

Reg. Section 1.1411-4(d)(4)

Definition of net investment income

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

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

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

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

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

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

Example (1). Calculation of net gain.

(i) In Year 1, A, an unmarried individual, realizes a capital loss of \$40,000 on the sale of P stock and realizes a capital gain of \$10,000 on the sale of Q stock, resulting in a net capital loss of \$30,000. Both P and Q are C corporations. A has no other capital gain or capital loss in Year 1. In addition, A receives wages of \$300,000 and earns \$5,000 of gross income from interest. For income tax purposes, under section 1211(b), A may use \$3,000 of the net capital loss against other income. Under section 1212(b)(1), the

remaining \$27,000 is a capital loss carryover. For purposes of determining A's Year 1 net gain under paragraph (a)(1)(iii) of this section, A's gain of \$10,000 on the sale of the Q stock is reduced by A's loss of \$40,000 on the sale of the P stock. In addition, A may reduce net investment income by the \$3,000 of the excess of capital losses over capital gains allowed for income tax purposes under section 1211(b).

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

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

Example (3). Section 121(a) exclusion.

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

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

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

Example (4). Section 1031 like-kind exchange.

(i) In Year 1, A, an unmarried individual who is not a dealer in real estate, purchases Greenacre, a piece of undeveloped land, for \$10,000. A intends to hold Greenacre for investment.

(ii) In Year 3, A enters into an exchange in which A transfers Greenacre, now valued at \$20,000, and \$5,000 cash for Blackacre, another piece of undeveloped land, which has a

fair market value of \$25,000. The exchange is a transaction for which no gain or loss is recognized under section 1031.

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

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

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



(4) Gains and losses excluded from net investment income.

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

(A) General rule. Net gain does not include gain or loss attributable to property (other than property from the investment of working capital (as described in §1.1411-6)) held in a trade or business not described in §1.1411-5.

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

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

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

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

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

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

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

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

Example (2). Installment sale.

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

(ii)

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

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

(iii)

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

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

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

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

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

(v)

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

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

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

may exclude the \$85,000 gain from net investment income pursuant to paragraph (d)(4)(i) of this section.

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

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

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