

The Estate Planner

*By Lewis Saret**

The 3.8-Percent Medicare Contribution Proposed Regulations—Part II

Introduction

This is the second part of a two-part series¹ that address the proposed regulations that provide guidance with respect to Code Sec. 1411. Code Sec. 1411 imposes a 3.8-percent tax on net investment income for individuals, trusts and estates. This column resumes where the first part ended.

Note. As of the date that this column was submitted for publication, several comments have been submitted to the Treasury Department concerning the proposed regulations, some of which are extensive. Attached as an Appendix to this column is a list of issues raised in such comments, along with cites to the comments submitted to the Treasury.

Application to Estates and Trusts

In addition to placing a 3.8-percent tax on certain individuals, Code Sec. 1411 also applies a 3.8-percent net investment income tax on estates and trusts. This tax is determined by applying a 3.8-percent tax for a tax year on the lesser of:

- the estate's or trust's Undistributed Net Investment Income (UNII), or
- the estate's or trust's Adjusted Gross Income (AGI) above a threshold.

The threshold amount is the dollar amount that begins the highest tax bracket for a particular year and is currently approximately \$11,950.²

Code Sec. 1411 provides that AGI for estates and trusts, as for individuals, is defined in Code Sec. 67(e).



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In addition, Code Sec. 1411 and the proposed regulations thereunder also provide an extensive definition for Net Investment Income (NII). However, the term “Undistributed Net Investment Income,” which applies solely to estates and trusts, is not defined in Code Sec. 1411. Therefore, the proposed regulations provide that in determining an estate’s or a trust’s UNII, the estate or trust must calculate its NII, then reduce that amount by the certain deductions to arrive at its UNII. Specifically, NII is reduced by the following two types of deductions:

1. Distributions of NII to beneficiaries under Code Sec. 651 or 661
2. Deductions paid or permanently set aside for a charitable purpose, allowable under Code Sec. 642(c)³

In order to maintain consistency with the provisions of Subchapter J, the proposed regulations adopt a class system of income categorization for distributions and deductions. This means that allowable distributions and deductions must be allocated between investment income and excluded income in a manner similar to Reg. §1.661(c)-1.⁴ Only amounts attributable to investment income may reduce an estate’s or a trust’s NII.

For the purposes of Code Sec. 1411, excluded income includes the following:

- Income excluded from gross income under chapter 1
- Income excluded from NII, as determined under Proposed Reg. §1.1411-4
- Items of gross income and net gain specifically excluded by Code Sec. 1411 and the regulations thereunder or other guidance published by the Treasury⁵

Planning Pointer. The proposed regulations suggest the following steps in computing an estate’s or trust’s UNII:

1. Determine amount of distributable net income from entire amount of income (e.g., by allocating items of income to the principal and to distributable net income).
2. Determine the estate’s or trust’s NII and excluded income as defined under Proposed Reg. §1.1411-3(e)(5).
3. Determine the proportional basis between the deduction or distribution and the distributable net income by dividing the total amount allowable for a specific item of deduction or

distribution by the distributable net income determined in Step 1. Apply the proportional basis to each item of income in the deduction or distributable net income to determine the composition of the deduction distribution.

4. Reduce each item of income in NII by the amount determined in Step 2 associated with that item to arrive at the estate’s or trust’s UNII after consideration of such item of deduction or distribution.
5. Repeat Steps 3 and 4 until NII has been properly reduced by all allocable distributions and deductions to arrive at the estate’s or trust’s UNII.

Example 1.⁶

In year 1, Midas Trust has no expenses and the income shown in Table 1.

Table 1.

Dividends	\$15,000
Interest	10,000
Capital gain	5,000
Taxable IRA distribution	60,000
Total income	<u>\$90,000</u>

Midas Trust makes a \$10,000 distribution of accounting income to Adam.

For trust accounting purposes, Midas Trust allocates its income between principal and income as shown in Table 2.

Table 2.

Description	Total Income	Income	Principal
Dividends	\$15,000	\$15,000	\$0
Interest	10,000	10,000	0
Capital gain	5,000	0	5,000
Taxable IRA distribution	<u>60,000</u>	<u>25,000</u>	<u>35,000</u>
Total income	<u>\$90,000</u>	<u>\$50,000</u>	<u>\$40,000</u>

Therefore, Midas Trust’s distributable net income (DNI) for year 1 is \$50,000 (i.e., dividends of \$15,000, interest of \$10,000 and taxable IRA distributions of \$25,000).

Midas Trust gets a Code Sec. 661 income distribution deduction of \$10,000 for the distribution to Adam. This distribution reduces each class of income that is part of Midas Trust’s DNA on a proportional basis. Because the distribution equals 20 percent of DNI (i.e., \$10,000/\$50,000), it results in the allocation of income depicted in Table 3.

Table 3.

Description	Total Income	Distribution	Midas Trust
Dividends	\$15,000	\$3,000	\$12,000
Interest	10,000	2,000	8,000
Taxable IRA distribution	<u>25,000</u>	<u>5,000</u>	<u>20,000</u>
Total income	<u>\$50,000</u>	<u>\$10,000</u>	<u>\$40,000</u>

Midas Trust's NII equals \$30,000. This consists of the \$15,000 of dividend income, \$10,000 of interest income and \$5,000 of capital gain received by Midas Trust. Note that the \$60,000 of taxable income from IRA distributions is excluded from Midas Trust's NII.⁷

Midas Trust's UNII equals \$25,000. This amount equals Midas Trust's NII of \$30,000, less the amount of dividend income (*i.e.*, \$3,000) and interest income (*i.e.*, \$2,000) deemed to be distributed to Adam. Therefore, Midas Trust's UNII consists of the types of income shown in Table 4.

Table 4.

Description	Total Income
Capital gain allocated to principal	\$5,000
Undistributed dividend income (\$15,000 - \$3,000)	12,000
Undistributed income income (\$10,000 - \$2,000)	<u>8,000</u>
Total UNII	<u>\$25,000</u>

As a result of the foregoing facts, Adam's NII, stemming from the distribution from the Midas Trust, includes \$3,000 of dividend income and \$2,000 of interest income. Note, however, that Adam's NII does not include the \$5,000 of ordinary income attributable to the distribution to Adam because Proposed Reg. §1.1411-8 excludes such retirement account income from NII.

Example 2

Same facts as Example 1 except for the following:

- The Midas Trust Agreement requires the Midas Trust to distribute \$30,000 to Adam.
- The trust has a \$10,000 Code Sec. 642(a) deduction for amounts paid for charitable purposes.
- The trust makes a discretionary distribution of \$10,000 to Bob, a beneficiary of the Midas Trust.

As in Example 1, Midas Trust's NII equals \$30,000, which consists of \$15,000 of dividend income, \$10,000 of investment income, and \$5,000 of capital gain received by the trust.

Here, the income items must be allocated between the distribution to Adam, Bob, and the charity pursuant to Reg. §§1.661(b)-2, and 1.662(b)-2.

For purposes of the mandatory distribution to Adam the Midas Trust's DNI equals \$50,000.⁸

Midas Trust gets an income distribution deduction of \$30,000 for the distribution to Adam. This distribution reduces each class of income that is part of the trust's DNI on a proportional basis.⁹ Because the distribution equals 60 percent of the trust's DNI (*i.e.*, \$30,000/\$50,000) it results in the allocation of income illustrated in Table 5.

Table 5.

Description	Total Income	Distribution	Remaining Income
Dividends	\$15,000	\$9,000	\$6,000
Interest	10,000	6,000	4,000
Taxable IRA distribution	<u>25,000</u>	<u>15,000</u>	<u>10,000</u>
Total income	<u>\$50,000</u>	<u>\$30,000</u>	<u>\$20,000</u>

As a result of the foregoing, the distribution to Adam consists of \$15,000 of NII (*i.e.*, dividends of \$9,000 and interest of \$6,000), and \$15,000 of income excludable from NII (*i.e.*, the \$15,000 attributable to the taxable IRA distribution).

After the foregoing calculation, the Midas Trust's remaining DNI equals \$20,000 (*i.e.*, total DNI of \$50,000 less \$30,000 of DNI allocated to the mandatory distribution to Adam).

The Midas Trust gets a \$10,000 income distribution deduction for the distribution to Bob. Because Bob's distribution equals 20 percent of the trust's DNI (*i.e.*, \$10,000/\$50,000) it results in the allocation of income shown in Table 6.

Table 6.

Description	Total Income	Distribution	Remaining Income
Dividends	\$15,000	\$3,000	\$12,000
Interest	10,000	2,000	8,000
Taxable IRA distribution	<u>25,000</u>	<u>5,000</u>	<u>20,000</u>
Total income	<u>\$50,000</u>	<u>\$10,000</u>	<u>\$40,000</u>

The distribution to Bob consists of \$5,000 of NII (*i.e.*, dividends of \$3,000 and interest of \$2,000), and \$5,000 of income excludable from NII (*i.e.*, \$5,000 attributable to the taxable IRA distribution).

The distribution to the charity is determined as follows. Because the \$10,000 distribution equals 20 percent of the Midas Trust's DNI (*i.e.*, \$10,000

of distribution/\$50,000), the NII allocated to that distribution is as shown in Table 7.

Table 7.

Description	Total NII	Distribution to Charity
Dividends	\$15,000	\$3,000
Interest	10,000	2,000
Taxable IRA distribution	0	0
Total income	\$25,000	\$5,000
Capital gain allocated to principal for trust accounting purposes	\$5,000	
Total NII	\$30,000	

As a result of the foregoing, Midas Trust's UNII equals \$5,000. This amount equals Midas Trust's NII of \$30,000 (*i.e.*, dividends of \$15,000, interest of \$10,000, and capital gain of \$5,000), less the amount of dividend income (*i.e.*, \$9,000 + \$3,000 + \$3,000 = \$15,000) and interest income (*i.e.*, \$6,000 + \$2,000 + \$2,000 = \$10,000) deemed to be distributed to Adam, Bob and the charity. Therefore, Midas Trust's UNII consist of the types of income shown in Table 8.

Table 8.

Description	Total Income
Capital gain allocated to principal	\$5,000
Undistributed dividend income (\$15,000 - \$9,000 - \$3,000 - \$3,000)	\$0
Undistributed interest income (\$10,000 - \$6,000 - \$2,000 - \$2,000)	\$0
Total income	\$5,000

Net Investment Income

Code Sec. 1411 defines the term Net Investment Income (or "NII") as the excess of the following:

1. The sum of—
 - a. **Code Sec. 1411(c)(1)(A)(i).** Gross income from interest, dividends, annuities, royalties and rent, other than such income that is derived in the ordinary course of a trade or business that is not described in Code Sec. 1411(c)(1)(A)(ii).
 - b. **Code Sec. 1411(c)(1)(A)(ii).** Other gross income derived from a trade or business that is considered either (i) a passive activity with respect to the taxpayer, or (ii) a trade or business of trading in financial instruments or commodities.
 - c. **Code Sec. 1411(c)(1)(A)(iii).** Net gain to the extent taken into account in computing taxable income attributable to property dispositions

(other than property held in a trade or business described above in Code Sec. 1411(c)(1)(A)(ii).

2. Less deductions properly allocable to the gross income or net gain under the proposed regulations¹⁰

The proposed regulations elaborate on the Code Sec. 1411 definition of NII and provide extensive guidance on the determination and calculation of NII.

The proposed regulations divide the definition of NII into two large sections: a discussion of the three elements that compose the Net Investment Income sum and then an explanation of the properly allocable deductions that can reduce this amount.

Code Sec. 1411(c)(1)(A)(i)– Gross Income from Interest, Dividends, Annuities, Royalties and Rents (Other Than from Certain Trades/Businesses)

The first component of NII refers to items of income that are traditionally considered investment income, such as gross income from interest and dividends. One significant limitation on NII is that Code Sec. 1411 limits the type of gross income to include only items of gross income that are not derived during the ordinary course of a trade or business (except for passive activities and businesses of trading in financial instruments or commodities).¹¹

“Ordinary Course of a Trade or Business” Exception

Since the purpose of Code Sec. 1411 is to apply a tax on investment income, gross income derived from the ordinary course of a trade or business is generally excluded from NII. Code Sec. 1411 includes this exception to the first prong of the NII definition under Code Sec. 1411(a)(1)(A)(i). The proposed regulations provide the following two-part test for determining whether an item of gross income qualifies as excludable income derived in the ordinary course of a trade or business.

For item to be excluded from the calculation of NII under the Ordinary Course of a Trade or Business exception, the item must be:

- “derived in” a trade or business that is not described in Code Sec. 1411(c)(1)(A)(ii) (*i.e.*, a trade or business that is either a passive

activity with respect to the taxpayer or is engaged in trading of in financial instruments or commodities), and

- derived in the “ordinary course” of the trade or business.¹²

“Derived in” Passive/Trader Business

To determine whether an item of income was “derived in” a trade or business, the proposed regulations consider two cases that are either a passive activity or a trader business:

1. The individual, estate or trust is engaged in the trade or business directly
2. The individual, estate or trust is engaged in the trade or business indirectly.

If the engagement in the trade or business is “direct,” then the determination of whether gross income is considered “derived in” a trade or business is made at an individual level.¹³ For this purpose, the preamble to the proposed regulations indicates that “direct” ownership includes businesses owned as sole proprietorships or through disregarded entities under Reg. §301.7701-3.¹⁴ If the trade or business is not owned directly but is instead owned through one or more passthrough entities (e.g., partnerships or S corporations), then the determination of whether gross income is:

- considered derived in a trade or business that is a passive activity with respect to the taxpayer is made at the owner level.¹⁵
- considered derived in a trade or business of trader trading in financial instruments or commodities is made at the entity level.¹⁶

Example 3.¹⁷ Victoria, an individual, owns an interest in Penthouse Partnership, which is engaged in a trade or business. Penthouse Partnership owns an interest in Lobby Partnership, which is not engaged in a trade or business. In Year 1, Lobby Partnership receives \$10,000 in dividends, \$5,000 of which is allocated to Victoria through Penthouse Partnership. The \$5,000 of dividends is not “derived in” a trade or business since Lobby Partnership is not engaged in a trade or business. This is true even though Penthouse Partnership is engaged in a trade or business. Therefore, the Ordinary Course of a Trade or Business exception doesn’t apply, and Victoria’s \$5,000 of dividends for Year 1 is included in her NII.

Example 4.¹⁸ Jane, an individual, owns stock in the S corporation, Austin Corp. Austin Corp. is engaged in a banking trade or business that isn’t involved in trading in financial instruments or commodities, and is not a passive activity with respect to Jane. In Year 1, Austin Corp. earns \$100,000 of interest in the ordinary course of its trade or business, \$5,000 of which is Jane’s *pro rata* share. Because Austin Corp. is not engaged in a trade or business of trading in financial instruments or commodities and because Austin Corp.’s trade or business is not a passive activity with respect to Jane, the Ordinary Course of a Trade or Business exception applies. Therefore, in Year 1, Jane’s \$5,000 of interest is not included in Jane’s NII.

Ordinary Course

Neither Code Sec. 1411 nor the proposed regulations define the term “ordinary course” of a trade or business. Instead, the preamble to the proposed regulations indicates that the Treasury intends for taxpayers to turn to other regulation and preexisting case law for guidance. To illustrate, the preamble to the proposed regulations specifically refer to *Lilly*¹⁹ and Reg. §1469-2T(c)(3)(ii) as provisions for further guidance.²⁰

Interest and Dividends

In general, gross income from interest and dividends follow rules of Code Chapter 1.²¹

Caution. The preamble to the proposed regulations indicates that substitute interest and dividend payments are always included in NII. This is not always the case under Code Chapter 1.²²

Notional Principal Contracts

The preamble to the proposed regulations indicates that generally gross income from notional principal contracts is not included in NII. However, taxpayers should be cognizant that if the gross income from the notional principal contract is derived in a trade or business that is a passive activity with respect to the taxpayer or a trader business trading in financial instruments or commodities, or if there is a net gain on a disposition of the notional principal contract, that amount will be included in NII.²³

Annuities

Code Sec. 1411 does not define “annuities”; however, the preamble to the proposed regulations suggests that taxpayers should rely on provisions under Code Sec. 72 in determining whether amounts are considered as annuities.²⁴ This means that “annuities” for the purpose of NII in Code Sec. 1411 include the following:

- Gross income from an annuity, endowment or life insurance²⁵
- Amounts, such as lump-sum distributions, included as gross income but not specifically as annuity²⁶

It also means that annuities for NII purposes exclude the portion of gross income from an annuity that amounts to the contracted excepted return.²⁷

Code Sec. 1411(c)(1)(A)(ii)– Gross Income from Trade or Business That Is Passive Activity or Trader Business

The second part of the NII calculation refers to other gross income from trades or businesses that are either:

- passive activities with respect to the taxpayer; or
- trader businesses that trade in financial instruments or commodities.

Neither Code Sec. 1411 nor the proposed regulations define the term “trade or business.” However, the preamble to the proposed regulations indicate the intention of the Treasury to incorporate the rules under Code Sec. 162, which permits a deduction for ordinary and necessary expenses paid or incurred in carrying on a trade or business, in the definition of a trade or business for Code Sec. 1411 purposes.²⁸

Passive Activity

Proposed Reg. §1.1411-5 provides that a passive activity with respect to an individual includes any activity that both:

- is a trade or business within the means of Code Sec. 162, and
- qualifies as a passive activity under Code Sec. 469 and the regulations thereunder.²⁹

Note. The definition of “passive activity income” under the proposed regulations is narrower than that used in Code Sec. 469. To illustrate, the

preamble to the proposed regulations indicates that the income from the following types of activities is not subject to the 3.8-percent tax:

- Code Sec. 469 passive activity trades or businesses include not only trades or businesses for Code Sec. 162 purpose, but also activities undertaken in anticipation of the commencement of a trade or business and any research or experimentation activity under Code Sec. 174.
- Code Sec. 469 also defines a “passive activity” to include any rental activity (*i.e.*, not only trade or business rental activities).

The proposed regulations provide that they apply the Code Sec. 162 definition of a trade or business even though that is narrower than the Code Sec. 469 definition.³⁰

Therefore, from an analytical standpoint, a taxpayer must first determine if the activity where the taxpayer owns an interest is considered a Code Sec. 162 trade or business. Then, a taxpayer should determine whether that interest qualifies as a passive activity under Code Sec. 469.³¹

The following are a few special situations explored in the proposed regulations for illustration purposes:

- Real estate professionals
- Rental activity exceptions
- Grouping rules
- Income recharacterization rules
- Activity recharacterization rules³²

Note. The proposed regulations emphasize that these situations are not meant to be an exhaustive list. Taxpayers are encouraged to refer to other related sections in Chapter 1 for further guidance on specific areas that aren’t addressed in the proposed regulations and this article.³³

Material Participation

The preamble to the proposed regulations provides that Code Sec. 469(h)(1) which provides a definition of “material participation” as “involvement in the operations of the activity on a basis which is regular, continuous, and substantial,” should be applied in determining whether a taxpayer materially participates in a Code Sec. 162 trade or business.³⁴ Only if the taxpayer’s gross income from a trade or business is from a trade or business under Code Sec. 162 and satisfies the definition for “material

participation" under Code Sec. 496 is the item of gross income excluded from NII.

Real Estate Professionals

Generally, if a taxpayer is a real estate professional, the taxpayer's interest in rental real estate is not subject to Code Sec. 469 if the taxpayer's participation is material, and the rental real estate activities are not considered passive activities with respect to the professional. However, a taxpayer who qualifies as a real estate professional is not necessarily engaged in a trade or business with respect to the rental real estate activity. Therefore, gross income from rental real estate that is earned by taxpayers who are real estate professionals may still be included in NII pursuant to Code Sec. 1411(c)(1)(A)(i) (*i.e.*, gross income from rents, other than such income which is derived in the ordinary course of a trade or business that constitutes passive activities with respect to the taxpayer or one of certain types of trader businesses). Therefore, real estate professionals must determine if their gross income qualifies under the Ordinary Course of a Trade or Business exception. To do this, they must determine if the activity is included under Code Sec. 162 trades or businesses. If it is, then the gross income is excluded under Code Sec. 1411(c)(1)(A)(i) because the income from the activity will be "derived in the ordinary course of a trade or business that is not described in paragraph (2)" (*i.e.*, not a passive activity or trader business), because Code Sec. 469 does consider the activity as passive with respect to the taxpayer. On the other hand, however, if the activity does not rise to the level of a trade or business, then it will be included in the taxpayer's NII under Code Sec. 1411(c)(1)(A)(i) because it will not fall within the exclusion for ordinary trade or business income.³⁵

Planning Pointer. Taxpayers can reference the IRS, Passive Activity Loss Audit Technique Guide, Chapter 2: Rental Losses, which details the specific steps that IRS auditors use to determine if taxpayers are "real estate professionals."

Rental Activity Exceptions

Code Sec. 469(j)(8) and the regulations thereunder provide a definition for rental activities as well as a list of exceptions to the definition. In the pursuit of consistency, these rental activity exceptions will also apply for determining whether a rental activity

is considered a passive activity with respect to taxpayer under Code Sec. 1411. In general, if an activity qualifies under one of the exceptions under Code Sec. 469, then the activity is not considered a passive activity if the taxpayer materially participates in the activity. Therefore, the income derived from the activity is not included in NII under Code Sec. 1411(c)(1)(A)(ii) (other gross income derived from a trade or business that is either a passive activity with respect to the taxpayer or a trade or business of trading in financial products or commodities).

However, since the income may still be included in NII pursuant to Code Sec. 1411(a)(1)(A)(i), taxpayers must also test that the activity satisfies the Ordinary Course of Business or Trade exception. Therefore, in addition to meeting one of these exceptions, the proposed regulations also require that the activity be derived in a Code Sec. 162 trade or business. Only when both of these requirements are met does the Ordinary Course of a Business or Trade exception apply and the rental activity income excluded from the calculation of NII for Code Sec. 1411 purposes.³⁶

Grouping Rules

The proposed regulations through Reg. §1.469-4 grant taxpayers the opportunity to regroup their activities for the purpose of applying passive activity loss rules once any time after the first tax year beginning after December 31, 2013. Taxpayers may rely on the proposed regulations in regrouping their activities. In addition, taxpayers should be cognizant that any such regrouping is irrevocable and will apply to the current and all subsequent tax years.³⁷

Income and Activity Recharacterization Rules

Code Sec. 469 and the regulations thereunder provide certain rules that restrict the ability of taxpayers to artificially inflate passive income from certain types of passive activities. The proposed regulations suggest that these rules are to apply to Code Sec. 1411 as well.³⁸ Although an extensive discussion of these rules is beyond the scope of this column, the preamble of the proposed regulations for Code Sec. 1411 contains a detailed discussion of these issues.

Example 5.³⁹ Louis, an unmarried individual, rents a commercial building to Sam for \$50,000 in Year 1. Louis' rental activity does not involve the conduct of a Code Sec. 162 trade or business, but under Code Sec. 469(c)(2), Louis' rental activity

is a passive activity. Because the Code Sec. 162 trade or business requirement is not satisfied, Louis' rental income of \$50,000 is not considered derived from a trade or business and therefore is not included in NII under Code Sec. 1411(a)(1)(A)(ii). However, Louis' rental income of \$50,000 will still constitute gross income from rents and therefore is included in NII pursuant to Code Sec. 1411(a)(1)(A)(i) since it does not require a trade or business.

Example 6. In Year 1, Jason, an unmarried individual, owns an interest in JRT Partnership, a partnership for federal income tax purposes. JRT Partnership is engaged in two activities which qualify as trades or businesses within the meaning of Code Sec. 162, and neither of which is trading in financial instruments or commodities. For Year 1, Jason chooses not to group the two activities pursuant to Reg. §1.469-4. Jason participates in the first activity for more than 500 hours during Year 1 and would be treated as materially participating in that activity. However, Jason only participated 50 hours in the second activity during Year 1, and so Jason would not be treated as materially participating in the latter activity. Therefore, his NII under Code Sec. 1411(c)(1)(A)(ii) would include income derived from JRT Partnership's second activity since that activity would be considered passive with respect to Jason.

Example 7.⁴⁰ Same facts as Example 6 except Jason elects to group the two activities under Reg. §1.469-4, for the purposes of this section. Pursuant to Reg. §§1.469-4 and 1.469-5T(a)(1), Jason materially participates in the group activity, and therefore, for the purposes of this section, neither of the activities is a passive activity with respect to Jason. Therefore, with respect to Jason, both activities would thus not be considered trades or businesses under Code Sec. 1411(c)(1)(A)(ii) includable in NII, and his other gross income for Year 1 related to these two activities would be zero.

Trading in Financial Instruments or Commodities

Code Sec. 1411(c)(1)(A)(ii) includes in NII gross income from a trade or business of trading in financial instruments or commodities. For this purpose the proposed regulations distinguish among dealers, traders and investors. For the purpose of Code Sec.

1411(c)(2)(B), the Treasury and the IRS emphasize that only a person that is a trader in commodities or in financial instruments is considered engaged in a trade or business under Code Sec. 1411(a)(1)(A)(ii). This is consistent with preexisting provisions provided for the purpose of Chapter 1.⁴¹

In addition, the proposed regulations refer to Code Sec. 731(c)(2)(C) for a workable definition of the term "financial instrument" and defines it to include the following:

- Equity interests such as stocks
- Proof of indebtedness
- Options
- Future or forward contracts
- Notional principal contracts
- Other derivatives
- Other evidences of an interest in one of the foregoing items⁴²

The definition for the term "commodities," which is stated in Code Sec. 1411 to have the same meaning as provided in Code Sec. 475(e)(2), remains unchanged under the proposed regulations.

Code Sec. 1411(a)(1)(A)(iii)—Net Gain Attributable to Property Dispositions

The third component of NII includes net gain attributable to the disposition of property other than property held in a trade or business other than property held in a trade or business not described in Code Sec. 1411(a)(1)(A)(ii). The proposed regulations provide that the term "disposition" includes "a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition."⁴³ In addition, taxpayers should be cognizant that since Code Sec. 1411 states that the amount included in NII is a "net gain" on disposition of property, losses are allowable under Code Sec. 1211(b) to offset gains. However, only losses that are attributable to property held in a trade or business that is not exempted under the Ordinary Course of Trade or Business exception or included pursuant to Code Sec. 1411(c)(1)(A)(ii) can be used towards reducing gains. In addition, the total net gain cannot be below zero.⁴⁴

In general, the income tax rules in Code Chapter 1 are also used to determine whether a disposition of property is included for Code Sec. 1411 purposes. This means that the treatment of distributions and stocks from partnerships or S corporations are treated in a similar manner as they are treated for the purposes of Code Chapter 1. In addition,

gains or losses from a deemed liquidation of S Corporations are also included as Net Gain in NII. A more extensive discussion of the calculation of this gain for the disposition of interests in partnerships and S corporations is provided later in this column. In addition, property from investment of working capital, which is not included as net gain, is explained in Proposed Reg. §1.1411-6 and will also be discussed later in this column.

“Held in Trade or Business” Provision

Since the net gains from the disposition of a property are exempt from NII if the disposed property was held in a trade or business, other than trades or businesses described in Code Sec. 1411(c)(1)(A)(i) (*i.e.*, passive activities and certain trader businesses), the proposed regulations provide additional guidance regarding whether a property is considered “held in a trade or business.”

To determine whether a property is “held in” a trade or business, the proposed regulations consider three cases:

1. Gains or losses from sales of partnership interest or S corporation stock
2. Gains or losses that occur when the taxpayer is engaged in the trade or business directly (*e.g.*, through a sole proprietorship or disregarded entity)
3. Gain or loss that occurs when the taxpayer is engaged in the trade or business indirectly (*e.g.*, through a partnership or an S corporation)

For gains in a partnership interest or S corporation stock, since the proposed regulations generally do not consider partnership interests or S corporation stock as property held in a trade or business, they do not satisfy the Held in Trade or Business provision. Therefore, gains from such sales are generally included in NII.⁴⁵ If the taxpayer engages in the trade or business directly, then the determination of whether net gain is attributable to the disposition of property considered “held in” a trade or business is made at an individual level. If the property is considered “held in” the trade or business, then the net gain is excluded from NII.⁴⁶

If a taxpayer engages in a business indirectly (*i.e.*, through one or more passthrough entities), the determination of whether a net gain from such entity is treated as includible in NII pursuant to Code Sec. 1411(c)(1)(A)(ii) (*i.e.*, income from a passive activity or a trader business) is made in the following manners:

- To test whether the property is held in a trade or business considered as passive activity with respect to the owner, determination is made at the owner level
- To test whether the property is held in a trade or business trading in financial instruments or commodities, determination is made at the entity level

Example 8.⁴⁷ Mike, an unmarried individual, rents a boat to Karen for \$100,000 in Year 1. Mike’s rental activity is not considered a Code Sec. 162 trade or business, but is considered a passive activity under Code Sec. 469(c)(2). In Year 2, Mike sells the boat to Karen, and Mike realizes and recognizes a taxable gain attributable to the disposition of the boat of \$500,000. Because the Held in a Trade or Business exception is inapplicable, for Year 2, Mike would include the \$500,000 gain from the disposition of his boat in his calculation of Net Gain NII.

Properly Allocable Deductions

Code Sec. 1411 and proposed regulations thereunder allow taxpayers to reduce their Net Investment Income sum by a number of deductions, collectively referred to as “properly allocable deductions.” Generally, only deductions specifically allowed under the proposed regulations which can be properly allocated to an item of gross income or net gain included in NII can be accounted for. In addition, since the NII for any tax year cannot be less than zero, the total amount of deductions taken into account in a year cannot exceed the total amount of gross income and net gain included in the NII sum.⁴⁸

In situations where the total amount of properly allocable deductions does exceed NII in a particular tax year, the proposed regulations only allow the remaining deductions to be taken account in another tax year in a similar manner as under chapter 1. This means that certain types of carryforwards, such as a capital loss carryforward under Code Sec. 1212, are allowed under Code Sec. 1411. However, taxpayers should be take note that net operating loss deductions related to Code Sec. 172 are never allowed in determining NII.⁴⁹

Note. The proposed regulations discuss a potential categorization problem with deductions carryforward into a future tax year. Under current provisions, when items become net operating

losses carried into another year, they are no longer allocable to specific items of gross income or net gain. Therefore, to properly allocate them would place an undue burden on taxpayers. Net losses, however, are still included in a taxpayer's MAGI. The IRS requests comments on this disparity and methods that may allow these deductions to be included in NII.⁵⁰

The proposed regulations allow the following four types of properly allocable deductions:

1. Deductions under Code Sec. 62 related to gross income under Part 2 of the NII sum
2. Itemized deductions under Code Sec. 63
3. Loss deductions under Code Sec. 165
4. Special rules for CFCs and PFICs⁵¹

Code Sec. 62 Deductions

Code Sec. 62 allows certain deductions from gross income to arrive at adjusted gross income (*i.e.*, AGI). The proposed regulations allow certain deductions pursuant to Code Sec. 62 in arriving at NII. Gross income from rents and royalties included in NII are allowed to be reduced by deductions under Code Sec. 62(a)(4) allocable to rent and royalty income, respectively. In addition, the proposed regulations allow several deductions under Code Sec. 62(a)(1) to be allocable to NII from a passive activity or trader business under Code Sec. 1411(c)(1)(A)(ii). Penalties on early withdrawal of savings as under Code Sec. 62(a)(9) are also considered properly allocable deductions.⁵²

However, taxpayers should be mindful of the special rules related to self-employment deductions. The proposed regulations state that since self-employment income is generally excluded under Code Sec. 1411's calculation of NII, any deductions related to self-employment income are also excluded.⁵³ This topic is addressed further later in this column.

This provision has interesting repercussions for traders in financial instruments or commodities whose gross income is earned by trading in financial instruments or commodities. Since the second prong of the NII definition (under Code Sec. 1411(c)(1)(A)(ii)) specifically includes gross income from trading in financial or commodities, this amount is not considered self-employment income. However, properly allocable deductions attributable to this amount are taken into account in determining a taxpayer's self-employment income. Since none of the gross income is being

allocated to self-employment income, the reduction would not properly reduce the trader's gross income.⁵⁴ To resolve this disparity, the IRS proposes a special rule for traders in financial instruments or commodities, allowing traders to allocate any remaining deductions attributed to self-employment that is related to trading in financial instruments or commodities to reduce NII.⁵⁵

Itemized Deductions in Code Sec. 63

The following itemized deductions can help reduce a taxpayer's NII:

- Investment interest expense (Code Sec. 163(d)(1))
- Interest expenses (Code Sec. 163(d)(4)(C))
- Deductible state, local and foreign taxes (Code Sec. 164(a)(3)), so long as the portion that is properly allocable to gross income under Code Sec. 1411 is determined using a reasonable method (This method is up to the taxpayer's discretion.)⁵⁶

In addition, the proposed regulations allow deductions under Code Sec. 67, which refers to the two-percent floor on miscellaneous itemized deductions, and Code Sec. 68, which refers to overall limitations in itemized deductions, to apply to Code Sec. 1411 to the extent that they are deductible for Chapter 1 purposes.⁵⁷ Taxpayers are to take the following steps to determine this amount, applying Code Sec. 67 before applying Code Sec. 68:

1. Applying Code Sec. 67, the amount of itemized deductions deductible for NII = Taxpayer's Miscellaneous Itemized Deductions × (Total Miscellaneous Itemized Deductions after Code Sec. 67 and before only Code Sec. 68/Total Miscellaneous Itemized before both Code Secs. 67 and 68)
2. Applying Code Sec. 68, the amount of itemized deductions for NII for both = Taxpayer's Miscellaneous Itemized Deductions after Applying Code Sec. 67 × (Total Itemized Deductions Allowed after both Code Secs. 67 and 68/Total Itemized Deductions Allowed after Code Sec. 67 and before Code Sec. 68).⁵⁸

Loss Deductions

Taxpayers are generally not allowed to reduce NII by any form of deductions allowed under Code Sec. 165. However, deductible losses under Code Sec. 165 related specifically to net gain are allowed to reduce Part C of a taxpayer's NII sum.⁵⁹

Below are a few examples that illustrate these provisions.

Example 9⁶⁰—Net Gain. In Year 1, Joe, an unmarried individual, realizes a capital loss of \$40,000 on the sale of Moontrust stock and realized a capital gain of \$10,000 on Catalyst stock, resulting in a net capital loss of \$30,000. Both Moontrust and Catalyst are C corporations. Joe also realizes a gain of \$20,000 on the sale of his rental property in Orange County, which is treated as ordinary income under Code Sec. 1250. In addition, Joe receives wages of \$300,000 and earns \$5,000 of gross income from interest.

In determining Joe's net gain under Code Sec. 1411, Joe must first determine the amount of deductible related to capital losses he's allowed. For income tax purposes, under Code Sec. 1211(b), Joe may use \$3,000 of the net capital loss against other income. Under Code Sec. 1212(b)(1), the remaining \$27,000 is a capital loss carryover.

For the purposes of determining Joe's net gain under the first (*i.e.*, investment income) prong of the NII definition in Code Sec. 1411, Joe's gain of \$10,000 on the sale of the Catalyst stock is reduced to zero by his loss of \$40,000 on the sale of Moontrust stock. In addition, Joe's \$20,000 gain on the sale of rental property in Orange County is reduced by the \$3,000 loss allowed under Code Sec. 1211(b), to \$17,000. Therefore, Joe's net gain for Year 1 is \$17,000.

In Year 2, Joe has a capital gain of \$30,000 on the sale of Jeffreys stock. Jeffreys is a C corporation. Joe has no other capital gain or loss in Year 2. For income tax purposes, Joe may reduce the \$30,000 gain by the Year 1 Code Sec. 1212(b) \$27,000 capital loss carryover. For the purposes of determining his Year 2 net gain for NII under Code Sec. 1411, Joe's \$30,000 gain may also be reduced by the \$27,000 capital loss carryover from Year 1. Therefore, in Year 2, Joe has a \$3,000 net gain for the purpose of net gain in the definition of NII.

Example 10⁶¹—Net Operating Loss Deduction (Code Sec. 172). In Year 1, Susan, an unmarried individual, has the following items of income

and deductions: \$60,000 in wages, \$20,000 in gross income from a trade or business of trading in financial instruments or commodities, \$70,000 in loss from her sole proprietorship, and \$30,000 in trading activity expense deductions. As a result, for income tax purposes Susan sustains a Code Sec. 172(c) net operating loss of \$20,000. Susan makes an election under Code Sec. 172(b)(3) to waive the carryback period for this net operating loss.

For purposes of Code Sec. 1411, Susan's NII for Year 1 is the excess of the \$20,000 in gross income from the trading activity over the \$30,000 deduction for the trading activity expenses. Net investment income cannot be less than zero for a tax year; therefore, Susan's NII for Year 1 is \$0.

Example 11⁶²—Sale of Principal Residence. In Year 1, Maria, an unmarried individual, sells a house that she has owned and used as her principal residence for five years and realizes a \$200,000 gain. In addition, A also realized \$7,000 in long-term capital gain and has \$5,000 of short-term capital loss carryover from a previous year.

For Code Sec. 1411 purposes, under Code Sec. 121(a), Maria excludes the \$200,000 gain realized from the sale of her principal residence from her Year 1 gross income, and consequently from NII. In determining Maria's Year 1 net gain, she reduces the \$7,000 capital gain by the \$5,000 capital loss carryover allowed under Code Sec. 1211(b). Therefore, for Year 1, Maria has a net gain of \$2,000.

Example 12⁶³—Code Sec. 163(d) Limitation. In Year 1, Robert, an unmarried individual, pays interest of \$4,000 on debt incurred to purchase stock. Robert also has \$10,000 of income from a trade or business that is a passive activity. Under Reg. §1.163-8T, the interest is allocable to the stock and is investment interest within the meaning of Code Sec. 163(d)(3). In addition, under Code Sec. 163(d)(2), the \$4,000 investment interest is a carryforward of disallowed interest that is treated as investment interest paid by Robert in the succeeding tax year. Therefore, for the purposes of determining Robert's Year 1 NII, he may not deduct the \$4,000 investment interest, and so his NII for Year 1 is \$10,000.

In year 2, Robert has \$5,000 of Code Sec. 163(d) (4) NII. For both income tax purposes and for determining Code Sec. 1411 NII, Robert's \$4,000 carryforward of interest expense disallowed in Year 1 may be deducted in Year 2.

Example 13⁶⁴—Code Sec. 1031 Like-Kind Exchanges. In Year 1, Matthew, an unmarried individual who is not a dealer in real estate, purchases Treeland, a piece of undeveloped land, for \$10,000. Matthew intends to hold Treeland for investment. In Year 3, Matthew enters into an exchange in which he transfers Treeland, which is now worth \$20,000, and \$5,000 cash for Drapwood, 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 Code Sec. 1031. Therefore, for purposes of Code Sec. 1411, Matthew's NII for Year 3 does not include any realized gain from the exchange of Treeland for Drapwood.

Example 14⁶⁵—Code Sec. 1031 Like-Kind Exchanges. Same facts as Example 11 except now in Year 5, Matthew sells Drapwood for \$35,000 in cash. Since Matthew's basis for Drapwood is \$15,000 (composed of \$10,000 substituted basis in Treeland and \$5,000 additional cost of acquisition), he recognizes a capital gain of \$20,000. Therefore, for the purposes of Code Sec. 1411, Matthew's NII in Year 5 includes the \$20,000 gain recognized from the sale of Drapwood.

Special Provisions for Partnerships and S Corporations

Generally, an interest in a partnership or S corporation does not constitute property held in a trade or business. Therefore, gains or losses from the disposition of an interest in a partnership or S corporation are included in the calculation of net gain included in NII pursuant to Code Sec. 1411(c)(1)(A)(iii).

Because, for Code Sec. 1411 purposes, Congress wanted to put transferors of partnership or S corporation interests in the same position as if the partnership or S corporation had disposed of all of its properties, with the resulting gain/loss passing through to the owners, Congress enacted Code Sec. 1411(c)(4). Code Sec. 1411(c)(4) provides that for partnership or

S corporation dispositions, gain for such dispositions is taken into account for 3.8-percent surtax purposes only to the extent of the net gain that would be so taken into account by the transferor under Code Sec. 1411(c)(1)(A)(iii) if all of the partnership/S corporation's property were sold at fair market value immediately before the interest was disposed of.⁶⁶ Unfortunately, the amount that denotes the gain or loss recorded due to a sale of interest and the amount that results from the sale of properties may not always match. Therefore, the proposed regulations provide that after determining this amount, which represents the unadjusted net gain or loss from the disposition of interest, taxpayers must adjust this amount to determine the net gain or loss actually included in net gain. To accomplish this, taxpayers are to apply a deemed asset sale method that treats the calculation on a property-by-property basis to determine the amount of adjustments, if any, are allowed towards this net sum. This final adjusted number is then included in NII.⁶⁷

To determine whether a particular disposition of interest in a partnership or S corporation can be adjusted under this provision, the proposed regulations provide that a disposition of an interest in a partnership or S corporation is adjusted only if both:

- The partnership or S corporation is engaged in one or more trade or business as defined under Code Sec. 162, and at least one of them is not trading in financial instruments or commodities as described in Proposed Reg. §1.1411-5(b).
- With respect to the partnership or S corporation in which interest is disposed of, at least one of the trade or business is not a passive activity with respect to the transferor as described in Proposed Reg. §1.1411-5(a).⁶⁸

If taxpayers have elected to make a Code Sec. 338(h)(10) election with regards to the disposition of stock in an S corporation, then this adjustment does not apply to the disposition.⁶⁹

Below is a summary of the general steps in determining amount of net gain or loss included in NII, attributable to the disposition of an interest in a partnership or S corporation:

1. Calculate unadjusted net gain under Part C of the NII sum outlined in Proposed Reg. §1.1411-4.
2. Determine whether adjustments due to Code Sec. 1411(c)(4) are applicable. If they are not, then the amount calculated in Step 1 is the net gain included in NII.
3. If adjustments are applicable, then apply the Deemed Asset Sales Method outlined below to

determine the amount of adjustments and adjust net gain or net loss accordingly. This adjusted sum is then included in NII.

Deemed Asset Sales Method

The proposed regulations adopt a deemed asset sales method to determine the amount of adjustments associated with the net gain or loss from the disposition of an interest in a partnership or S corporation. Gains or losses from a disposition of an interest in a partnership or S corporation (other than certain entities that are either passive activities or trader businesses) must first be calculated and then adjusted as follows:

1. **Deemed Sale of Properties.** Assume a hypothetical disposition of all of the entity's properties for cash equal to the fair market value of each property immediately before the disposition of the interest.⁷⁰
2. **Determination of Gain or Loss.** Determine the amount of gain or loss on each of the entity's properties by comparing the fair market value of each property with its adjusted basis. The gain or loss of each property must be computed separately.⁷¹
3. **Allocation of Gain or Loss.** Allocate the interest in question the amount of gain or loss determined above to the transferor pursuant to the rules of Code Chapter 1. Include compliance with Code Secs. 704 and 743 and regulations thereunder. For S corporations, the allocation amount is determined under Code Sec. 1366(a), but excludes Code Sec. 1366(f)(2) which assumes a hypothetical imposition of tax under Code Sec. 1374.⁷² This sum is the net gain or net loss for the disposition of an interest in a partnership or S corporation prior to adjustments.
4. **Adjustment to Gain or Loss.** Determine which amounts of gain or loss would be taken into account in determining net gain for the transferors by removing those that should not be included. This means each property must be tested as to whether it is held in a trade or business not described in Proposed Reg. §1.1411-5 (*i.e.*, certain businesses that are passive activities or trader businesses). If the property satisfies the provision, then an adjustment must be made. Repeat this process, aggregating amounts of gain or loss that require adjustments. This aggregated adjustment amount is then applied to the unadjusted net gain or loss as follows:
 - a. If aggregating these amounts creates a net gain, then a negative adjustment of equal amount is made to the net unadjusted gain or net unadjusted loss determined in Step 3, such that the remaining amount is not less than zero. This means if the amount determined in Step 3 is a net loss, no adjustment is allowed.
 - b. If aggregating these amounts creates a net loss, then a positive adjustment of equal amount is made to the net unadjusted gain or net unadjusted loss determined in Step 3, such that the remaining amount is not above the following amounts. If the amount determined in Step 3 is a net loss, then the adjusted net loss after accounting for the positive adjustment cannot exceed zero. If the amount determine in Step 3 is a net gain, no adjustment is allowed.⁷³

This final amount, which represents the adjusted net gain or loss from disposition of an interest in a partnership or S corporation, is added to NII.

Note. For property that is held by more than one trade or business, taxpayers are to allocate the fair market value and adjusted basis of the property among the trades or businesses in a manner that reasonably reflects their use of the property in the last 12 months.⁷⁴

Note. For the purposes of Code Sec. 1411, taxpayers are to consider goodwill in their calculation of their adjustment to net gain or loss from the disposition of interest in a partnership or S corporation when using the deemed sale approach. This means that if the transferor is allocated a gain or loss from goodwill under the deemed sale, that amount is also included as a gain or loss from disposition of property held in a trade or business.⁷⁵

Example 16⁷⁶

Alice and Jane are shareholders of Bernstein, an S corporation. Alice owns 75 percent of the stock in Bernstein, and Jane owns the remaining 25 percent. During Year 1, Bernstein is engaged in a single trade or business. With respect to Bernstein, Alice's engagement is not considered passive, but Jane's engagement is. Bernstein owns three properties (one in Los Angeles, one in Santa Barbara, and

one in Santa Fe) held exclusively in Bernstein's trade that have an aggregate fair market value of \$120,000. On September 1 of Year 1, Alice and Jane sell their Bernstein stock to Sean for the fair market value of Bernstein's properties (Alice sells for \$90,000, and Jane sells for \$30,000). At the time of the disposition, Alice's adjusted basis in her Bernstein stock is \$75,000, and Jane's adjusted basis in her Bernstein stock is \$25,000. Bernstein's properties have the adjusted bases and fair market value immediately before disposition, illustrated in Table 9.

Table 9.

Property	Adjusted Basis	Fair Market Value
Los Angeles	\$10,000	\$50,000
Santa Barbara	\$70,000	\$30,000
Santa Fe	\$20,000	\$40,000

The following steps should be taken to determine Alice and Jane's net gain or loss to be included in Part C of their respective NII sum.

- 1. Calculate Net Gain.** On the stock sale to Sean, Alice recognizes a gain of \$15,000 (\$90,000 – \$75,000), which is subject to the Net Gain provision of NII sum described under Proposed Reg. §1.1411-4(a)(1)(iii), and Jane recognizes a gain of \$5,000 (\$30,000 – \$25,000).
- 2. Determine Applicability of Code Sec. 1411(c)(4).** Code Sec. 1411(c)(4) is applicable to Alice because her engagement with Bernstein, which is not considered a passive activity with respect to her, is not a trade or business described in Proposed Reg. §1.1411-5. Therefore, her net gain is subject to an adjustment under the Deemed Asset Sale Method. However, with respect to Jane, Bernstein is described in Proposed Reg. §1.1411-5 since Bernstein is a passive activity with respect to Jane. Therefore, Code Sec. 1411(c)(4) and the adjustments outlined thereunder are inapplicable to Jane, and Jane's gain upon the stock disposition remains at \$5,000. For Year 1, Jane would include a \$5,000 gain attributable to this disposition of interest in her calculation of Part C of her NII sum.
- 3. Deemed Asset Sale Method for Alice's Net Gain.**
 - a. *Step 1.* Upon a hypothetical disposition of Bernstein's properties for cash equal to fair market value, Bernstein would receive \$50,000 for the Los Angeles property,

\$30,000 for the Santa Barbara property, and \$40,000 for the Santa Fe property.

- b. *Step 2.* The determination of gain or loss on the deemed sale of Bernstein's properties are as illustrated in Table 10.

Table 10.

Property	Adjusted Basis	Fair Market Value	Gain or Loss
Los Angeles	\$10,000	\$50,000	\$40,000
Santa Barbara	\$70,000	\$30,000	(\$40,000)
Santa Fe	\$20,000	\$40,000	\$20,000

- c. *Step 3.* Since Bernstein is an S corporation, allocation of properties is determined by Code Sec. 1366. Under Code Sec. 1366, Alice is allocated a \$30,000 (\$40,000 × 75 percent) gain from the Los Angeles property, a \$30,000 (\$40,000 × 75 percent) loss from the Santa Barbara property, and a \$15,000 (\$20,000 × 75 percent) gain from the Santa Fe property.
- d. *Step 4.* Because all three properties are held in Bernstein's trade or business, Alice must make an adjustment for the loss or gain described in this section to the amount of net gain included in her NII. The gain or loss on each of the three properties are added together (\$30,000 – \$30,000 + \$15,000), resulting in a negative adjustment of \$15,000. A negative adjustment is required, and Alice's gain of \$15,000 on the disposition of the interest under Part C of the NII sum is reduced by \$15,000. Therefore, for Year 1, Alice has zero gain with respect to the stock disposition for the purposes of her NII.

Example 17.⁷⁷ Same facts as Example 16, except now Alice's adjusted basis for her Bernstein stock is \$70,000 instead of \$75,000. This means on the stock sale to Sean, Alice recognizes a gain of \$20,000 (\$90,000 – \$70,000), which is considered Net Gain included in her NII. The deemed sale would result in a negative adjustment of \$15,000 (\$30,000 – \$30,000 + \$15,000), as before. A negative adjustment is required, and Alice's gain of \$20,000 on the disposition of the interest under Part C of the NII sum is reduced by \$15,000. Therefore, for Year 1, Alice has \$5,000 of net gain with respect to

the stock disposition for the purposes of Part C of the NII sum.

Example 18.⁷⁸ Same facts as Example 16, except now Alice's adjusted basis for her Bernstein stock is \$80,000. This means on the stock sale to Sean, Alice recognizes a gain of \$10,000 (\$90,000 – \$80,000), which is considered Net Gain included in her NII. The deemed sale would result in a negative adjustment of \$15,000 (\$30,000 – \$30,000 + \$15,000), as before. A negative adjustment is required, and Alice's gain of \$10,000 on the disposition of the interest included in her NII is reduced by a negative adjustment, but is limited to \$10,000, since Net Gain cannot be below zero. Therefore, for Year 1, Alice has zero net gain with respect to the stock disposition for the purposes of Part C of the NII sum.

Example 19.⁷⁹ Same facts as Example 16, except now Alice's adjusted basis in her stock is \$105,000, and she sells her interest for \$67,500. In addition, the Santa Fe property now has an adjusted basis of \$60,000 and fair market value of \$10,000. Table 11 reflects these changes.

Table 11.

Property	Adjusted Basis	Fair Market Value	Gain or Loss
Los Angeles	\$10,000	\$50,000	\$40,000
Santa Barbara	\$70,000	\$30,000	(\$40,000)
Santa Fe	\$60,000	\$10,000	(\$50,000)

On the stock sale to Sean, Alice recognizes a loss of \$37,500 (\$67,500 – \$105,000), which is included in NII. In the deemed sale, Alice would be allocated a \$30,000 gain from the Los Angeles property, a \$30,000 loss from the Santa Barbara property, and a \$37,500 (\$50,000 × 75 percent) loss from the Santa Fe property. The deemed sale would result in a positive adjustment of \$37,500 (\$30,000 – \$30,000 – \$37,500). A positive adjustment is required, and Alice's loss of \$37,500 on the disposition of the interest under Part C of the NII sum is increased by the positive adjustment of \$37,500. Therefore, for Year 1, Alice has zero loss with respect to the stock disposition for the

purposes of NII, described under Proposed Reg. §1.1411-4(a)(1)(iii).

Example 20⁸⁰

Same facts as Example 16, except now Bernstein owns a fourth property in San Diego (adjusted basis of \$20,000 and fair market value of \$100,000) that is not held in Bernstein's trade and only Alice sells her S corporation stock to Sean for Alice's proportionate share of the fair market value of Bernstein's properties. At the time of disposition, Alice's adjusted basis in her Bernstein stock is \$90,000. Table 12 reflects these changes.

Table 12.

Property	Adjusted Basis	Fair Market Value	Gain or Loss
Los Angeles	\$10,000	\$50,000	\$40,000
Santa Barbara	\$70,000	\$30,000	(\$40,000)
Santa Fe	\$20,000	\$40,000	\$20,000
San Diego	\$20,000	\$100,000	\$80,000

The following steps must be taken to determine Alice's net gain or loss to be included in her NII.

- 1. Calculate Net Gain.** On the stock sale to Sean, Alice recognizes a gain of \$75,000 ((\$220,000 – 120,000) × 75 percent), which is subject to the Net Gain provision of NII sum described under Proposed Reg. §1.1411-4(a)(1)(iii).
- 2. Determine Applicability of Code Sec. 1411(c)(4).** Code Sec. 1411(c)(4) is applicable to Alice since Bernstein is not a trade or business described in Proposed Reg. §1.1411-5(a)(1) with respect to Alice. Therefore, her net gain is subject to an adjustment under the Deemed Asset Sale Method.
- 3. Deemed Asset Sale Method for Alice's Net Gain.**
 - a. Step 1.** Upon a hypothetical disposition of Bernstein's properties for cash equal to fair market value, Bernstein would receive \$50,000 for the Los Angeles property, \$30,000 for the Santa Barbara property, \$40,000 for the Santa Fe property, and \$100,000 for the San Diego property.
 - b. Step 2.** The determination of gain or loss on the deemed sale of Bernstein's properties are provided in the table above.
 - c. Step 3.** Since Bernstein is an S corporation, allocation of properties is determined by Code Sec. 1366. Under Code Sec. 1366, Alice is allocated a \$30,000 (\$40,000 × 75 percent) gain from the Los Angeles property, a \$30,000

(\$40,000 × 75 percent) loss from the Santa Barbara property, a \$15,000 (\$20,000 × 75 percent) gain from the Santa Fe property, and a \$60,000 (\$80,000 × 75 percent) gain from the San Diego property.

- d. *Step 4.* Because Bernstein is not a trade or business described in Proposed Reg. §1.411-5(a)(1) with respect to Alice, Alice must make an adjustment for the loss or gain described in this section to the amount of net gain determined under Part C of her NII sum. However, because the property in San Diego is not held in Bernstein's trade or business, Alice's \$60,000 gain from that property is not taken into account in the adjustment. Therefore, the gain or loss on the properties in Los Angeles, Santa Barbara and Santa Fe only are added together, resulting in a negative adjustment of \$15,000 (\$30,000 – \$30,000 + \$15,000). Therefore, for Year 1, Alice's net gain of \$75,000 due to this disposition of interest is reduced by \$15,000, and Alice has a \$60,000 net gain with respect to the stock disposition for the purposes of NII.

Example 21⁸¹

Elizabeth and William are shareholders of an S corporation, Lotech. Elizabeth owns 50 percent of the stock in Lotech. During Year 2, Lotech is engaged in two businesses: a microchip designing business ("Microchip Business") and a computer mouse designing business ("Mouse Business"). With respect to the Microchip Business, Elizabeth is not engaged in a trade or business described in Proposed Reg. §1.1411-5, but with respect to the Mouse Business, Elizabeth considers her activity as passive, and so she is engaged in a trade or business as described in Proposed Reg. §1.1411-5. In addition to cash and goodwill, Lotech has five properties. Two of the properties located in Silicon Valley are used exclusively by the Microchip Business. A third property for administration is not held for use in either the Microchip Business or the Mouse Business. The remaining two properties, Property 4 and Property 5, are used exclusively by the Mouse Business. On June 2 of Year 2, Elizabeth sells her Lotech stock to Collin for her proportionate share of the fair market value of Lotech's properties. At the time of the disposition, Elizabeth's adjusted basis in her Lotech stock is

\$30,000. Lotech's properties have the adjusted basis and fair market value immediately before the disposition as shown in Table 13.

Table 13.

Property Value	Business	Adjusted Basis	Fair Market
Property 1	Microchip Business	\$5,000	\$10,000
Property 2	Microchip Business	\$5,000	\$5,000
Property 3	Neither	\$0	\$10,000
Property 4	Mouse Business	\$20,000	\$30,000
Property 5	Mouse Business	\$10,000	\$15,000
Cash	Both	\$10,000	\$10,000
Goodwill	Both	\$10,000	\$30,000

The following steps must be taken to determine Elizabeth's net gain or loss to be included in NII.

- 1. Calculate Net Gain.** On the stock sale to Collin, Elizabeth recognizes a gain of \$25,000 ((\$55,000 – 30,000) × 75 percent), which is subject to the Net Gain provision of NII sum described under Proposed Reg. §1.1411-4(a)(1)(iii).
- 2. Determine Applicability of Code Sec. 1411(c)(4).** Code Sec. 1411(c)(4) is applicable to Collin. However, only adjustments related to property used in the Microchip Business since the Mouse Business is considered a trade or business described in Proposed Reg. §1.1411-5 with respect to Elizabeth. Therefore, her net gain is subject to an adjustment under the Deemed Asset Sale Method for the properties used in Microchip Business.
- 3. Deemed Asset Sale Method for Elizabeth's Net Gain.**
 - Step 1.* Upon a hypothetical disposition of Lotech's properties for cash equal to fair market value, Lotech would receive \$10,000 for Property 1, \$5,000 for Property 2, \$10,000 for Property 3, \$30,000 for Property 4, \$15,000 for Property 5, \$10,000 in cash, and \$30,000 for goodwill.
 - Step 2.* The determination of gain or loss on the deemed sale of Bernstein's properties are as shown in Table 14.
 - Step 3.* Since Lotech is an S corporation, allocation of properties is determined by Code Sec. 1366. Under Code Sec. 1366, Elizabeth is allocated a \$25,000 gain ((\$2,500 from Property 1, \$0 from Property 2, \$5,000 from Property 3, \$5,000 from Property 4, \$2,500 from Property 5, \$0 from cash, \$10,000 from goodwill).

- d. *Step 4.* Because Lotech's businesses are not trades or businesses described in Proposed Reg. §1.411-5(a)(1) with respect to Elizabeth, Elizabeth must make an adjustment for the gain or loss described in this section to the amount of net gain included in her NII, but only with respect to the gain or loss on the properties used in the Microchip Business. This includes Property 1, Property 2 and part of goodwill. The goodwill is allocated to the Microchip Business and the Mouse Business based on the relative fair market value of the property, except for cash, held for use in each trade or business. This means, the fair market value of the property held for use in the Microchip Business is \$15,000 and the fair market value of the property held for use in the Mouse Business is \$45,000. Therefore, 25 percent or \$2,500 of Elizabeth's gain on the goodwill is attributable to the Microchip Business.

Elizabeth's share of the gain on Property 1, Property 2, and goodwill are added together and result in a negative adjustment of \$5,000 (\$2,500 + \$0 + \$2,500). Therefore, for Year 1, Elizabeth takes into account a negative adjustment of \$5,000 and has a net gain of \$20,000 (\$25,000 – \$5,000) for the purposes of NII.

Installment Sales

The proposed regulations also provide guidance on the treatment of dispositions of interest made in an installment sale transaction under Code Sec. 453. For installment sales, the proposed regulations suggest that taxpayers are to determine any adjustment to net gain in the year of disposition, and then apply and recognize the gain and adjustments proportionally according to Code Sec. 453. In situations where the installment sale transaction took place prior to 2013, the amount of net gain from the particular disposition

of interest is not subject to Code Sec. 1411. However, taxpayers are given the option to elect to have Code Sec. 1411 apply. This election is irrevocable and would result in treating the installment sale in a similar manner to interests sold after Code Sec. 1411's effective date.⁸²

Note. Qualified Subchapter S trusts (QSST) that make a Code Sec. 1361(d)(2) election can be considered shareholders of an S corporation. For the purposes of this section, the proposed regulations state that income beneficiaries who are considered owners under Code Sec. 678 due to Code Sec. 1361(d)(1) are not considered owners of the S corporation. Therefore, the proposed regulations suggest that any gain or loss recognized due to a sale will only be recognized for the trust and not the income beneficiaries.⁸³ The IRS invites comments from those who believe special rules are needed to coordinate the disposition of stock in an S corporation under Code Sec. 1411 with QSST rules.

Working Capital Exception

The proposed regulations provide that for the purposes of Code Sec. 1411, working capital generally refers to capital set aside for use in and the future needs of a trade or business.⁸⁴ This can be found under Proposed Reg. §1.1411-6. Since working capital is not used currently in a trade or business, it fails the Ordinary Course of a Trade or Business exception, and so taxpayers must include amounts considered as working capital when determining their 3.8-percent tax. Therefore, any net gain or gross income from the investment of working capital must be properly attributed to and included in the calculation of NII. However, since the IRS is considering working capital as source of investment income, taxpayers are allowed to reduce the amounts by associating properly allocable deductions when determining their NII sum.⁸⁵

Table 14.

Property	Business	Adjusted Basis	Fair Market Value	Gain or Loss
Property 1	Microchip Business	\$5,000	\$10,000	\$5,000
Property 2	Microchip Business	\$5,000	\$5,000	\$0
Property 3	Neither	\$0	\$10,000	\$10,000
Property 4	Mouse Business	\$20,000	\$30,000	\$10,000
Property 5	Mouse Business	\$10,000	\$15,000	\$5,000
Cash	Both	\$10,000	\$10,000	\$0
Goodwill	Both	\$10,000	\$30,000	\$20,000

Example 22.⁸⁶ Jason, an unmarried individual, operates a restaurant, which is a Code Sec. 162 trade or business, which is neither a trader business nor a passive activity with respect to

Jason. Jason owns and conducts the restaurant business through Links, an S corporation wholly owned by Jason. Links is able to pay all of the restaurant's current obligations with cash flow generated by the restaurant. Links utilizes an interest-bearing checking account, whose average daily balance is about \$2,500, for daily ordinary business. In addition, Links has set aside \$20,000 for the potential future needs of the business, which he places in an interest-bearing savings account, in case cash flows become insufficient to pay reoccurring business expenses. In calculating Jason's NII, both the \$2,500 average daily balance of the checking account and the \$20,000 savings account balance constitute working capital, and so interest earned by this working capital is not exempt under the Ordinary Course of a Trade or Business exception. Therefore, the interest income derived by Links from its checking and savings accounts and allocated to Jason under Code Sec. 1366 will be included in NII.

Distributions from Qualified Plans

Code Sec. 1411(5) provides that certain distributions from a qualified plans or arrangement are not included in NII. These include the following:

- Qualified pensions, stock bonuses or profit-sharing plans (Code Sec. 401(a))
- Qualified annuity plans (Code Sec. 403(a))
- Tax-sheltered annuities (Code Sec. 403(b))
- Individual retirement accounts (IRAs) (Code Sec. 408)
- Roth IRAs (Code Sec. 408A)
- Deferred compensation plans of a state or local government or a tax-exempt organization (Code Sec. 457(b))⁸⁷

To help taxpayers determine when an amount of distribution is within the meaning of Code Sec. 1411(5)(a), the proposed regulations, specifically Proposed Reg. §1.1411-8, provide additional guidance for taxpayers. According to the proposed regulations, amounts of distribution from a plan that is included under one of three rules is exempted under Code Sec. 1411(5)(a) and therefore, not included in NII:

1. Actual distributions, such as a rollover to an eligible retirement plan under Code Sec. 402(c)(8)(B) and corrective distributions from

a qualified plan or arrangement to maintain its tax-favored plan⁸⁸

2. Amounts that are deemed distributions, such as a deemed distribution under Code Sec. 72(p)⁸⁹
3. Amounts not treated as distributions, but that are includible in gross income pursuant to rules related to amounts held in a qualified plan or arrangement, such as any income of the trust of a qualified plan that is applied to purchase a participant's life insurance coverage (the P.S. 58 costs)⁹⁰

The proposed regulations also define "corrective distributions" to include the following:

- A distribution of excess deferrals (Reg. §1.402(g)-1(e)(3))
- A distribution of excess contribution related to Code Sec. 408 IRAs (Reg. §1.408-4(c))
- A distribution of excess contribution related to Code Sec. 408A Roth IRAs (Q&A-1(d) of Reg. §1.408A-6)
- A distribution of excess deferrals related to eligible Code Sec. 457(b) plans (Reg. §1.457-4(e)(2)-(4))⁹¹

Warning. While distributions from these particular qualified plans or arrangements are exempted from the calculation of a taxpayer's NII for the purpose of Code Sec. 1411, they are still includible in gross income under Chapter 1. Therefore, taxpayers should be aware that these amounts of distributions should be taken into account when determining the their MAGI or AGI.⁹²

Self-Employment Income

Since the purpose of Code Sec. 1411 is to place a surtax on net investment income, generally self-employment income is excluded from the determination of NII. This is stated under Code Sec. 1411(c)(6) and expanded in Proposed Reg. §1.1411-9. The proposed regulations indicate that taxpayers should refer to the definition provided in Code Sec. 1402(b) for self-employment income. Code Sec. 1402(b) provides that the term "Self-Employment Income" is generally defined as the gross income derived by an individual from any trade or business carried on by such individual, less the deductions allowed which are attributable to such trade or business, plus his distributive share of income or loss described in Code Sec.

702(a)(8) from any trade or business carried on by a partnership of which he is a member, but that shall not include the net earnings from self-employment if such net earnings for the tax year are less than \$400.⁹³ In addition, exceptions from the definition of net earnings listed in Code Sec. 1402(a)(1)–(7) shall also apply for the purposes of Code Sec. 1411. For taxpayers with income or loss from more than one trade or business, the IRS states that all items taken into account in determining net earnings from self-employment, regardless from which trade or business, will be taken into account in determining a taxpayer's self-employment income. Therefore, these amounts included in net earnings from self-employment are not included in NII.⁹⁴

The proposed regulations also provide special rules for taxpayers involved in a trade or business trading in a financial instruments or commodities. For those taxpayers, the IRS allows any deductions related to a taxpayer's net earnings self-employment to reduce the taxpayer's self-employment income. Any amount of deduction that exceeds the taxpayer's net earnings from self-employment can be included in determining and help reduce a taxpayer's NII.⁹⁵

Example 23.⁹⁶ Ashley is a general partner in Comley Partnership, a partnership carrying on a trade or business that is not a trade or business that trades in financial instruments or commodities. During Year 1, Ashley's distributive share from Comley Partnership is \$1 million, \$300,000 of which is attributable to the gain on the sale of Comley's capital assets. Code Sec. 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, Ashley has \$700,000 self-employment income subject to self-employment tax. This \$700,000 is not included as part of NII. However, the \$300,000 attributable to the gain on Comley's sale of a capital asset is excluded from net earnings from self-employment income and thus is not covered by the exception in Code Sec. 1411(c) (6). Therefore, the \$300,000 attributable to the gain on Comley's sale of a capital asset is included as part of NII if the other requirements of Code Sec. 1411 are satisfied.

Example 24.⁹⁷ Roger is an individual engaged in two businesses, a restaurant (which is not trading in financial instruments or commodities) and a small investment management business (which is trading in financial instruments or commodities). Roger has made a mark-to-market election under Code Sec. 475(f) with respect to the small investment management business. During Year 1, Roger had net earnings from self-employment from the restaurant of \$35,000. During Year 1, he also had \$300,000 of gross income and \$75,000 of expenses from the investment management business. Roger's \$300,000 of gross income from the investment management business is excluded from net earnings from self-employment and self-employment income. Roger's \$75,000 of deductions from the investment management business reduce his \$35,000 of net earnings from self-employment from the restaurant to \$0. Pursuant to provisions provided in the proposed regulations, the remaining \$40,000 of deductions are taken into account in determining Roger's NII, thus reducing his gross income from the investment management business from \$300,000 to \$260,000. Therefore, assuming these two businesses are Roger's only sources of income for Year 1, his gross income for Year 1 is \$260,000 for the purposes of the 3.8-percent tax.

Controlled Foreign Corporations and Passive Foreign Investment Companies

The proposed regulations also provide additional guidance for the treatment of distributions to and investment income earned by beneficiaries from controlled foreign corporations and passive foreign investment companies. Although further guidance is provided, the IRS also requests comment on whether investment income derived from these entities should or should not be included and what is the best method for their inclusion without placing an undue burden on taxpayers. This topic is beyond the scope of this column; however, taxpayers seeking further guidance are encouraged to read Proposed Reg. §1.1411-10 or the preamble to the proposed regulations where additional information is provided.

Appendix

In preparing the final regulations for Code Sec. 1411, the IRS has invited taxpayers and professionals to submit comments. These comments, ranging from Code Sec. 1411 to unique types of trusts to general clarification of terms, will be presented before a board later this spring before a decision is made as to whether they will be included in the final Regulations. Below is a list of some key comments that have been submitted to the IRS for review that request that:

General Comments

- In situations when rental activity is insubstantial in relation to a trade or business activity, the “trade or business” status of the activity be tested in whole as a grouped activity that includes the rental activity.¹
- Clarification as to the first year a taxpayer can regroup his or her activities should be provided. In addition, it is respectfully recommended that in the event the final regulations differ substantially from the proposed regulations, a second regrouping election be afforded to taxpayers.²
- S corporations and partnerships be allowed to elect to change their groupings in light of the application Code Sec. 1411, as well as extending the regrouping election option to any taxpayer, regardless of current NII or MAGI status.³
- The final regulations codify many of the suggestions provided in the Preamble to the proposed regulations.⁴
- A separate section that clarifies the characterization of rents be included, explaining when it is considered or not considered derived in the ordinary course of a trade or business.⁵

Related to Reg. §1.1411-2: Application to Individuals

- Losses triggered under the disposition of an entire interest in a passive activity, outlined under Code Sec. 469(g), be considered a form of properly allocable deductions for the determination of a taxpayer’s NII.⁶

Related to Reg. §1.1411-3: Application to Trusts and Estates

- Charitable set-aside deductions available for pooled income fund’s long-term capital gains for income tax purposes be allowed to reduce a pooled income fund’s NII.⁷
- A new paragraph be added to state that estates, where all unexpired interests in the estate are devoted to one or more of the purposes described in Code Sec. 170(c)(2)(B), are exempted from the application of Code Sec. 1411.⁸
- Beneficiaries of charitable remainder trusts be allowed to elect to determine distributed NII on a class-by-class basis within each tier described in Reg. §1.664-1(d)(1).⁹¹⁰
- The final regulations state that Code Sec. 1411 applies only to U.S. beneficiaries who have received distributions from a foreign trust or estate, and not the foreign trust or estate.¹¹
- The Undistributed Net Investment Income of a foreign estate or trust be tracked in a manner similar to undistributed net income described in Code Sec. 665(a) and that the income does not include income accumulated before 2013.¹²
- A comprehensive clarification of what constitutes a material participation in the case of an estate or trust be included in the final regulations.¹³¹⁴
- Clarification that dispositions of S corporation stock by a QSST is treated as a disposition of the S corporation stock by the income beneficiary for purposes of determining material participation under Code Sec. 465 and 469.¹⁵
- Rules under Reg. §§1.641(c)-1(d)(3) and 1.1361-1(m)(5)(ii) be used when an ESBT disposes of S corporation stock and that the installment method upon the sale or disposition of stock in an S corporation by a ESBT be permitted in calculating effects of Code Sec. 1411.¹⁶

Related to Reg. §1.1411-4: Definition of Net Investment Income (NII)

- The final regulations explicitly state that Code Sec. 165 losses from trading businesses are included to reduce gross income from the trading business for the purposes of calculating

a trader's NII from the trading business under Part B of the NII sum.¹⁷

- Carryforward losses that result from net operating losses from prior years and that can be tracked separately to a form of deduction considered a properly allocable deductions be allowed to be taken into account when determining NII. Net operating losses deductible under Code Sec. 172 should continue to be included in a taxpayer's MAGI.^{18,19}
- For determining NII, investment income subject to the tax should be net of the full amount of investment interest, portfolio management expenses and fees for investment advice regardless of whether these deductions are subject to limitation under other Code sections.²⁰
- Loss that exceeds a taxpayer's NII for a tax year be permitted as carryforward.²¹
- The definition of "Net Investment Income" in the proposed regulations be streamlined to track more closely to the definition under Code Sec. 1411.²²
- Properly allocable deductions to NII include carryforward passive activity losses as well as interest expense allocable under Reg. §1.163-8T to expenditures taken into account in determining investment income or gain.²³
- MAGI include passive activity losses, losses allowed under the \$25,000 offset for certain rental real estate activities, and losses allowed under Code Sec. 469(g).²⁴

Related to Reg. §1.1411-5: Trade or Business to Which Code Sec. 1411 Applies

- The IRS either (1) consider rental income of real estate professionals who materially participate in their rental real estate activity be excluded from the NII sum, or (2) consider additional examples illustrating when the level of rental real estate trust or business for purposes of Code Sec. 1411 met for real estate professionals.²⁵
- Recharacterized income and gain for determining NII should follow rules under Code Sec. 469 and the regulations thereunder.^{26,27}
- An allocation of unsuspended losses between passive and nonpassive categories under Code Sec. 469(g) be excluded from Code Sec. 1411. In addition, it is respectfully recommended that

losses unsuspended under Code Sec. 469(g) should be carried forward to offset future gains.²⁸

- Clearer rules for income from guaranteed payments for the use of capital that is not included from Code Sec. 1411. A two-step process that analyzes this income as a distributive share of a partnership income is summarized below:
 1. Characterize income based upon the income and activities of the payer partnership.
 2. Income would then constitute as NII if such income is included in one of the three parts of the NII sum.²⁹
- Clarification is provided that allow taxpayers employed full time by an LLC or LLP to be considered materially participating in the entity. Therefore, income from the entity should be excluded from the NII sum and upon a disposition of interest, only gains on the entity's passive instruments should be included in the NII sum.³⁰
- Clarification on the scope of 'passive activity' be provided, especially as compared to the definition provided under Code Sec. 469.³¹

Related to Reg. §1.1411-6: Income on Investment of Working Capital

- Highly liquid assets that includes any short-term debt instruments with maturity of less than one year be presumed to not appreciate or depreciate in value and can be excluded from the calculation of "asset sale gain" in determining NII.^{32,33}
- In the first year an existing trust or estate has capital gains and net investment income, the fiduciaries of those existing trusts and estates be allowed to reconsider whether capital gains will be included in the distributable net income of those trusts or estates according to Code Sec. 643.³⁴

Related to Reg. §1.1411-7: Disposition of Interests in Partnerships and S Corporations

- Gain from disposition of an interest of a partnership or S corporation as NII be included "only to the extent of" net gain that would be taken into account assuming all property was sold for fair market value immediately before disposition of such interest.³⁵

- S corporations and partnerships as well as their partners and shareholder owners not be required to entity-level tax attributes on their actual income tax returns. Instead, entities may be required to report a single asset sale gain figure for each trade or business on the K-1 for the individual owner disposing of his or her interest.³⁶
- For top-tier and lower-tier S corporations and partnerships, gain for the purposes of Code Sec. 1411 calculations should be made based on the hypothetical asset sale of the assets on of their respective tier. In addition, for top-tier entities, it is respectfully recommended that the calculation of the asset sale gain component for minority interests below a certain threshold be based on the sale of the interest in the passthrough entity itself.³⁷
- Instead of a hypothetical allocation of goodwill to each property held in each trade or business, goodwill should be allocated to the separate trades or businesses based on the actual facts and circumstances of the situation in the same manner as other assets.³⁸

- Gain recognized on the distribution of property or money from a partnership or an S corporation be presumed to be included under Part C of the NII sum for ease of administration.³⁹
- An exemption for gain recognized under the installment method from sales that occurred prior to January 1, 2013, be included in the final regulations.⁴⁰
- Additional examples illustrating how to apply the exception for certain active interests in partnerships and S corporations" be provided.⁴¹

Related to Reg. §1.1411-8: Distributions from Qualified Plans

- The final regulations state that Code Sec. 1411 does not apply to net unrealized appreciation in employer securities on the subsequent disposition of the securities since this is part of the distribution of the qualified plan. In addition, it is respectfully recommended that any post-distribution appreciation in the value of the securities and any post-distribution payment of dividends on such shares is subject to Code Sec. 1411.⁴²

ENDNOTES

¹ COMMENTS CONCERNING PROPOSED TREASURY REGULATIONS UNDER SECTION 1411 DRAFT (American Bar Association, 2013).

² Michael J. Grace, *Attorney Suggests Amendments to Proposed Net Investment Income Tax Regs.*, 2013 TNT 44-24, Mar. 6, 2013.

³ COMMENTS, *supra* note 1.

⁴ Grace, *supra* note 2.

⁵ *Id.*

⁶ COMMENTS, *supra* note 1.

⁷ *Id.*

⁸ *Id.*

⁹ *Id.*

¹⁰ Green, Tina R. Texas State Bar Comments on Proposed Net Investment Income Tax Regs.: 2013 TNT 44-23., 6 Mar. 2013.

¹¹ COMMENTS, *supra* note 1.

¹² *Id.*

¹³ *Id.*

¹⁴ Grace, *supra* note 2.

¹⁵ COMMENTS, *supra* note 1.

¹⁶ *Id.*

¹⁷ *Id.*

¹⁸ *Id.*

¹⁹ Carol A. Cantrell, *Texas CPAs Suggest Adding De Minimis Exception to Proposed Net Investment Income Tax Regs.*, 2013 TNT 47-72., 11 Mar. 2013.

²⁰ *Id.*

²¹ *Id.*

²² Grace, *supra* note 2.

²³ *Id.*

²⁴ *Id.*

²⁵ COMMENTS, *supra* note 1.

²⁶ *Id.*

²⁷ Grace, *supra* note 2.

²⁸ *Id.*

²⁹ COMMENTS, *supra* note 1.

³⁰ Cantrell, *supra* note 19.

³¹ Grace, *supra* note 2.

³² COMMENTS, *supra* note 1.

³³ Cantrell, *supra* note 19.

³⁴ Tina R. Green, *Texas State Bar Comments on Proposed Net Investment Income Tax Regs.*, 2013 TNT 44-23, 6 Mar. 2013.

³⁵ COMMENTS, *supra* note 1.

³⁶ *Id.*

³⁷ *Id.*

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ *Id.*

⁴¹ Grace, *supra* note 2.

⁴² COMMENTS, *supra* note 1.

ENDNOTES

* The author gratefully acknowledges the assistance of Jenny Ong in the preparation of this column.

¹ The first part of this series is located at Lewis J. Saret, *The Estate Planner, The 3.8-Percent Medicare Contribution Proposed Regulations, Part I*, TAXES, Mar. 2013, at 27.

² Code Sec. 1411(a)(2).

³ Proposed Reg. §1.1411-3(e).

⁴ Proposed Reg. §1.1411-3(e).

⁵ Proposed Reg. §1.1411-3(e)(5).

⁶ Proposed Reg. §1.1411-3(f), Examples 1 and 2.

⁷ Proposed Reg. §1.1411-3(e)(5).

⁸ Proposed Reg. §1.1411-3(f), Example 2(ii), citing to Reg. §1.661(b)-2, Example 1(b).

⁹ Reg. §1.662(b)-1.

¹⁰ Code Sec. 1411(c)(1).

¹¹ Code Sec. 1411(c)(1)(A)(i).

¹² Preamble, at 30.

¹³ Proposed Reg. §1.1411-4(b)(1).

¹⁴ Preamble, at 30.

¹⁵ Proposed Reg. §1.1411-4(b)(2)(i).

¹⁶ Proposed Reg. §1.1411-4(b)(2)(ii).

¹⁷ Proposed Reg. §1.1411-4(b)(3), Example 1.

¹⁸ Proposed Reg. §1.1411-4(b)(3), Example 3.

¹⁹ *Lilly*, SCT, 343 US 90, 93 (1953), *rev'g*, CA-51, 188 F2d 269, *aff'g*, 14 TC 1066 (1950).

²⁰ Preamble, at 34.

²¹ Preamble, at 26.

²² Preamble, at 27.

²³ Preamble, at 26.

²⁴ Preamble, at 28.

- ²⁵ Code Sec. 72(a).
²⁶ Code Sec. 72(e).
²⁷ Code Sec. 72(b).
²⁸ Preamble, at 47.
²⁹ Proposed Reg. §1.1411-5(b)(1).
³⁰ Preamble, at 48; Proposed Reg. §1.1411-5(b)(2).
³¹ Preamble, at 49.
³² Preamble, at 50–56.
³³ Preamble, at 49.
³⁴ Preamble, at 50.
³⁵ Preamble, at 50.
³⁶ Preamble, at 51.
³⁷ Preamble, at 53.
³⁸ Preamble, at 53.
³⁹ Proposed Reg. §1.1411-5(b)(2), Example 1.
⁴⁰ Proposed Reg. §1.1411-5(b)(2), Example 2.
⁴¹ Preamble, at 58.
⁴² Proposed Reg. §1.1411-5(c)(1).
⁴³ Proposed Reg. §1.1411-4(d)(1).
⁴⁴ Proposed Reg. §1.1411-4(d)(2).
⁴⁵ Proposed Reg. §1.1411-4(d)(3)(ii)(B)(1).
⁴⁶ Preamble, at 39; Proposed Reg. §1.1411-4(d)(3)(ii)(B)(2).
⁴⁷ Proposed Reg. §1.1411-4(d)(3)(C), Example.
⁴⁸ Proposed Reg. §1.1411-4(f)(1).
⁴⁹ Proposed Reg. §1.1411-4(f)(1)(ii).
⁵⁰ Preamble, at 42.
⁵¹ Proposed Reg. §1.1411-4(f).
⁵² Proposed Reg. §1.1411-4(f)(2).
⁵³ Proposed Reg. §1.1411-4(f)(2).
⁵⁴ Preamble, at 43.
⁵⁵ Preamble, at 44.
⁵⁶ Proposed Reg. §1.1411-4(f)(3)(i).
⁵⁷ Proposed Reg. §1.1411-4(f)(3)(ii).
⁵⁸ Proposed Reg. §1.1411-4(f)(3)(ii).
⁵⁹ Proposed Reg. §1.1411-4(f)(4).
⁶⁰ Proposed Reg. §1.1411-4(h), Example 1.
⁶¹ Proposed Reg. §1.1411-4(h), Example 3.
⁶² Proposed Reg. §1.1411-4(h), Example 4.
⁶³ Proposed Reg. §1.1411-5(h), Example 5.
⁶⁴ Proposed Reg. §1.1411-5(h), Example 7.
⁶⁵ Proposed Reg. §1.1411-5(h), Example 7.
⁶⁶ Code Sec. 1411(c)(4).
⁶⁷ Preamble, at 60.
⁶⁸ Proposed Reg. §1.1411-7(a)(2)(i).
⁶⁹ Proposed Reg. §1.1411-7(a)(2)(ii).
⁷⁰ Proposed Reg. §1.1411-7(c)(2).
⁷¹ Proposed Reg. §1.1411-7(c)(3).
⁷² Proposed Reg. §1.1411-7(c)(4).
⁷³ Proposed Reg. §1.1411-7(c)(5).
⁷⁴ Proposed Reg. §1.1411-7(c)(5)(ii)(A).
⁷⁵ Proposed Reg. §1.1411-7(c)(5)(ii)(B).
⁷⁶ Proposed Reg. §1.1411-7(e), Example 1.
⁷⁷ Proposed Reg. §1.1411-7(e), Example 2.
⁷⁸ Proposed Reg. §1.1411-7(e), Example 3.
⁷⁹ Proposed Reg. §1.1411-7(e), Example 4.
⁸⁰ Proposed Reg. §1.1411-7(e), Example 5.
⁸¹ Proposed Reg. §1.1411-7(e), Example 7.
⁸² Proposed Reg. §1.1411-7(b).
⁸³ Preamble, at 67.
⁸⁴ Preamble, at 58.
⁸⁵ Proposed Reg. §1.1411-6(a).
⁸⁶ Proposed Reg. §1.1411-6(b), Example.
⁸⁷ Code Sec. 1411(5), Preamble, at 69.
⁸⁸ Proposed Reg. §1.1411-8(b)(1).
⁸⁹ Proposed Reg. §1.1411-8(b)(2).
⁹⁰ Proposed Reg. §1.1411-8(b)(3).
⁹¹ Preamble, at 69–70.
⁹² Preamble, at 70.
⁹³ Proposed Reg. §1.1411-9(a); Code Sec. 1402(a)–(b).
⁹⁴ Proposed Reg. §1.1411-9(a).
⁹⁵ Proposed Reg. §1.1411-9(b).
⁹⁶ Proposed Reg. §1.1411-9(c), Example 1.
⁹⁷ Proposed Reg. §1.1411-9(c), Example 4.