

Reg. Section 1.1411-5(b)(1)

Trades or businesses to which tax applies

(a) In general. A trade or business is described in this section if such trade or business involves the conduct of a trade or business, and such trade or business is either--

(1) A passive activity (within the meaning of paragraph (b) of this section) with respect to the taxpayer; or

(2) The trade or business of a trader trading in financial instruments (as defined in paragraph (c)(1) of this section) or commodities (as defined in paragraph (c)(2) of this section).

(b) Passive activity.

(1) In general. A passive activity is described in this section if--

(i) Such activity is a trade or business; and

(ii) Such trade or business is a passive activity with respect to the taxpayer within the meaning of section 469 and the regulations thereunder.

(2) Application of income recharacterization rules.

(i) Income and gain recharacterization. To the extent that any income or gain from a trade or business is recharacterized as "not from a passive activity" by reason of §1.469-2(f)(2), §1.469-2(f)(5), or §1.469-2(f)(6), such trade or business does not constitute a passive activity within the meaning of paragraph (b)(1)(ii) of this section solely with respect to such recharacterized income or gain.

(ii) Gain recharacterization. To the extent that any gain from a trade or business is recharacterized as "not from a passive activity" by reason of §1.469-2(c)(2)(iii) and does not constitute portfolio income under §1.469-2(c)(2)(iii)(F), such trade or business does not constitute a passive activity within the meaning of paragraph (b)(1)(ii) of this section solely with respect to such recharacterized gain.

(iii) Exception for certain portfolio recharacterizations. To the extent that any income or gain from a trade or business is recharacterized as "not from a passive activity" and is further characterized as portfolio income under §1.469-2(f)(10) or §1.469-2(c)(2)(iii)(F), then such trade or business constitutes a passive activity



within the meaning of paragraph (b)(1)(ii) of this section solely with respect to such recharacterized income or gain.

(3)Examples. The following examples illustrate the principles of paragraph (b)(1) of this section and the ordinary course of a trade or business exception in §1.1411-4(b). In each example, unless otherwise indicated, the taxpayer uses a calendar taxable year, the taxpayer is a United States citizen, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

Example (1). Rental activity. A, an unmarried individual, rents a commercial building to B for \$50,000 in Year 1. A is not involved in the activity of the commercial building on a regular and continuous basis, therefore, A's rental activity does not involve the conduct of a trade or business, and under section 469(c)(2), A's rental activity is a passive activity. Because paragraph (b)(1)(i) of this section is not satisfied, A's rental income of \$50,000 is not derived from a trade or business described in paragraph (b)(1) of this section. However, A's rental income of \$50,000 still constitutes gross income from rents within the meaning of § 1.1411-4(a)(1)(i) because rents are included in the determination of net investment income under §1.1411-4(a)(1)(i) whether or not derived from a trade or business described in paragraph (b)(1) of this section.

Example (2). Application of grouping rules under section 469. In Year 1, A, an unmarried individual, owns an interest in PRS, a partnership for Federal income tax purposes. PRS is engaged in two activities, X and Y, which constitute trades or businesses, and neither of which constitute trading in financial instruments or commodities (within the meaning of paragraph (a)(2) of this section). Pursuant to §1.469-4, A has properly grouped X and Y together as one activity (the grouped activity). A participates in X for more than 500 hours during Year 1 and would be treated as materially participating in activity X within the meaning of § 1.469-5T(a)(1) if A's material participation were determined only with respect to activity X. A only participates in Y for 50 hours during Year 1. If not for the grouping of the X and Y activities together, A would not be treated as materially participating in Y within the meaning of §1.469-5T(a). However, pursuant to §§1.469-4 and 1.469-5T(a)(1), A materially participates in the grouped activity. Therefore, for purposes of paragraph (b)(1)(ii) of this section, neither X nor Y is a passive activity with respect to A. Accordingly, with respect to A, neither X nor Y is a trade or business described in paragraph (b)(1) of this section.

Example (3). Application of the rental activity exceptions. B, an unmarried individual, is a partner in PRS, which is engaged in an equipment leasing activity. The average period of customer use of the equipment is seven days or less (and therefore meets the exception in §1.469-1T(e)(3)(ii)(A)). B materially participates in the equipment leasing activity (within the meaning of § 1.469-5T(a)). The equipment leasing activity constitutes a trade or business. In Year 1, B has modified adjusted gross income (as defined in §1.1411-2(c)) of \$300,000, all of which is derived from PRS. All of the income from PRS is derived in the ordinary course of the equipment leasing activity, and all of PRS's property is held in the equipment leasing activity. Of B's allocable share of income from PRS, \$275,000 constitutes gross income from rents (within the meaning of §1.1411-4(a)(1)(i)). While \$275,000 of the gross income from the equipment leasing activity meets

the definition of rents in §1.1411-4(a)(1)(i), the activity meets one of the exceptions to rental activity in §1.469-1T(e)(3)(ii) and B materially participates in the activity. Therefore, the trade or business is not a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Because the rents are derived in the ordinary course of a trade or business not described in paragraph (a) of this section, the ordinary course of a trade or business exception in §1.1411-4(b) applies, and the rents are not described in §1.1411-4(a)(1)(i). Furthermore, because the equipment leasing trade or business is not a trade or business described in paragraph (a)(1) or (a)(2) of this section, the \$25,000 of other gross income is not net investment income under § 1.1411-4(a)(1)(ii). However, the \$25,000 of other gross income may be net investment income by reason of section 1411(c)(3) and § 1.1411-6 if it is attributable to PRS's working capital. Finally, gain or loss from the sale of the property held in the equipment leasing activity will not be subject to §1.1411-4(a)(1)(iii) because, although it is attributable to a trade or business, it is not a trade or business to which the section 1411 tax applies.

Example (4). Application of section 469 and other gross income under §1.1411-4(a)(1)(ii). Same facts as Example 3, except B does not materially participate in the equipment leasing trade or business and therefore the trade or business is a passive activity with respect to B for purposes of paragraph (b)(1)(ii) of this section. Accordingly, the \$275,000 of gross income from rents is described in §1.1411-4(a)(1)(i) because the rents are derived from a trade or business that is a passive activity with respect to B. Furthermore, the \$25,000 of other gross income from the equipment leasing trade or business is described in §1.1411-4(a)(1)(ii) because the gross income is derived from a trade or business described in paragraph (a)(1) of this section. Finally, gain or loss from the sale of the property used in the equipment leasing trade or business is subject to §1.1411-4(a)(1)(iii) because the trade or business is a passive activity with respect to B, as described in paragraph (b)(1)(ii) of this section.

Example (5). Application of the portfolio income rule and section 469. C, an unmarried individual, is a partner in PRS, a partnership engaged in a trade or business that does not involve a rental activity. C does not materially participate in PRS within the meaning of §1.469-5T(a). Therefore, the trade or business of PRS is a passive activity with respect to C for purposes of paragraph (a)(1) of this section. C's \$500,000 allocable share of PRS's income consists of \$450,000 of gross income from a trade or business and \$50,000 of gross income from dividends and interest (within the meaning of §1.1411-4(a)(1)(i)) that is not derived in the ordinary course of the trade or business of PRS. Therefore, C's \$500,000 allocable share of PRS's income is subject to section 1411. C's \$50,000 allocable share of PRS's income from dividends and interest is subject to §1.1411-4(a)(1)(i) because the share is gross income from dividends and interest that is not derived in the ordinary course of a trade or business (that is, the ordinary course of a trade or business exception in §1.1411-4(b) is inapplicable). C's \$450,000 allocable share of PRS's income is subject to §1.1411-4(a)(1)(ii) because it is gross income from a trade or business that is a passive activity.

(c) Trading in financial instruments or commodities.

(1) Definition of financial instruments. For purposes of section 1411 and the regulations thereunder, the term financial instruments includes stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of an interest in any of the items described in this paragraph (c)(1). An evidence of an interest in any of the items described in this paragraph (c)(1) includes, but is not limited to, short positions or partial units in any of the items described in this paragraph (c)(1).

(2) Definition of commodities. For purposes of section 1411 and the regulations thereunder, the term commodities refers to items described in section 475(e)(2).

(d) Effective/applicability date. This section applies to taxable years beginning after December 31, 2013. However, taxpayers may apply this section to taxable years beginning after December 31, 2012, in accordance with §1.1411-1(f).