

Reg. Section 1.1411-4(b)

Definition of net investment income.

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


(1) The sum of--

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

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

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

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



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

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

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

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

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

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

Example 1.

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

Example 2.

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

Example 3.

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

Example 4.

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

...