to the inclusion. The Treasury Department and the IRS do not adopt this recommendation because the approach raises administrative and compliance concerns, including concerns regarding the ability of QEF shareholders to compel a QEF to provide them with the information necessary to comply with a look-through rule.

A commentator pointed out that the same earnings could be subject to section 1411 tax twice if a taxpayer that made an election under § 1.1411–10(g) subsequently transfers CFC or QEF shares to a taxpayer that does not make the election. The Treasury Department and the IRS agree with the commentator that the earnings and profits of a CFC or QEF should be subject to tax under section 1411 only once. Accordingly, these final regulations provide that if earnings and profits of a CFC or QEF were included in the net investment income of an individual, estate, or trust pursuant to a § 1.1411–10(g) election, then a subsequent distribution of those earnings is excluded from the net investment income of any transferee, provided that the transferee can establish entitlement to the exclusion under rules similar to the rules in § 1.959–1(d) (which establish a successor in interest's ability to exclude from chapter 1 income the previously taxed earnings and profits with respect to an interest in a CFC acquired from another person).

In addition, the commentator noted a separate double counting issue with respect to earnings and profits that are included in income as a dividend under section 1248. For example, a seller would be subject to tax under section 1411 when it includes the earnings and profits in income as a dividend under section 1248, and a purchaser who did not make an election under § 1.1411–10(g) also would be subject to tax under section 1411 on a subsequent distribution of the earnings and profits because the distribution would be treated as a dividend for purposes of section 1411. The Treasury Department and the IRS agree that it is appropriate to prevent double taxation in the section 1248 context, and these final regulations include a rule that prevents double taxation with respect to amounts treated as a dividend under section 1248 for purposes of section 1411.

The final regulations include a new rule that applies when a taxpayer makes an election under § 1.1411–10(g) effective for taxable years beginning after December 31, 2013, but does not make an election under § 1.1411–10(g)(4)(iii) for a taxable year beginning before January 1, 2014 (2013 taxable year), and the taxpayer is subject to section 1411 in the 2013 taxable year. Under the new rule, any distributions of previously taxed earnings and profits during taxable years beginning after December 31, 2013, that are attributable to section 951 and 1293 inclusions in the 2013 taxable year, will be treated as dividends for purposes of section 1411 notwithstanding the election under § 1.1411–10(g). Without this rule, it may be possible to avoid taxation under section 1411 for any section 951 and 1293 inclusions during the 2013 taxable year. This is so because those inclusions would not be subject to tax under section 1411 during the 2013 taxable year in the absence of an election under § 1.1411–10(g) and, as a result of the election under § 1.1411–10(g) for taxable years beginning after December 31, 2013, distributions of previously taxed earnings and profits accrued in the 2013 taxable year would not be subject to section 1411. In order to simplify taxpayer record-keeping, for purposes of applying this special rule, distributions of previously taxed earnings and profits from the CFC or QEF during taxable years beginning after December 31, 2013, will be deemed to first come out of previously taxed earnings and profits attributable to section 951 and 1293 inclusions in the 2013 taxable year.

The Treasury Department and the IRS received a comment that suggested adding an example to the final regulations to illustrate a situation in which the earnings and profits of a CFC are never subject to section 1411 under section 1411(c)(1)(A)(i) and § 1.1411–4(a)(1)(i). The suggested example would include a fact pattern in which a taxpayer that did not make an election under § 1.1411–10(g) includes a section 951 inclusion in income for chapter 1 purposes. In the next year, and before the distribution of earnings and profits attributable to the section 951 inclusion, the taxpayer sells the CFC shares for no gain or loss (as computed for purposes of section 1411) to a taxpayer that makes an election under § 1.1411–10(g) with respect to the CFC. Under these facts, the earnings and profits related to the section 951 inclusion are never subject to tax under section 1411. The Treasury Department and the IRS believe that the application of § 1.1411–10 to this fact pattern is clear, and that an example is not necessary to illustrate the relevant provisions of § 1.1411–10. The commentator also asked that the final regulations clarify the meaning of the phrase ''with respect to which an election under paragraph (g) of this section is not in effect.'' The final regulations clarify that the references in § 1.1411–10 to an election under paragraph (g) not being in effect refer to the person that is determining the section 1411 consequences with respect to holding a particular CFC or QEF.

The Treasury Department and the IRS requested comments on whether guidance is necessary to determine the deductions that are properly allocable to items of net investment income if the election under § 1.1411–10(g) is not made. One such comment was received regarding the allocation of interest expense under section 163(d)(1). Section 1.1411–4(f)(3)(i) allows interest expense as a deduction against net investment income only to the extent allowed under section 163(d)(1), which limits investment interest expense in part based on a taxpayer's investment income. In the absence of an election under § 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. The commentator suggested that, where differences in timing occur, taxpayers should be allowed to calculate their section 163(d)(1) investment interest expense deduction based on amounts included in income for section 1411 purposes, in determining the amount of investment interest expense allocable to net investment income under section 1411. The Treasury Department and the IRS agree with this comment and these final regulations provide that the section 163(d)(1) investment interest expense deduction related to items of net investment income described in § 1.1411–10(c) may be calculated for purposes of section 1411 by adjusting section 163(d)(1)(B) ''investment income'' for purposes of section 1411 to reflect the inclusions under section 951 and section 1293 that are not included in section 1411 net investment income, and the distributions of previously taxed earnings and profits that are included in section 1411 net investment income. To the extent that the taxpayer chooses to calculate any of these deductions based on the amount of net investment income described in § 1.1411–10(c), that method of calculation must be consistently applied for purposes of section 1411 and may only be changed with the consent of the IRS.

C. CFCs and QEFs Held Through Domestic Partnerships and S Corporations

A comment was received on the conforming basis adjustment rules in § 1.1411–10(d)(2) that apply to a taxpayer that owns an interest in a CFC or QEF through a domestic partnership and that does not make an election under § 1.1411–10(g). The commentator stated that it was unclear whether basis adjustments pass through for both section 951 inclusions and distributions of previously taxed earnings and profits. The Treasury Department and the IRS believe that the rules in § 1.1411–10(d), which apply only for purposes of section 1411, adequately address the basis consequences specific to section 1411 that occur when a domestic partnership receives a distribution of previously taxed earnings and profits. The Treasury Department and the IRS believe that general questions about basis adjustments in the context of CFCs and QEFs held through passthrough entities would be more appropriately addressed in guidance under chapter 1.

The Treasury Department and the IRS received a comment that recommended issuing proposed rules regarding adjustments to basis under section 743 for section 1411 purposes. The commentator requested that the regulations clarify that basis adjustments under section 743 relate solely to the transferee and that transferee partners be permitted to adjust the basis of partnership property for purposes of section 1411 regardless of whether the partnership has elected under section 754 or has a substantial built-in loss. Under these regulations, except as otherwise provided, chapter 1 principles and rules apply in determining the tax under section 1411. Therefore, the Treasury Department and the IRS have determined that it is unnecessary to clarify that basis adjustments under section 743 relate solely to the transferee partner because this result is clear under existing law for purposes of chapter 1. The Treasury Department and the IRS have further determined that allowing a transferee partner to adjust its basis in partnership property when the partnership is not otherwise required to do so could create unnecessary administrative complexity for the partnership. Thus, the Treasury Department and the IRS have decided that additional rules relating to section 743 for section 1411 purposes are not necessary.

A comment was received that recommended that a rule be added to the final regulations to require partnerships to provide their partners with the information needed by the partners to compute their tax under section 1411 with respect to CFCs and PFICs held by the partnerships. The Treasury Department and the IRS do not adopt this recommendation. Rather, the IRS is in the process of revising the relevant IRS forms and instructions (such as Form 1065, ''U.S. Return of Partnership Income,'' and the associated Schedule K–1) to require partnerships and S corporations to provide to their partners and shareholders the information necessary to compute their tax under section 1411 with respect to CFCs and PFICs held by partnerships and S corporations.

A commentator recommended that the final regulations include a rule to treat a section 751(c) amount corresponding to the amount included in income as a dividend under section 1248 for section 1411 purposes as net investment income under section 1411(c)(1)(A)(i) rather than under section 1411(c)(1)(A)(iii). In the alternative, the commentator requested that an example be added to the final regulations to illustrate the operation of section 751 (taking into account section 1248) when a partner sells an interest in a partnership that holds CFC stock. The Treasury Department and the IRS believe that the section 1411 characterization of the section 751(c) amount that corresponds to a section 1248 dividend should be consistent with the chapter 1 characterization and not treated as a dividend, and thus do not adopt the recommendation to treat the amount as net investment income under section 1411(c)(1)(A)(i) or add an example to the final regulation.

D. Section 1.1411–10(g) Election Applicable to CFCs and QEFs

The proposed regulations permitted individuals, estates, and trusts to make an election pursuant to § 1.1411–10(g) to include section 951 inclusions and section 1293 inclusions in net investment income in the same manner and in the same taxable year as the amounts are included in income for chapter 1 purposes. Under the proposed regulations, the election was required to be made on or before the due date for filing the individual's, estate's, or trust's income tax return for the first taxable year that the individual, estate, or trust holds stock of a CFC or QEF and was subject to tax under section 1411 or would be subject to tax under section 1411 if the election were made. Under the proposed regulations the election, if made, applied to all CFCs and QEFs held directly or indirectly by the individual, estate, or trust, regardless of whether the interest in the CFC or QEF is held in the year the election is made or is acquired subsequently.

Commentators suggested that the § 1.1411–10(g) election should be permitted to be made on an entity-by-entity basis, rather than to all CFCs and QEFs held by the taxpayer, or subsequently acquired. The Treasury Department and the IRS adopt this recommendation, and these final regulations provide that the § 1.1411–10(g) election is made on an entity-by-entity basis.

The Treasury Department and the IRS received comments recommending that domestic partnerships and S corporations be allowed to make the § 1.1411–10(g) election. The commentators stated that the partner (or shareholder) level election would create an administrative burden for the partnership (or S corporation) because it would require the partnership (or S corporation) to maintain two sets of records with respect to its CFC and QEF investments: one for chapter 1 purposes and one for section 1411 purposes. In response to these comments, the final regulations include a rule that allows a domestic partnership, S corporation, or common trust fund to make the election in § 1.1411–10(g) for taxable years that begin after December 31, 2013. In addition, a domestic partnership, S corporation, or common trust fund can make the election in § 1.1411–10(g) for a taxable year beginning before January 1, 2014, if all of the partners, shareholders, or participants (as the case may be) consent to the election. The final regulations also provide that a § 1.1411–10(g) election may be made with respect to interests in CFCs or QEFs held indirectly through certain domestic entities such as domestic partnerships or S corporations if the domestic entity does not make a § 1.1411–10(g) election.

A commentator requested that the rule regarding the time for making an election under § 1.1411–10(g) election be revised so that taxpayers would not have to make an election until the first year in which they have a section 951 inclusion or section 1293 inclusion. The commentator stated that a rule based on ownership of a CFC or QEF, rather than a chapter 1 income inclusion, created a trap for the unwary because taxpayers may not consider the rules in § 1.1411–10 until they have a chapter 1 income inclusion. The Treasury Department and the IRS adopt this comment, and the final regulations revise the rules for making a § 1.1411–10(g) election to provide, in relevant part, that the election must be made no later than the first taxable year beginning after December 31, 2013, in which a person both has a section 951 or section 1293 inclusion under chapter 1 with respect to a CFC or QEF and is subject to section 1411 (or would be subject to tax under section 1411 if the election were made with respect to the CFC or QEF). Therefore, the final regulations permit a taxpayer to make the election in a year before the first year in which there is a chapter 1 inclusion under sections 951 or 1293 and the person is subject to tax under section 1411 (or would be subject to tax under section 1411 if the election were made). In addition, the final regulations provide that individuals, estates and trusts may make the election for a taxable year beginning before January 1, 2014.

A commentator suggested that the regulations be revised to allow taxpayers to make the § 1.1411–10(g) election on an amended return. The Treasury Department and the IRS adopt this suggestion, and these final regulations provide that the initial election can be made on an original or an amended return, provided that the year of the election, and all years affected by the election, are not closed by the period of limitations under section 6501.

The Treasury Department and the IRS also received comments suggesting the addition of certain procedural rules related to making § 1.1411–10(g) elections. A comment requested that the final regulations set forth a procedure for taxpayers to make protective § 1.1411–10(g) elections. In addition, a comment suggested that rules for making untimely § 1.1411–10(g) elections should be added to the final regulations, and recommended that the rules be consistent with the rules for making untimely QEF elections. Moreover, a comment suggested that purging elections, similar to QEF purging elections, should be allowed with respect to § 1.1411–10(g) elections. The Treasury Department and the IRS do not adopt these suggestions because they are not necessary in light of the changes these final regulations provide to increase the opportunities for the election to be made.

The § 1.1411–10(g) election generally will be made by individuals, estates, and trusts on Form 8960, ''Net Investment Income Tax—Individuals, Estates, and Trusts.'' Domestic partnerships, S corporations, and common trust funds will make the election on attachments to their relevant partnership or income tax returns.

12. Taxpayer Reliance on Proposed and Final Regulations

These regulations are effective for taxable years beginning after December 31, 2013, except that § 1.1411–3(d) applies to taxable years beginning after December 31, 2012. Taxpayers are reminded that section 1411 is effective for taxable years beginning after December 31, 2012.

Part 12 of the preamble to the proposed regulations stated that taxpayers may rely on the proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations. Furthermore, the preamble stated that any election made in reliance on the proposed regulations will be in effect for the year of the election, and will remain in effect for subsequent taxable years. In addition, taxpayers who opt not to make an election in reliance on the proposed regulations are not precluded from making that election pursuant to these final regulations.

For taxable years beginning before January 1, 2014, taxpayers may rely on either the proposed regulations or these final regulations for purposes of compliance with section 1411. See § 1.1411–1(f). However, to the extent that taxpayers take a position in a taxable year beginning before January 1, 2014 that is inconsistent with these final regulations, and such position affects the treatment of one or more items in a taxable year beginning after December 31, 2013, then such taxpayer must make reasonable adjustments to ensure that their section 1411 tax liability in the taxable years beginning after December 31, 2013, is not inappropriately distorted. For example, reasonable adjustments may be required to ensure that no item of income or deduction is taken into account in computing net investment income more than once, and that carryforwards, basis adjustments, and other similar items are adjusted appropriately.

Effective/Applicability Date

These final regulations apply to taxable years beginning after December 31, 2013, except that § 1.1411–3(d) applies to taxable years beginning after December 31, 2012.

Special Analyses

It has been determined that this Treasury decision 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 is hereby certified that the collection of information in § 1.1411–10(g) of these final regulations will not have a significant economic impact on a substantial number of small entities. Although a number of small entities may be subject to the requirements of this rule, any economic impact is minimal. This certification is based on the fact that the time required to secure and maintain the required information is minimal and taxpayers would ordinarily already collect and retain much of this information for other income tax and business purposes. The minimal information should be readily available to the parties and the professional skills that would be necessary to make the election would be the same as those required to prepare a return for the small business. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses, and no comments were received.

Drafting Information

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

List of Subjects

26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

26 CFR Part 602

Reporting and recordkeeping requirements.

Adoption of the Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are 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 an entry for paragraph (b)(3)(iv) to the § 1.469–11 the table of contents to read as follows:

§ 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) Eligibility criteria.

(C) Consequences of amended returns and examination adjustments.

(*1*) Taxpayers first subject to section 1411.

(*2*) Taxpayers ceasing to be subject to section 1411.

(*3*) Examples.

(D) 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 meets the Eligibility Criteria, as defined in paragraph (b)(3)(iv)(B) of this section, such individual, estate, or trust, in the first taxable year beginning after December 31, 2013, in which section 1411 would apply to such taxpayer, may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year. For this purpose, the determination of whether a taxpayer meets the Eligibility Criteria is made without regard to the effect of regrouping. The regrouping must be made in the manner prescribed by forms, instructions, or in other guidance on an original return for the taxable year for which the regrouping is done. A taxpayer that is an individual, estate, or trust may regroup its activities for any taxable year that begins during 2013, if the individual, estate, or trust meets the Eligibility Criteria 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 (b)(3)(iv) will apply to the taxable year for which the regrouping is done and all subsequent years.

(B) *Eligibility criteria.* The term *Eligibility Criteria* means that 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 § 1.1411–3(a)(1)(ii)(B)(*2*).

(C) *Consequences of amended returns and examination adjustments*—(*1*) *Taxpayers first subject to section 1411.* An individual, estate, or trust also may regroup activities, in the matter described in paragraph (b)(3)(iv)(A) of this section, on an amended return only if the changes reported on such amended return cause the taxpayer to meet the Eligibility Criteria for the first time beginning in the taxable year for which the amended return is applicable and the taxable year is not closed by the period of limitations on assessments under section 6501. If the amended return is for a tax year that precedes a tax year for which a taxpayer had regrouped its activities pursuant to paragraph (b)(3)(iv)(A) of this section, the regrouping on such amended return must be consistent with the taxpayer's subsequent year's regrouping. If a regrouping on an amended return is inconsistent with a subsequent year's grouping, the subsequent year's grouping is invalid under § 1.469–4(e)(1) unless a material change in facts and circumstances occurred in the subsequent year such that the subsequent year's grouping constitutes a permissible regrouping under § 1.469–4(e)(2). Similar rules also apply for any taxable year that begins during 2013.

(*2*) *Taxpayers ceasing to be subject to section 1411.* In the event a taxpayer regroups activities pursuant to paragraphs (b)(3)(iv)(A) or (C) of this section and it is subsequently determined that such taxpayer does not meet the Eligibility Criteria for the year of such regrouping, such regrouping will have no effect for that year and all future years. Appropriate adjustments should be made to reflect the voiding of the ineffective regrouping. However, notwithstanding the previous sentence, if an individual, estate, or trust meets the Eligibility Criteria in a subsequent year, such taxpayer is deemed to treat such regrouping as being made in such subsequent year unless the taxpayer either regroups in a different manner (so long as such alternative regrouping is permissible under § 1.469–4) or properly reflects the ineffective regrouping in the previous year. The subsequent year's regrouping may be made on an original or on an amended return for that year. This paragraph (b)(3)(iv)(C)(*2*) shall not apply if a taxpayer does not meet the Eligibility Criteria for the year of such regrouping as a result of the carryback of a net operating loss pursuant to section 172. Similar rules also apply for any taxable year that begins during 2013.

(*3*) *Examples.* The following examples illustrate the principles of paragraph (b)(3)(iv)(C) of this section. In each example, unless otherwise indicated, the taxpayer uses a calendar taxable year, the taxpayer is a United States citizen, and Year 1 is a taxable year in which section 1411 is in effect:

Example 1. In Year 1, X, a single individual, reports modified adjusted gross income (as defined in § 1.1411–2(c)) of $198,000 (including $12,000 of net investment income (as defined in § 1.1411–4)); thus is not subject to 1411. After X filed his original return, X receives a corrected Form 1099–DIV, which increases his modified adjusted gross income (as defined in § 1.1411–2(c)) and his net investment income by $2,500. X files an amended return for Year 1 in Year 2 reporting modified adjusted gross income of $200,500 and net investment income of $14,500. Pursuant to paragraph (b)(3)(iv)(C)(*1*) of this section, X may regroup his passive activities on an amended return, because X now has MAGI above the applicable threshold amount and net investment income.

Example 2. Same facts as *Example 1,* except that the $2,500 increase to modified adjusted gross income and net investment income was a result of an examination of X's Year 1 return. Pursuant to paragraph (b)(3)(iv)(C)(*1*) of this section, X may regroup his passive activities on an amended return.

Example 3. In Year 1, Y, a single individual reported modified adjusted gross income (as defined in § 1.1411–2(c)) of $205,000 and net investment income (as defined in § 1.1411–4) of $500. Pursuant to paragraph (b)(3)(iv)(A) of this section, Y regrouped his four passive activities, A, B, C, and D, into a single activity group. Prior to the Year 1 regrouping, Y had grouped A and B into one group, and treated each of C and D as separate activities. Y did not meet the Eligibly Criteria in any year prior to Year 1 or Year 2. In Year 3, Y's employer issued Y a corrected Year 1 Form W–2, which reduced Y's taxable wages by $6,000. As a result, Y no longer meets the Eligibility Criteria in Year 1 because Y's modified adjusted gross income is now $199,000. Therefore, Y's Year 1 regrouping is no longer effective and the prior groupings are in effect (that is, Activity A and B are one group and Activity C and Activity D separately). Appropriate adjustments should be made to reflect the ineffective regrouping. However, if Y had a material change in facts and circumstances such that Y could regroup in Year 1 or a subsequent year, as applicable, by reason of § 1.469–4(e)(2), then the regrouping will be deemed to occur. Y could designate a different regrouping for the year of the material change in facts and circumstances.

Example 4. Same facts as *Example 3,* except that Y met the Eligibly Criteria in Year 2. In this case, Y's Year 1 regrouping is no longer effective and Y must report his income consistent with the pre-Year 1 groupings. In Year 2, Y has three options. First, without any action by Y, Y's activities are regrouped as originally reported in Year 1. In this case, the regrouping from the Year 1 return is deemed to occur on the Year 2 return. This option is the default option. Second, pursuant to paragraph (b)(3)(iv)(C)(*2*) of this section, Y may file an amended return to report his income consistent with groupings in effect prior to Year 1. Third, Y may file an original or an amended return to regroup in a manner different from groupings in effect prior to Year 1 and different from the Year 1 groupings (for example, Y could choose to group Activity C and D into single activity, thus causing Y to have two groups; Group A–B and Group C–D).

(D) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012.

* * * * *

■ **Par. 4.** An undesignated center heading and § 1.1411–0 are added immediately following § 1.1403–1 to read as follows:

Net Investment Income Tax

§ 1.1411–0 Table of contents of provisions applicable to section 1411.

This section lists the table of contents for §§ 1.1411–1 through 1.1411–10.

§ 1.1411–4 Definition of Net Investment Income

§ 1.1411–5 Trades and Businesses to Which Tax Applies

§ 1.1411–6 Income on Investment of Working Capital Subject to Tax

§ 1.1411–7 Exception for Dispositions of Certain Active Interests in Partnerships and S Corporations [Reserved]

§ 1.1411–8 Exception for Distributions From Qualified Plans

§ 1.1411–9 Exception for Self-Employment Income

§ 1.1411–10 Controlled Foreign Corporations and Passive Foreign Investment Companies

■ **Par. 5.** Sections 1.1411–1 through 1.1411–10 are added to read as follows:

* * * * *

* * * * *

§ 1.1411–1 General rules.

(a) *General rule.* Except as otherwise provided, all Internal Revenue Code (Code) provisions that apply for chapter 1 purposes in determining taxable income (as defined in section 63(a)) of a taxpayer also apply in determining the tax imposed by section 1411.

(b) *Adjusted gross income.* All references to an individual's adjusted gross income are treated as references to adjusted gross income as defined in section 62, and all references to an estate's or trust's adjusted gross income are treated as references to adjusted gross income as defined in section 67(e). However, there may be additional adjustments to adjusted gross income because of investments in controlled foreign corporations (CFCs) or passive foreign investment companies (PFICs). See § 1.1411–10(e).

(c) *Effect of section 1411 and the regulations thereunder for other purposes.* The inclusion or exclusion of items of income, gain, loss, or deduction in determining net investment income for purposes of section 1411, and the assignment of items of income, gain, loss, or deduction to a particular category of net investment income under section 1411(c)(1)(A), does not affect the treatment of any item of income, gain, loss, or deduction under any provision of the Code other than section 1411.

(d) *Definitions.* The following definitions apply for purposes of calculating net investment income under section 1411 and the regulations thereunder—

(1) The term *gross income from annuities* under section 1411(c)(1)(A) 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). In the case of a sale of an annuity, to the extent the sales price of the annuity does not exceed its surrender value, the gain recognized would be treated as gross income from an annuity within the meaning of section 1411(c)(1)(A)(i) and § 1.1411–4(a)(1)(i). However, 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 from an annuity described in section 1411(c)(1)(A)(i) and § 1.1411–4(a)(1)(i) and the excess of the sales price over the surrender value as gain from the disposition of property included in section 1411(c)(1)(A)(iii) and § 1.1411–4(a)(1)(iii). The term *gross income from annuities* does not include amounts paid in consideration for services rendered. For example, distributions from a foreign retirement plan that are paid in the form of an annuity and include investment income that was earned by the retirement plan does not constitute income from an annuity within the meaning of section 1411(c)(1)(A)(i).

(2) The term *controlled foreign corporation (CFC)* is as defined in section 953(c)(1)(B) or 957(a).

(3) The term *gross income from dividends* includes any item treated as a dividend for purposes of chapter 1. See also § 1.1411–10 for additional amounts that constitute gross income from dividends. The term *gross income from dividends* includes, but is not limited to, amounts treated as dividends—

(i) Pursuant to subchapter C that are included in gross income (including constructive dividends);

(ii) Pursuant to section 1248(a), other than as provided in § 1.1411–10;

(iii) Pursuant to § 1.367(b)–2(e)(2);

(iv) Pursuant to section 1368(c)(2); and

(v) Substitute dividends that represent payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction.

(4) The term *excluded income* means:

(i) Items of income excluded from gross income in chapter 1. For example, interest on state and local bonds excluded from gross income under section 103 and gain from the sale of a principal residence excluded from gross income under section 121.

(ii) Items of income not included in net investment income, as determined under §§ 1.1411–4 and 1.1411–10. For example, wages, unemployment compensation, Alaska Permanent Fund Dividends, alimony, and Social Security Benefits.

(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. For example, gains from the disposition of property used in a trade of business not described in section 1411(c)(2) under § 1.1411–4(d)(4)(i), distributions from certain Qualified Plans described in section 1411(c)(5) and § 1.1411–8, income taken into account in determining self-employment income that is subject to tax under section 1401(b) described in section 1411(c)(6) and § 1.1411–9, and section 951(a) inclusions from a CFC for which a § 1.1411–10(g) election is not in effect.

(5) The term *individual* means any natural person.

(6) The term *gross income from interest* includes any item treated as interest income for purposes of chapter 1 and substitute interest that represents payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction.

(7) The term *married* and *married taxpayer* has the same meaning as in section 7703.

(8) The term *net investment income (NII)* means net investment income as defined in section 1411(c) and § 1.1411–4, as adjusted pursuant to the rules described in § 1.1411–10(c).

(9) The term *passive foreign investment company (PFIC)* is as defined in section 1297(a).

(10) The term *gross income from rents* includes amounts paid or to be paid principally for the use of (or the right to use) tangible property.

(11) The term *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.

(12) The term *trade or business* refers to a trade or business within the meaning of section 162.

(13) The term *United States person* is as defined in section 7701(a)(30).

(14) The term *United States shareholder* is as defined in section 951(b).

(e) *Disallowance of certain credits against the section 1411 tax.* Amounts that may be credited against only the tax imposed by chapter 1 of the Code may not be credited against the section 1411 tax imposed by chapter 2A of the Code unless specifically provided in the Code. For example, the foreign income, war profits, and excess profits taxes that are allowed as a foreign tax credit by section 27(a), section 642(a), and section 901, respectively, are not allowed as a credit against the section 1411 tax.

(f) *Application to taxable years beginning before January 1, 2014*—(1) *Retroactive application of regulations.* Taxpayers that are subject to section 1411, and any other taxpayer to which these regulations may apply (such as partnerships and S corporations), may apply §§ 1.1411–1 through 1.1411–10 (including the ability to make any election(s) contained therein) in any taxable year that begins after December 31, 2012, but before January 1, 2014, for which the period of limitation under section 6501 has not expired.

(2) *Reliance and transitional rules.* For taxable years beginning before January 1, 2014, the Internal Revenue Service will not challenge a taxpayer's computation of tax under section 1411 if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 1411. For example, a taxpayer's compliance with the provisions of the proposed and final regulations under section 1411 (REG–130507–11 or REG–130843–13), generally, will be considered a reasonable, good faith effort to comply with the requirements of section 1411 if reliance on such regulation projects under section 1411 are applied in their entirety, and the taxpayer makes reasonable adjustments to ensure that their section 1411 tax liability in the taxable years beginning after December 31, 2013, is not inappropriately distorted by the positions taken in taxable years beginning after December 31, 2012, but before January 1, 2014. A similar rule applies to any other taxpayer to which these regulations may apply (such as partnerships and S corporations).

(g) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012, in accordance with paragraph (f) of this section.

§ 1.1411–2 Application to individuals.

(a) *Individual to whom tax applies*—(1) *In general.* Section 1411 applies to an individual who is a citizen or resident of the United States (within the meaning of section 7701(a)(30)(A)). Section 1411 does not apply to nonresident alien individuals (within the meaning of section 7701(b)(1)(B)). See paragraph (a)(2)(vi) of this section for special rules regarding bona fide residents of United States territories.

(2) *Special rules*—(i) *Dual resident individuals treated as residents of a foreign country under an income tax treaty.* A dual resident taxpayer (as defined in § 301.7701(b)–7(a)(1)) who determines that he or she is a resident of a foreign country for treaty purposes pursuant to an income tax treaty between the United States and the foreign country and who claims benefits of the treaty as a nonresident of the United States will be treated as a nonresident alien of the United States for purposes of paragraph (a)(1) of this section.

(ii) *Dual-status resident aliens.* A dual-status individual who is a resident of the United States for a portion of a taxable year and a nonresident alien for the other portion of the taxable year will not be subject to section 1411 with respect to the portion of the year for which that individual is treated as a nonresident alien. The only income the individual must take into account for purposes of section 1411 is the income he or she receives during the portion of the year for which he or she is treated as a resident of the United States. The threshold amount under paragraph (d)(1) of this section applies.

(iii) *Joint returns in the case of a nonresident alien individual married to a United States citizen or resident*—(A) *Default treatment.* In the case of a United States citizen or resident who is married 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 United States citizen or resident spouse will be subject to the threshold amount for a married taxpayer filing a separate return in paragraph (d)(1)(ii) of this section, and the nonresident alien spouse will not be subject to tax under section 1411. In accordance with the rules for married individuals filing separate returns, the spouse that is a United States citizen or resident must determine his or her own net investment income and modified adjusted gross income.

(B) *Taxpayer election.* Married taxpayers who file a joint Federal income tax return pursuant to a section 6013(g) election for purposes of chapter 1 and chapter 24 also may elect to be treated as making a section 6013(g) election for purposes of chapter 2A (relating to the tax imposed by section 1411).

(*1*) *Effect of election.* For purposes of calculating the tax imposed under section 1411(a)(1), the effect of an election under section 6013(g) is to include the combined income of the United States citizen or resident spouse and the nonresident spouse in the section 1411(a)(1) calculation and to apply the threshold amount for a taxpayer making a joint return as set out in paragraph (d)(1)(i) of this section.

(*2*) *Procedural requirements for making election.* Taxpayers with a section 6013(g) election in effect for chapter 1 and chapter 24 purposes for any taxable year beginning after December 31, 2012, or taxpayers making a section 6013(g) election for chapter 1 and chapter 24 purposes in any taxable year beginning after December 31, 2012, who want to apply their section 6013(g) election for purposes of chapter 2A must make the election for the first taxable year beginning after December 31, 2013, in which the United States taxpayer is subject to tax under section 1411. The determination of whether the United States taxpayer is subject to tax under section 1411 is made without regard to the effect of the section 6013(g) election described in paragraph (a)(2)(iii)(B) of this section. The election, if made, must be made in the manner prescribed by forms, instructions, or in other guidance on an original or amended return for the taxable year for which the election is made. An election can be made on an amended return only if the taxable year for which the election is made, and all taxable years that are affected by the election, are not closed by the period of limitations on assessments under section 6501. Further, once made, the duration and termination of the section 6013(g) election for chapter 2A is governed by the rules of section 6013(g)(2) through (g)(6) and the regulations thereunder.

(*3*) *Ineffective elections.* In the event a taxpayer makes an election described in paragraph (a)(2)(iii)(B) of this section and subsequently determines that such taxpayer does not meet the criteria for making such election in such tax year described in paragraph (a)(2)(iii)(B)(*2*) of this section, then such original election will have no effect for that year and all future years. In such a case, the taxpayer should make appropriate adjustments to properly reflect the ineffective election. However, notwithstanding the previous sentence, if a taxpayer meets the criteria for the same election in a subsequent year, such taxpayer is deemed to treat such original election as being made in that subsequent year unless the taxpayer files (or amends) the return for such subsequent year to report the taxpayer's net investment income tax without the original election. Furthermore, this paragraph (a)(2)(iii)(B)(*3*) shall not apply if a taxpayer does not meet the criteria described in paragraph (a)(2)(iii)(B)(*2*) of this section for making such election in such tax year solely as a result of the carryback of a net operating loss pursuant to section 172.

(iv) *Joint returns for a year in which nonresident alien married to a United States citizen or resident becomes a United States resident*—(A) *Default treatment.* In the case of a United States citizen or resident who is married to an individual who is a nonresident alien individual at the beginning of any taxable year, but is a United States resident at the close of such taxable year, each spouse will be treated as married filing separately for the entire year for purposes of section 1411. For purposes of calculating the tax imposed under section 1411(a)(1), each spouse will be subject to the threshold amount for a married taxpayer filing a separate return in paragraph (d)(1)(ii) of this section. The spouse who becomes a United States resident during the tax year will be subject to section 1411 only with respect to income received for the portion of the year for which he or she is treated as a United States resident. Each spouse must determine his or her own net investment income and modified adjusted gross income.

(B) *Taxpayer election.* Married taxpayers who file a joint Federal income tax return pursuant to a section 6013(h) election for purposes of chapter 1 and chapter 24 also may elect to be treated as making a section 6013(h) election for purposes of chapter 2A for such tax year.

(*1*) *Effect of election.* For purposes of calculating the tax imposed under section 1411(a)(1), the effect of an election under section 6013(h) is to include the combined income of the United States citizen or resident spouse and the dual-status resident spouse in the section 1411(a)(1) calculation and to apply the threshold amount for a taxpayer making a joint return as set out in paragraph (d)(1)(i) of this section.

(*2*) *Procedural requirements for making election.* Taxpayers who make a section 6013(h) election for purposes of chapter 1 and chapter 24 for any taxable year beginning after December 31, 2012, may elect to have their section 6013(h) election apply for purposes of chapter 2A. The election, if made, must be made in the manner prescribed by forms, instructions, or in other guidance on an original or amended return for the taxable year for which the election is made. An election can be made on an amended return only if the taxable year for which the election is made, and all taxable years that are affected by the election, are not closed by the period of limitations on assessments under section 6501. Further, in all cases, once made, the section 6013(h) election is governed by the rules of section 6013(h)(2) and the regulations thereunder.

(iv) *Grantor trusts.* For rules regarding the treatment of owners of grantor trusts, see § 1.1411–3(b)(1)(v).

(v) *Bankruptcy estates.* A bankruptcy estate administered under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of the Bankruptcy Code (Title 11 of the United States Code) of a debtor who is an individual is treated as a married taxpayer filing a separate return for purposes of section 1411. See § 1.1411–2(d)(1)(ii).

(vi) *Bona fide residents of United States territories*—(A) *Applicability.* An individual who is a bona fide resident of a United States 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)(vi)(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 (within the meaning of § 1.1411–1(d)).

(B) *Coordination with exception for nonresident aliens.* An individual who is both a bona fide resident of a United States 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*) *United States territory.* The term *United States 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 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 (at year in which section 1411 is in effect), A, an unmarried United States 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. 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% multiplied by $20,000, the lesser of $50,000 net investment income or $20,000 excess of modified adjusted gross income over the threshold amount).

(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 CFCs and PFICs.* Additional rules in § 1.1411–10(e)(1) apply to an individual that is a United States shareholder of a controlled foreign corporation (CFC) or that is a United States person that directly or indirectly owns an interest in a passive foreign investment company (PFIC).

(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 filing a separate return, $125,000; and

(iii) In the case of any other individual, $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 reduces 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. However, taxpayers may apply this section to taxable years beginning after December 31, 2012, in accordance with § 1.1411–1(f).

§ 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 under 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 as adjusted under § 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) reduces 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 CFCs and PFICs.* Additional rules in § 1.1411–10 apply to an estate or trust that holds an interest in a controlled foreign corporation (CFC) or a passive foreign investment company (PFIC).

(b) *Application to certain trusts and estates*—(1) *Exception for certain trusts and estates.* The following trusts are not subject to the tax imposed by section 1411:

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

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

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

(iv) 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).

(v) 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 is 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.

(vi) Electing Alaska Native Settlement Trusts subject to taxation under section 646.

(vii) Cemetery Perpetual Care Funds to which section 642(i) applies.

(viii) Foreign trusts (as defined in section 7701(a)(31)(B) and § 301.7701–7(a)(2)) (but see §§ 1.1411–3(e)(3)(ii) and 1.1411–4(e)(1)(ii) for rules related to distributions from foreign trusts to United States beneficiaries).

(ix) Foreign estates (as defined in section 7701(a)(31)(A)) (but see § 1.1411–3(e)(3)(ii) for rules related to distributions from foreign estates to United States beneficiaries).

(2) *Special rules for certain taxable trusts and estates*—(i) *Qualified funeral trusts.* For purposes of the calculation of any tax imposed by section 1411, section 1411 and the regulations thereunder are applied to each qualified funeral trust (within the meaning of section 685) by treating each beneficiary's interest in each such trust as a separate trust.

(ii) *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)(v) and (d)(1)(ii).

(c) *Application to electing small business trusts (ESBTs)*—(1) *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) are 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 are 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)) are included in the grantor's calculation of net investment income and are not included in the ESBT's computation of tax described in paragraph (c)(1)(ii) of this section.

(2) *Computation of tax.* This paragraph (c)(2) provides the method for an ESBT to compute the tax under section 1411.

(i) *Step one.* The S portion and non-S portion computes 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.

(ii) *Step two.* The ESBT calculates its adjusted gross income (as defined in paragraph (a)(1)(ii)(B)(*1*) of this section). The ESBT's adjusted gross income is the adjusted gross income of the non-S portion, 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).

(iii) *Step three.* The ESBT pays tax on the lesser of—

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

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

(3) *Example.* (i) In Year 1 (a year that section 1411 is in effect), the non-S portion of Trust, an ESBT, has dividend income of $15,000, interest income of $10,000, and capital loss of $5,000. Trust's S portion has net rental income of $21,000 and a capital gain of $7,000. The Trustee's annual fee of $1,000 is allocated 60% to the non-S portion and 40% 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) 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
Capital Gain	7,000
Trustee Annual Fee	(400)
Total S portion undistributed net investment income	27,600

(B) The undistributed net investment income for the non-S portion is $12,400 and is determined as follows:

Dividend Income	$15,000
Interest Income	10,000
Deductible Capital Loss	(3,000)
Trustee Annual Fee	(600)
Distributable net income distribution	(9,000)
Total non-S portion undistributed net investment income	12,400

(C) Trust combines 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	$27,600
Non-S portion's undistributed net investment income	12,400
Combined undistributed net investment income	40,000

(iii) *Step two.* (A) The ESBT calculates its adjusted gross income. Pursuant to paragraph (c)(2)(ii) 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
Deductible Capital Loss	(3,000)
Trustee Annual Fee	(600)
Distributable net income distribution	(9,000)
S Portion Income	27,600
Adjusted gross income	40,000

(C) The S portion's single item of ordinary income used in the ESBT's adjusted gross income calculation is $27,600. This item of income is determined by starting with net rental income of $21,000 and capital gain of $7,000 and reducing it by the S portion's $400 share of the annual trustee fee.

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

(A) The combined undistributed net investment income ($40,000); or

(B) The excess of adjusted gross income ($40,000) over the dollar amount at which the highest tax bracket in section 1(e) applicable to a trust begins for the taxable year.

(d) *Application to charitable remainder trusts (CRTs)*—(1) *Operational rules*—(i) *Treatment of annuity or unitrust distributions.* If one or more items of net investment income comprise all or part of an annuity or unitrust distribution from a CRT, such items retain their character as net investment income in the hands of the recipient of that annuity or unitrust distribution.

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

(iii) *Accumulated net investment income.* The accumulated net investment income of a CRT is the total amount of net investment income received by a CRT 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.

(2) *Application of Section 664*—(i) *General rule.* The Federal income tax rate of the item of net investment income, to be used to determine the proper classification of that item within the appropriate income category as described in § 1.664–1(d)(1)(i)(b), is the sum of the income tax rate applicable to that item under chapter 1 and the tax rate under section 1411. Thus, the accumulated net investment income and excluded income (as defined in § 1.1411–1(d)(4)) of a CRT in the same income category constitute separate classes of income within that category as described in § 1.664–1(d)(1)(i)(b).

(ii) *Special rules for CRTs with income from CFCs or PFICs.* [Reserved]

(iii) *Examples.* The following examples illustrate the provisions of this paragraph (d)(2).

Example 1. (i) In 2009, A formed CRT as a charitable remainder annuity trust. The trust document requires an annual annuity payment of $50,000 to A for 15 years. For purposes of this example, assume that CRT is a valid charitable remainder trust under section 664 and has not received any unrelated business taxable income during any taxable year.

(ii) As of January 1, 2013, CRT has the following items of undistributed income within its § 1.664–1(d)(1) categories and classes:

Category	Class	Tax rate (percent)	Amount
Ordinary Income	Interest	39.6	$4,000
	Net Rental Income	39.6	8,000
	Non-Qualified Dividend Income	39.6	2,000
	Qualified Dividend Income	20.0	10,000
Capital Gain	Short-Term	39.6	39,000
	Unrecaptured Section 1250 Gain	25.0	1,000
	Long-Term	20.0	560,000
Other Income			None
Total undistributed income as of January 1, 2013			624,000

Pursuant to § 1.1411–3(d)(1)(iii), none of the $624,000 of undistributed income is accumulated net investment income (ANII) because none of it was received by CRT after December 31, 2012. Thus, the entire $624,000 of undistributed income is excluded income (as defined in § 1.1411–1(d)(4)).

(iii) During 2013, CRT receives $7,000 of interest income, $9,000 of qualified dividend income, $4,000 of short-term capital gain, and $11,000 of long-term capital gain. Prior to the 2013 distribution of $50,000 to A, CRT has the following items of undistributed income within its § 1.664–1(d)(1) categories and classes after the application of paragraph (d)(2) of this section:

Category	Class	Excluded/ANII	Tax rate (percent)	Amount
Ordinary Income	Interest	NII	43.4	$7,000
	Interest	Excluded	39.6	4,000
	Net Rental Income	Excluded	39.6	8,000
	Non-Qualified Dividend Income	Excluded	39.6	2,000
	Qualified Dividend Income	NII	23.8	9,000
	Qualified Dividend Income	Excluded	20.0	10,000
Capital Gain	Short-Term	NII	43.4	4,000
	Short-Term	Excluded	39.6	39,000
	Unrecaptured Section 1250 Gain	Excluded	25.0	1,000
	Long-Term	NII	23.8	11,000
	Long-Term	Excluded	20.0	560,000
Other Income				None

(iv) The $50,000 distribution to A for 2013 will include the following amounts:

Category	Class	Excluded/ANII	Tax rate (percent)	Amount
Ordinary Income	Interest	NII	43.4	$7,000
	Interest	Excluded	39.6	4,000
	Net Rental Income	Excluded	39.6	8,000
	Non-Qualified Dividend Income	Excluded	39.6	2,000
	Qualified Dividend Income	NII	23.8	9,000
	Qualified Dividend Income	Excluded	20.0	10,000
Capital Gain	Short-Term	NII	43.4	4,000
	Short-Term	Excluded	39.6	6,000
	Unrecaptured Section 1250 Gain	Excluded	25.0	None
	Long-Term	NII	23.8	None
	Long-Term	Excluded	20.0	None

The amount included in A's 2013 net investment income is $20,000. This amount is comprised of $7,000 of interest income, $9,000 of qualified dividend income, and $4,000 of short-term capital gain.

(v) As a result, as of January 1, 2014, CRT has the following items of undistributed income within its § 1.664–1(d)(1) categories and classes:

Category	Class	Excluded/ANII	Tax rate (percent)	Amount
Ordinary Income	Interest			None

Category	Class	Excluded/ANII	Tax rate (percent)	Amount
	Net Rental Income			None
	Non-Qualified Dividend Income			None
	Qualified Dividend Income			None
Capital Gain	Short-Term	Excluded	39.6	$33,000
	Unrecaptured Section 1250 Gain	Excluded	25.0	1,000
	Long-Term	ANII	23.8	11,000
	Long-Term	Excluded	20.0	560,000
Other Income				None

Example 2 [Reserved].

(3) *Elective simplified method.* [Reserved]

(e) *Calculation of undistributed net investment income*—(1) *In general.* This paragraph (e) 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 is calculated in the same manner as that of an individual. See § 1.1411–10(c) for special rules regarding CFCs, PFICs, 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 reduced by distributions of net investment income to beneficiaries and by 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 is 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 § 1.1411–1(d)(4)), 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 (e)(5) 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, as applicable, from foreign estates and 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 is 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, 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 (e)(5) of this section.

(5) *Examples.* The following examples illustrate the provisions of this paragraph (e). In each example, Year 1 is a year in which section 1411 is in effect and the taxpayer is not a foreign estate or trust:

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 $75,000 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.

(ii) Trust's distributable net income is $100,000 ($15,000 in dividends plus $10,000 in interest plus $75,000 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 10% of distributable net income ($10,000 divided by $100,000). Therefore, the distribution consists of dividend income of $1,500, interest income of $1,000, and ordinary income attributable to the individual retirement account of $7,500. 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 $75,000 of taxable income attributable to the individual retirement account is excluded income under § 1.1411–1(d)(4). Trust's undistributed net investment income under paragraph (e)(2) of this section is $27,500, which is Trust's net investment income ($30,000) less the amount of dividend income ($1,500) and interest income ($1,000) distributed to A. The $27,500 of undistributed net investment income is comprised of the capital gain allocated to principal ($5,000), the remaining undistributed dividend income ($13,500), and the remaining undistributed interest income ($9,000).

(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 $1,500 and interest income of $1,000, but does not include the $7,500 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 $20,000 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 $100,000. 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 30% of distributable net income ($30,000 divided by $100,000). Therefore, the distribution consists of dividend income of $4,500, interest income of $3,000, and ordinary income attributable to the individual retirement account of $22,500. A's mandatory distribution thus consists of $7,500 of net investment income and $22,500 of excluded income.

(iii) Trust's remaining distributable net income is $70,000. Trust's remaining undistributed net investment income is $22,500. 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 10% of distributable net income ($10,000 divided by $100,000). For purposes of determining undistributed net investment income, Trust's net investment income is reduced by $2,500 under paragraph (e)(4) of this section (dividend income of $1,500, interest income of $1,000, but with no reduction for amounts attributable to the individual retirement account of $7,500).

(iv) With respect to the discretionary distribution to B, Trust's remaining distributable net income is $60,000. Trust's remaining undistributed net investment income is $20,000. Trust's deduction under section 661 for the distribution to B is $20,000. The $20,000 distribution equals 20% of distributable net income ($20,000 divided by $100,000). 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 $15,000. B's distribution consists of $5,000 of net investment income and $15,000 of excluded income.

(v) Trust's undistributed net investment income is $15,000 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 $15,000, Trust's net investment income of $30,000 is reduced by $7,500 of the mandatory distribution to A, $2,500 of the section 642(c) deduction, and $5,000 of the discretionary distribution to B. The undistributed net investment income consists of the remaining dividend income of $6,000 ($15,000 less $4,500 less $1,500 less $3,000), interest income of $4,000 ($10,000 less $1,000 less $3,000 less $2,000), and the $5,000 of undistributed capital gain.

Example 3. Fiscal Year Estate. (i) D died in 2011. D's estate (Estate) filed its first return that established its fiscal year ending October 31, 2011. During Estate's fiscal year ending October 31, 2013, it earned $10,000 of interest, $1,000 of dividends, and $15,000 of short-term gains. The Estate distributed its interest and dividends to S, D's spouse and sole beneficiary, on a quarterly basis; the last quarter's payment for that taxable year was made to S on December 5, 2013. Pursuant to § 1.662(c)–1, S is deemed to have received the first three payments for that taxable year, regardless of the actual payment dates, on October 31, 2013, the last day of Estate's taxable year. Estate makes a timely section 663(b) election to treat the fourth quarter distribution to S as having been made on October 31, 2013, the last day of Estate's preceding taxable year. Accordingly, S is deemed to have received $10,000 of interest and $1,000 of dividends on October 31, 2013.

(ii) Because Estate's fiscal year ending October 31, 2013, began on November 1, 2012, the Estate is not subject to section 1411 on income received during that taxable year. Therefore, none of the income received by Estate during its fiscal year ending October 31, 2013, is net investment income. Pursuant to paragraph (e)(3)(ii) of this section, because none of the distributed interest or dividend income constituted net investment income to Estate, the $10,000 of interest and $1,000 of dividends that Estate distributed to S does not constitute net investment income to S.

(f) *Effective/applicability date.* This section applies to taxable years beginning after December 31, 2013, except that paragraph (d) of this section applies to taxable years of CRTs that begin after December 31, 2012. However, taxpayers other than CRTs may apply this section to taxable years beginning after December 31, 2012, in accordance with § 1.1411–1(f).

§ 1.1411–4 Definition of net investment income.

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

(1) The sum of—

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example 1. Calculation of net gain. (i) In Year 1, A, an unmarried individual, realizes a capital loss of $40,000 on the sale of P stock and realizes a capital gain of $10,000 on the sale of Q stock, resulting in a net capital loss of $30,000. Both P and Q are C corporations. A has no other capital gain or capital loss in Year 1. In addition, A receives wages of $300,000 and earns $5,000 of gross income from interest. For income tax purposes, under section 1211(b), A may use $3,000 of the net capital loss against other income. Under section 1212(b)(1), the remaining $27,000 is a capital loss carryover. For purposes of determining A's Year 1 net gain under paragraph (a)(1)(iii) of this section, A's gain of $10,000 on the sale of the Q stock is reduced by A's loss of $40,000 on the sale of the P stock. In addition, A may reduce net investment income by the $3,000 of the excess of capital losses over capital gains allowed for income tax purposes under section 1211(b).

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

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

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

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

(iii) For section 1411 purposes, under section 121(a), A excludes the $200,000 gain realized from the sale of A's principal residence from A's Year 1 gross income and, consequently, from A's net investment income. In determining A's Year 1 net gain under paragraph (a)(1)(iii) of this section, A reduces the $7,000 capital gain by the $5,000 capital loss carryover allowed under section 1211(b).

Example 4. Section 1031 like-kind exchange. (i) In Year 1, A, an unmarried individual who is not a dealer in real estate, purchases Greenacre, a piece of undeveloped land, for $10,000. A intends to hold Greenacre for investment.

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

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

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

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

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

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

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

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

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

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

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

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

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

Example 2. Installment sale. (i) PRS, partnership for Federal income tax purposes, operates an automobile dealership. B and C, unmarried individuals, each own a 40% interest in PRS and both materially participate in the activities of PRS for all relevant years. Therefore, with respect to B and C, PRS is not a trade or business described in section 1411(c)(2) and § 1.1411–5. D owns the remaining 20% of PRS. Assume, for purposes of this example, that PRS is a passive activity with respect to D, and therefore is a trade or business described in section 1411(c)(2)(A) and § 1.1411–5(a)(1).

(ii)(A) In Year 0, a year preceding the effective date of section 1411, PRS relocates its dealership to a larger location. As a result of the relocation, PRS sells its old dealership facility to a real estate developer in exchange for $1,000,000 cash and a $4,500,000 promissory note, fully amortizing over the subsequent 15 years, and bearing adequate stated interest. PRS reports the sale transaction under section 453. PRS's adjusted tax basis in the old dealership facility is $1,075,000. Assume for purposes of this example that PRS has $300,000 of recapture income (within the meaning of section 453(i)); the buyer is not related to PRS, B, C, or D; and the buyer is not assuming any liabilities of PRS in the transaction.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(iii) *Taxes described in section 164(a)(3).* Taxes imposed on income described in section 164(a)(3) that are allocable to net investment income pursuant to paragraph (g)(1) of this section. Foreign income, war profits, and excess profits taxes are allowable as deductions under section 164(a)(3) in determining net investment income only if the taxpayer does not choose to take any foreign tax credits under section 901 with respect to the same taxable year. See section 275(a)(4). For rules applicable to refunds of taxes described in this paragraph, see paragraph (g)(2) of this section.

(iv) *Items described in section 72(b)(3).* In the case of an amount allowed as a deduction to the annuitant for the annuitant's last taxable year under section 72(b)(3), such amount is allowed as a properly allocable deduction in the same taxable year if the income from the annuity (had the annuitant lived to receive such income) would have been included in net investment income under paragraph (a)(1)(i) of this section (and not excluded from net investment income by reason of § 1.1411–8).

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

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

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

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

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

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

Example 1. (i) A, an unmarried individual, owns an interest in PRS, a partnership for Federal income tax purposes. PRS is engaged in a trading business described in section 1411(c)(2)(B) and § 1.1411–5(a)(2) and has made a valid and timely election under section 475(f)(2). A's distributive share from PRS in Year 1 consists of $125,000 of interest and dividends and $60,000 of ordinary losses from the trading business. In addition to A's investment in PRS, A sold undeveloped land in Year 1 for a long-term capital gain of $50,000. A has no capital losses carried over from a preceding year.

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

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

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

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

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

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

(ii) For purposes of chapter 1, B includes the $50,000 of annuity income in the computation of adjusted gross income. The $21,000 long-term capital gain is offset by the $15,000 short-term capital loss, so B includes $6,000 of net long-term capital gain in the computation of adjusted gross income.

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

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

(6) *Other deductions.* Any other deduction allowed by subtitle A that is

identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see § 601.601(d)(2)(ii)(*b*) of this chapter) as properly allocable to gross income or net gain under this section.

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

(i) *Deductions subject to section 67.* The amount of miscellaneous itemized deductions (as defined in section 67(b)) tentatively deductible in determining net investment income after applying section 67 (but before applying section 68) is the lesser of:

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

(D)(*1*) The amount of itemized deductions allocable to net investment income after applying section 67 to deductions that are also miscellaneous itemized deductions but before applying section 68 is $155,000. This amount is the sum of $60,000 of miscellaneous itemized deductions determined in (C)(2), plus $20,000 in state income tax properly allocable to net investment income, plus $75,000 of investment interest expense. However, under section 68(c)(2), the $75,000 deduction for investment interest expenses is not subject to the section 68 limitation on itemized deductions and is excluded from the computation under § 1.1411–4(f)(7). Thus, the amount of itemized deductions allocable to net investment income and subject to section 68, after applying section 67 but before applying section 68, is $80,000.

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

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

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

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

(g) *Special rules*—(1) *Deductions allocable to both net investment income and excluded income.* In the case of a properly allocable deduction described in section 1411(c)(1)(B) and paragraph (f) of this section that is allocable to both net investment income and excluded income, the portion of the deduction that is properly allocable to net investment income may be determined by taxpayers using any reasonable method. Examples of reasonable methods of allocation include, but are not limited to, an allocation of the deduction based on the ratio of the amount of a taxpayer's gross income (including net gain) described in § 1.1411–4(a)(1) to the amount of the taxpayer's adjusted gross income (as defined under section 62 (or section 67(e) in the case of an estate or trust)). In the case of an estate or trust, an allocation of a deduction pursuant to rules described in § 1.652(b)–3(b) (and § 1.641(c)–1(h) in the case of an ESBT) is also a reasonable method.

(2) *Recoveries of properly allocable deductions*—(i) *General rule.* If a taxpayer is refunded, reimbursed, or otherwise recovers any portion of an amount deducted as a section 1411(c)(1)(B) properly allocable deduction in a prior year, and such amount is not otherwise included in net investment income in the year of recovery under section 1411(c)(1)(A),

the amount of the recovery will reduce the taxpayer's total section 1411(c)(1)(B) properly allocable deductions in the year of recovery (but not below zero). The preceding sentence applies regardless of whether the amount of the recovery is excluded from gross income by reason of section 111.

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

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

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

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

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

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

Example 2. State income tax refund. In Year 1, D, an individual, allocated $15,000 of taxes out of a total of $75,000 to net investment income under paragraph (f)(3)(iii) of this section. D received no tax benefit from the deduction in Year 1 for chapter 1 purposes due to the alternative minimum tax, but it did reduce D's section 1411 tax. In Year 3, D received a refund of $5,000. For chapter 1 purposes, D excludes the $5,000 refund from gross income in Year 3 by reason of section 111. In Year 3, D allocated $30,000 of state income taxes out of a total of $90,000 to net investment income under paragraph (f)(3)(iii) of this section. Although the refund is excluded from D's gross income, D must nonetheless reduce Year 3's section 1411(c)(1)(B) properly allocable deductions by $1,000 ($5,000 × ($15,000/$75,000)). D's allocation of 33⅓% of section 164(a)(3) taxes in Year 3 to net investment income is irrelevant to the calculation of the amount of the reduction required by this paragraph (g)(2).

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

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

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

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

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

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

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

§ 1.1411–5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Example 2. Same facts as *Example 1.* In Year 2, B materially participates in the retail sales activity of SCorp, and disposes of his entire interest in SCorp for a $9,000 long-term capital gain. Pursuant to § 1.469–2T(e)(3), the $9,000 gain is characterized as nonpassive income. Pursuant to section 469(f)(1)(A), the remaining $2,000 of suspended passive loss is allowed because the $9,000 gain is treated as nonpassive income. Assume that under section 1411(c)(4) and § 1.1411–7, B takes into account only $700 of the $9,000 gain in computing net investment income for Year 2. Pursuant to paragraph (g)(8)(i) of this section, B may take into account $700 of the $2,000 loss allowed by section 469(f)(1)(A) in computing net investment income for Year 2. Pursuant to paragraph (g)(8)(i) of this section, B may not deduct the remaining $1,300 passive loss allowed for chapter 1 in calculating net investment income for Year 2.

(9) *Treatment of section 469(g)(1) losses.* Losses allowed in computing taxable income by reason of section 469(g) are taken into account in computing net gain under paragraph (d) of this section or as properly allocable

deductions under paragraph (f) of this section, as applicable, in the same manner as such losses are taken into account in computing taxable income (as defined in section 63).

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

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

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

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

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

(2) *Applicable portion of a net operating loss.* In any taxable year in which a taxpayer incurs a net operating loss, the applicable portion of such loss is the lesser of:

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

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

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

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

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

Example 1. (i)(A) In Year 1, A, an unmarried individual, has the following items of income and deduction: $200,000 in wages, $50,000 in gross income from a trade or business of trading in financial instruments or commodities (as defined in § 1.1411–5(a)(2)) (trading activity), $10,000 of dividends, $1,000,000 in loss from his sole proprietorship (which is not a trade or business described in § 1.1411–5), $12,000 of non-business investment expenses, and $250,000 in trading loss deductions. As a result, for income tax purposes A sustains a section 172(c) net operating loss of $1,000,000. A makes an election under section 172(b)(3) to waive the carryback period for this net operating loss.

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

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

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

(iii)(A) For Year 3, A has $400,000 of wages, $200,000 in trading gains which are gross income from the trading activity, $250,000 of income from his sole proprietorship, and $10,000 in trading loss deductions. For income tax purposes, A deducts the remaining $460,000 of the net operating loss from Year 1. In addition, under § 1.1411–2(c), the $460,000 net operating loss deduction reduces A's Year 3 modified adjusted gross income to $380,000.

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

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

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

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

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

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

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

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

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

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

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

§ 1.1411–5 Trades or businesses to which tax applies.

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

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

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

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

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

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

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

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

(iii) *Exception for certain portfolio recharacterizations.* To the extent that any income or gain from a trade or business is recharacterized as ''not from a passive activity'' and is further characterized as portfolio income under § 1.469–2T(f)(10) or § 1.469–2(c)(2)(iii)(F), then such trade or business constitutes a passive activity within the meaning of paragraph (b)(1)(ii) of this section solely with respect to such recharacterized income or gain.

(3) *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 United States citizen, and Year 1 and all subsequent years are taxable years 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 is not involved in the activity of the commercial building on a regular and continuous basis, therefore, A's rental activity does not involve the conduct of a trade or business, and 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 still constitutes gross income from rents within the meaning of § 1.1411–4(a)(1)(i) because rents are included in the determination of net investment income under § 1.1411–4(a)(1)(i) whether or not derived from a trade or business described in paragraph (b)(1) of this section.

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, 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 together as one activity (the grouped activity). A participates in X for more than 500 hours during Year 1 and would be treated as materially participating in activity X within the meaning of § 1.469–5T(a)(1) if A's material participation were determined only with respect to activity X. A only participates in Y for 50 hours during Year 1. If not for the grouping of the X and Y 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.

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. 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. 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, and the rents are not described in § 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 net investment income under § 1.1411–4(a)(1)(ii). However, the $25,000 of other gross income may be net investment income by reason of section 1411(c)(3) and § 1.1411–6 if it is attributable to PRS's working capital. 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 described in § 1.1411–4(a)(1)(i) because the rents are derived from a trade or business that is a passive activity with respect to B. Furthermore, the $25,000 of other gross income from the equipment leasing trade or business is described in § 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 that does not involve a rental activity. C does not materially participate in PRS within the meaning of § 1.469–5T(a). 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. 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. However, taxpayers may apply this section to taxable years beginning after December 31, 2012, in accordance with § 1.1411–1(f).

§ 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)(ii) apply. See § 1.1411–4(f) for rules regarding properly allocable deductions with respect to an investment of working capital and § 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.* The following example illustrates the principles of this section. Assume for purposes of the example that the taxpayer uses a calendar taxable year, the taxpayer is a United States citizen, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

Example. (i) 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.

(ii) Both the $2,500 average daily balance of the checking account and the $20,000 savings account balance constitute working capital under § 1.469–2T(c)(3)(ii) 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 constitutes gross income from interest under § 1.1411–4(a)(1)(i).

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

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

§ 1.1411–7 Exception for dispositions of interests in partnerships and S corporations. [Reserved]

§ 1.1411–8 Exception for distributions from qualified plans.

(a) *General rule.* Net investment income 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 (Code).

(2) *Amounts treated as distributed.* Any amount that is treated as distributed from a qualified plan or arrangement under the 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.

(4) *Amounts related to employer securities*—(i) *Dividends related to employer securities.* Any dividend that is deductible under section 404(k) and is paid in cash directly to plan participants or beneficiaries is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. However, any amount paid as a dividend after the employer securities have been distributed from a qualified plan is not a distribution within the meaning of section 1411(c)(5), and thus is included in net investment income.

(ii) *Amounts related to the net unrealized appreciation in employer securities.* The amount of any net unrealized appreciation attributable to employer securities (within the meaning of section 402(e)(4)) realized on a disposition of those employer securities is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. However, any appreciation in value of the employer securities after the distribution from the qualified plan is not a distribution within the meaning of section 1411(c)(5), and is included in net investment income.

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

§ 1.1411–9 Exception for self-employment income.

(a) *General rule.* Except as provided in paragraph (b) of this section, net investment income 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) and (a)(1)(iii) 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), are 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. For purposes of these examples, assume the taxpayer is a United States citizen, uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

Example 1. 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 under paragraph (a) of this section. 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 from self-employment income, and thus is not covered by the exception in section 1411(c)(6). Therefore, the $300,000 attributable to the gain on PRS's sale of a capital asset is included as 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. Business Y is a nonpassive activity of B. 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, 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, B will not take into account 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)). 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 a valid and timely election under section 475(f)(2). D derives $400,000 of trading gains, which are gross income described in § 1.1411–4(a)(1) and $15,000 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. Therefore, under paragraph (a) of this section, the $400,000 of gross income is not covered by the exception in section 1411(c)(6). Because D had $0 net earnings from self-employment, the $15,000 of deductions did not reduce D's net earnings from self-employment under paragraph (b) of this section and § 1.1411–(4)(f)(2)(ii). Therefore, the $15,000 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 made a valid and timely 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 trading gains, which are gross income described in § 1.1411–4(a)(1) and $40,000 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 $40,000 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 $5,000 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 $295,000) for purposes of section 1411.

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

§ 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 of a controlled foreign corporation (CFC), or that is a United States person that directly or indirectly owns an interest in a passive foreign investment company (PFIC). 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 is either a United States shareholder of a CFC or that has made an election under section 1295 to treat a PFIC as a qualified electing fund (QEF). References in this section to an election under paragraph (g) of this section being in effect relate to an election that is applicable to the person that is determining the section 1411 consequences with respect to holding a particular CFC or QEF.

(b) *Amounts derived from a trade or business described in § 1.1411–5*—(1) *In general.* Except as provided in paragraph (b)(2) of this section, an amount included in gross income under section 951(a) or section 1293(a) that is also income derived from a trade or business described in section 1411(c)(2) and § 1.1411–5 (applying the relevant rules in § 1.1411–4(b)) 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 and the regulations thereunder 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 that amount. For purposes of section 1411 and the regulations thereunder, 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 (applying the relevant rules in § 1.1411–4(b)), 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 paragraph (c)(2)(ii) of this section do not apply to that amount.

(2) *Coordination rule for changes in trade or business status.* With respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, the rules in paragraphs (c) through (f) of this section apply to a distribution of earnings and profits described in paragraph (c)(1)(i)(A) of this section that was not taken into account as net investment income under paragraph (b) of this section.

(c) *Calculation of net investment income*—(1) *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)(1).

(i) *Distributions of previously taxed earnings and profits*—(A) *Rules when an election under paragraph (g) of this section is not in effect with respect to the shareholder*—(*1*) *General rule.* Except as otherwise provided in this paragraph (c)(1)(i), with respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, 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. Solely, 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) are considered first attributable to those 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, and with respect to amounts included under section 951(a), without regard to whether the earnings and profits are described in section 959(c)(1) or section 959(c)(2).

(*2*) *Exception for distributions attributable to earnings and profits previously taken into account for purposes of section 1411.* 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 not treated as a dividend for purposes of section 1411(c)(1)(A)(i) and § 1.1411–4(a)(1)(i), to the extent that an individual, estate, or trust establishes, by providing information that is similar to, and in the same manner as, the information described in § 1.959–1(d) (relating to previously taxed earnings and profits), that the distribution is attributable to—

(*i*) Amounts included in gross income by any person for chapter 1 purposes under section 951(a) or section 1293(a) that have been taken into account by any person as net investment income by reason of paragraph (b) of this section or an election under paragraph (g) of this section; or

(*ii*) Amounts included in gross income by any person as a dividend pursuant to section 1248(a) that, by reason of paragraph (c)(3)(ii) of this section, have been taken into account by any person as net investment income under section 1411(c)(1)(A)(i) and § 1.1411–4(a)(1)(i).

(B) *Rule when an election under paragraph (g) of this section is in effect with respect to the shareholder.* Except as otherwise provided in this paragraph (c)(1)(i), if an election under paragraph (g) of this section is in effect, 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 not treated as a dividend for purposes of section 1411(c)(1)(A)(i) and § 1.1411–4(a)(1)(i).

(C) *Special rule for certain distributions related to 2013 taxable years*—(*1*) *Scope.* The rule in this paragraph (c)(1)(i)(C) applies to individuals, estates, and trusts that were subject to section 1411 during a taxable year that began after December 31, 2012, and before January 1, 2014, and that satisfy all of the conditions set forth in paragraph (c)(1)(i)(C)(*2*) of this section. This rule also applies to all domestic partnerships and S corporations that satisfy all of the conditions set forth in paragraph (c)(1)(i)(C)(*2*) of this section.

(*2*) *Rule.* A distribution of earnings and profits from a CFC or QEF, with respect to which an election under paragraph (g) is in effect, 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) to the extent that—

(*i*) The distribution of earnings and profits is attributable to an amount included by an individual, estate, trust, domestic partnership, S corporation or common trust fund in gross income for chapter 1 purposes under section 951(a) or section 1293(a) with respect to the CFC or QEF for a taxable year that began after December 31, 2012, and before January 1, 2014;

(*ii*) The individual, estate, trust, domestic partnership, S corporation, or common trust fund made the election under paragraph (g) of this section with respect to the CFC or QEF in a taxable year that began after December 31, 2013; and

(*iii*) The individual, estate, trust, domestic partnership, S corporation, or common trust fund did not make the election described in paragraph (g)(4)(iii) of this section (concerning making an election under paragraph (g) of this section for a taxable year that begins before January 1, 2014).

(*3*) *Ordering rule.* Solely, for purposes of this paragraph (c)(1)(i)(C)(*3*), distributions of earnings and profits attributable to amounts that have been included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) are considered first attributable to the earnings and profits derived from a taxable year that began after December 31, 2012, and before January 1, 2014.

(ii) *Excess distributions that constitute 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).

(2) *Net gain.* For purposes of section 1411(c)(1)(A)(iii) and § 1.1411–4(a)(1)(iii), the rules in this paragraph (c)(2) 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 CFCs and QEFs.* With respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, for purposes of calculating the net gain under §§ 1.1411–4(a)(1)(iii) and 1.1411–4(d) that is attributable to the direct or indirect disposition of that stock (including for purposes of determining gain or loss on the direct or indirect disposition of that stock by a domestic partnership, S corporation, or common trust fund), basis is 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 CFCs or QEFs.* With respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, for purposes of calculating the net gain under §§ 1.1411–4(a)(1)(iii) and 1.1411–4(d) that is attributable to the disposition of an interest in a domestic partnership or S corporation that directly or indirectly owns that stock, basis is determined in accordance with the provisions of paragraph (d) of this section.

(3) *Application of section 1248.* With respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, for purposes of section 1411 and § 1.1411–4—

(i) In determining the gain recognized on the sale or exchange of stock 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 sections 1248(d)(1) and (d)(6), except that those exclusions will apply with respect to the earnings and profits of a foreign corporation that are attributable to:

(A) Amounts taken into account as net investment income under paragraph (b) of this section; and

(B) 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 that are attributable to amounts previously taxed in a taxable year beginning before December 31, 2012, have been distributed is determined based on the rules described in paragraph (c)(1)(i) of this section.

(4) *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).

(5) *Properly allocable deductions*—(i) *General rule.* For purposes of section 1411(c)(1)(B) and § 1.1411–4(f), the section 163(d)(1) investment expense deduction may be calculated by—

(A) Increasing the amount of investment income determined for chapter 1 purposes under section 163(d)(4)(B) by the amount of dividends described in § 1.1411–10(c) that are derived from a CFC or QEF with respect to which an election under paragraph (g) of this section is not in effect;

(B) Decreasing the amount of investment income for determined chapter 1 purposes under section 163(d)(4)(B) by the amount included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) that is attributable to a CFC or QEF with respect to which an election under paragraph (g) of this section is not in effect; and

(C) Increasing or decreasing, as applicable, the amount of investment income for chapter 1 purposes under section 163(d)(4)(B) by the difference between the amount calculated with respect to a disposition under paragraphs (c)(2)(iii) and (c)(2)(iv) of this section and the amount of the gain or loss attributable to the relevant disposition as calculated for chapter 1 purposes.

(ii) *Additional rules.* For purposes of section 1411(c)(1)(B) and § 1.1411–4(f), if the method of calculation described in paragraph (c)(5)(i) of this section is applied:

(A) The amount of investment interest not allowed as a deduction under section 163(d)(2) must be calculated consistent with the method of calculation described in paragraph (c)(5)(i).

(B) The method of calculation must be adopted by an individual, estate, or trust no later than the first year in which the individual, estate, or trust is subject to section 1411.

(C) The method of calculation must be applied with respect to all CFCs and QEFs for all taxable years with respect to which an election under paragraph (g) of this section is not in effect.

(D) A method of calculation under this paragraph is a method of accounting, which must be applied consistently, and may only be changed by the taxpayer by securing the consent of the Commissioner in accordance with § 1.446–1(e) and following the administrative procedures issued under § 1.446–1(e)(3)(ii).

(d) *Conforming basis adjustments*—(1) *Basis adjustments under sections 961 and 1293*—(i) *Stock held by individuals, estates, or trusts.* With respect to stock of a CFC or QEF which is held by an individual, estate, or trust, either directly or indirectly through one or more entities each of which is foreign, for which an election under paragraph (g) of this section is not in effect—

(A) The basis increases made 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 the regulations thereunder; and

(B) The basis decreases made pursuant to sections 961(b) and 1293(d) attributable to amounts treated as dividends for purposes of section 1411 under paragraph (c)(1)(i) of this section are not taken into account for purposes of section 1411 and the regulations thereunder.

(ii) *Stock held by domestic partnerships or S corporations*—(A) *Rule when an election under paragraph (g) of this section is not in effect.* The rules of this paragraph (d)(1)(ii)(A) apply with respect to stock of a CFC or QEF held directly by a domestic partnership or S corporation, or indirectly through one or more entities each of which is foreign, for which an election under paragraph (g) of this section is not in effect. 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 S corporation or domestic partnership, as the case may be, will not take into account for purposes of section 1411 and the regulations thereunder 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 treated as dividends for purposes of section 1411 under paragraph (c)(1)(i) of this section (the section 1411 recalculated basis). If the domestic partnership or S corporation disposes of the stock of a CFC or QEF, the section 1411 recalculated basis will be used to determine the distributive share or pro rata share of the gain or loss for purposes of section 1411 for partners or shareholders.

(B) *Rules when an election under paragraph (g) of this section is in effect.* If an election under paragraph (g) of this section is in effect with respect to stock of a CFC or QEF held directly or indirectly by a domestic partnership or S corporation, the partner's distributive share or the shareholder's pro rata share of the gain or loss for purposes of section 1411 is the same as the distributive share or pro rata share of the gain or loss for purposes of chapter 1. 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 CFCs or QEFs.* The rules of this paragraph (d)(2) apply with respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, and that is held by a domestic partnership, either directly or indirectly through one or more entities each of which is foreign. In such a case, the basis increases provided under section 705(a)(1)(A) to the partners for purposes of chapter 1 that are attributable to amounts that the domestic partnership includes or 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. Instead, each partner's adjusted basis in the partnership interest is increased by its share of any distributions to the partnership from the CFC or QEF that are treated as dividends for purposes of section 1411 under paragraph (c)(1)(i) of this section. Similar rules apply when the stock of the CFC or QEF 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) is 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 CFCs or QEFs.* The rules of this paragraph (d)(3) apply with respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, and that is held by an S corporation, directly or indirectly through one or more entities

each of which is foreign. In such case, the basis increases provided in section 1367(a)(1)(A) to its shareholders for chapter 1 purposes that are attributable to amounts that the S corporation includes or 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. Instead, each shareholder's adjusted basis of stock in the S corporation is increased by its share of the distributions to the S corporation from the CFC or QEF that are treated as dividends for purposes of section 1411 under paragraph (c)(1)(i) of this section. Similar rules apply when the S corporation holds an interest in a CFC or QEF 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) is used to determine all tax consequences related to tax basis (for example, loss limitation rules and the characterization of S corporation distributions).

(4) *Special rules for participants in common trust funds.* Rules similar to the rules in paragraphs (d)(2) and (3) of this section apply to ownership interests in common trust funds (as defined in section 584).

(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)(1)(i), (c)(1)(ii), (c)(2)(i), and (c)(4) 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)(2)(iii) and (iv) of this section and the amount of the gain or loss attributable to the relevant disposition as calculated for chapter 1 purposes;

(iii) Decreased by any amount included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) attributable to a CFC or QEF with respect to which no election under paragraph (g) of this section is in effect; and

(iv) To the extent the section 163(d)(1) investment interest expense deduction is calculated using the method of calculation set forth in paragraph (c)(5) of this section and the deduction is taken into account under § 1.1411–4(f)(2), increased or decreased, as appropriate, by the difference between the amount of the section 163(d)(1) investment interest expense deduction calculated under paragraph (c)(5) of this section and the amount calculated for chapter 1 purposes.

(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)(1)(i), (c)(1)(ii), (c)(2)(i), and (c)(4) 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)(2)(iii) and (iv) of this section and the amount of the gain or loss attributable to the relevant disposition as calculated for chapter 1 purposes;

(iii) Decreased by any amount included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) attributable to a CFC or QEF with respect to which no election under paragraph (g) of this section is in effect; and

(iv) To the extent the section 163(d)(1) investment interest expense deduction is calculated using the method of calculation set forth in paragraph (c)(5) of this section and taken into account under § 1.1411–4(f)(2), increased or decreased, as appropriate, by the difference between the amount of the section 163(d)(1) investment interest expense deduction calculated under paragraph (c)(5) of this section and the amount calculated for chapter 1 purposes.

(f) *Application to estates and trusts.* All of the items described in paragraph (c) of this section are included in the net investment income of an estate or trust or its beneficiaries. The amounts described in paragraphs (e)(2)(i) through (iv) of this section, regardless of whether the estate or trust receives those amounts directly or indirectly through another estate or trust, increase or decrease, as applicable, the estate's or trust's distributable net income for purposes of section 1411. The estate or trust, or the beneficiaries thereof, must take those 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 CFCs and QEFs*—(1) *Effect of election.* If an election under paragraph (g) of this section is made with respect to a CFC or QEF, amounts included in gross income for chapter 1 purposes under section 951(a) or section 1293(a)(1)(A) with respect to the CFC or QEF in taxable years beginning with the taxable 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) with respect to the QEF in taxable years beginning with the taxable 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). See paragraphs (c)(1)(i)(B) and (c)(1)(i)(C) of this section for the effect of this election on certain distributions of previously taxed earnings and profits.

(2) *Years to which election applies*—(i) *In general.* An election under paragraph (g) of this section applies to the taxable year for which it is made and all subsequent taxable years, and applies to all subsequently acquired interests in the CFC or QEF. An election under paragraph (g) of this section is irrevocable.

(ii) *Termination of interest in CFC or QEF.* Complete termination of a person's interest in the CFC or QEF does not terminate the person's election under paragraph (g) of this section with respect to the CFC or QEF. Thus, if the person reacquires stock of the CFC or QEF, that stock is considered to be stock for which an election under paragraph (g) of this section has been made and is in effect.

(iii) *Termination of partnership.* If a domestic partnership that makes the election under paragraph (g) of this section is terminated pursuant to section 708(b)(1)(B), the election is binding on the new partnership.

(3) *Who may make the election.* An individual, estate, trust, domestic partnership, S corporation, or common trust fund may make an election under paragraph (g) of this section with respect to each CFC or QEF that it holds directly or indirectly through one or more entities, each of which is foreign. In addition, an individual, estate, trust, domestic partnership, S corporation, or common trust fund may make an election under paragraph (g) of this section with respect to a CFC or QEF

that it holds indirectly through a domestic partnership, S corporation, estate, trust, or common trust fund if the domestic partnership, S corporation, estate, trust, or common trust fund does not make the election. The election, if made, for an estate or trust must be made by the fiduciary of that estate or trust.

(4) *Time and manner for making the election*—(i) *Individuals, estates, and trusts*—(A) *General rule.* Except as otherwise provided in this paragraph, in order for an election under paragraph (g) of this section by an individual, estate, or trust (other than a CRT) with respect to a CFC or QEF to be effective, the election must be made no later than the first taxable year beginning after December 31, 2013, during which the individual, estate, or trust—

(*1*) Includes an amount in gross income for chapter 1 purposes under section 951(a) or section 1293(a) with respect to the CFC or QEF; and

(*2*) 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 CFC or QEF.

(B) *Special rule for charitable remainder trusts (CRTs).* Except as otherwise provided in this paragraph, in order for an election under paragraph (g) of this section by a CRT with respect to a CFC or QEF to be effective, the election must be made no later than the first taxable year beginning after December 31, 2013, during which the CRT includes an amount in gross income for chapter 1 purposes under section 951(a) or section 1293(a) with respect to the CFC or QEF.

(ii) *Certain domestic passthrough entities.* Except as otherwise provided in this paragraph, in order for an election under paragraph (g) of this section by a domestic partnership, S corporation, or common trust fund with respect to a CFC or a QEF to be effective, the election must be made no later than the first taxable year beginning after December 31, 2013, during which the domestic partnership S corporation, or common trust fund—

(A) Includes an amount in gross income for chapter 1 purposes under section 951(a) or section 1293(a) with respect to the CFC or QEF; and

(B) Has a direct or indirect owner that is subject to tax under section 1411 or would be subject to tax under section 1411 if the election were made.

(iii) *Taxable years that begin before January 1, 2014*—(A) *Individuals, estates, or trusts.* An individual, estate, or trust may make an election under paragraph (g) of this section for a taxable year that begins before January 1, 2014.

(B) *Certain domestic passthrough entities.* A domestic partnership, S corporation, or common trust fund may make an election under paragraph (g) of this section for a taxable year that begins before January 1, 2014, provided that all of its partners, shareholders, or participants, as the case may be, consent to the election. In the case of a partner, shareholder, or participant that is a partnership, S corporation, or common trust fund, all of the partners, shareholders, and participants also must consent to the election.

(iv) *Time for making election.* In all cases, the election under paragraph (g) of this section must be made in the manner prescribed by forms, instructions, or in other guidance on the individual's, estate's, trust's, domestic partnership's, S corporation's, or common trust fund's original or amended return for the taxable year for which the election is made. An election can be made on an amended return only if the taxable year for which the election is made, and all taxable years that are affected by the election, are not closed by the period of limitations on assessments under section 6501. An individual, estate, trust, domestic partnership, S corporation, or common trust fund may not seek an extension of time to make the election under any other provision of the law, including § 301.9100 of this chapter.

(h) *Examples.* The following examples illustrate the rules of this section. In each example, unless otherwise indicated, the individuals, the foreign corporation (FC), the QEF (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 United States 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. In 2012, A includes $40,000 in gross income for chapter 1 purposes under section 951(a)(1)(A) 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 under 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)(3) 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 2017, 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 under paragraph (g)(4)(i) 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)(4)(i) of this section was timely made. Pursuant to paragraph (g)(2) 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)(2) 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 United States citizen, owns a 50% interest in PRS, a domestic partnership. D, a United States citizen, and E, a United States citizen, each own a 25% 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. PRS does 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 PRS did not make an election under paragraph (g) of this section, C, 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, C reduces his modified adjusted gross income by $20,000, and 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)(1)(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 PRS did not make an election under paragraph (g) of this section, pursuant to paragraph (c)(2)(i) of this section, C has $20,000 of net investment income, and 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, C increases his adjusted basis in PRS by $20,000 to $120,000, and 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, C increases his modified adjusted gross income by $20,000, and 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 PRS did not make an election under paragraph (g) of this section, C, 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 (C remains at $120,000, and D and E each remain at $60,000). Pursuant to paragraph (e)(1)(ii) of this section, C reduces his modified adjusted gross income by $30,000, and 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% ($25,000) to C, 25% ($12,500) to D, and 25% ($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 an election by PRS under paragraph (g) of this section, results in gain of $55,000 to C, $27,500 to D, and $27,500 to E. Therefore, C has net investment income of $55,000, and D and E each have net investment income of $27,500. Pursuant to paragraph (e)(1)(ii) of this section, C increases his modified adjusted gross income by $30,000, and 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. However, taxpayers may apply this section to taxable years beginning after December 31, 2012, in accordance with § 1.1411–1(f).

PART 602—OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

■ **Par. 6.** The authority citation for part 602 continues to read as follows:

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

■ **Par. 7.** In § 602.101, paragraph (b) is amended by adding the following entry to the table in numerical order to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR Part or section where identified and described	Current OMB control No.
* * *	* *
1.1411–10(g)	1545–2227
* * *	* *

John Dalrymple,

Deputy Commissioner for Services and Enforcement.

Approved: November 14, 2013.

Mark J. Mazur,

Assistant Secretary of the Treasury (Tax Policy).

[FR Doc. 2013–28410 Filed 11–26–13; 4:15 pm]

BILLING CODE 4830–01–P