

Proposed Reg. Section 1.1411-7(a)(1)

Exception for dispositions of certain active interests in partnerships and S corporations.

(a) In general.

(1) General application. In the case of a transferor that disposes of an interest in a partnership or S corporation described in paragraph (a)(3) of this section (transferor), the gain or loss from the disposition recognized under chapter 1 that is taken into account under §1.1411-4(a)(1)(iii) shall be calculated in accordance with this section. The calculation in paragraph (b) of this section reflects the net gain or net loss that the transferor would take into account if the partnership or S corporation sold all of its Section 1411 Property (as defined in paragraph (a)(2)(iv) of this section) for fair market value immediately before the disposition of such interest. In certain instances, transferors may qualify to use an alternative calculation described in paragraph (c) of this section in lieu of the calculation described in paragraph (b) of this section. Paragraph (d) of this section contains additional rules for Section 1411(c)(4) Dispositions (as defined in paragraph (a)(2)(ii) of this section) in deferred recognition transactions. Paragraph (f) of this section provides rules for adjusting the amount of gain or loss computed under this paragraph (a)(1) for transferors subject to basis adjustments required by § 1.1411-10(d). Paragraph (g) of this section provides rules for information disclosures by a partnership or S corporation to transferors and for information reporting by individuals, trusts, and estates. If a transferor disposes of an interest in a partnership or S corporation not described in paragraph (a)(3) of this section, then this section does not apply and the full amount of the gain or loss, as computed under chapter 1 and adjusted by §1.1411-10(d) (if applicable), is taken into account in computing the transferor's net investment income.

(2) Definitions. For purposes of this section--

- (i) The term Passthrough Entity means an entity taxed as a partnership or an S corporation. For purposes of this section, a reference to an interest in any S corporation shall mean a reference to stock in such S corporation.

(ii) The term Section 1411(c)(4) Disposition means a disposition of an interest in a Passthrough Entity described in paragraph (a)(3) of this section.

(iii) The term Section 1411 Holding Period means the year of disposition and the transferor's two taxable years preceding the disposition or the time period the transferor held the interest, whichever is less; provided, however, that for purposes of applying this paragraph (a)(2)(iii), the transferor will--

(A) Include the period that a previous owner or owners held the interest transferred if the transferor acquired its interest from another Passthrough Entity in a nonrecognition transaction during the year of disposition or the prior two taxable years;

(B) Include the period that the transferor held an interest in a Subsidiary Passthrough Entity if the transferor transferred that interest to a Passthrough Entity in a nonrecognition transaction during the year of disposition or the prior two taxable years; and

(C) Include the period that a previous owner or owners held the interest transferred if the transferor acquired its interest by gift.

(iv) The term Section 1411 Property means property owned by or held through the Passthrough Entity that, if disposed of by the entity, would result in net gain or loss allocable to the transferor of a type that is includable in determining net investment income of the transferor under §1.1411-4(a)(1)(iii).

(v) The term Subsidiary Passthrough Entity means an interest in a Passthrough Entity owned, directly or indirectly, by another Passthrough Entity.

(3) Section 1411(c)(4) Dispositions.

(i) Transfers by individuals, estates, and trusts. The disposition by a transferor of an interest in a Passthrough Entity is a Section 1411(c)(4) Disposition only if--

(A) The Passthrough Entity is engaged in one or more trades or businesses (within the meaning of section 162), or owns an interest (directly or indirectly) in a Subsidiary Passthrough Entity that is engaged in one or more trades or businesses (within the meaning of section 162), that is not described in §1.1411-5(a)(2) (trading in financial instruments or commodities); and

(B) One or more of the trades or businesses of the Passthrough Entity described in paragraph (a)(3)(i)(A) of this section is not a §1.1411-5(a)(1) (passive activity) trade or business of the transferor.

(ii) Transfers by Passthrough Entities. Where a Passthrough Entity (the “holder”) disposes of an interest in a Subsidiary Passthrough Entity, that disposition qualifies as a Section 1411(c)(4) Disposition with respect to a partner or shareholder of the Passthrough Entity if the partner or shareholder would satisfy the requirements of paragraph (a)(3)(i) of this section if it held the interest in the Subsidiary Passthrough Entity directly. For this purpose, the partner or shareholder shall be treated as owning a proportionate share of any Subsidiary Passthrough Entity in which the partner or shareholder owns an indirect interest through one or more tiers of Passthrough Entities.

(4) Special rules.

(i) Certain liquidations. If a fully taxable disposition of all of the Passthrough Entity's assets is followed by the complete liquidation of the Passthrough Entity as part of a single plan, then the disposition will be treated as an asset sale for purposes of section 1411, and no additional gain or loss will be included in net investment income under §1.1411-4(a)(1)(iii) on the subsequent liquidation of the Passthrough Entity by any transferor who would have satisfied paragraph (a)(3) of this section prior to the sale. A sale of stock in an S corporation with respect to which an election under section 336(e) or section 338(h)(10) is made shall be treated as a fully taxable disposition of the Passthrough Entity's assets followed by the liquidation of the Passthrough Entity for purposes of this paragraph (a)(4)(i).

(ii) Excluded gain or loss. The difference between the amount of gain or loss taken into account in computing taxable income for purposes of chapter 1 and the amount of gain or loss taken into account after the application of this section shall constitute excluded income or excluded loss, as applicable, for purposes of §1.1411-4(d)(4)(ii).

(iii) Rules applicable to S corporation shareholders.

(A) Certain S corporation dispositions. If the transfer of an interest in an S corporation causes the S election to terminate on the day of the transfer, then the corporation shall continue to be treated as an S corporation for purposes of applying the rules of this section to the transferor notwithstanding that §1.1362-3(a) treats the day of the transfer as the first day of the corporation's C corporation short year (as defined therein).

(B) S corporations subject to section 1374. For purposes of the calculation under paragraph (b) of this section, the amount of gain or loss allocated to the transferor is determined under section 1366(a), and the allocation does not take into account any reduction in the transferor's pro rata share of gains under section 1366(f)(2) resulting from the hypothetical imposition of tax under section 1374 as a result of the deemed sale.

(C) Treatment of Qualified Subchapter S Trusts (QSSTs). In the case of a disposition of S corporation stock by a QSST, the rules of this section are applied by treating the QSST as the owner of the S corporation stock.