

Reg. Section 1.1411-4(g)(7)

Definition of net investment income.

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

(2) Recoveries of properly allocable deductions --(i) General rule. If a taxpayer is refunded, reimbursed, or otherwise recovers any portion of an amount deducted as a section 1411(c)(1)(B) properly allocable deduction in a prior year, and such amount is not otherwise included in net investment income in the year of recovery under section 1411(c)(1)(A), the amount of the recovery will reduce the taxpayer's total section 1411(c)(1)(B) properly allocable deductions in the year of recovery (but not below zero). The preceding sentence applies regardless of whether the amount of the recovery is excluded from gross income by reason of section 111.

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

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

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

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

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

Example 1.

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

Example 2.

State income tax refund. In Year 1, D, an individual, allocated \$ 15,000 of taxes out of a total of \$ 75,000 to net investment income under paragraph (f)(3)(iii) of this section. D received no tax benefit from the deduction in Year 1 for chapter 1 purposes due to the alternative minimum tax, but it did reduce D's section 1411 tax. In Year 3, D received a refund of \$ 5,000. For chapter 1 purposes, D excludes the \$ 5,000 refund from gross income in Year 3 by reason of section 111. In Year 3, D allocated \$ 30,000 of state income taxes out of a total of \$ 90,000 to net investment income under paragraph (f)(3)(iii) of this section. Although the refund is excluded from D's gross income, D must nonetheless reduce Year 3's section 1411(c)(1)(B) properly allocable deductions by \$ 1,000 ($\$ 5,000 \times (\$ 15,000 / \$ 75,000)$). D's allocation of 33 1/3% of section 164(a)(3) taxes in Year 3 to net investment income is irrelevant to the calculation of the amount of the reduction required by this paragraph (g)(2).

Example 3.

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

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

death in computing its net investment income because, although real estate taxes are deductible under section 164 and specifically are allowed by section 691(b), the real estate taxes would not have been a properly allocable deduction of the decedent under § 1.1411-4(f).

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

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


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

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

(5) Treatment of self-charged interest income. Gross income from interest (within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section) that is received by the taxpayer from a nonpassive activity of such taxpayer, solely for purposes of section 1411, is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5. The amount of interest income that is treated as derived in the ordinary course of a trade or business not described in § 1.1411-5, and thus excluded from the calculation of net investment income, under this paragraph (g)(5) is limited to the amount that would have been considered passive activity gross income under the rules of § 1.469-7 if the payor was a passive activity of the taxpayer. For purposes of this rule, the term nonpassive activity does not include a trade or business described in § 1.1411-5(a)(2). However, this rule does not apply to the extent the corresponding deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

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

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

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

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

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

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

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

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

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

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

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

Example 1.

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

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

losses, \$ 1,000 of passive income from the single family rental property and \$ 1,000 of section 469(f)(1)(C) losses.

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

Example 2.

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

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

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

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

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

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