Internal Revenue bulletin

Bulletin No. 2013–51
December 16, 2013

HIGHLIGHTS OF THIS ISSUE

These synopses are intended only as aids to the reader in identifying the subject matter covered. They may not be relied upon as authoritative interpretations.

INCOME TAX

Rev. Rul. 2013–27, page 676.

This revenue ruling holds that a covered entity must include in gross income amounts it collects from policyholders to offset the cost of the fee imposed under § 9010 of the Affordable Care Act.

T.D. 9644, page 676.

Section 1411 imposes a 3.8 percent tax on certain individuals, estates, and trusts (the "Net Investment Income Tax"). The tax is imposed on the lesser of the taxpayer's (A) Net Investment Income for such taxable year, or (B) the excess of taxpayer adjusted gross income over certain statutorily defined threshold amounts. The regulations provide guidance on the general application of the Net Investment Income Tax to individuals, estates, and trusts, and the computation of Net Investment Income.

REG–130843–13, page 771.

These regulations provide guidance on the computation of net investment income under section 1411 of the Code. The regulations affect individuals, estates, and trusts whose incomes meet certain income thresholds. Comments on this proposed rule are requested by March 3, 2014.

EMPLOYMENT TAX

T.D. 9645, page 738.

Final regulations under section 3101 of the Code provide guidance on the Additional Hospital Insurance Tax on income above threshold amounts ("Additional Medicare Tax"), as added by the Affordable Care Act. Specifically, these final regulations provide guidance for employers and individuals relating to the implementation of Additional Medicare Tax, relating to the requirement to file a return reporting Additional Medicare Tax, the employer process for making adjustments of underpayments and overpayments of Additional Medicare Tax, and the employer and employee processes for filing a claim for refund for an overpayment of Additional Medicare Tax.

SELF-EMPLOYMENT TAX

T.D. 9645, page 738.

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Finding Lists begin on page ii.

Department of the Treasury
Internal Revenue Service

EXCISE TAX

T.D. 9643, page 750.

These final regulations provide guidance on the annual fee imposed on covered entities engaged in the business of providing health insurance for United States health risks. This fee was enacted by section 9010 of the Patient Protection and Affordable Care Act. The final regulations affect persons engaged in the business of providing health insurance. The final regulations provide an explanation of terms, a description of the reporting requirements, the calculation and notification of a preliminary fee, an error correction process, the final fee calculation and notification, and instructions regarding how to claim a refund.

Notice 2013–76, page 769.

This notice provides guidance on the health insurance providers fee related to (1) the time and manner for submitting Form 8963, *Report of Health Insurance Provider Information*, (2) the time and manner for notifying covered entities of their preliminary fee calculation, (3) the time and manner for submitting a corrected Form 8963 for the error correction process, and (4) the time for notifying covered entities of their final fee calculation.

ADMINISTRATIVE

T.D. 9642, page 747.

These final regulations require information reporting by persons who receive mortgage insurance premiums aggregating $600 or more during any calendar year.

The IRS Mission

Provide America's taxpayers top-quality service by helping them understand and meet their tax responsibilities and enforce the law with integrity and fairness to all.

Introduction

The Internal Revenue Bulletin is the authoritative instrument of the Commissioner of Internal Revenue for announcing official rulings and procedures of the Internal Revenue Service and for publishing Treasury Decisions, Executive Orders, Tax Conventions, legislation, court decisions, and other items of general interest. It is published weekly.

It is the policy of the Service to publish in the Bulletin all substantive rulings necessary to promote a uniform application of the tax laws, including all rulings that supersede, revoke, modify, or amend any of those previously published in the Bulletin. All published rulings apply retroactively unless otherwise indicated. Procedures relating solely to matters of internal management are not published; however, statements of internal practices and procedures that affect the rights and duties of taxpayers are published.

Revenue rulings represent the conclusions of the Service on the application of the law to the pivotal facts stated in the revenue ruling. In those based on positions taken in rulings to taxpayers or technical advice to Service field offices, identifying details and information of a confidential nature are deleted to prevent unwarranted invasions of privacy and to comply with statutory requirements.

Rulings and procedures reported in the Bulletin do not have the force and effect of Treasury Department Regulations, but they may be used as precedents. Unpublished rulings will not be relied on, used, or cited as precedents by Service personnel in the disposition of other cases. In applying published rulings and procedures, the effect of subsequent legislation, regulations, court decisions, rulings, and procedures must be considered, and Service personnel and others concerned are cautioned against reaching the same conclusions in other cases unless the facts and circumstances are substantially the same.

The Bulletin is divided into four parts as follows:

Part I.—1986 Code.
This part includes rulings and decisions based on provisions of the Internal Revenue Code of 1986.

Part II.—Treaties and Tax Legislation.
This part is divided into two subparts as follows: Subpart A, Tax Conventions and Other Related Items, and Subpart B, Legislation and Related Committee Reports.

Part III.—Administrative, Procedural, and Miscellaneous.
To the extent practicable, pertinent cross references to these subjects are contained in the other Parts and Subparts. Also included in this part are Bank Secrecy Act Administrative Rulings. Bank Secrecy Act Administrative Rulings are issued by the Department of the Treasury's Office of the Assistant Secretary (Enforcement).

Part IV.—Items of General Interest.
This part includes notices of proposed rulemakings, disbarment and suspension lists, and announcements.

The last Bulletin for each month includes a cumulative index for the matters published during the preceding months. These monthly indexes are cumulated on a semiannual basis, and are published in the last Bulletin of each semiannual period.

Part I. Rulings and Decisions Under the Internal Revenue Code of 1986

Section 61.—Gross Income Defined

Rev. Rul. 2013–27

ISSUE

Are amounts a covered entity collects from policyholders to offset the cost of the annual fee imposed on health insurance providers under § 9010 of the Affordable Care Act included in the covered entity's gross income under § 61(a) of the Internal Revenue Code?

FACTS

M is a United States corporation that is engaged in the business of providing health insurance for United States health risks. Section 9010 of the Patient Protection and Affordable Care Act (PPACA), Public Law No. 111–148 (124 Stat. 119 (2010)), as amended by section 10905 of PPACA, and as further amended by section 1406 of the Health Care and Education Reconciliation Act of 2010, Public Law 111–152 (124 Stat. 1029) (2010)) (collectively, the Affordable Care Act or ACA), imposes an annual fee on each covered entity engaged in the business of providing health insurance (annual fee). M is a "covered entity" within the meaning of § 9010(c)(1).

In Taxable Year X, the annual fee imposed on M pursuant to § 9010 is $10x. To offset part of the cost of the annual fee, M imposes a surcharge totaling $6x on certain of M's health insurance policyholders that is separately stated from the premium billed to them. To offset the remaining cost of the annual fee, M increases by a total of $4x the amount charged for health insurance premiums to M's remaining policyholders. The additional charge is not stated separately on the policyholders' bills. M collects from policyholders the total amount of the $10x cost of the annual fee imposed by § 9010.

LAW

Section 61(a) provides that, except as otherwise provided in subtitle A, gross income means all income from whatever source derived.

Section 9010(a) of the ACA imposes an annual fee on each covered entity engaged in the business of providing health insurance. Under § 9010(c)(1), a covered entity is generally an entity that provides health insurance for a United States health risk. A covered entity is liable for the annual fee in each calendar year beginning after 2013.

Section 9010(f)(2) treats the annual fee as a tax described in § 275(a)(6), which denies a deduction for certain taxes.

ANALYSIS

Unless a specific exclusion from income applies, an amount a taxpayer collects from a third party to cover the cost of a liability, including deductible and nondeductible liabilities incurred in a trade or business, is included in the taxpayer's gross income under § 61. Amounts a taxpayer charges customers for goods and services typically offset the taxpayer's costs of doing business. No provision of the Code or other law excludes these amounts from a taxpayer's gross income simply because the taxpayer is passing overhead costs and other business expenses to its customers. As discussed below, these amounts consistently have been found to be includible in income.

Rev. Rul. 79–27, 1979–1 C.B. 217, involves a taxpayer engaged in mining and selling coal, on which a federal excise tax was imposed. The taxpayer separately stated the excise tax on invoices to its customers. Noting that the excise tax was the liability of the taxpayer and could not be assessed on the customer, the ruling holds that additional amounts the taxpayer received from its customers on account of the separately stated excise tax were included in the taxpayer's gross income. See also *Iowa Southern Utilities Co. v. United States*, 841 F.2d 1108 (Fed. Cir. 1988) (surcharge utility collected from customers to offset specific expense is includable in gross income); *Hinshaw's Inc. v. Commissioner*, T.C. Memo. 1994–327 (1994) (recoupment from customers of cost of insurance that state law required taxpayer to purchase is included in taxpayer's gross income).

Section 9010 of the ACA imposes the annual fee on a covered entity, not on the covered entity's health insurance policyholders. The fee is part of the covered entity's cost of doing business. No exemption or exclusion from gross income applies to additional amounts that the covered entity charges its policyholders to cover the cost of this fee. Accordingly, M charging and collecting from its policyholders the $10x, whether or not separately stated, is no different than M passing other business expenses on to its customers as part of M's charges for providing health insurance. As a result, M must include the $10x in gross income.

HOLDING

Amounts a covered entity collects from policyholders to offset the cost of the annual fee imposed on health insurance providers under § 9010 of the ACA are included in the covered entity's gross income under § 61(a).

DRAFTING INFORMATION

The principal author of this revenue ruling is Edward C. Schwartz of the Office of Associate Chief Counsel (Income Tax and Accounting). For further information regarding this revenue ruling, contact Mr. Schwartz at (202) 317–7006 (not a toll-free call).

Section 1411.—Imposition of Tax

T.D. 9644

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 602

Net Investment Income Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final Regulations.

SUMMARY: This document contains final regulations under section 1411 of the Internal Revenue Code (Code). These regulations provide guidance on the general application of the Net Investment Income Tax and the computation of Net Investment Income. The regulations affect individuals, estates, and trusts whose incomes meet certain income thresholds.

DATES: *Effective Date*: These regulations are effective on December 2, 2013.

Applicability Dates: For dates of applicability, see §§1.469–11(b)(3)(iv)(D);1.1411–1(g);1.1411–2(e);1.1411–3(f);1.1411–4(i);1.1411–5(d);1.1411–6(c);1.1411–8(c);1.1411–9(d); and 1.1411–10(i).

FOR FURTHER INFORMATION CONTACT: David H. Kirk or Adrienne M. Mikolashek at (202) 317-6852 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507) under control number 1545-2227. The collection of information in these final regulations is in §1.1411–10(g). The collection of information in §1.1411–10(g) is necessary for the IRS to determine whether a taxpayer has made an election pursuant to §1.1411–10(g) and to determine whether the amount of tax has been reported and calculated correctly.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

Background

I. *In General*

This document contains final amendments to 26 CFR part 1 under sections 469 and 1411 of the Internal Revenue Code (Code). Section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010 (Public Law 111–152, 124 Stat. 1029) (HCERA) added section 1411 to a new chapter 2A of subtitle A (Income Taxes) of the Code effective for taxable years beginning after December 31, 2012.

On December 5, 2012, the Treasury Department and the IRS published a notice of proposed rulemaking in the **Federal Register** (REG–130507–11; 77 FR 72612) relating to the Net Investment Income Tax. On January 31, 2013, corrections to the proposed regulations were published in the **Federal Register** (78 FR 6781). The Treasury Department and the IRS received numerous comments in response to the proposed regulations. All comments are available at *www.regulations.gov* or upon request. The Treasury Department and the IRS held a public hearing on the proposed regulations on April 2, 2013.

In addition to these final regulations, the Treasury Department and the IRS are contemporaneously publishing a notice of proposed rulemaking in the **Federal Register** (REG–130843–13) relating to the Net Investment Income Tax. Public comments on the 2012 proposed regulations identified two issues that the IRS and the Treasury Department will study further and on which the IRS and the Treasury Department request additional comments. Those issues, the treatment of accumulation distributions from foreign trusts and material participation of estates and trusts, are discussed in parts 4.D and 4.F of this preamble, respectively. Comments on those issues should be submitted in writing by March 3, 2014, and can be mailed to the Office of Associate Chief Counsel (Passthroughs and Special Industries), Re: REG–130507–11 – Estates/Trusts, CC: PSI:B02, Room 5011, 1111 Constitution Avenue NW., Washington, DC 20224. All comments received will be available for public inspection at *www.regulations.gov* (IRS REG–130507–11).

II. *Statutory Provisions*

Section 1402(a)(1) of the HCERA added section 1411 to a new chapter 2A of subtitle A (Income Taxes) of the Code effective for taxable years beginning after December 31, 2012. Section 1411 imposes a 3.8 percent tax on certain individuals, estates, and trusts. See section 1411(a)(1) and (a)(2). The tax does not apply to a nonresident alien or to a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B). See section 1411(e).

In the case of an individual, section 1411(a)(1) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the individual's net investment income for such taxable year, or (B) the excess (if any) of: (i) the individual's modified adjusted gross income for such taxable year, over (ii) the threshold amount. Section 1411(b) provides that the threshold amount is: (1) in the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), $250,000; (2) in the case of a married taxpayer (as defined in section 7703) filing a separate return, $125,000; and (3) in the case of any other individual, $200,000. Section 1411(d) defines modified adjusted gross income as adjusted gross income increased by the excess of: (1) the amount excluded from gross income under section 911(a)(1), over (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amount excluded from gross income under section 911(a)(1). Section 1.1411–2 of the final regulations provides guidance on the computation of the net investment income tax for individuals.

In the case of an estate or trust, section 1411(a)(2) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the estate's or trust's undistributed net investment income, or (B) the excess (if any) of: (i) the estate's or trust's adjusted gross income (as defined in section 67(e)) for such taxable year, over (ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year. Section 1.1411–3 of the final regulations provides guidance on the computation of the net investment income tax for estates and trusts.

Section 1411(c)(1) provides that net investment income means the excess (if any) of: (A) the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the tax does not apply, (ii) other gross income derived from a trade or business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply; over (B) the deductions allowed by subtitle A that are properly allocable to such gross income or net gain. Sections 1.1411–4 and 1.1411–10 of the final regulations provide guidance on the calculation of net investment income under section 1411(c)(1).

Section 1411(c)(1)(A) defines net investment income, in part, by reference to trades or businesses described in section 1411(c)(2). A trade or business is described in section 1411(c)(2) if such trade or business is: (A) a passive activity (within the meaning of section 469) with respect to the taxpayer, or (B) a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)). Section 1.1411–5 of the final regulations provides guidance on the trades or businesses described in section 1411(c)(2).

Section 1411(c)(3) provides that income on the investment of working capital is not treated as derived from a trade or business for purposes of section 1411(c)(1) and is subject to tax under section 1411. Section 1.1411–6 of the final regulations provides guidance on working capital under section 1411(c)(3).

In the case of the disposition of an interest in a partnership or an S corporation, section 1411(c)(4) provides that gain or loss from such disposition is taken into account for purposes of section 1411(c)(1)(A)(iii) only to the extent of the net gain or net loss that would be so taken into account by the transferor if all property of the partnership or S corporation were sold at fair market value immediately before the disposition of such interest. Section 1.1411–7 of the final regulations is reserved for guidance under section 1411(c)(4). However, regulations are being proposed contemporaneously with these final regulations that address the application of section 1411(c)(4) to dispositions of interests in partnerships or S corporations.

Section 1411(c)(5) provides that net investment income does not include distributions from a plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b). Section 1.1411–8 of the final regulations provides guidance on distributions from qualified plans under section 1411(c)(5).

Section 1411(c)(6) provides that net investment income also does not include any item taken into account in determining self-employment income for a taxable year on which a tax is imposed by section 1401(b). Section 1.1411–9 of the final regulations provides guidance regarding self-employment income under section 1411(c)(6).

Summary of Comments and Explanation of Provisions

The Treasury Department and the IRS received numerous written and electronic comments regarding the proposed regulations. The comments included requests for clarification and recommendations relating to: (1) the calculation of net investment income; (2) the treatment of several special types of trusts; (3) the interaction between various aspects of section 469 and the regulations thereunder with the calculation of net investment income; (4) the method of gain calculation regarding a sale of an interest in a partnership or S corporation; and (5) multiple areas where the proposed regulations could be simplified. After consideration of all of the comments, the proposed regulations are adopted as amended by this Treasury decision. In general, the final regulations follow the approach of the proposed regulations with some modifications in response to comments and questions that have arisen with respect to the application of the proposed regulations. This preamble describes comments received by the Treasury Department and the IRS on the most significant issues.

1. *Comments of General Applicability*

A. *Confirmation in the regulation text of certain statements made in the preamble*

The Treasury Department and the IRS received a number of comments noting that some of the rules set forth in the preamble were not contained in the regulation text itself. In response to these comments, the final regulations provide additional guidance within the regulation text. For example, §1.1411–1(d) of the final regulations contains additional guidance related to various definitions applicable to multiple sections of the regulations, which had appeared only in the preamble to the proposed regulations. In addition, the final regulations contain supplemental clarifications and examples.

In addition, one commentator stated that the preamble to the proposed regulations acknowledges that certain types of income may not be subject to tax under section 1411, even if such income is not explicitly excepted from the tax under section 1411(c)(1)(A)(i) or (c)(1)(A)(iii), or is earned in a trade or business that is not a passive activity or in a trade or business of trading in financial instruments or commodities. Multiple commentators suggested that the final regulations confirm that there are types of income that are not included in net investment income. One commentator suggested the best way to illustrate principles of income that are not net investment income is inclusion of one or more examples of income not subject to tax under section 1411. Another commentator requested that the final regulations include a non-exhaustive list of items of income that are not net investment income.

The final regulations do not provide a list of income or deduction items that are excluded from the calculation of net investment income. However, the final regulations provide, in certain instances, additional guidance on items of income that are or are not included in net investment income. For example, pursuant to one comment asking whether distributions from foreign pension plans are included in net investment income, the definition of "annuity" in §1.1411–1(d) of the final regulations clarifies that the term annuities, as used in section 1411(c) and §1.1411–4, does not include amounts paid in consideration for services rendered even if such amounts are subject to the rules of section 72. This is consistent with United States income tax treaties that prescribe one set of rules for "annuities" that are not paid in exchange for services, but another set of rules for pension distributions paid in the form of an annuity. See, for example, paragraphs 1 and 3 of Article 17 (Pensions, Social Security, Annuities, Alimony, and Child Support) of the 2006 United States Model Income Tax Convention. In addition, the final regulations provide examples of items excluded from net investment income in §1.1411–1(d)(4).

Furthermore, these final regulations, as with the notice of proposed rulemaking, re-confirm the application of chapter 1 provisions in the absence of special rules for purposes of the net investment income tax. The Treasury Department and the IRS may issue other guidance in the future, as necessary, to address the treatment of particular income items whose treatment is not apparent from the general rules of section 1411 and these final regulations or from chapter 1.

B. *Section 1411 and estimated taxes*

Two commentators stated that, because many investors do not know until the end of the year if a passthrough investment will generate net investment income for that year, the Treasury Department and the IRS should not penalize taxpayers for failure to include net investment income in their calculation of estimated tax payments. One commentator suggested that the estimated tax calculation fully exempt the tax imposed by section 1411. Another commentator urged the Treasury Department and the IRS to grant penalty relief for failure to pay the appropriate estimated tax payments due to the impact of section 1411.

Section 1402(a)(2) of the HCERA amended section 6654 of the Code to provide that the tax imposed under chapter 2A (which includes section 1411) is subject to the estimated tax provisions. To assist taxpayers with their compliance obligations for taxable years beginning after December 31, 2012, the notice of proposed rulemaking extended reliance upon the proposed regulations for this first taxable year in which section 1411 was in effect. Although the Treasury Department and IRS recognize that the actual tax liability of a taxpayer may not be known at the time that an estimated tax payment is due, a similar issue is present for chapter 1 purposes. Moreover, taxpayers subject to estimated tax payments may not be subject to a penalty under certain circumstances. See section 6654(b). After consideration of these comments, the Treasury Department and IRS decline to extend penalty relief.

C. *Availability of tax credits to reduce section 1411 tax*

The Treasury Department and the IRS received comments asking whether foreign income, war profits, and excess profits taxes ("foreign income taxes") are allowed under sections 27(a) and 901 as a credit against the section 1411 tax. Under the express language of sections 27(a) and 901(a), foreign income taxes are not creditable against United States taxes other than those imposed by chapter 1 of the Code. Section 1.1411–1(e) of the final regulations clarifies that amounts that are allowed as credits only against the tax imposed by chapter 1 of the Code, including credits for foreign income taxes, may not be credited against the section 1411 tax, which is imposed by chapter 2A of the Code. This limitation is similar to the limitation applicable to a number of other credits that are allowed only against the tax imposed by chapter 1 of the Code. See, for example, section 38.

The Treasury Department and the IRS also received comments asking whether United States income tax treaties may provide an independent basis to credit foreign income taxes against the section 1411 tax. The Treasury Department and the IRS do not believe that these regulations are an appropriate vehicle for guidance with respect to specific treaties. An analysis of each United States income tax treaty would be required to determine whether the United States would have an obligation under that treaty to provide a credit against the section 1411 tax for foreign income taxes paid to the other country. If, however, a United States income tax treaty contains language similar to that in paragraph 2 of Article 23 (Relief from Double Taxation) of the 2006 United States Model Income Tax Convention, which refers to the limitations of United States law (which include sections 27(a) and 901), then such treaty would not provide an independent basis for a credit against the section 1411 tax.

2. *Comments Regarding Regrouping under Section 469*

Section 1.469–4(e)(1) provides that, except as provided in §§1.469–4(e)(2) and 1.469–11, after a taxpayer has grouped activities, the taxpayer may not regroup those activities in subsequent taxable years. The preamble to the proposed regulations acknowledged that the enactment of section 1411 may cause taxpayers to reconsider their previous grouping determinations.

The proposed regulations provided taxpayers an opportunity to regroup their activities in the first taxable year beginning after December 31, 2012, in which: (1) the taxpayer met the applicable income threshold under section 1411, and (2) had net investment income. The determination in the preceding sentence was to be made without regard to the effect of the regrouping. Pursuant to proposed §1.469–11(b)(3)(iv)(A), a taxpayer may regroup his or her activities once, and any such regrouping applies to the taxable year for which the regrouping is made and all subsequent years. Furthermore, the disclosure requirements of §1.469–4(e) and Revenue Procedure 2010–13 (2010-1 CB 329) require taxpayers who regroup their activities pursuant to proposed §1.469–11(b)(3)(iv) to report their regroupings to the IRS.

The Treasury Department and the IRS received several comments regarding proposed amendments to §1.469–11(b)(3)(iv). One commentator suggested that all individuals, trusts, and estates – regardless of whether they have net investment income or modified adjusted gross income above the threshold – be permitted a "fresh start" with respect to their section 469 groupings. The commentator stated that restricting the fresh start only to taxpayers subject to section 1411 places lower income taxpayers at a disadvantage. In addition, multiple commentators recommended that S corporations and partnerships be permitted to change their groupings in light of the application of section 1411 for any tax year that begins during 2013 or 2014. These commentators acknowledged that section 1411 does not apply to partnerships and S corporations directly, but stated that the Treasury Department and the IRS have regulatory authority to allow these entities to change the groupings reported to their owners and that the disclosure required under Revenue Procedure 2010-13 may operate to improve tax administration in this complex area.

Multiple commentators suggested that, in the case of a failure to make regrouping elections in 2013 or 2014, the final regulations should allow taxpayers to make their regrouping election on an amended return. These commentators noted that denying regrouping on an amended return where there is an adjustment to income after a return has been filed may be unfair.

The final regulations retain the requirement that regrouping under §1.469–11(b)(3)(iv) may occur only during the first taxable year beginning after December 31, 2012, in which (1) the taxpayer meets the applicable income threshold under section 1411, and (2) has net investment income. The Treasury Department and the IRS believe that the interaction between section 1411 and section 469 justifies the section 1411 regrouping rule, and that, if a taxpayer does not have a section 1411 tax liability, the reason for allowing the regrouping does not apply. The Treasury Department and the IRS acknowledge that, in the case of regrouping elections by partnerships and S corporations, one commentator's implied assertion is correct that imposition of section 1411 on a passthrough entity's owner(s) is the same change in law that precipitated the proposed regulation's allowance of regrouping in the first instance. However, if the Treasury Department and the IRS were to expand the scope of the regulations to allow regrouping by partnerships and S corporations, then taxpayers with no tax liability under section 1411 indirectly would be allowed to regroup. Accordingly, the final regulations do not adopt this suggestion.

However, after considering the comments, the Treasury Department and the IRS agree with the commentators' concerns regarding the potential unfairness to taxpayers who become subject to section 1411 after adjustments to, for example, income or deduction items after an original return has been filed. Therefore, the final regulations allow a taxpayer to regroup under §1.469–11(b)(3)(iv) on an amended return, but only if the taxpayer was not subject to section 1411 on his or her original return (or previously amended return), and if, because of a change to the original return, the taxpayer owed tax under section 1411 for that taxable year. This rule applies equally to changes to modified adjusted gross income or net investment income upon an IRS examination. However, if a taxpayer regroups on an original return (or previously amended return) under these rules, and then subsequently determines that the taxpayer is not subject to section 1411 in that year, such regrouping is void in that year and all subsequent years until a valid regrouping is done. The voiding of the regrouping may cause additional changes to the taxpayer's current year return and may warrant corrections to future year returns to restore the taxpayer's original groupings. The final regulations contain two exceptions to such voided elections. First, the final regulations allow a taxpayer to adopt the voided grouping in a subsequent year without filing an amended return if the taxpayer is subject to section 1411 in such year. Second, if the taxpayer is subject to section 1411 in a subsequent year, the taxpayer may file an amended return to regroup in a manner that differs from the previous year's voided regrouping. The final regulations provide four new examples on the amended return regrouping rules. Furthermore, §1.1411–2(a)(2)(iii) of the final section 1411 regulations also contains a similar rule applicable to section 6013(g) elections.

3. *Comments Regarding the Application of Section 1411 to Individuals*

Section 1411(a)(1) imposes a tax on individuals, but section 1411(e)(1) provides that section 1411 does not apply to a nonresident alien. The proposed regulations provided that the term *individual* for purposes of section 1411 is any natural person, except for natural persons who are nonresident aliens. The final regulations retain this position.

A. *Dual-resident individuals*

During the consideration of comments concerning the application of section 1411 to foreign individuals, the Treasury Department and the IRS considered how section 1411 applies to a dual-resident individual, within the meaning of §301.7701(b)–7(a)(1), who determines that he or she is a resident of a foreign country for tax purposes pursuant to an income tax treaty between the United States and that foreign country and claims benefits of the treaty as a nonresident of the United States. Consistent with §301.7701(b)–7(a)(1), which provides that such an individual will be treated as a nonresident alien of the United States for purposes of computing that individual's United States income tax liability, the final regulations provide that the individual is treated as a nonresident for purposes of section 1411.

B. *Dual-Status individuals*

The Treasury Department and the IRS also considered how section 1411 should apply to a dual-status individual who is a resident of the United States for part of the year and a nonresident for the other part of the year. The Treasury Department and the IRS believe that a dual-status resident should be subject to section 1411 only with respect to the portion of the year during which the individual is a United States resident, and the final regulations clarify this. However, consistent with the rule for taxable years of less than 12 months in §1.1411–2(d)(2), the threshold amount under §1.1411–2(d)(1) is not reduced or prorated for a dual-status resident. The Treasury Department and the IRS may reconsider this rule if taxpayers are applying it inappropriately.

C. *Section 6013(h) elections*

During the consideration of comments concerning the application of section 1411 to foreign individuals, the Treasury Department and the IRS considered whether the final regulations should provide an election with respect to section 6013(h) that is similar to the election that §1.1411–2(a)(2)(i)(B) of the proposed regulations provided for section 6013(g). Section 6013(h) allows a dual-status individual who is a nonresident alien at the beginning of any taxable year but at the close of such taxable year is a United States resident, and who is married to a United States citizen or resident, to make a joint election with his or her spouse to be treated as a United States resident for purposes of chapters 1 and 24 for such taxable year. The Treasury Department and the IRS believe that such an election is appropriate. Accordingly, §1.1411–2(a)(2)(iv)(B) of the final regulations provides that a dual-status individual who makes a section 6013(h) election with his or her spouse for purposes of chapters 1 and 24 also may make a section 6013(h) election for purposes of chapter 2A. For purposes of calculating the tax imposed under section 1411(a)(1), the effect of such an election is to include the combined income of the United States citizen or resident spouse and the dual-status spouse in the section 1411(a)(1) calculation and subject the income of both spouses to the $250,000 threshold amount in section 1411(b)(1) for taxpayers filing a joint return. Section 1.1411–2(a)(2)(iv)(B)(*2*) of the final regulations provides procedural requirements for making this election.

If the spouses do not make a section 6013(h) election for purposes of chapter 2A (whether or not they make the election for purposes of chapters 1 and 24), the final regulations require each spouse to determine his or her own net investment income and modified adjusted gross income (MAGI), and subjects each spouse to the $125,000 threshold amount for spouses filing separately. Consistent with the rule for taxable years of less than 12 months in §1.1411–2(d)(2), the threshold amount under §1.1411–2(d)(1) is not reduced or prorated in the case of the dual-status resident spouse for the portion of the year that he or she is treated as a United States resident. The Treasury Department and the IRS may reconsider this rule if taxpayers are applying it inappropriately.

4. *Comments Regarding the Application of Section 1411 to Estates and Trusts*

In general, section 1411(a)(2) imposes on estates and trusts a tax of 3.8 percent on the lesser of their undistributed net investment income or the excess of their adjusted gross income (as defined in section 67(e)) over the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

A. *Exclusion of certain estates and trusts from the application of section 1411*

The preamble to the proposed regulations stated that section 1411 applies to ordinary trusts described in §301.7701–4(a) that are subject to the provisions of part 1 of subchapter J of chapter 1 of subtitle A of the Code, even if the trusts have special computational rules within part 1 of subchapter J. The proposed regulation preamble identified four such trusts to which section 1411 will apply: (1) pooled income funds described in section 642(c)(5), (2) cemetery perpetual care funds described in section 642(i), (3) qualified funeral trusts described in section 685, and (4) Alaska Native settlement trusts described in section 646. The Treasury Department and the IRS requested public comments as to whether there may be administrative reasons to exclude one or more of these types of trusts from section 1411. In response, numerous commentators advocated for exclusion or inclusion of the trusts identified above.

i. Pooled Income Funds (PIFs)

Commentators recommended that the final regulations provide that section 1411 not apply to PIFs because doing so would be tantamount to taxing a charity that ultimately receives the property after the expiration of the income interest. Specifically, only the PIF's undistributed short-term gains are subject to tax under chapter 1, and those gains are held for ultimate distribution to charity. The commentators stated that the provisions of the Code dealing with charitable organizations, and contributions to them, should be broadly construed in favor of charitable organizations and their donors and, thus, section 1411 should not apply to PIFs. Furthermore, one commentator stated that treating PIFs in a manner significantly different from charitable remainder trusts is inequitable. The commentator analogized PIFs, operationally, to charitable remainder trusts. However, the commentator acknowledged that, unlike charitable remainder trusts, PIFs, by being taxable on undistributed short-term capital gains, do not escape all instances of federal income taxation. The commentators recommended that the final regulations either: (1) provide that a PIF's short-term capital gains be excluded from net investment income, or (2) exclude PIFs from the application of section 1411 altogether.

The final regulations do not adopt these suggestions. The Treasury Department and the IRS recognize that imposing tax on the PIF will reduce the amount of property the charitable remainderman will receive after the expiration of the income interest. However, section 1411 limits its exclusion to wholly charitable trusts; this group of trusts does not include either charitable remainder trusts or PIFs. While charitable remainder trusts are excluded from section 1411 by the express language of section 664, there is no comparable provision excluding PIFs.

Another commentator recommended that the final regulations provide that the section 642(c) charitable set-aside deduction that is available for a PIF's long-term capital gains for income tax purposes also reduce a PIF's net investment income. For purposes of taxation under chapter 1 of the Code, the taxable income of the PIF is limited, generally, to the undistributed short-term capital gains because the PIF will receive an income distribution deduction for the income paid to the income beneficiaries and any long-term capital gains will be offset by the section 642(c)(3) charitable set aside deduction. As is generally true throughout these regulations, the final regulations mirror this treatment under chapter 1 for purposes of section 1411.

ii. Cemetery Perpetual Care Funds

One commentator stated that there is no administrative reason why Cemetery Perpetual Care Funds (Cemetery Trusts) should not be treated the same as other trusts for purposes of section 1411, and accordingly recommended taxing such trusts under section 1411.

Two other commentators advocated for the exclusion of Cemetery Trusts from section 1411 because inclusion of such trusts would be inconsistent with the policy behind section 1411. They stated that Cemetery Trusts are established for consumer protection, and also to ensure that cemetery properties are maintained in perpetuity and do not become an obligation of the government. They noted that, as is the case with a qualified funeral trust, a cemetery perpetual care trust is essentially a collection of many small, individual trusts held for the benefit of unrelated gravesite owners whose only common interest is that they are owed the same promise of future services from the funeral provider or cemetery company. Thus, under section 642(i), the only "beneficiary" is a taxable cemetery company. Therefore, the commentators stated that the imposition of section 1411 tax on the aggregate income of a perpetual care fund would effectively be a tax on an operating business, which directly conflicts with the terms of section 1411.

The Treasury Department and the IRS agree that cemetery trusts should be excluded from section 1411. By benefitting an operating company, these trusts are similar to the business trusts that are excluded from the operation of section 1411. Accordingly, §1.1411–3(b)(1) of the final regulations exclude Cemetery Perpetual Care Funds described in section 642(i) from the application of section 1411.

iii. Electing Alaska Native Settlement Trusts (ANSTs)

Several commentators argued that ANSTs should be excepted from the net investment income tax as a matter of statutory construction and as a matter of tax policy.

Some commentators explained that the usual rules regarding the income taxation of trusts and their beneficiaries do not apply to ANSTs and their beneficiaries, and accordingly, ANSTs should not be viewed as trusts for purposes of section 1411. Specifically, section 646 provides special rules for the taxation of ANSTs at the lowest individual tax rate. Furthermore, section 646 treats all distributions, to the extent of the trust's current and accumulated taxable income, as amounts excludable from the gross income of the recipient beneficiaries. Additionally, section 646 prohibits the trust from claiming a distribution deduction, which is a deduction allowed in computing a trust's income under chapter 1 and also a deduction allowable for purposes of section 1411.

Commentators further explained that the statutory framework for the taxation of ANSTs reflects important policy considerations relating to the beneficiaries of ANSTs, which were expressed in the Congressional findings and declaration of policy in the Alaska Native Claims Settlement Act (Public Law 92-203, 85 Stat. 688) ("ANCSA"). See 43 U.S.C. §1601. The commentators said that those policies include the following: Alaska Natives have long been recognized as being among the poorest inhabitants of our nation, with poverty rates significantly higher than the national average; ANSTs are not vehicles wealthy individuals might use to avoid the reach of section 1411 by employing a trust to reinvest investment income rather than making distributions; rather, ANSTs are entities created to provide for "the real economic and social needs of Natives" by making distributions and/or reinvesting trust income to grow the trust to better provide for the future needs of its beneficiaries.

The Treasury Department and the IRS agree with the commentators that ANSTs should not be subject to section 1411, and that this exclusion is consistent with the chapter 1 taxation of these entities at the lowest individual tax rate. Therefore, the final regulations modify §1.1411–3(b)(1) to exclude from section 1411 all ANSTs that have made an election under section 646.

iv. Qualified Funeral Trusts (QFTs) Taxable under Section 685

One commentator stated that it was illogical for section 1411 to apply to QFTs because Congress intended to impose section 1411 on "private trusts," which high-income individuals often establish as vehicles for the management and intergenerational transfer of wealth. Another commentator stated that there is no administrative reason why QFTs should not be treated the same as other trusts for purposes of section 1411.

Three commentators noted that a QFT's regular tax liability is calculated on a per-contract basis and then consolidated into a single return. Specifically, section 685(c) provides that the tax imposed on the QFT is calculated by treating each beneficiary's interest in his or her contract as a separate trust. The commentators stated that, because the individual contracts are generally under $10,000, the annual investment income on them likewise is generally well under $10,000. Thus, as a practical matter, the commentators believed that QFTs would not incur this tax (due to the investment income on each contract being below the section 1411(a)(2)(B)(ii) threshold amount).

The final regulations do not exclude QFTs from the application of the net investment income tax. However, the final regulations do confirm that the calculation of the section 1411 tax will be consistent with the taxation of QFTs in chapter 1. As a result, §1.1411–3(b)(2)(i) of the final regulations provides that section 1411 is applied to the QFT by treating each beneficiary's interest in that beneficiary's contract as a separate trust.

v. Charitable Purpose Estates

Section 1411(e)(2) and proposed §1.1411–3(b)(1) exclude from the application of section 1411 a trust all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B) (referred to as "Charitable Purpose Trusts"). The final regulations retain this rule in §1.1411–3(b)(1).

One commentator pointed out that proposed §1.1411–3(d) does not have an exclusion comparable to proposed §1.1411–3(b)(1) to exempt an estate all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B) (referred to as "Charitable Purpose Estates"). The commentator noted that, although Charitable Purpose Trusts are statutorily exempt from the net investment income tax, Charitable Purpose Estates are subject to section 1411 but may achieve the same result through the use of the charitable deduction in section 642(c). Thus, through the operation of provisions outside of section 1411, it is expected that Charitable Purpose Estates typically will not have a section 1411 tax liability.

The commentator also pointed out that a Charitable Purpose Estate's need to rely on the section 642(c) deduction to achieve this result (and thus, this inconsistency between Charitable Purpose Trusts and Charitable Purpose Estates) could have an inadvertent and adverse impact on both Charitable Purpose Estates and Charitable Purpose Trusts for chapter 1 purposes – specifically, on their decision to make an election under section 645 (a "645 Election"). Section 645 was enacted to eliminate the differences in income tax treatment between the disposition of a decedent's property by will (through an estate) and by a revocable trust (that becomes irrevocable on the decedent's death). See H.R. Rep. No. 148, 105th Cong., 1st Sess. 618 (1997).

Assuming a wholly-charitable disposition by a decedent, the commentator stated that a trustee of the decedent's formerly revocable trust and the executor of the related estate would normally join in a 645 Election to minimize the cost and burden of administration and to achieve consistency in the income tax treatment of the estate and trust. However, unless an estate and trust have the same exemption from section 1411, the trustees of a Charitable Purpose Trust may be reluctant to join in an otherwise useful election.

The Treasury Department and the IRS agree with the commentator's recommendation. Given that, whether under section 1411(e)(2) or section 642(c), no section 1411 tax is imposed on a wholly charitable trust or estate, respectively, the Treasury Department and the IRS believe it is consistent with the Congressional intent of both section 1411 and section 645 to treat both types of entities as exempt from section 1411. Accordingly, §1.1411–3(b)(1) of the final regulations excludes from the application of section 1411 an estate in which all of the unexpired interests are devoted to one or more of the purposes described in section 170(c)(2)(B).

B. *Application of section 1411 to Electing Small Business Trusts (ESBTs)*

The proposed regulations preserved the chapter 1 treatment of the ESBT as two separate trusts for computational purposes but consolidated the ESBT into a single trust for determining the adjusted gross income threshold in section 1411(a)(2)(B)(ii). This is consistent with the chapter 1 treatment of ESBTs, which are entitled to only a single personal exemption, rather than one per ESBT portion, notwithstanding the fact that the income for each portion is computed separately. Moreover, this rule in the proposed regulations put ESBTs on the same footing as other taxable trusts by applying a single section 1(e) threshold to ESBTs similar to other taxable trusts. Proposed §1.1411–3(c)(1)(ii) described the method to determine the ESBT's section 1411 tax base. First, the ESBT separately calculates the undistributed net investment income of the S portion and non-S portion in accordance with the general rules for trusts under chapter 1, and then combines the undistributed net investment income of the S portion and the non-S portion. Second, the ESBT determines its adjusted gross income, solely for purposes of section 1411, by adding the net income or net loss from the S portion to the adjusted gross income of the non-S portion as a single item of income or loss. Finally, to determine whether the ESBT is subject to section 1411, the ESBT compares the combined undistributed net investment income with the excess of its adjusted gross income over the section 1(e) threshold.

One commentator challenged the authority of the Treasury Department and the IRS to issue regulations that require the use of chapter 1's separate trust treatment of the S portion and non-S portion of an ESBT for purposes of section 1411. The commentator also stated that the lack of any mention of ESBTs in section 1411 or its legislative history means that there is no regulatory authority for the treatment of an ESBT as detailed in the proposed regulations.

The preamble to the proposed regulations stated, in relevant part, that "[s]ection 1411 (which constitutes chapter 2A of the Code) contains terms commonly used in Federal income taxation and cross-references certain provisions of chapter 1 such as sections 67(e), 469, 401(a), and 475(e)(2)." However, the preamble also stated that "there is no indication in the legislative history of section 1411 that Congress intended, in every event, that a term used in section 1411 would have the same meaning ascribed to it for other Federal income tax purposes (such as chapter 1)." The Treasury Department and the IRS believe that the ESBT regulations under section 1411, which generally conform to the chapter 1 framework but with certain modifications needed for section 1411 compliance purposes, fall well within the general regulatory authority pursuant to section 7805.

Two other commentators addressed the inability to offset net investment income losses (capital, ordinary, and/or passive) from one portion of the ESBT with net investment income from the other portion. The commentators recommended that, if one portion has income or a net capital gain and the other has a net capital loss, the ESBT should be able to offset one against the other in the same manner as a non-ESBT nongrantor trust. Both commentators focused on the annual calculation of net investment income, but neither addressed the potential problems from allowing income and losses to offset: (1) loss duplication in carryover years (because loss would offset gain across portions in year 1 and also be a carryover to year 2 within the originating portion), or (2) differences in loss carryforwards for purposes of chapters 1 and 2A.

The Treasury Department and the IRS agree with the commentators' observations that the method of consolidation in the proposed regulations, in certain instances, may put ESBTs at a computational disadvantage, from a section 1411 perspective, to similarly situated nongrantor trusts in the case of netting of income and losses. However, this computational disadvantage exists with regard to the tax imposed under chapter 1, and the rules regarding ESBTs (and the final regulations generally) adopt chapter 1 principles. The Treasury Department and the IRS believe a full integration of the S portion and non-S portion into a single trust for purposes of section 1411 is administratively burdensome to both taxpayers and the IRS because it would cause the section 1411 calculations to deviate significantly from the calculations for purposes of chapter 1, resulting in the need for additional rules to address the computational differences and treatment of separate carryover regimes. For example, a full integration of the S and non-S portion would allow passive income and passive losses from each portion to offset each other, which would result in different loss carryforwards for regular tax and section 1411 purposes. A similar outcome would occur if capital gains and losses could offset between the portions in a manner inconsistent with chapter 1. Therefore, the final regulations retain the calculation of an ESBT's undistributed net investment income and modified adjusted gross income without change, but have relocated the operative ESBT rules to §1.1411–3(c).

One commentator recommended that the final regulations clarify that, when an ESBT disposes of S corporation stock, the rules under §§1.641(c)–1(d)(3) and 1.1361–1(m)(5)(ii) that permit the use of the installment method on the sale or disposition of stock in an S corporation by an ESBT, also should apply for purposes of section 1411. The Treasury Department and the IRS believe that the general administrative principles enumerated in §1.1411–1(a) accomplish this result for section 1411 purposes. Accordingly, a special rule within §1.1411–3(c) is not necessary to achieve what the commentator requested.

C. *Application of section 1411 to Charitable Remainder Trusts (CRTs)*

The proposed regulations provided special computational rules for the classification of the income of and the distributions from charitable remainder trusts, solely for section 1411 purposes. Proposed §1.1411–3(c)(2)(i) provided that distributions from a CRT to a beneficiary for a taxable year consist of net investment income in an amount equal to the lesser of the total amount of the distributions for that year, or the current and accumulated net investment income of the CRT. Proposed §1.1411–3(c)(2)(iii) defined the term *accumulated net investment income* (ANII) as the total amount of net investment income received by a CRT for all taxable years beginning after December 31, 2012, less the total amount of net investment income distributed for all prior taxable years beginning after December 31, 2012.

The Treasury Department and the IRS acknowledged in the preamble to the proposed regulations that the classification of income as net investment income or non-net investment income would be separate from, and in addition to, the four tiers under section 664(b), which would continue to apply for chapter 1 purposes. The Treasury Department and the IRS also stated in the preamble that they considered an alternative method for determining the distributed amount of net investment income under which net investment income would be determined on a class-by-class basis within each of the §1.664–1(d)(1) enumerated categories. The Treasury Department and the IRS acknowledged that, although differentiating between net investment income and non-net investment income within each class and category might be more consistent with the structure created for CRTs by section 664 and the corresponding regulations, the Treasury Department and the IRS were concerned that the apparent recordkeeping and compliance burden on trustees would outweigh the benefits of this alternative.

Multiple commentators asked that the final regulations follow the existing rules under section 664 that create subclasses in each category of income as the tax rates on certain types of income are changed from time to time. They said that CRT trustees are already maintaining the appropriate records and are familiar with the existing rules, so compliance would be less complicated than under the new system described in the proposed regulations. Some of the commentators suggested that the final regulations allow the trustee to elect between the method described in the proposed regulations and the existing rules under section 664.

Section 1.1411–3(d)(2) of the final regulations adopts the commentators' request to categorize and distribute net investment income based on the existing section 664 category and class system. The provisions of §1.1411–3(d)(2), as discussed in this preamble, will apply to taxable years of CRTs that begin after December 31, 2012, provided however that, for CRTs that relied on the proposed regulations for returns filed before the publication of these final regulations in the **Federal Register**, the CRT and its beneficiary (as applicable) do not have to amend their returns to comply with rules set forth in these final regulations. For such a CRT, when transitioning from the method in the proposed regulations to the method in these final regulations, the CRT may use any reasonable method to allocate the remaining undistributed net investment income for that year to the categories and classes under section 664.

The final regulations retain the concept of ANII. ANII is defined as the total amount of net investment income received by a charitable remainder trust for all taxable years beginning after December 31, 2012, less the total amount of net investment income distributed for all prior taxable years beginning after December 31, 2012. The final regulations apply the section 664 category and class system to ANII by providing that the Federal income tax rate applicable to an item of ANII, for purposes of allocating that item of ANII to the appropriate class within a category of income as described in §1.664–1(d)(1), is the sum of the income tax rate imposed on that item under chapter 1 and the rate of the tax imposed under section 1411. Thus, if a charitable remainder trust has both excluded income (such as income received by the trust prior to January 1, 2013, or other income received after December 31, 2012, but excluded from net investment income) and ANII in an income category, such excluded income and ANII will constitute separate classes of income for purposes of §1.664–1(d)(1)(i)(b).

The Treasury Department and the IRS believe special rules are necessary to apply the section 664 category and class system contained in §1.664–1(d) to certain distributions made to charitable remainder trusts that own interests in CFCs and PFICs not making the §1.1411–10(g) election to account for the difference between the income inclusion for chapter 1 and for section 1411 purposes. Accordingly, the final regulations reserve paragraph §1.1411–3(d)(2)(ii) for special rules in this case. The companion notice of proposed rulemaking (REG–130843–13) contains special rules relating to CFCs and PFICs and are proposed to be effective for tax years beginning after December 31, 2013.

The final regulations reserve paragraph §1.1411–3(d)(3) for rules allowing the CRT to elect between the simplified method contained in the proposed regulations and the section 664 method contained in these final regulations. The companion notice of proposed rulemaking (REG–130843–13) provides rules to enable a CRT to choose between the simplified method described in the proposed regulations (with the modification noted in the companion notice) and the existing rules under section 664. The rules contained in the companion proposed regulation are proposed to be effective for taxable years beginning after December 31, 2012.

D. *Application of section 1411 to foreign estates and trusts*

Section 1411 does not address specifically the treatment of foreign estates and foreign nongrantor trusts. Proposed §§1.1411–3(d)(2)(i) and 1.1411–3(b)(6) provided, as a general rule, that foreign estates and foreign trusts are not subject to section 1411.

i. Foreign Estates

The proposed regulations requested comments as to whether section 1411 should apply to foreign estates with United States beneficiaries. The Treasury Department and the IRS received several comments recommending that the section 1411 tax not apply to foreign estates, even those with United States beneficiaries, as there is little potential abuse in this context. Although some commentators recommended providing special rules for foreign estates with United States beneficiaries, the Treasury Department and the IRS continue to believe that section 1411 should not apply to foreign estates that often have little or no connection to the United States. Accordingly, §1.1411–3(b)(1)(ix) of the final regulations provides that the section 1411 tax does not apply to foreign estates. This rule, however, does not exempt United States beneficiaries of foreign estates from the application of section 1411 to distributions from foreign estates. The taxation under section 1411 of United States beneficiaries receiving distributions of net investment income from a foreign estate will be consistent with the general operation of subparts A through D of part I of subchapter J and will be subject to section 1411. See §§1.1411–3(e)(3)(ii) and 1.1411–4(e)(1).

ii. Foreign Trusts

The preamble to proposed §1.1411–3(c)(3) requested comments on the application of section 1411 to net investment income of foreign trusts that is earned or accumulated for the benefit of United States beneficiaries, including whether section 1411 should apply to the foreign trust, or to the United States beneficiaries upon an accumulation distribution. Commentators recommended that section 1411 should not apply to foreign trusts that accumulate income for the benefit of United States beneficiaries, but rather, that United States beneficiaries should be subject to section 1411 upon the receipt of an accumulation distribution from a foreign trust.

The Treasury Department and the IRS agree that section 1411 should apply to United States beneficiaries that receive distributions of accumulated net investment income from a foreign trust rather than to the foreign trust itself. The Treasury Department and the IRS continue to study how section 1411 should apply to accumulation distributions from foreign trusts to United States beneficiaries and intend to issue subsequent guidance on this issue. Pending the issuance of such guidance, section 1411 will not apply to distributions of accumulated income from a foreign trust to United States beneficiary. Therefore, §1.1411–4(e)(1)(ii) of the final regulations is reserved.

The Treasury Department and the IRS request additional comments concerning this issue, including recommendations on methods by which to identify accumulation distributions as net investment income. In particular, the Treasury Department and the IRS are interested in possible methods by which to determine the "additional tax" imposed under section 667(b) when the distribution is "thrown back" to the relevant past tax year, possible methods by which to identify and exclude the "additional tax" imposed under section 667(b) from years prior to the effective date of section 1411, whether a default rule similar to that contained in Notice 97–34 may be a viable approach for section 1411 purposes, and other specific technical recommendations (accompanied by numerical examples, if possible) for applying section 1411 to accumulation distributions.

E. *Calculation of undistributed net investment income*

The proposed regulations provided that undistributed net investment income of an estate or trust is its net investment income (as determined under proposed §1.1411–4), reduced by the net investment income included in the distribution to beneficiaries deductible by the estate or trust under section 651 or section 661, and by the net investment income for which the estate or trust was entitled to a section 642(c) deduction, in each case as computed in accordance with §1.642(c)–2 and the allocation and ordering rules under §1.662(b)–2. The proposed regulations adopted the class system of income categorization, generally embodied in sections 651 through 663 and the regulations thereunder, to arrive at the trust's net investment income reduction in the case of distributions that are comprised of both net investment income and net excluded income items. Section 1.1411–3(e) of the final regulations retain this approach.

Proposed §1.1411–3(f) provided examples of the calculation of undistributed net investment income. One commentator noted that *Example 1* and *Example 2* of the proposed regulations contain incorrect computations of distributable net income, which consequently causes an incorrect calculation of undistributed net investment income. The final regulations correct the computational error in these examples.

Some commentators recommended that the final regulations allow fiduciaries to reconsider a previous decision to include capital gains in the distributable net income (DNI) of an estate or trust. Section 1.643(a)–3(b)(1) provides that a fiduciary may allocate capital gains between corpus and DNI as long as such decision is a reasonable and impartial exercise of discretion and part of a consistent practice over time. In general, the commentators noted that, because section 1411 causes many capital gains to be included in net investment income, an estate or trust that does not include capital gains in DNI causes such net investment income to be retained in the estate or trust and thus, because of the low income threshold applicable to estates and trusts, to be subjected to the section 1411 tax more readily than if it had been distributed. The commentators note that, when a fiduciary considers whether capital gains are to be treated as part of DNI pursuant to section 643, as part of its duty to the trust or estate and its beneficiaries, a fiduciary takes into account any tax that would be imposed, including any tax imposed pursuant to section 1411. If the tax imposed by section 1411 had existed in the year that an existing trust or estate had first incurred capital gains, the fiduciary may have exercised its discretion differently. The commentators request that the final regulations allow a fiduciary a "fresh start" to determine whether capital gains are to be treated as part of DNI.

The final regulations do not adopt this suggestion. A fiduciary's decision regarding the inclusion of capital gains in DNI is comparable to other elections under chapter 1 that only indirectly impact the computation of net investment income. In addition, the potential for fluctuations in the effective tax rate on capital gains is a factor that is foreseeable by fiduciaries making these elections.

F. *Material participation of estates & trusts*

Several commentators noted that the enactment of section 1411 has created an additional and compelling reason for the need to determine how an estate or a trust materially participates in an activity. An estate's or a trust's income or gain from a trade or business activity in which the entity materially participates does not constitute income from a passive activity under section 469 or section 1411. One commentator noted that, in the case of estates or trusts that have not incurred losses from a passive activity, those estates and trusts previously have not had to characterize either losses or income under section 469.

Commentators stated that the legislative history of section 469 suggests that only a fiduciary's participation should control in determining whether an estate or a trust materially participates in a trade or business activity. In certain situations, case law has concluded that the participation of beneficiaries and employees also should be considered. One commentator noted that case law and IRS guidance conflict, leaving taxpayers with uncertainty in determining the material participation of a trust.

A number of commentators requested that the Treasury Department and the IRS provide guidance on material participation of estates and trusts. However, the commentators acknowledged that guidance on material participation would apply under both sections 469 and 1411, and consequently suggested the initiation of a guidance project to propose the rules for which §1.469–5T(g) has been reserved.

The Treasury Department and the IRS believe that the commentators have raised valid concerns. The Treasury Department and the IRS considered whether the scope of these regulations should be broadened to include guidance on material participation of estates and trusts. The Treasury Department and the IRS, however, believe that this guidance would be addressed more appropriately in the section 469 regulations. Further, because the issues inherent in drafting administrable rules under section 469 regarding the material participation of estates and trusts are very complex, the Treasury Department and the IRS believe that addressing material participation of trusts and estates at this time would significantly delay the finalization of these regulations. However, the issue of material participation of estates and trusts is currently under study by the Treasury Department and the IRS and may be addressed in a separate guidance project issued under section 469 at a later date. The Treasury Department and the IRS welcome any comments concerning this issue, including recommendations on the scope of any such guidance and on specific approaches to the issue.

5. *Comments Regarding the Calculation of Net Investment Income*

Section 1411(c)(1) defines net investment income as the excess (if any) of (A) the sum of: (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the tax does not apply, (ii) other gross income from trades or businesses to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply, over (B) deductions allowed by subtitle A that are properly allocable to such gross income or net gain. Section 1.1411–4 of the proposed regulations provided guidance on the calculation of net investment income. The final regulations retain the general structure of proposed §1.1411–4 with some modifications as discussed in this part.

A. *Interaction with section 469*

Section 469 and the regulations thereunder provide several rules that restrict the ability of taxpayers to artificially generate passive income from certain types of passive activities. The preamble to the proposed regulations provided a summary of the section 469 rules applicable for purposes of section 1411. The preamble identified certain aspects of the section 469 regulations that would apply for section 1411 purposes (such as the various types of recharacterization rules), and other areas where certain section 469 rules were not applicable for purposes of section 1411 (for example, the scope of a passive activity under section 469 is broader than the section 1411(c)(2)(A) definition of passive activity).

The preamble to the proposed regulations identified a series of section 469 rules that recharacterize income from a passive activity as income not from a passive activity (income recharacterization rules). Commentators requested the final regulations clarify the interaction between certain aspects of the income recharacterization rules and items of gross income included in section 1411(c)(1)(A). One such income recharacterization involves section 469(e)'s definition of portfolio income versus working capital. The comments regarding portfolio income are discussed in this part of the preamble and comments regarding working capital are discussed in part 7 of this preamble. Part 6 discusses comments regarding the net income recharacterization rules.

B. *Gross income items described in section 1411(c)(1)(a)(i)*

i. Portfolio Income

The Treasury Department and the IRS received several comments regarding the interaction between section 1411(c)(1)(A)(i) and the portfolio income items described in section 469(e)(1)(A) and the regulations thereunder. One commentator suggested that the final regulations cross reference the definition of portfolio income so that items included in portfolio income for section 469 purposes are net investment income under section 1411(c)(1)(A)(i).

In general, section 469(e)(1)(A)(i)(I) defines portfolio income as interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. The Treasury Department and the IRS recognize that this definition is similar to section 1411(c)(1)(A)(i). However, pursuant to the specific grant of authority to promulgate regulations under section 469 provided to the Treasury Department and the IRS in section 469(l), §1.469–2T(c)(3) expands the definition of portfolio income to include, for example, income from controlled foreign corporations and qualified electing funds.

Furthermore, §1.469–1T(d)(1) provides that the characterization of items of income or deduction as passive activity gross income (within the meaning of §1.469–2T(c)) does not affect the treatment of any item of income or gain under any provision of the Code other than section 469. Therefore, the characterization of certain types of income, gain, loss, and deduction as portfolio income under §1.469–2T(c)(3) is expressly limited to the section 469 context. While many of the provisions of section 469 impact the classification of income, gain, loss, and deduction for net investment income purposes within section 1411, such interaction with section 469 is generally limited to the determination of whether those items are attributable to a passive activity within the meaning of section 1411(c)(2)(A). Accordingly, because the scope of portfolio income as defined in the regulations under section 469 does not match the scope of net investment income items in section 1411(c)(1)(A)(i), the final regulations do not adopt this recommendation.

ii. Definition of "Derived in the Ordinary Course of a Trade or Business"

The preamble to the proposed regulations stated that the ordinary course of a trade or business exception is a two-part test. First, the item must be "derived in" a trade or business not described in section 1411(c)(2). Second, such item must be derived in the "ordinary course" of such trade or business. The preamble to the proposed regulations provided that a trade or business refers to a trade or business within the meaning of section 162 but the phrase was not defined in the proposed regulations. The proposed regulations did not provide guidance on the meaning of "ordinary course."

a. Definition of a trade or business

Several commentators requested guidance concerning the meaning of "trade or business." Commentators suggested that the regulations include references to relevant case law and administrative guidance. A commentator requested that the regulations expand upon existing guidance by including bright-line examples of what constitutes a trade or business to aid taxpayers in determining if income is derived in the ordinary course of a trade or business and thus is excluded from net investment income.

As noted in part 6.A. of the preamble to the proposed regulations, the rules under section 162 have long existed as guidance for determining the existence of a trade or business and are applied in many circumstances. Whether an activity constitutes a trade or business for purposes of section 162 is generally a factual question. For example, in *Higgins v. Commissioner*, 312 U.S. 212 (1941), the Supreme Court stated that the determination of "whether the activities of a taxpayer are 'carrying on a trade or business' requires an examination of the facts in each case." 312 U.S. at 217. Except for certain clarifications made in response to the proposed regulations, further guidance concerning the definition of trade or business is beyond the scope of these regulations.

In response to these commentators, §1.1411–1(d) of the final regulations provides that the term *trade or business*, when used in section 1411 and the final regulations, describes a trade or business within the meaning of section 162. The section 162 reference incorporates case law and administrative guidance applicable to section 162.

One commentator noted that determining whether income is earned in a section 162 trade or business under a separate entity approach, as reflected in proposed §1.1411–4(b), will yield unexpected results that are inconsistent with section 162. For purposes of determining whether income is earned under section 162, the commentator noted that §1.183–1(d) provides that activities are determined and their section 162 trade or business status is evaluated by aggregating undertakings in any reasonable manner determined by the taxpayer.

The Treasury Department and the IRS do not believe that the determination of a trade or business under section 162 mandates the use of the definition of "activity" within the meaning of §1.183–1(d). Section 183 disallows expenses in excess of income attributable to activities not engaged in for profit. Section 1.183-1(a) provides that section 162 and section 212 activities are not subject to section 183 limitations. The definition of activity within §1.183–1(d) allows taxpayers latitude to combine different activities into a single activity to establish that the taxpayer is engaged in an activity for profit, and thus is not subject to the section 183 limitation. However, once the taxpayer determines that section 183 is not applicable, the taxpayer then must determine whether the activity is a section 162 trade or business or a section 212 for-profit activity. Furthermore, different definitions of "activity" can be found in sections 465 and 469. Therefore, the Treasury Department and the IRS do not believe that determining whether a trade or business exists using the activity determinations of Code provisions unrelated to section 162 is appropriate.

The Treasury Department and the IRS received multiple comments regarding the determination of a trade or business within the context of rental real estate. Specifically, commentators stated that *Example 1* of proposed §1.1411–5(b)(2) is inconsistent with existing case law regarding the definition of a trade or business of rental real estate. Commentators cited cases such as *Fackler v. Commissioner*, 45 BTA 708 (1941), aff'd, 133 F.2d 509 (6th Cir. 1943); *Hazard v. Commissioner*, 7 T.C. 372 (1946); and *Lagreide v. Commissioner*, 23 T.C. 508 (1954), for the proposition that the activities of a single property can rise to the level of a trade or business.

The Treasury Department and the IRS agree with commentators that, in certain circumstances, the rental of a single property may require regular and continuous involvement such that the rental activity is a trade or business within the meaning of section 162. However, the Treasury Department and the IRS do not believe that the rental of a single piece of property rises to the level of a trade or business in every case as a matter of law. For example, §1.212–1(h) provides that the rental of real property is an example of a for-profit activity under section 212 and not a trade or business.

Within the scope of a section 162 determination regarding a rental activity, key factual elements that may be relevant include, but are not limited to, the type of property (commercial real property versus a residential condominium versus personal property), the number of properties rented, the day-to-day involvement of the owner or its agent, and the type of rental (for example, a net lease versus a traditional lease, short-term versus long-term lease). Therefore, due to the large number of factual combinations that exist in determining whether a rental activity rises to the level of a section 162 trade or business, bright-line definitions are impractical and would be imprecise. The same is true wherever the section 162 trade or business standard is used and is not unique to section 1411. The Treasury Department and the IRS decline to provide guidance on the meaning of trade or business solely within the context of section 1411. However, the Treasury Department and the IRS have modified *Example 1* in §1.1411–5(b)(3) to explicitly state that the rental property in question is not a trade or business under applicable section 162 standards.

In cases where other Code provisions use a trade or business standard that is the same or substantially similar to the section 162 standard adopted in these final regulations, the IRS will closely scrutinize situations where taxpayers take the position that an activity is a trade or business for purposes of section 1411, but not a trade or business for such other provisions. For example, if a taxpayer takes the position that a certain rental activity is a trade or business for purposes of section 1411, the IRS will take into account the facts and circumstances surrounding the taxpayer's determination of a trade or business for other purposes, such as whether the taxpayer complies with any information reporting requirements for the rental activity imposed by section 6041.

b. Definition of "derived in the ordinary course"

Section 1411 does not define the phrase "derived in the ordinary course" within the context of a trade or business. The preamble to the proposed regulations stated that other regulation sections and case law provide guidance on whether an item of gross income is derived in the ordinary course of a trade or business and specifically referenced §1.469–2T(c)(3)(ii) as an example.

The Treasury Department and the IRS received comments regarding the meaning of the phrase "derived in the ordinary course" within the context of section 1411(c)(1)(A)(i) and proposed §1.1411–4(b).

Within the context of section 469, income from interest, dividends, royalties, and annuities is classified as portfolio income unless such income is derived in the ordinary course of a trade or business. Section 1.469–2T(c)(3)(ii)(A) through (c)(3)(ii)(G), which implements section 469(e)(1)(B), identifies several situations where interest, dividends, royalties, or annuities are derived in the ordinary course of a trade or business, and therefore are not portfolio income. If the interest, dividends, royalties, or annuities do not fall into one of these situations, then they constitute working capital because they are not derived in the ordinary course of a trade or business. If the assets that generate the interest, dividends, royalties, and annuities are not held in a trade or business, however, then the classification of the income as working capital by reference to §1.469–2T(c)(3)(ii) is irrelevant.

Proposed §1.1411–6 defined working capital by reference to section 469(e)(1)(B) and §1.469–2T(c)(3)(ii). The definition of working capital in §1.1411–6(a) of the final regulations continues to reference §1.469–2T(c)(3)(ii). If a trade or business receives interest, dividends, royalties, or annuities, and the income is working capital under §1.1411–6(a), then it is not derived in the ordinary course of a trade or business for purposes of section 1411(c)(1)(A)(i) and §1.1411–4(b). Conversely, if a trade or business receives interest, dividends, royalties, or annuities, and the income is not working capital under §1.1411–6(a) because it falls within one of the situations in §1.469–2T(c)(3)(ii), then such income is derived in the ordinary course of a trade or business for both section 469 and section 1411(c)(1)(A)(i) and §1.1411–4(b). As a result of the interaction between §1.1411–6(a) and §1.469–2T(c)(3)(ii), the Treasury Department and the IRS do not believe that any special rules are necessary within §1.1411–4(b) defining "derived in the ordinary course" or, conversely, "working capital" with respect to section 1411(c)(1)(A)(i) income other than rents. In the case of rents, which are not covered by §1.469–2T(c)(3), case law will provide guidance on whether rents are derived in the ordinary course of a trade or business. Additional public comments pertaining to the definition of working capital are discussed in part 7 of this preamble.

iii. Income from Annuities

The preamble of the proposed regulations provided that gross income from annuities includes the amount received as an annuity under an annuity, endowment, or life insurance contract that is includible in gross income as a result of the application of section 72(a) and section 72(b), and an amount not received as an annuity under an annuity contract that is includible in gross income under section 72(e).

The Code does not define the term *annuity*. Section 72(a) provides that gross income includes any amount received as an annuity under an annuity, endowment, or life insurance contract. Section 72(b), however, excludes from gross income that part of an amount received as annuity that bears the same ratio to that amount as the investment in the contract bears to the expected return under the contract (determined as of the annuity starting date).

Section 72(e) governs the treatment of amounts received under an annuity contract that are not received as an annuity (such as lump sum distributions or surrenders). Section 72(e)(2) provides in general that such amounts received on or after the annuity starting date are included in gross income, and that amounts received before the annuity starting date are included in gross income to the extent allocable to income on the contract on an income-first basis.

The preamble to the proposed regulations provided that gain or loss from the sale of an annuity is treated as net investment income for purposes of section 1411. To the extent the sales price of an annuity does not exceed its surrender value, the gain recognized is treated as gross income described in section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i). If the sales price of the annuity exceeds its surrender value, the seller treats the gain equal to the difference between the basis in the annuity and the surrender value as gross income described in section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i), and treats the excess of the sales price over the surrender value as gain from the disposition of property under section 1411(c)(1)(A)(iii) and §1.1411–4(a)(1)(iii). The final regulations generally retain this approach.

One commentator stated that the definition of the term "annuity" provided in the preamble of the proposed regulations is too expansive. The commentator requested that the final regulations clarify that only items of income for which a taxpayer is liable under section 72(a) are subject to the net investment income tax. The final regulations do not adopt the requested change. The principles and rules under chapter 1 of the Code generally apply, where appropriate, in interpreting the statutory language of section 1411. Section 1411(c)(1)(A)(i) provides that net investment income includes "gross income from … annuities." Amounts received as an annuity under an annuity contract are includible in gross income under section 72(a) and section 72(b). However, there are other types of distributions from annuity contracts that are includible in gross income under section 72(e). Such amounts may include, for example, dividends received from an annuity contract. See section 72(e)(1)(B). We believe it is appropriate to apply these same rules in determining what constitutes gross income from annuities for purposes of section 1411. Therefore, amounts received under annuity contracts that are includible in income under section 72(a), (b), and (e) are subject to the net investment income tax.

One commentator requested that the final regulations clarify that net investment income from charitable gift annuities established post-2012 will be spread over the annuitant's life expectancy, similar to other items of income, pursuant to §1.1011–2(c), Example 8. The commentator also requested that the final regulations clarify that the income recognized and distributed from charitable gift annuities established prior to 2013 is not subject to the net investment income tax. The commentator asked that the final regulation extend the benefit afforded to CRTs with regard to pre-2013 gifts to pre-2013 funded charitable gift annuities.

Charitable gift annuities, like installment sales and other tax deferral transactions, defer the recognition of income to a future year. Charitable gift annuities share more characteristics with installment sales than with CRTs. In the case of installment sales, amounts received in taxable years beginning after December 31, 2012, on installment sales made prior to the effective date of section 1411 are included in net investment income, unless an exception applies. See §1.1411–4(d)(4)(i)(C), *Example 2*. A CRT, as defined in section 664, must provide for the distribution of a specified payment, at least annually, to one or more persons (at least one of which is a noncharitable beneficiary). Upon the termination of the noncharitable interest or interests, the remainder must either be held in continuing trust for charitable purposes or be paid to or for the use of one or more organizations described in section 170(c). During its operation, a CRT is a tax-exempt entity. Unlike charitable gift annuities, the Federal income tax character of the income received by a CRT's annuity or unitrust beneficiary is dependant on the Federal income tax character of the income received by the CRT in the year of distribution and, in many cases, income received in year(s) prior to the distribution. In the case of charitable gift annuities, the amount and character of the income paid to the annuity recipient generally is known at the inception of the annuity. Furthermore, the amount and character of the income paid to the annuity recipient is not dependent on the charity's use (or sale) of the property exchanged for the annuity. The section 1411 policy reason behind the exclusion of pre-2013 accumulated income within a CRT from net investment income is that the character is passed through from the CRT to the recipient, and pre-2013 income is not net investment income. Because the character of the distribution to the recipient of a charitable gift annuity is not dependent on its character in the hands of the payor, the final regulations do not adopt the requested change.

B. *Gross income items described in section 1411(c)(1)(a)(ii)*

Net investment income also includes other gross income derived from a trade or business described in section 1411(c)(2). For a trade or business described in section 1411(c)(2)(A), that is, a trade or business that is a passive activity with respect to the taxpayer, proposed §1.1411–4(c) provided that section 1411(c)(1)(A)(ii) includes other gross income that is not included in section 1411(c)(1)(A)(i) or section 1411(c)(1)(A)(iii). For a trade or business described in section 1411(c)(2)(B), that is, a trade or business of trading in financial instruments or commodities (a "trading business"), proposed §1.1411–4(c) provided that section 1411(c)(1)(A)(ii) includes all other gross income from such trade or business that is not included in section 1411(c)(1)(A)(i). See part 5.b.ii.a of this preamble for a discussion of the definition of a trade or business for purpose of section 1411.

The Treasury Department and the IRS received a number of comments regarding the proper treatment of gains and losses from a trade or business of trading in financial instruments or commodities described in section 1411(c)(2)(B). For chapter 1 purposes, a taxpayer engaged in a trading business combines gains and losses from trading activities to arrive at a net amount of gain or loss from the trading business. Under proposed §1.1411–4(c)(2), all gross income from a trading business is included in net investment income under section 1411(c)(1)(A)(ii), except for interest, dividends, rents, royalties, and annuities included in net investment income under section 1411(c)(1)(A)(i). Under proposed §1.1411–4(f)(4), section 165 losses are taken into account under section 1411(c)(1)(A)(iii) and are subject to a limit on net losses. Commentators interpreted these proposed regulations to mean that all gains from the trading activities of a trading business are included in net investment income under section 1411(c)(1)(A)(ii), while the offsetting trading losses would be under section 1411(c)(1)(A)(iii). As a result, the section 1411(c)(1)(A)(iii) loss limitation would prevent a trading business from netting the gains and losses for purposes of the net investment income tax. Multiple commentators recommended that trading losses generated by a trading business should be allocated to the same category as trading gains. Some commentators recommended that proposed §1.1411–4(f)(4) not apply to trading gains, which would allow trading losses to offset trading gains under section 1411(c)(1)(A)(ii). Other commentators recommended that trading gains should be included in net investment income under section 1411(c)(1)(A)(iii) rather than under section 1411(c)(1)(A)(ii).

The Treasury Department and the IRS agree that trading gains and losses should be assigned to the same category of net investment income. Because section 1411(c)(2)(B) does not distinguish between a trader who has made a section 475(f) mark-to-market election (a "section 475 trader") and a trader who has not made a section 475(f) mark-to-market election (a "non-section 475 trader"), aligning gains and losses from a trading business requires rules that apply equally to a section 475 trader and to a non-section 475 trader. Chapter 1, however, provides different timing and character rules for the two types of traders. For a section 475 trader, all securities and commodities held in a trading business are marked to market on the last day of the tax year, both realized and mark-to-market gains or losses have ordinary character, and any net trading loss may be used to offset other income under chapter 1. In contrast, a non-section 475 trader generally does not mark securities and commodities to market, gains and losses recognized from trading are capital in character, and any net trading loss would be subject to chapter 1 capital loss limitations. One possible solution is to assign the trading gains and losses from both section 475 traders and non-section 475 traders to section 1411(c)(1)(A)(ii), which would permit a non-section 475 trader to use net trading losses to offset other net investment income. Another possible solution is to assign the trading gains and losses from both section 475 traders and non-section 475 traders to section 1411(c)(1)(A)(iii), thereby making a section 475 trader subject to the loss limitations of that section. Under either scenario, some traders would be treated differently for purposes of section 1411 and chapter 1. This would have required those traders to maintain a separate set of books and records specifically to comply with section 1411.

To minimize the inconsistencies between chapter 1 and section 1411 for traders, the final regulations assign all trading gains and trading losses to section 1411(c)(1)(A)(iii). The final regulations also permit a taxpayer to deduct excess losses from the trading business of a section 475 trader from other categories of income. Part 5.C of this preamble describes the treatment of those excess losses. Section 1.1411–4(c) of the final regulations provides that gross income from a trading business is included in net investment income under section 1411(c)(1)(A)(ii) only to the extent that income is not included in section 1411(c)(1)(A)(i) or (c)(1)(A)(iii). This change aligns the categorization of income between section 1411(c)(1)(A)(i), (c)(1)(A)(ii), and (c)(1)(A)(iii) in a manner consistent with income from a passive activity trade or business described in section 1411(c)(2)(A). As a result, the final regulations now categorize gross gains from the disposition of property associated with a trading business as net investment income under section 1411(c)(1)(A)(iii), which may be offset by losses from trading dispositions. However, see part 5.C of this preamble for a discussion of additional changes relative to section 1411(c)(1)(A)(iii) and section 1411(c)(1)(B) that impact the calculation of net investment income for items of gain and loss attributable to a trading business.

C. *Calculation of net gain in section 1411(c)(1)(a)(iii)*

The proposed regulations provided that net investment income includes net gain (to the extent taken into account in computing taxable income) attributable to the sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition (collectively, referred to as the disposition) of property other than property held in a trade or business not described in section 1411(c)(2). The proposed regulations provided that, because section 1411(c)(1)(A)(iii) uses the term "net gain" and not the term "net gain or loss," the amount of net gain included in net investment income may not be less than zero. However, the proposed regulations also provided that losses allowable under section 1211(b)(1) and (b)(2) are permitted to offset gain from the disposition of assets other than capital assets that are subject to section 1411.

i. Overall Limits on Losses

Several commentators suggested that, instead of limiting net gain to zero, losses in excess of gains should offset other net investment income in order to reflect the true economic net investment income for any given year. One commentator acknowledged that the position taken by the proposed regulations appears consistent with the statutory definition of net investment income because section 1411(c)(1)(A)(iii) appears to preclude the possibility of a net loss. Another commentator observed that the proposed regulations place excessive stress on the word "gain" in section 1411(c)(1)(A)(iii), and insufficient stress on the word "net." Stressing the word "gain" prevents a taxpayer from deducting a $3,000 capital loss limit against other investment income (such as interest). Another commentator stated that, because chapter 1 imposes significant constraints on deducting capital losses against non-capital income (such as the prohibition on carrybacks of such losses for individuals), and imposes a variety of limitations on deducting ordinary losses under section 165, including losses that become section 165 deductions through the operation of other provisions such as section 475, 988, or 1231, there does not appear to be any reason to impose additional limitations on those deductions for section 1411 purposes. A number of commentators recommended that losses in excess of gains be allowed as a properly allocable deduction that may offset other net investment income from section 1411(c)(1)(A)(i) or (c)(1)(A)(ii). Some commentators suggested that section 1411(c)(1)(B) properly allocable deductions include any capital losses allowed for chapter 1 purposes. Several other commentators suggested that there should be no limit imposed on losses, capital or ordinary.

Section 1.1411–4(d)(2) of the final regulations retains the overall limitation of the proposed regulations on allowable losses that the calculation of net gain within section 1411(c)(1)(A)(iii) cannot be less than zero. The Treasury Department and the IRS believe that provision follows the statutory language of section 1411(c)(1)(A)(iii). However, §1.1411–4(f)(4) of the final regulations provides that losses described in section 165, whether described in section 62 or section 63(d), are allowed as a properly allocable deduction to the extent such losses exceed the amount of gain described in section 61(a)(3) and are not taken into account in computing net gain by reason of §1.1411–4(d). Thus, although §1.1411–4(d)(2) imposes an overall limitation on net gain included in net investment income by reason of section 1411(c)(1)(A)(iii), §1.1411–4(f)(4) allows losses in excess of gains as a properly allocable deduction to the extent the losses would be allowable in computing taxable income under chapter 1. Losses are first applied to calculate net gain under §1.1411–4(d), and then §1.1411–4(f)(4) applies to the excess losses. This ordering rule prevents taxpayers from deducting the same loss twice: first in calculating net gain under §1.1411–4(d), and then again in §1.1411–4(f)(4). As a result, final §1.1411–4(f)(4) allows, as a properly allocable deduction, the $3,000 capital loss ($1,500 in the case of an individual filing as married filing separately) allowed by section 1211(b) in all cases. Furthermore, a taxpayer, such as a section 475 trader, that has ordinary losses in excess of ordinary gains and net capital gains, may claim those excess losses as a §1.1411–4(f)(4) properly allocable deduction.

Furthermore, the final regulations retain the definition of disposition as the sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition of property.

A commentator suggested that section 1411 does not apply to a deemed sale resulting from section 877A. Section 877A(a)(1) provides, in relevant part, that "For purposes of this subtitle, all property of a covered expatriate shall be treated as sold on the day before the expatriation date for its fair market value." The Treasury Department and the IRS believe that any gain taken into account in computing a covered expatriate's taxable income is also included in net investment income because the operative provision of section 877A(a)(1) treats the property as sold for purposes of subtitle A, which includes section 1411. Accordingly, the final regulations clarify that a deemed sale under section 877A, which applies for purposes of subtitle A, is a disposition of property subject to section 1411.

ii. Treatment of Certain Capital Loss Carryforwards

The proposed regulations provided, and the final regulations retain, the provision that except as otherwise expressly provided in regulations, the income tax gain and loss recognition rules in chapter 1 apply for purposes of determining net gain under section 1411. Losses properly taken into account in determining net gain include all losses deductible under section 165 to the extent they are attributable to property that is either: (1) not held in a trade or business, or (2) held in a trade or business described in proposed §1.1411–5. Therefore, under the proposed regulations, net gain took into account capital losses carried over from prior years by reason of section 1212(b)(1) (including years preceding the effective date of section 1411). The final regulations retain this position.

The Treasury Department and the IRS received several comments and inquiries regarding the treatment of capital loss carryforwards. The final regulations reserve paragraph §1.1411–4(d)(4)(iii) for special rules that the Treasury Department and the IRS believe are necessary to properly address capital loss carryforwards. The companion notice of proposed rulemaking (REG–130843–13) contains an explanation of the proposed rule and the proposed regulation text.

D. *Properly allocable deductions described in section 1411(c)(1)(b)*

Section 1411(c)(1)(B) provides that net investment income includes deductions allowed by subtitle A that are properly allocable to gross income or net gain described in section 1411(c)(1)(A). Section 1.1411–4(f)(1)(i) of the proposed regulations provided that "[u]nless specifically stated otherwise, only properly allocable deductions described in this paragraph (f) may be taken into account in determining net investment income." Specifically, proposed §1.1411–4(f)(3) provided that properly allocable deductions include: (A) investment interest expense, (B) investment expenses described in section 163(d)(4)(C), and (C) state, local, and foreign income taxes described in section 164(a)(3). The Treasury Department and the IRS intend this rule to limit the deductions against net investment income to those specifically enumerated in paragraph (f).

One commentator recommended that the final regulations provide that the phrase "properly allocable deductions" comprise all of the chapter 1 deductions that are allowed against chapter 1 gross income from rent, dividends, royalties, annuities and interest, other gross income derived from a trade or business, and net gains attributable to the disposition of property other than property held in a trade or business.

The Treasury Department and the IRS believe the recommended language would permit taxpayers to argue that they can take deductions that have no direct relation to net investment income, and it would lead to uncertainty and to disputes between taxpayers and the IRS over what constitutes properly allocable deductions. However, the Treasury Department and the IRS acknowledge that flexibility is needed within §1.1411–

4(f) so that future changes in law or circumstances can be more easily integrated into the regulations. Although the cross-references in §1.1411–4(f)(2) to deductions described in section 62(a) provide section 1411(c)(1)(B) flexibility to automatically take into account additions or changes to chapter 1 deductions attributable to trades or business, rents, and royalties, these regulations would have to be amended to expand properly allocable deductions in the event of such changes not captured by section 62(a)(1) or 62(a)(4). To strike a balance between the intent of the proposed rule (to provide a specific list of deductions to limit uncertainty and controversy) and the recognized value of future flexibility inherent in the commentators' recommendation, §1.1411–4(f)(6) of the final regulations allows the Treasury Department and the IRS to publish additional guidance in the Internal Revenue Bulletin that expands the list of properly allocable deductions.

i. Inclusion of Additional Properly Allocable Deductions

Commentators requested that properly allocable deductions also include amounts described in sections 72(b)(3), 642(h), 691(b), 691(c), 1341, and 7518 (c)(1)(A).

Section 72(b)(3) allows a deduction for unrecovered basis in an annuity when an annuitant dies with unrecovered basis in the annuity contract. Section 72(b)(3) allows the deduction on the decedent's final income tax return. The Treasury Department and the IRS believe that, because an annuity contract would have produced income subject to tax under section 1411 had the annuitant continued living, it is appropriate to allow the deduction under section 72(b)(3) in calculating the net investment income for the decedent's final taxable year. Accordingly, §1.1411–4(f)(3)(iv) of the final regulations provides that the section 72(b)(3) deduction for unrecovered annuity basis is a properly allocable deduction.

Section 642(h) provides "[i]f on the termination of an estate or trust, the estate or trust has (1) a net operating loss carryover under section 172 or a capital loss carryover under section 1212, or (2) for the last taxable year of the estate or trust deductions (other than the deductions allowed under subsections (b) or (c)) in excess of gross income for such year, then such carryover or such excess shall be allowed as a deduction . . . to the beneficiaries succeeding to the property of the estate or trust."

Section 691(b) provides that an estate (or successor to property) may take deductions described in section 162, 163, 164, 212, or 611 in respect of a decedent, which are not properly allowable to the decedent in the taxable period prior to or in which falls the date of the decedent's death (these items are often referred to as Deductions in Respect of a Decedent, or "DRD"). Section 691(b) is the statutory mechanism that allows a deduction to the estate (or other successor to property) because, under the normal accounting rules, the decedent would have been entitled to the deduction but failed to live long enough to take it. The section 691(b) listing of deductions is an exclusive list. If a deduction is not listed (such as suspended capital losses), then it is not deductible under this provision.

The Treasury Department and the IRS believe that it is appropriate to provide a special rule that allows a beneficiary to succeed to the deductions of a terminating estate or trust in the same fashion as that provided by section 642(h) for chapter 1 purposes. In addition, the Treasury Department and the IRS believe that it is appropriate to provide a special rule that allows for deductions described in section 691(b) to be claimed by an estate or a successor to the estate. However, to limit the deductions to those that would have been deductible had the predecessor been able to deduct the expenses, the scope of allowable deductions under these special rules is limited to only those deductions allowed under §1.1411–4(f), and only to the extent that the terminating estate or trust has negative net investment income upon termination.

Section 691(c) allows a deduction for estate taxes imposed on items of income that are Income in Respect of a Decedent (IRD) under section 691(a). The section 691(c) deduction allowed for estate tax attributable to IRD that is ordinary income must be claimed as an itemized deduction, and not as a deduction from gross income in arriving at adjusted gross income (AGI), because it is not among the deductions listed in section 62. However, the section 691(c) deduction is not subject to the 2-percent floor under section 67.

In the case of IRD that is capital gain, section 691(c)(4) provides that "[f]or purposes of section 1(h), 1201, 1202, and 1211, the amount taken into account with respect to any item described in subsection (a)(1) shall be reduced (but not below zero) by the amount of the deduction allowable under paragraph (1) of this subsection with respect to such item."

Net investment income may include items of IRD (such as annuities and outstanding installment sale payments) that may carry with it a deduction under section 691(c) for chapter 1 purposes. Therefore, the Treasury Department and the IRS believe it is consistent with the general principles of section 691 also to allow the section 691(c) deduction to reduce net investment income. Section 1.1411–4(f)(3)(v) of the final regulations provides that the deduction described in section 691(c) is a properly allocable deduction, except to the extent that the section 691(c) deduction is taken into account in determining net gain (within the meaning of §1.1411–4(d)) by reason of section 691(c)(4).

Generally, section 1341 applies if: (1) a taxpayer included an item in gross income in a prior taxable year because it appeared that the taxpayer had a claim of right to the item, and (2) a deduction is allowable for the repayment of the item in a later taxable year under some provision of the Code other than section 1341 because it is established that the taxpayer did not have a right to the item. If section 1341 applies, a taxpayer's tax liability for the year of repayment (or the taxable year in which the obligation to make repayment otherwise gives rise to a deduction) is based on the lesser of: (A) the tax for the taxable year, computed with a deduction of the repayment amount ("section 1341 deduction amount"), or (B) the tax for the year of repayment computed without the repayment deduction, less the decrease in tax imposed by chapter 1 in the prior taxable year(s) that would result solely from the exclusion of the restored item from gross income in the prior taxable year(s) ("section 1341 credit amount"). The section 1341 credit amount is intended to compensate the taxpayer for the tax paid in the year of income inclusion (for example, if the tax rates were higher in the year of inclusion).

One commentator recommended that the final regulations contain certain provisions similar to section 1341 to the extent that section 1341 would apply for chapter 1 in a particular year. The commentator noted that, because some types of income that might be restored under section 1341 might have been subjected to tax under section 1411 when included in a prior year, it would be equitable for the section 1411 regulations to contain a mechanism similar to section 1341 to allow a deduction under section 1411(c)(1)(B) for repayment of the income in a later year.

To the extent that a deduction is allowable under a provision of chapter 1 that specifically is allowed under section 1411(c)(1)(B) and §1.1411–4(f), that amount also would be a deduction for section 1411 purposes in the year of the repayment (or the taxable year in which the obligation to make repayment otherwise gives rise to a deduction). For example, if the repayment constituted a section 165 loss that was a properly allocable deduction, then that deduction also would be available for section 1411 purposes.

However, if the section 1341 credit amount produces a lower tax for the repayment year when compared to the section 1341 deduction amount, section 1341(b)(3) denies the taxpayer a deduction in the year of repayment in favor of the alternative credit for the tax cost. In this instance, the deduction is not allowed by subtitle A (which includes chapter 1, chapter 2, and chapter 2A) in the recovery year, and therefore would not be a properly allocable deduction under section 1411(c)(1)(B) and §1.1411–4(f). Therefore, the final regulations do not incorporate this recommendation.

One commentator recommended that the final regulations include amounts deposited in capital construction funds described in section 7518 as a properly allocable deduction under section 1411(c)(1)(B). Section 7518(c)(1)(A), which is in chapter 77 of subtitle F of the Code, provides that taxable income is reduced by certain amounts described in section 7518(a)(1)(A) that a taxpayer deposits into the fund. The final regulations do not adopt this recommendation. Section 1411(c)(1)(B) provides that net investment income includes deductions allowed by subtitle A that are properly allocable to such gross income or net gain described in section 1411(c)(1)(A). The reduction in taxable income provided by section 7518(c)(1)(A) is not a deduction allowed by subtitle A of the Code. Therefore, these deductible amounts are outside of the scope of section 1411(c)(1)(B).

Section 1.1411–4(f) of the final regulations also provides that properly allocable deductions include amounts described in section 212(3). Section 212(3) allows a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in connection with the determination, collection, or refund of any tax. Section 1.212–1(l) provides, in relevant part, that expenses paid or incurred by a taxpayer for tax counsel or expenses paid or incurred in connection with the preparation of tax returns or in connection with any proceedings involved in determining or contesting a tax liability are deductible. Section 1.1411–4(f)(3)(vi) of the final regulations provides that amounts described in section 212(3) and §1.212–1(l) that are allocable to net investment income using any reasonable method are properly allocable deductions.

Section 1.1411–4(f) also includes two additional properly allocable deductions attributable to investments in certain types of debt instruments. In the case of a contingent payment debt instrument, the holder may receive a payment that is less than the corresponding projected payment determined under the noncontingent bond method, resulting in a negative adjustment under §1.1275–4(b)(6). In general, a holder treats a negative adjustment as a reduction in interest income otherwise includible for the taxable year and, if there is any excess, as an ordinary loss for the taxable year to the extent of prior interest inclusions. The loss, in effect, reverses the holder's prior interest over-inclusions on the debt instrument. One commentator recommended that the final regulations provide that a holder's negative adjustment treated as an ordinary loss under §1.1275–4(b)(6) be a properly allocable deduction. The final regulations adopt this recommendation and treat the loss as a properly allocable deduction because it accurately reflects the taxpayer's economic net investment income attributable to the debt instrument and is otherwise allowed by chapter 1. The final regulations also provide a similar rule for a deflation adjustment on an inflation-indexed debt instrument subject to §1.1275–7.

If a taxpayer purchases a taxable debt instrument at a premium, the taxpayer can elect under section 171 to amortize the bond premium. In general, the amount of amortizable bond premium for a period offsets the interest income allocable to the period and the taxpayer includes the net amount of interest in taxable income. In certain circumstances, however, the taxpayer is entitled to deduct all or a portion of the bond premium under section 171(a)(1). For example, if an electing taxpayer acquires a Treasury bill at a premium and holds the bill until maturity, the taxpayer can deduct the premium at maturity under section 171(a)(1). See §1.171–2T(a)(4)(i)(C). In these circumstances, the final regulations provide that a deduction under section 171(a)(1) is a properly allocable deduction.

ii. Deduction for Income Taxes Described in Section 164(a)(3)

The Treasury Department and the IRS received comments on multiple aspects of proposed §1.1411–4(f)(3)(i)(C), which pertains to itemized deductions for state and local, and foreign income, war profits, and excess profits taxes described in section 164(a)(3) ("section 164(a)(3) taxes"). Proposed §1.1411–4(f)(3)(i)(C) provided that income taxes imposed on investment income that are described in section 164(a)(3) are deductible in determining net investment income. In the case of taxes imposed on both investment income and non-investment income, the proposed regulations provided that the portion of taxes properly allocable to investment income may be determined by taxpayers using any reasonable method. The proposed regulations further provided that allocating the deduction based on the ratio of investment income to total gross income is an example of a reasonable method.

Commentators recommended that the final regulations provide additional examples of reasonable methods of allocation of taxes between net investment income and non-net investment income. One commentator recommended that the final regulations provide that state income tax reported on the state income tax return, rather than the actual state income tax payments made during the year, should be used in calculating a trust or estate's deduction under proposed §1.1411–4(f)(3)(i)(C) for taxes under section 164(a)(3). One commentator requested alignment between the reasonable method of allocating section 164(a)(3) taxes in proposed §1.1411–4(f)(3)(i)(C) with the existing allocation rules in chapter 1 for estates and trusts. One commentator stated that the proposed method of allocation creates a problem because a trust or estate deducts state and local taxes for DNI purposes in a different manner. Another commentator recommended that the final regulations follow the long-standing state and local tax allocation rules of §1.652(b)–3(b).

The final regulations generally retain the position of the proposed regulations. Although the regulations provide an example of a reasonable method of allocation, it is not the only reasonable method. The final regulations do not provide other examples of generally applicable reasonable allocation methods because the Treasury Department and the IRS believe that providing multiple examples of reasonable methods may lead to taxpayers to incorrectly conclude that the methods listed are the only acceptable methods. Therefore, the Treasury Department and the IRS believe that the final regulations allow taxpayers flexibility to determine a method of allocation that best applies to their specific facts. The final regulations do provide, however, that for estates and trusts, an allocation between classes of income under §1.652(b)–3 is a reasonable allocation.

Several commentators suggested that foreign taxes should be a properly allocable deduction under section 1411(c)(1)(B), without reference to any election made by the taxpayer for chapter 1 purposes. Another commentator, however, suggested that the final regulations confirm that foreign taxes included in the foreign tax credit computation are not taxes included in section 164(a)(3) and, therefore, would not be allowed as a deduction allocable to net investment income. Section 1.1411–4(f)(3)(iii) of the final regulations provides that foreign income, war profits, and excess profits taxes may be allowable as deductions in determining net investment income only if the taxpayer does not choose to take any foreign tax credits under section 901 with respect to the same taxable year. This rule is consistent with the limitation in section 275(a)(4) on deductibility of those taxes.

Several commentators requested that the final regulations address the proper treatment of refunds of taxes deductible under section 164(a)(3). In response to this request, §1.1411–4(g)(2) of the final regulations provides guidance on refunds and recoveries of amounts deducted under section 1411(c)(1)(B) and §1.1411–4 in prior taxable years. In general, the final regulations provide that the recovery or refund of a previously deducted item shall reduce the total amount of properly allocable deductions in the year of the recovery. The final regulations first determine the recovered amount without regard to the application of the tax benefit rule in section 111 for chapter 1 purposes. For example, if a taxpayer receives a refund of state income taxes from a prior year, such a refund would be included in the taxpayer's gross income. However, if the taxpayer was subject to the alternative minimum tax in the year of the payment, the taxpayer may not have received any tax benefit under chapter 1, and therefore section 111 may exclude some, or all, of the refund from gross income. However, the deductibility of state income taxes for section 1411 purposes is independent of the deductibility of the taxes for alternative minimum tax purposes. Therefore, the applicability of the recovery rule in §1.1411–4(g)(2) is determined without regard to whether the recovered amount was excluded from gross income by reason of section 111.

The final regulations contain two exceptions to the general rule. The two exceptions apply the tax benefit rule of section 111 within the section 1411 system, and therefore operate independently of the application of section 111 for chapter 1 purposes. First, properly allocable deductions are not reduced in the year of the recovery if the amount deducted in the prior year did not reduce the amount of section 1411 liability. For example, the receipt in 2014 of a refund of income taxes paid in 2012 would not reduce a taxpayer's section 1411(c)(1)(B) deduction because section 1411 was not in effect in 2012 and thus the 2012 taxes were not properly allocable to net investment income. Second, properly allocable deductions are not reduced in the year of the recovery if the amount deducted in the prior year is included in net investment income by reason of section 1411(c)(1)(A). For example, a reimbursement of a deduction from a passive activity trade or business that is gross income for chapter 1 purposes is included as gross income from a passive activity under section 1411(c)(1)(A)(ii). Therefore, the recovery is already reflected in the recovery year's net investment income calculation.

In addition, §1.1411–4(g)(2) of the final regulations provides a special rule in the case of a recovery of a deduction that was allocated between net investment income and non-net investment income (such as section 164(a)(3) taxes). The final regulations provide that the amount taken into account under the recovery rule is based on the ratio used to allocate the item in the year of the deduction. For example, if a taxpayer allocated 45 percent of its total section 164(a)(3) taxes to net investment income in the year of the deduction, 45 percent of the recovery of such taxes will reduce the total amount of properly allocable deductions in the year of the recovery even though the taxpayer's allocation of section 164(a)(3) taxes to net investment income in the year of recovery may be, for example, 30 percent.

iii. Treatment of Estate and Trust Administration Expenses

Several commentators requested that the final regulations explicitly provide that section 1411(c)(1)(B) properly allocable deductions include fiduciary commissions, legal and accounting fees, and other estate and trust administration expenses. Subject to the limitations pursuant to section 67(e), the final regulations adopt this comment by amending proposed §1.1411–4(f)(3) to provide that properly allocable deductions include amounts described in §1.212–1(i) (allowing a deduction for reasonable amounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation) to the extent they are allocable to net investment income. The final regulations require that estates and trusts apportion any §1.212–1(i) expenses between net investment income and excluded income using any reasonable method.

iv. Limitations on Properly Allocable Deductions

Under the proposed regulations, properly allocable deductions that are itemized deductions subject to the 2-percent floor on miscellaneous itemized deductions under section 67 or to the overall limitation on itemized deductions under section 68 are deducted in determining net investment income only to the extent that they are deductible for income tax purposes after the application of both limitations. The proposed regulations provided a method for apportioning these limitations to determine the amount of deductions allowed in computing net investment income after applying sections 67 and 68. This method first applies section 67 to all deductions subject to the 2-percent floor. The disallowance is applied proportionately to each deduction subject to section 67. The proposed regulations then apply a similar process to deductions subject to section 68.

One commentator argued that applying general limitations on deductions under sections 67 and 68 is inconsistent with congressional intent, and that it may cause "taxable" net investment income to exceed "economic" net investment income. The commentator recommended that the final regulations allow the full amount of properly allocable itemized deductions to offset income items comprising net investment income without regard to the limitations imposed under sections 67 and 68.

Section 1411(c)(1)(B) provides that only those deductions that are allowed under subtitle A and properly allocable to component items of net investment income are deducted in determining net investment income. Sections 67 and 68 limit the amount of certain itemized deductions in determining taxable income for purposes of subtitle A and, therefore, also apply to limit the amount of those itemized deductions in determining net investment income. Accordingly, properly allocable deductions that are subject to section 67 or 68 are deducted in determining net investment income only to the extent that they are deductible after the application of the limitations.

Another commentator agreed that the limitations on itemized deductions under sections 67 and 68 should apply for section 1411 purposes, but suggested that these limitations only reduce the amount of properly allocable itemized deductions if such deductions exceed the aggregate amount of the deductions, whether properly allocable or not, that would be allowed after application of these limitations. In other words, the commentator requested an ordering approach to the section 67 and 68 limitations, instead of the pro-rata approach in the proposed regulations. Both the commentator's recommendation and the proposed regulation method are reasonable interpretations of section 1411(c)(1)(B), accordingly, the final regulations adopt the commentator's recommendation.

Under §1.1411–4(f)(7) of the final regulations, the amount of miscellaneous itemized deductions allowed under section 67 in determining net investment income (but before the application of section 68) is the lesser of: (1) the amount of miscellaneous itemized deductions before applying section 67 that are properly allocable to net investment income, or (2) the amount of all miscellaneous itemized deductions allowed after the application of section 67. The amount of itemized deductions subject to limitation under section 68 that are deducted in determining net investment income is the lesser of: (1) the amount of such deductions that are properly allocable to net investment income allowed after the application of section 67 but before the application of section 68, or (2) the amount of all deductions allowed after the application of section 68.

v. Treatment of Properly Allocable Deductions in Excess of Investment Income

Proposed §1.1411–4(f)(1)(ii) provided that any deductions described in §1.1411–4(f) in excess of gross income and net gain are not taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1. Many commentators recommended that the final regulations provide that negative net investment income (when section 1411(c)(1)(B) deductions exceed section 1411(c)(1)(A) income) be carried over and become a section 1411(c)(1)(B) deduction in the subsequent year.

The final regulations do not adopt this recommendation. Section 1411(c)(1)(B) provides that, in order for a deduction to be allowed, it must be: (1) allowed by subtitle A, and (2) be properly allocable to section 1411(c)(1)(A) income. Section 1411(c)(1)(B) only allows deductions allowed by other Code sections; it does not establish a basis for a deduction that does not exist elsewhere in the Code. However, as discussed in the following part of this preamble, the final regulations do permit deductions of net operating losses otherwise allowed by subtitle A that are properly allocable to section 1411(c)(1)(A) income.

vi. Net Operating Losses as a Properly Allocable Deduction

Proposed §1.1411–4(f)(1)(ii) provided that, in no event, will a net operating loss (NOL) deduction allowed under section 172 be taken into account in determining net investment income for any taxable year. The proposed regulations requested comments on whether a deduction should be allowed for an NOL in determining net investment income. Several commentators argued that, for purposes of section 1411(c)(1)(B), at least some portion of an NOL deduction should be a deduction properly allocable to gross income included in net investment income and therefore allowed in determining net investment income. Three commentators recommended that taxpayers be allowed to keep track of the portions of an NOL attributable to investment income for the loss year. One commentator recommended that the IRS adopt a simple rule for determining a portion of an NOL that is attributable to a "net investment loss" for a loss year (for example, using a ratio of the portion of the loss attributable to "net investment loss" to the NOL) and allow taxpayers to take a prorated portion of the NOL deduction into account in determining net investment income for a taxable year to which the NOL is carried.

The final regulations adopt a modified version of the commentator's approach in §1.1411–4(f)(2)(iv) and (h). Because NOLs are computed and carried over year-by-year, a separate ratio must be determined for each year. Thus, the final regulations provide that taxpayers may deduct a portion of an NOL deduction in determining their net investment income. The portion of an NOL deduction for a taxable year that may be deducted for section 1411 purposes is calculated by first determining the applicable portion of the NOL for each loss year. The applicable portion of the NOL is the lesser of: (1) the amount of the NOL for the loss year that the taxpayer would have incurred if only items of gross income that are used to determine net investment income and only properly allocable deductions were taken into account in determining the NOL in accordance with section 172(c) and (d), or (2) the amount of the taxpayer's NOL for the loss year. Next, the amount of the NOL carried from each loss year and deducted in the taxable year is multiplied by a fraction. The numerator of this fraction is the applicable portion of the NOL for the loss year as determined above. The denominator of the fraction is the total NOL for the loss year. A separate fraction is determined for each loss year. The result of this multiplication is the amount of the NOL deduction from the loss year that is allowed as a section 1411(c)(1)(B) deduction in the taxable year, referred to as the *section 1411 NOL* amount. The sum of the section 1411 NOL amounts for each NOL carried to and deducted in the taxable year, referred to as the total section 1411 NOL amount, is the amount of the NOL deduction for the taxable year that is properly allocable to net investment income.

E. *Calculation of net investment income in special situations*

Section 1411(c)(1)(A)(i) provides that net investment income does not include (among other things) items of interest, dividend, annuity, royalty or rent derived in the ordinary course of a trade or business that is not a passive activity with respect to the taxpayer within the meaning of section 469. Section 1411(c)(1)(A)(iii) provides that net investment income does not include (among other things) gain or loss from the disposition of property used in a trade or business that is not a passive activity of the taxpayer. In general, section 469 and the regulations thereunder provide four ways for an item of income to be nonpassive – grouping, activity recharacterization, income recharacterization, and material participation.

In the case of certain types of net investment income, such as rent and interest, commentators recommended that the final regulations exclude certain nonpassive net income, gain, or loss and self-charged interest from net investment income. Other commentators recommended that the final regulations provide a deduction that offsets the income.

As discussed in part 5.D.v. of this preamble, section 1411(c)(1)(B) only allows deductions allowed by other Code sections; it does not establish a basis for a deduction that does not exist elsewhere in the Code. Therefore, the Treasury Department and the IRS do not adopt the recommendation that the final regulations contain an offsetting deduction (or a reversal of a net loss item) that is subject to section 1411. Nevertheless, the Treasury Department and the IRS recognize that in some cases it is appropriate to exclude certain nonpassive items of income from net investment income. Accordingly, in the limited and specific situations described in this part of the preamble, the final regulations deem a particular item of income to be "derived in the ordinary course of a trade or business" for purposes of section 1411(c)(1)(A) and therefore excluded from net investment income. However, the Treasury Department and the IRS emphasize that these specific rules contained in these final regulations are for section 1411 purposes only, and thus taxpayers should not draw any inference regarding the treatment of these items for any purpose other than section 1411. See §1.1411–1(c).

i. Treatment of Self-Charged Interest

Commentators noted that, under the proposed regulations, a taxpayer who is not engaged in the trade or business of lending would have net investment income when it receives interest income attributable to a loan made to a passthrough entity in which it materially participates because the offsetting interest expense allocable to the taxpayer from the nonpassive activity would not be a properly allocable deduction under section 1411(c)(1)(B) and §1.1411–4(f). An analogous situation was identified during the 1986 enactment of section 469, which resulted in the promulgation of the self-charged interest rules in §1.469–7.

In response to these comments, the final regulations include a special rule that addresses self-charged interest. The special rule provides that, in the case of self-charged interest received from a nonpassive entity, the amount of interest income excluded from net investment income will be the taxpayer's allocable share of the nonpassive deduction. The rule cross-references the self charged interest rule of §1.469–7 for the operative mechanics. The mathematical result of the special rule is to exclude an amount of interest income from net investment income that is equal to the amount of interest income that would have been considered passive income under §1.469–7 if the nonpassive activity was considered passive activity. However, the special rule contains an exception. The special rule will not apply to a situation where the interest deduction is taken into account in determining self-employment income that is subject to tax under section 1401(b).

ii. Treatment of Certain Nonpassive Rental Activities

With regard to grouping and recharacterizations, commentators recommended that the final regulations clarify that determining whether income is net investment income should be based solely on its recharacterized or grouped status as nonpassive under section 469 and the regulations thereunder. Although the Treasury Department and the IRS recognize the administrative simplicity of this rule, the Treasury Department and the IRS believe that this rule is too broad as it would 'deem' certain items to be derived in a trade or business when it is unlikely that a section 162 trade or business is present. For example, see §§1.469–1T(e)(3)(ii)(D) (rental of property incidental to an investment activity) and 1.469–2T(f)(3) (rental of nondepreciable property). Therefore, the final regulations do not adopt this broad approach.

Another option advanced by some commentators is a special rule for self-charged rents similar to §1.469–7 pertaining to self-charged interest. However, a proposed rule for self-charged rents would be more complex than the rule for self-charged interest because the amount of the net investment income exclusion must take into account the deductions allowed (depreciation, taxes, interest, etc.) that are not present in self-charged interest. A self-charged rent rule would have to exclude from gross income rents in the same way as self-charged interest, and would also exclude a share of the deductions attributable to earning the income. In addition, a rule based on §1.469–7 would cover only rents within the context of section 1411(c)(1)(A)(i) and would not provide relief from the inclusion of the gain upon the sale of the property from net investment income. Accordingly, the final regulations do not adopt this recommendation.

However, the Treasury Department and the IRS appreciate the concerns raised by the commentators. Therefore, the final regulations provide special rules for self-charged rental income. The final regulations provide that, in the case of rental income that is treated as nonpassive by reason of §1.469–2(f)(6) (which generally recharacterizes what otherwise would be passive rental income from a taxpayer's property as nonpassive when the taxpayer rents the property for use in an activity in which the taxpayer materially participates) or because the rental activity is properly grouped with a trade or business activity under §1.469–4(d)(1) and the grouped activity is a nonpassive activity, the gross rental income is deemed to be derived in the ordinary course of a trade or business. Furthermore, in both of these instances, the final regulations provide that any gain or loss from the assets associated with that rental activity that are treated as nonpassive gain or loss will also be treated as gain or loss attributable to the disposition of property held in a nonpassive trade or business.

iii. Treatment of Section 469(c)(7) Real Estate Professionals

With regard to real estate professionals, many commentators recommended that the final regulations provide that, if a real estate professional materially participates in his or her rental real estate activities, then the rental income should be excluded from net investment income. The general theory behind the commentators' recommendation was that such rental income must be derived in the ordinary course of a trade or business because a taxpayer that qualifies as a real estate professional under section 469 is necessarily engaged in a real property trade or business. In certain situations, the Treasury Department and the IRS agree that some real estate professionals derive rental income in the ordinary course of the real property trade or business. However, for several reasons, the Treasury Department and the IRS do not believe that every real estate professional is necessarily engaged in the trade or business of rental real estate.

Section 469(c)(7)(C) provides 11 types of activities that constitute a real property trade or business. Only a few of the 11 enumerated activities may be relevant in determining whether rents are derived in the ordinary course of a trade or business, such as the activities of "rental" and "leasing." Some of the other enumerated items have little, if any, relation to rental activities. For example, an individual engaged in real property construction could satisfy the two tests enumerated in section 469(c)(7)(B) to qualify as a real estate professional, but the construction activities may not have any relation to whether the individual's rental income is derived in the ordinary course of a trade or business. In addition, the scope of activities that a taxpayer may consider in determining whether a real property trade or business exists is broader than the definition of a trade or business for section 1411 purposes. Section 1.469–9(b)(1) states "[a] trade or business is any trade or business determined by treating the types of activities in §1.469–4(b)(1) as if they involved the conduct of a trade or business, and any interest in rental real estate, including any interest in rental real estate that gives rise to deductions under section 212." Therefore, under §1.469–9(b)(1), individuals may establish real estate professional status by combining non-trade or business activities (such as multiple section 212 rental activities) for determining a taxpayer's real property trade or business. Because the analysis under section 469(c)(7) and the regulations thereunder to determine whether a taxpayer is a real estate professional differs from the analysis to determine whether rental income is derived in the ordinary course of a trade or business under section 1411(c)(1)(A)(i), the use of a taxpayer's real estate professional status as a proxy to determine whether rental income is derived in the ordinary course of a trade or business is not appropriate.

Once an individual establishes real estate professional status, that status only allows the taxpayer to treat rental real estate activities as nonpassive if the taxpayer satisfies at least one of the tests for material participation in §1.469–5T in the rental real estate activities. The status as a real estate professional alone does not establish that those rental real estate activities rise to the level of a trade or business within the meaning of section 162. Section 1.469–5T(a) provides seven tests to establish material participation. However, not all of the material participation tests provide conclusive evidence that a taxpayer is regularly, continuously, and substantially involved in a rental trade or business within the meaning of section 162. For example, a real estate broker that satisfies the section 469(c)(7) real estate professional requirements by reason of hours devoted to brokerage could classify his or her real property rental activity as nonpassive by satisfying §1.469–5T(a)(2). Under this test, the taxpayer needs to establish only that the taxpayer's participation in the activity was substantially all of the activity (taking into account all other persons involved in the activity) to establish material participation. As a result, and similar to the case of establishing real estate trade or business, the Treasury Department and the IRS believe that reliance on the §1.469–5T material participation tests as a proxy to establish regular, continuous, and substantial activity within the meaning of section 162 for section 1411 purposes is not appropriate.

The final regulations do, however, provide a safe harbor test for certain real estate professionals in §1.1411–4(g)(7). The safe harbor test provides that, if a real estate professional (within the meaning of section 469(c)(7)) participates in a rental real estate activity for more than 500 hours per year, the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. Alternatively, if the taxpayer has participated in a rental real estate activity for more than 500 hours per year in five of the last ten taxable years (one or more of which may be taxable years prior to the effective date of section 1411), then the rental income associated with that activity will be deemed to be derived in the ordinary course of a trade or business. The safe harbor test also provides that, if the hour requirements are met, the real property is considered as used in a trade or business for purposes of calculating net gain under section 1411(c)(1)(A)(iii). The Treasury Department and the IRS recognize that some real estate professionals with substantial rental activities may derive such rental income in the ordinary course of a trade or business, even though they fail to satisfy the 500 hour requirement in the safe harbor test. As a result, the final regulations specifically provide that such failure will not preclude a taxpayer from establishing that such gross rental income and gain or loss from the disposition of real property, as applicable, is not included in net investment income.

iv. Treatment of Former Passive Activities

Losses disallowed by section 469 stem from (1) expenses incurred in the passive activity or (2) a sale of a portion of the passive activity or property used in the activity, in excess of passive income from any source. Section 1.469–1T(f)(2)(i) and (ii) require taxpayers to trace disallowed losses back to the activities giving rise to the losses and to further trace the losses allocated to a particular activity back to the deductions from the activity giving rise to the net loss. When a taxpayer disposes of a partial interest in a passive activity or disposes of assets used within a passive activity, any losses realized from the disposition are treated as arising from the passive activity and are allocated to that activity. Sections 469(b), (g), and §1.469–1(f)(4) provide that, generally, passive losses that are disallowed in the current year carry forward to the succeeding tax year and remain suspended until the taxpayer has sufficient passive income to offset those losses or otherwise disposes of the entire activity in a fully taxable transaction with an unrelated party.

In cases where a taxpayer materially participates in an activity that was formerly a passive activity, the deductions produced by the activity in the current year are not subject to section 469. However, the carryover (or “suspended”) passive losses incurred in prior years when the activity was a passive activity remain disallowed passive losses subject to carryover. Section 469(f)(1)(A) allows the suspended passive losses when the former passive activity produces current-year net income (even though that income is technically from a nonpassive activity). To the extent the taxpayer has passive losses allocable to a former passive activity in excess of the current year nonpassive income from that activity (the section 469(f)(1)(A) amount), section 469(f)(1)(C) allows excess passive losses to offset net passive income from other passive activities of the taxpayer. Any suspended passive losses not allowed by section 469(f)(1)(A) or (C) remain suspended and are carried over to the following year.

Section 469 does not alter the character or nature of the items that make up the suspended passive loss. If the suspended losses are attributable to operating deductions in excess of operating income, such suspended losses retain that character as deductions described in section 62(a)(1) or 62(a)(4) when ultimately allowed by section 469. To the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character as section 165 losses when they are ultimately allowed by section 469.

If a taxpayer materially participates in a former passive trade or business activity, the gross income produced by that activity (and associated section 1411(c)(1)(B) properly allocable deductions) in the current year generally would not be net investment income because the activity is no longer a trade or business that is a passive activity within the meaning of section 469. However, in the case of rental income not derived in the ordinary course of a trade or business, a classification of the rental income as nonpassive for purposes of section 469 will not result automatically in the exclusion of such rental income and associated deductions from net investment income. Furthermore, it is possible that a section 469 former passive activity may still generate net investment income on its disposition to the extent the gain is included in section 1411(c)(1)(A)(iii) and not entirely excluded by, for example, section 1411(c)(4).

Suspended losses that are allowed by reason of section 469(f)(1)(A) or (C) may constitute properly allocable deductions under section 1411(c)(1)(B) and §1.1411–4(f)(2) (to the extent those losses would be described in section 62(a)(1) or 62(a)(4)) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) and §1.1411–4(d) (to the extent those losses would be described in section 62(a)(3) in the year they are allowed, depending on the underlying character and origin of such losses). The treatment of excess suspended losses of a former passive activity upon a fully taxable disposition is discussed in the next section of this preamble.

The final regulations clarify, for section 1411 purposes, the treatment of income, deductions, gains, losses, and the use of suspended losses from former passive activities. The Treasury Department and the IRS considered three alternatives. One approach is the complete disallowance of all suspended losses once the activity is no longer a passive activity (in other words, becomes a former passive activity or a nonpassive activity). The rationale behind this approach is that the income from the activity would not be includable in net investment income, thus the suspended losses become irrelevant. Another approach is the unrestricted allowance of all suspended losses in the year in which they are allowed by section 469(f), regardless of whether the nonpassive income is included in net investment income. The rationale behind this approach is that the losses were generated during a period when the activity was a passive activity, and if such losses were allowed in full, they would have potentially reduced net investment income, and therefore the losses should continue to retain their character as net investment income deductions. The third approach is a hybrid approach that allows suspended losses from former passive activities in calculation of net investment income (as properly allocable deductions under section 1411(c)(1)(B) or in section

1411(c)(1)(A)(iii) in the case of losses) but only to the extent of the nonpassive income from such former passive activity that is included in net investment income in that year. The final regulations adopt this hybrid approach.

For example, in the case of a former passive trade or business activity with suspended losses of $10,000 that generates $3,000 of net nonpassive income, section 469(c)(1)(A) allows $3,000 of the $10,000 suspended loss to offset the nonpassive income in the current year. Since the gross nonpassive income is not included in section 1411(c)(1)(A)(ii) (or in section 1411(c)(1)(A)(iii) in the case of gains from the disposition of property in such trade or business), none of the deductions and losses associated with such income are properly allocable deductions under section 1411(c)(1)(B) (or in section 1411(c)(1)(A)(iii) in the case of losses from the disposition of property in such trade or business). Thus, under the facts of this example, the final regulations provide that the $3,000 is not a properly allocable deduction (or a loss included in section 1411(c)(1)(A)(iii)). However, to the extent that the remaining suspended passive loss deduction of $7,000 is allowed by section 469(f)(1)(C) to offset other net passive activity income (which is included in net investment income by reason of section 1411(c)(1)(A) less deductions allowed by section 1411(c)(1)(B)), such amounts are considered properly allocable deductions under section 1411(c)(1)(B), or as a loss included in section 1411(c)(1)(A)(iii), as appropriate.

v. Treatment of Losses and Deductions Described in Section 469(g)(1)

Section 469(g)(1) provides, in relevant part, that if all gain or loss realized on a disposition is recognized, the excess of any loss from that activity for such taxable year (determined after the application of section 469(b)), over any net income or gain for that taxable year from all other passive activities (determined after the application of section 469(b)), shall be treated as a loss which is not from a passive activity. The preamble to the proposed regulations requested comments on "whether the losses triggered under section 469(g)(1) upon the disposition should be taken into account in determining the taxpayer's net gain on the disposition of the activity under section 1411(c)(1)(A)(iii) or whether the losses should be considered properly allocable deductions to gross income and net gain described in section 1411(c)(1)(A)(i) through (iii)." Because section 469(g)(1) provides that the allowed loss is treated as a loss "which is not from a passive activity," there is a question whether this language prevents the allowed losses from being treated as "properly allocable deductions" from passive activities for purposes of section 1411.

Commentators recommended that losses allowed under section 469(g) be taken into account in computing net gain under section 1411(c)(1)(A)(iii), and that any net loss in section 1411(c)(1)(A)(iii) resulting from the use of such losses should be treated as a properly allocable deduction under section 1411(c)(1)(B). One commentator suggested that, to the extent a taxpayer has a net loss under section 1411(c)(1)(A)(iii) that is attributable to the allowed loss under section 469(g), the excess section 469(g) loss should continue to be suspended and carried forward to offset future gain resulting from the disposition of other passive assets subject to inclusion in section 1411(c)(1)(A)(iii).

The final regulations provide that section 469(g) losses, which are treated as losses from a nonpassive activity, are taken into account for net investment income purposes in the same manner in which they are taken into account for chapter 1 purposes. As discussed in the context of section 469(f), section 469 does not alter the character or nature of the suspended passive loss. If the suspended losses allowed as a current year deduction by reason of section 469(g)(1) are attributable to operating deductions in excess of operating income, such suspended losses retain that character as, in most cases, deductions described in section 62(a)(1) or 62(a)(4). However, to the extent the suspended losses are comprised of losses originating from the disposition of property (such as ordinary section 1231 losses or capital losses), those losses also retain their character when they are ultimately allowed by section 469. Therefore, losses that are allowed by reason of section 469(g) may constitute properly allocable deductions under section 1411(c)(1)(B) or may be included within the calculation of net gain in section 1411(c)(1)(A)(iii) in the year they are allowed, depending on the underlying character and origin of such losses. The recommendations proposed by the commentators depart from the general operating principles in chapter 1 and add additional complexity. Therefore, the final regulations do not adopt the positions advanced by commentators that section 469(g)(1) suspended losses should offset the gain first, then be allowed as a properly allocable deduction or that it should continue to be suspended and carried forward.

Furthermore, section 469(g)(1) losses that are allowed by reason of a fully taxable disposition of a former passive activity are also fully taken into account for net investment income. As a result of the ordering rules in sections 469(f)(1) and (g)(1), any nonpassive gain realized on the disposition that causes passive losses to be allowed would be excluded from net investment income under the general former passive activity rules discussed in part 5.E.iv of this preamble. However, to the extent that any of the nonpassive gain is included in net investment income (for example, a portion of the gain remaining after the application of section 1411(c)(4)), the final regulations allow the same amount of suspended losses described in section 469(f)(1)(A) to be included in net investment income to offset the gain. The section 469(g)(1) losses allowed by reason of the disposition of the former passive activity are allowed in full because they relate to a period of time when the activity was a passive activity and represent true economic losses from a passive activity that do not materially differ from other section 469(g)(1) losses from non-former passive activities.

F. *Other comments relating to the calculation of net investment income*

The Treasury Department and the IRS received comments requesting that these final regulations address the treatment for section 1411 purposes of section 707(c) guaranteed payments for capital, section 736 payments to retiring or deceased partners, Real Estate Mortgage Investment

Conduits (REMICs), and certain notional principal contracts. After consideration of these comments, the Treasury Department and the IRS believe that it is appropriate to address the treatment of these payments in regulations. However, because such guidance was not included in the proposed regulations, these items are addressed in a companion notice of proposed rulemaking (REG–130843–13) relating to the Net Investment Income Tax.

6. *Section 1411 Trades or Businesses*

Section 1411(c)(1)(A) defines net investment income, in part, by reference to trades or businesses described in section 1411(c)(2). The trades or businesses described in section 1411(c)(2) are: (A) a passive activity (within the meaning of section 469) with respect to the taxpayer, and (B) trading in financial instruments or commodities (as defined in section 475(e)(2)).

A. *Passive activities*

The preamble to the proposed regulations stated that "the statutory language in sections 1411(c)(1)(A) and 1411(c)(2)(A) is intended to take into account only gross income from and net gain attributable to a passive activity that involves the conduct of a trade or business." The preamble to the proposed regulations acknowledged that, due to the differences in the definitions for purposes of section 1411 and section 469, gross income from some activities that are passive activities under section 469 will not be taken into account for purposes of section 1411(c)(1)(A)(ii) because the gross income is derived from an activity that does not rise to the level of a trade or business (within the meaning of section 162). In such cases, the gross income will not be taken into account under section 1411 unless it is taken into account under section 1411(c)(1)(A)(i) or section 1411(c)(1)(A)(iii).

The Treasury Department and the IRS have received several comments and inquiries regarding the consequences of the income recharacterization rules. The regulations under section 469 provide special rules that treat income from certain passive activities as not from a passive activity. See §1.469–2T(f)(2) (special rule for significant participation); §1.469–2T(f)(3) (rental of nondepreciable property); §1.469–2T(f)(4) (net interest income from passive equity-financed lending activity); §1.469–2(f)(5) (net income from certain property rented incidental to development activity); §1.469–2(f)(6) (property rented to a nonpassive activity); §1.469–2T(f)(7) (special rules applicable to the acquisition of an interest in a passthrough entity engaged in the trade or business of licensing intangible property). In addition, the preamble to the proposed regulations highlighted a special gain recharacterization rule in §1.469–2(c)(2)(iii) applicable to gains attributable to the disposition of substantially appreciated property formerly used in a nonpassive activity.

In order for these section 469 recharacterization rules to apply, the income or gain subject to recharacterization must be passive activity income under the general section 469 operating rules. If the income is nonpassive by reason of some other provision of section 469 (such as a taxpayer materially participating in the activity), the recharacterization rules are not applicable because there is no passive income to recharacterize.

In general, commentators had different opinions regarding the treatment under section 1411(c)(1) of income that is recharacterized under the rules in section 469. In the case of income from a passive activity trade or business, some commentators stated that net investment income does not include any amount of income or gain that is recharacterized as "not from a passive activity," either because it satisfies the ordinary course exception (derived in the ordinary course of a trade or business not described in section 1411(c)(2)) in section 1411(c)(1)(A)(i) or (iii), or because such income is not income within the scope of section 1411(c)(1)(A)(ii). Other commentators stated that such nonpassive income qualifies as net investment income under section 1411(c)(1)(A) because the activity's status as a passive activity trade or business described in section 1411(c)(2)(A) is unchanged, despite section 469's recharacterization of a portion of the income or gain to income "not from a passive activity."

Another commentator recommended that the final regulations not apply a single rule to all income recharacterization situations because the underlying section 469 rationale differs for each one. The commentator stated that the various income recharacterization rules do not recharacterize all the income and gains in the same way. In the case of income recharacterizations covered by §§1.469–2T(f)(3), 1.469–2T(f)(4), and 1.469–2T(f)(7), such income is further characterized as portfolio income (within the meaning of section 469(e)(1)(A)) by §1.469–2T(f)(10). In the case of the recharacterization of gains under §1.469–2(c)(2)(iii), the characterization of the gain as portfolio income is determined under §1.469–2(c)(2)(iii)(F) based on whether the property was held in an investment activity before it was used in a passive activity. The commentator recommended that the final regulations distinguish recharacterized income treated as portfolio income from recharacterized income not treated as portfolio income.

Section 1.1411–5(b)(2) of the final regulations provides clarification regarding the interaction between the net income recharacterization rules under section 469 and the section 1411 rules. For purposes of section 1411, the final regulations generally follow the section 469 characterization of the income and gain, particularly the treatment of the items as portfolio income. Section 1.1411–5(b)(2) of the final regulations provides that, to the extent that income or gain from a trade or business is subject to a net income recharacterization rule described in §§1.469–2T(f)(2), §1.469–2(f)(5), or §1.469–2(f)(6), the gross income or gain treated as "not from a passive activity" will not be considered derived from a trade or business described in section 1411(c)(2)(A). In addition, any gain recharacterized as "not from a passive activity" by reason of §1.469–2(c)(2)(iii) is not derived from a trade or business described in section 1411(c)(2)(A) if the gain does not constitute portfolio income under §1.469–2(c)(2)(iii)(F). In the case of recharacterization rules covered by §1.469–2T(f)(10) and §1.469–2(c)(2)(iii)(F), the underlying trade or business remains a passive activity within the meaning of section 1411(c)(1)(A) and §1.1411–5(a)(1).

B. *Trading in financial instruments or commodities*

The proposed regulations provided that, for purposes of section 1411(c)(2)(B), to determine whether gross income is derived from a section 162 trade or business of trading in financial instruments or commodities, the gross income must be derived from an activity that would constitute trading for purposes of chapter 1. Section 1.1411–5(c)(1) of the proposed regulations defined the term *financial instrument* to include 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 listed items. An evidence of an interest in any of these listed items includes, but is not limited to, short positions or partial units in any of these listed items.

Two comments were received regarding the definition of a financial instrument in the proposed regulations. One commentator asked for explicit language that financial instruments that are used in a trade or business and produce foreign currency gain are exempt from section 1411. The same commentator requested that the proposed definition of a financial instrument be narrowed so that it would exclude "non-financial instruments," such as contracts that reference electricity or weather. Another commentator suggested that the term "stock" in the definition of a financial instrument be replaced with the phrase "security as defined in section 2(a)(1) of the Securities Act of 1933" to broaden the scope of the definition.

With respect to the first comment, foreign currency gain or loss that otherwise is not subject to the Self-Employment Contribution Act is appropriately treated as net investment income. Regarding the definition of a financial instrument, the Treasury Department and the IRS believe that Congress chose that term to capture a broader class of instruments than the securities described in section 475. The suggestion to limit the definition of a "financial instrument" to exclude a derivative that is referenced to non-financial information, such as electricity or weather, would not be consistent with the intention to include in net investment income the income from all types of investment property. With respect to the second comment, there is no indication that Congress intended the definition of the term "financial instrument" to be coextensive with the definition of the term "security" used by the SEC, as evidenced by the fact that section 1411(c)(2)(B) uses the term "financial instrument," not "security." Accordingly, after consideration of both comments, neither suggestion was adopted in the final regulations.

7. *Comments Regarding Working Capital*

Section 1411(c)(3) provides that a rule similar to the rule of section 469(e)(1)(B) (the working capital rule) applies for purposes of section 1411. Section 469(e)(1)(B) provides that, for purposes of determining whether income is treated as from a passive activity, any income or gain attributable to an investment of working capital is treated as not derived in the ordinary course of a trade or business. Section 1.469-2T(c)(3)(iii) provides an exception to the portfolio income characterization rule for items that are derived in the ordinary course of a trade or business. Section 1.1411–6(a) of the proposed regulations provided that, for purposes of section 1411(c)(3), working capital and the income generated therefrom will be determined under principles similar to those described in §1.469–2T(c)(3)(ii).

Several commentators noted that the proposed regulations lack an adequate definition of "working capital" for purposes of section 1411. One commentator stated that the application of section 1411 is too restrictive because it taxes all working capital as income not derived in the ordinary course of business. Another commentator noted that the regulations should clearly define what property is considered working capital, particularly where capital is invested in a trade or business that either does not rise to the level of a trade or business under section 1411(c)(2)(A) or a trading business described in section 1411(c)(2)(B) that generates nonpassive income. One commentator noted that the cross-reference to working capital in section 469 does not account for the different purposes of the two statutory schemes. Commentators also stated that, if the final regulations do not elaborate on the definition of working capital, taxpayers must speculate where the dividing line is between active business assets and working capital.

Several commentators requested that the final regulations include a more comprehensive definition of working capital. One commentator recommended that proposed §1.1411–6 be withdrawn and replaced with industry-specific guidelines for a safe harbor. Another commentator suggested the final regulations exclude income generated from liquid, short-term investments, such as interest-bearing bank accounts, from the definition of working capital and further exclude a reasonable amount of working capital.

The specific cross-reference in section 1411(c)(3) to section 469(e)(1)(B) indicates Congress' intent that the definition of working capital in §1.1411–6 be consistent with the rules in section 469(e)(1)(B) and §1.469–2T(c)(3)(ii). Accordingly, the proposed regulations intentionally aligned the section 1411 treatment of working capital with the section 469 rules. In addition, the rule in the proposed regulations avoids complexity that divergent definitions would have on tax administration and compliance. The Treasury Department and the IRS appreciate that certain businesses require different amounts of working capital based on their industries or general business practices, but the Treasury Department and the IRS do not believe that the promulgation of working capital definitions based on industry-specific characteristics would be administrable. Further, if the rules on working capital were materially different for section 469 and section 1411 purposes, such items would have to be reevaluated annually and would require detailed accounting and reporting burdens for both the IRS and taxpayers. As a result, the final regulations retain the provisions in proposed §1.1411–6 without change. However, see part 5.A.ii.(b) of this preamble for a discussion of changes to the proposed regulations regarding items derived in the ordinary course of a trade or business.

8. *Comments Regarding the Calculation of Gain or Loss Attributable to the Disposition of Interests in Partnerships and S Corporations*

The proposed regulations described the method for adjusting a transferor's gain or loss from the disposition of a partnership interest or S corporation stock based on the entity's ownership of assets that are nonpassive with respect to the transferor. Under that method, a transferor first computes its gain (or loss) on disposition of its interest in the entity, and then reduces that gain (or loss) by the amount of nonpassive gain (or loss) that would have been allocated to the transferor upon a hypothetical sale of all of the entity's assets for fair market value immediately before the transfer.

Several commentators questioned the proposed regulations' methodology for adjusting a transferor's gain or loss on the disposition of its partnership interest or S corporation stock. These commentators noted that section 1411(c)(4) requires that gain (or loss) from such dispositions be taken into account under section 1411(c)(1)(A)(iii) "only to the extent of the net gain [or loss] which would be taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest." The commentators suggested that section 1411(c)(4) therefore includes gain/loss from the disposition of a partnership interest or S corporation stock only to the extent of the transferor's share of gain/loss from the entity's passive assets. Thus, under the commentator's approach, the amount of gain or loss included in section 1411(c)(A)(iii) is the lesser of a taxpayer's gain on the disposition of the interest or the taxpayer's share of gain or loss on the deemed sale of the entity's assets that would be included in calculating the taxpayer's net investment income. Commentators also discussed the complexity of the proposed regulations, stating that the regulations imposed a high compliance burden, including requiring a transferor to obtain information from the entity regarding valuation and tax basis.

After considering these comments, the Department of Treasury and the IRS are withdrawing the proposed regulations that address this issue and are issuing new proposed regulations under §1.1411–7 adopting the commentators' suggestion, which are being published contemporaneously with these final regulations (REG–130843–13).

9. *Comments Regarding the Exclusion of Certain Income under Section 1411(c)(5)*

Section 1411(c)(5) provides that net investment income does not include any distribution from the following plans or arrangements:

(1) A qualified pension, stock bonus, or profit-sharing plan under section 401(a);

(2) A qualified annuity plan under section 403(a);

(3) A tax-sheltered annuity under section 403(b);

(4) An individual retirement account (IRA) under section 408;

(5) A Roth IRA under section 408A; or

(6) A deferred compensation plan of a State and local government or a tax-exempt organization under section 457(b).

Section 1.1411–8(a) of the proposed regulations provided that, for purposes of section 1411, any amount actually distributed from a qualified plan or arrangement is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. The final regulations generally retain the rules in the proposed regulations relating to whether an amount is a distribution from a plan within the meaning of section 1411(c)(5) and, thus, excluded from net investment income. In addition, the final regulations retain the rule that, for purposes of section 1411, amounts that are deemed distributions under the Code for income tax purposes are distributions for purposes of section 1411(c)(5), even if these distributions are not treated as actual distributions for purposes of the qualification requirements under section 401(a). The final regulations also retain the rule in the proposed regulations that any amount that is not treated as a distribution for purposes of the qualification requirements under the Code, but is otherwise includible in gross income pursuant to a rule relating to amounts held in a qualified plan or arrangement is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income.

One commentator asked for clarification on the application of section 1411 to employer securities. The commentator specifically asked for clarification on whether section 1411 applies to dividends on employer securities held by an employee stock ownership plan (as defined in section 4975(e)(7) of the Code) that are paid directly to plan participants. A-3 of §1.404(k)–1T provides that a deductible dividend under section 404(k) that is paid directly to a plan participant or beneficiary is treated as a distribution under the plan for purposes of sections 72, 401, and 402 of the Code. The final regulations clarify that any dividend that is deductible under section 404(k) and is paid in cash directly to a plan participant or beneficiary is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. This rule does not apply to amounts paid as a dividend after the employer securities have been distributed from a qualified plan. Those amounts paid as dividends are included in net investment income.

The commentator also asked for clarification on whether section 1411 applies to the net unrealized appreciation realized on a disposition of employer securities that occurs after the securities were distributed from a qualified plan. Section 402(e)(4) provides that the net unrealized appreciation in employer securities that are distributed from a qualified plan is excluded from gross income in the year of the distribution in certain circumstances. In the case of a lump-sum distribution (within the meaning of section 402(e)(4)(D)), the net unrealized appreciation in the employer securities distributed is excluded from gross income. In the case of any other distribution (other than a distribution that is not currently taxable under the rollover rules), the net unrealized appreciation in the employer securities distributed is generally excluded from gross income only to the extent that it is attributable to after-tax employee contributions. Net unrealized appreciation is defined in §1.402(a)–1(b)(2)(i) as the excess of the market value of employer securities at the time of distribution over the cost or other basis of such securities to the trust. The final regulations clarify that any such net unrealized appreciation in employer securities that is realized in a disposition of those employer securities is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. The regulations also provide that any appreciation in value that occurs subsequent to the distribution of the employer securities from a qualified plan is included in net investment income when realized.

10. *Comments Regarding the Interaction between Section 1411 and Self-Employment Tax*

Section 1411(c)(6) provides that net investment income does not include items taken into account in determining self-employment income for such taxable year on which a tax is imposed by section 1401(b). Several commentators, in considering the interaction of self-employment tax and section 1411, suggested that the regulations clarify that a taxpayer who is fully employed by a limited liability company (LLC) or a limited liability partnership (LLP) materially participates in that entity, and, therefore, the taxpayer's distributive share of income from the LLC or LLP is self-employment income for which a tax is imposed by section 1401. The final regulations do not adopt this suggestion because the imposition of self-employment taxes on LLC members and partners of an LLP is outside the scope of these regulations.

Proposed §1.1411–9(b) provided a special rule for traders; specifically that deductions described in proposed §1.1411–4(f)(2)(ii) that do not reduce a taxpayer's net earnings from self-employment (after aggregating the net earnings from self-employment from all of the taxpayer's trades or business) are not considered taken into account for purposes of section 1411(c)(6) and may be considered in determining the taxpayer's net investment income under section 1411. One commentator suggested that this rule be amended to provide that a taxpayer can elect whether properly allocable deductions related to the taxpayer's trade or business of trading in financial instruments or commodities reduce net earnings from self-employment. The expenses of a trader maintaining a trade or business of trading in financial instruments or commodities are taken into account for purposes of determining self-employment income. Thus, such expenses, but for the special rule in §1.1411–9(b), could not be used to reduce net investment income. The Treasury Department and the IRS believe that a trader should be able to reduce net investment income by amounts not used to reduce net earnings from self-employment income. Thus, the special rule is an exception under section 1411 for the benefit of taxpayers. The special rule was not intended to alter the result under the self-employment tax provisions. Accordingly, the final regulations do not adopt the commentator's suggestion.

11. *Comments Regarding the Section 1411 Treatment of Controlled Foreign Corporations and Passive Foreign Investment Companies*

A. *Income derived from a trade or business described in section 1411(c)(2)*

Pursuant to section 1411(c)(1)(A)(ii), gross income derived from a trade or business described in section 1411(c)(2) is net investment income. A trade or business is described in section 1411(c)(2) if it is a passive activity (within the meaning of section 469) with respect to the taxpayer or a trade or business of trading in financial instruments or commodities (as defined in section 475(e)(2)). Proposed §1.1411–10(b), which applies to certain owners of controlled foreign corporations (CFCs) and passive foreign investment companies (PFICs), provides that the special rules in proposed §1.1411–10 do not apply to income derived by those taxpayers from a trade or business described in section 1411(c)(2) and §1.1411–5. Instead, such income is included in net investment income under section 1411(c)(1)(A)(ii) and §1.1411–4(a)(1)(ii).

A commentator asked if the determination of whether income is "derived from" a trade or business described in section 1411(c)(2) for §1.1411–10(b) purposes is made by reference to the trade or business of the CFC or the PFIC, or the trade or business of the taxpayer (or passthrough entity in which the taxpayer invests) that holds the CFC or PFIC. The commentator noted that the rules in proposed §1.1411–4(b) provided guidance on determining whether income is derived in a trade or business for purposes of section 1411(c)(1)(A)(ii). However, the commentator stated that the rule in proposed §1.1411–10(b) may be of limited applicability if the rules in §1.1411–4(b) apply for purposes of proposed §1.1411–10(b). Section 1.1411–10(b)(1) of these final regulations clarifies that the trade or business determination for purposes of §1.1411–10(b) is made pursuant to the rules set forth in §1.1411–4(b)(2), which provide that the determination is either based on the taxpayer's trade or business or the trade or business of the passthrough entity in which the taxpayer invests.

Commentators also recommended that guidance be provided regarding the application of §1.1411–10(b) to income derived from a trade or business that is a passive activity within the meaning of section 469 because of a concern that taxpayers may not be treated as engaged in a passive activity with respect to a CFC or qualified electing fund (QEF). Although theoretically the definition of "passive activity" under section 469 could include holding an interest in a CFC or PFIC, the commentators pointed out that amounts included in income under sections 951(a) (section 951 inclusions) and 1293(a) (section 1293 inclusions) are excluded from the definition of "passive income" for section 469 purposes, and, instead, are treated as portfolio income under §1.469–2T(c)(3)(i)(A). The commentators stated that the exclusion of these items from "passive income" may mean that income derived from CFCs and QEFs would never be treated as income derived from a "passive activity." In such a case, §1.1411–10(b) would never apply to a section 951 inclusion or section 1293 inclusion even if the inclusion was derived from a CFC or QEF held in a trade or business that is a passive activity. After consideration of the comments, the Treasury Department and the IRS do not believe that the final regulations need to be clarified in order for §1.1411–10(b) to apply to a taxpayer that holds a CFC or QEF in a trade or business that is a passive activity with respect to the taxpayer. Section 1411(c)(2)(A) and the regulations promulgated thereunder cross-reference section 469 solely for purposes of defining "passive activity." Section 1.1411–10 does not cross-reference the section 469(e) rules, which provide guidance on whether income is treated as income from a passive activity, or the rule in §1.469–2T(c)(3)(i)(A), which addresses portfolio income. In addition, §1.469–1T(d)(1) provides that the characterization of items of income as passive activity gross income (within the meaning of §1.469–2T(c)) applies only for purposes of section 469. The rule in §1.1411–10(b) does not incorporate the section 469 rules on portfolio income, and, thus, applies to income derived by a taxpayer from a CFC or QEF that is held in a trade or business that is a passive activity within the meaning of section 469.

The Treasury Department and the IRS also received a comment that addressed the application of the rules in §1.1411–10(b) when a taxpayer holds a CFC or PFIC in connection with a trade or business described in section 1411(c)(2) in some, but not all, years. The commentator explained that the trade or business determination is made on an annual basis, which creates the potential for taxpayers to alternate between being subject to the rules in §1.1411–10(b) and the other applicable rules in §1.1411–10 on an annual basis. As a result, when a taxpayer does not make an election under §1.1411–10(g), a taxpayer could either be subject to double taxation under section 1411, or could avoid tax under section 1411, depending on the facts and circumstances. The commentator suggested that the trade or business determination that was in effect in the year in which the taxpayer acquired an interest in a CFC or PFIC should apply to all years in which the taxpayer holds the CFC or PFIC. Although the Treasury Department and the IRS do not adopt the commentator's suggested approach, the final regulations coordinate the application of the rules in §1.1411–10 when a taxpayer's trade or business determination, either as a trader or for passive activity purposes, causes the taxpayer to alternate between being subject to §1.1411–10(b) and the other applicable rules in §1.1411–10, to eliminate both the possibility of double taxation and the avoidance of taxation.

B. *Income derived from CFCs and QEFs*

In general, the proposed regulations provided that distributions of previously taxed earnings and profits attributable to section 951 inclusions and section 1293 inclusions are dividends for purposes of section 1411, absent an election under §1.1411–10(g). If a taxpayer made the §1.1411–10(g) election, the proposed regulations provided that section 951 inclusions and section 1293 inclusions (rather than the distributions of previously taxed earnings and profits) are treated as dividends for purposes of section 1411.

Commentators recommended that the Treasury Department and the IRS revise the final regulations to treat section 951 inclusions and section 1293 inclusions as dividends for purposes of section 1411 (without regard to any election by the taxpayer), rather than treating the distributions of previously taxed earnings and profits attributable to section 951 inclusions or section 1293 inclusions (that were included in chapter 1 income in a taxable year beginning after December 31, 2012) as dividends. The commentators stated that the rules in the proposed regulations applicable to CFCs and QEFs when an election under §1.1411–10(g) is not in effect are unduly complicated and impose significant administrative burdens on taxpayers. A commentator also recommended modifying the regulations to generally impose section 1411 when section 951 inclusions and section 1293 inclusions are taxed for purposes of chapter 1, and permit taxpayers to elect to defer such tax until the distribution of the earnings and profits that previously were taxed pursuant to sections 951(a) or 1293(a) (in a taxable year beginning after December 31, 2012).

As set forth in the preamble to the proposed regulations, section 951 inclusions and section 1293 inclusions are not treated as dividends except when expressly provided for in the Code. See *Rodriguez v. Commissioner*, 137 T.C. 174 (2011), *aff'd*. 722 F.3d 306 (5th Cir. 2013). Accordingly, the Treasury Department and the IRS do not adopt the commentators' recommendations to treat section 951 inclusions and section 1293 inclusions as dividends for purposes of section 1411. For the same reason, the Treasury Department and the IRS do not adopt the recommendation to provide a default rule that would treat section 951 inclusions and section 1293 inclusions as subject to section 1411 when the inclusions are taken into account for purposes of chapter 1, unless the taxpayer affirmatively elected to defer taxation under section 1411 until the distribution of earnings and profits related to the inclusions.

The Treasury Department and the IRS also received a comment that recommended the application of a look-through approach for determining whether income derived with respect to a CFC or QEF is included in net investment income. Pursuant to a look-through approach, taxpayers would determine whether section 1411 applied to a section 951 inclusion or section 1293 inclusion by analyzing the income earned directly by the CFC or QEF that gave rise to the inclusion. The Treasury Department and the IRS do not adopt this recommendation because the approach raises administrative and compliance concerns, including concerns regarding the ability of QEF shareholders to compel a QEF to provide them with the information necessary to comply with a look-through rule.

A commentator pointed out that the same earnings could be subject to section 1411 tax twice if a taxpayer that made an election under §1.1411–10(g) subsequently transfers CFC or QEF shares to a taxpayer that does not make the election. The Treasury Department and the IRS agree with the commentator that the earnings and profits of a CFC or QEF should be subject to tax under section 1411 only once. Accordingly, these final regulations provide that if earnings and profits of a CFC or QEF were included in the net investment income of an individual, estate, or trust pursuant to a §1.1411–10(g) election, then a subsequent distribution of those earnings is excluded from the net investment income of any transferee, provided that the transferee can establish entitlement to the exclusion under rules similar to the rules in §1.959–1(d) (which establish a successor in interest's ability to exclude from chapter 1 income the previously taxed earnings and profits with respect to an interest in a CFC acquired from another person).

In addition, the commentator noted a separate double counting issue with respect to earnings and profits that are included in income as a dividend under section 1248. For example, a seller would be subject to tax under section 1411 when it includes the earnings and profits in income as a dividend under section 1248, and a purchaser who did not make an election under §1.1411–10(g) also would be subject to tax under section 1411 on a subsequent distribution of the earnings and profits because the distribution would be treated as a dividend for purposes of section 1411. The Treasury Department and the IRS agree that it is appropriate to prevent double taxation in the section 1248 context, and these final regulations include a rule that prevents double taxation with respect to amounts treated as a dividend under section 1248 for purposes of section 1411.

The final regulations include a new rule that applies when a taxpayer makes an election under §1.1411–10(g) effective for taxable years beginning after December 31, 2013, but does not make an election under §1.1411–10(g)(4)(iii) for a taxable year beginning before January 1, 2014 (2013 taxable year), and the taxpayer is subject to section 1411 in the 2013 taxable year. Under the new rule, any distributions of previously taxed earnings and profits during taxable years beginning after December 31, 2013, that are attributable to section 951 and 1293 inclusions in the 2013 taxable year, will be treated as dividends for purposes of section 1411 notwithstanding the election under §1.1411–10(g). Without this rule, it may be possible to avoid taxation under section 1411 for any section 951 and 1293 inclusions during the 2013 taxable year. This is so because those inclusions would not be subject to tax under section 1411 during the 2013 taxable year in the absence of an election under §1.1411–10(g) and, as a result of the election under §1.1411–10(g) for taxable years beginning after December 31, 2013, distributions of previously taxed earnings and profits accrued in the 2013 taxable year would not be subject to section 1411. In order to simplify taxpayer record-keeping, for purposes of applying this special rule, distributions of previously taxed earnings and profits from the CFC or QEF during taxable years beginning after December 31, 2013, will be deemed to first come out of previously taxed earnings and profits attributable to section 951 and 1293 inclusions in the 2013 taxable year.

The Treasury Department and the IRS received a comment that suggested adding an example to the final regulations to illustrate a situation in which the earnings and profits of a CFC are never subject to section 1411 under section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i). The suggested example would include a fact pattern in which a taxpayer that did not make an election under §1.1411–10(g) includes a section 951 inclusion in income for chapter 1 purposes. In the next year, and before the distribution of earnings and profits attributable to the section 951 inclusion, the taxpayer sells the CFC shares for no gain or loss (as computed for purposes of section 1411) to a taxpayer that makes an election under §1.1411–10(g) with respect to the CFC. Under these facts, the earnings and profits related to the section 951 inclusion are never subject to tax under section 1411. The Treasury Department and the IRS believe that the application of §1.1411–10 to this fact pattern is clear, and that an example is not necessary to illustrate the relevant provisions of §1.1411–10. The commentator also asked that the final regulations clarify the meaning of the phrase "with respect to which an election under paragraph (g) of this section is not in effect." The final regulations clarify that the references in §1.1411–10 to an election under paragraph (g) not being in effect refer to the person that is determining the section 1411 consequences with respect to holding a particular CFC or QEF.

The Treasury Department and the IRS requested comments on whether guidance is necessary to determine the deductions that are properly allocable to items of net investment income if the election under §1.1411–10(g) is not made. One such comment was received regarding the allocation of interest expense under section 163(d)(1). Section 1.1411–4(f)(3)(i) allows interest expense as a deduction against net investment income only to the extent allowed under section 163(d)(1), which limits investment interest expense in part based on a taxpayer's investment income. In the absence of an election under §1.1411– 10(g), differences may occur in the timing of income derived with respect to CFCs and QEFs for chapter 1 and chapter 2A purposes. The commentator suggested that, where differences in timing occur, taxpayers should be allowed to calculate their section 163(d)(1) investment interest expense deduction based on amounts included in income for section 1411 purposes, in determining the amount of investment interest expense allocable to net investment income under section 1411. The Treasury Department and the IRS agree with this comment and these final regulations provide that the section 163(d)(1) investment interest expense deduction related to items of net investment income described in §1.1411–10(c) may be calculated for purposes of section 1411 by adjusting section 163(d)(1)(B) "investment income" for purposes of section 1411 to reflect the inclusions under section 951 and section 1293 that are not included in section 1411 net investment income, and the distributions of previously taxed earnings and profits that are included in section 1411 net investment income. To the extent that the taxpayer chooses to calculate any of these deductions based on the amount of net investment income described in §1.1411–10(c), that method of calculation must be consistently applied for purposes of section 1411 and may only be changed with the consent of the IRS.

C. *CFCs and QEFs held through domestic partnerships and S corporations*

A comment was received on the conforming basis adjustment rules in §1.1411–10(d)(2) that apply to a taxpayer that owns an interest in a CFC or QEF through a domestic partnership and that does not make an election under §1.1411–10(g). The commentator stated that it was unclear whether basis adjustments pass through for both section 951 inclusions and distributions of previously taxed earnings and profits. The Treasury Department and the IRS believe that the rules in §1.1411–10(d), which apply only for purposes of section 1411, adequately address the basis consequences specific to section 1411 that occur when a domestic partnership receives a distribution of previously taxed earnings and profits. The Treasury Department and the IRS believe that general questions about basis adjustments in the context of CFCs and QEFs held through passthrough entities would be more appropriately addressed in guidance under chapter 1.

The Treasury Department and the IRS received a comment that recommended issuing proposed rules regarding adjustments to basis under section 743 for section 1411 purposes. The commentator requested that the regulations clarify that basis adjustments under section 743 relate solely to the transferee and that transferee partners be permitted to adjust the basis of partnership property for purposes of section 1411 regardless of whether the partnership has elected under section 754 or has a substantial built-in loss. Under these regulations, except as otherwise provided, chapter 1 principles and rules apply in determining the tax under section 1411. Therefore, the Treasury Department and the IRS have determined that it is unnecessary to clarify that basis adjustments under section 743 relate solely to the transferee partner because this result is clear under existing law for purposes of chapter 1. The Treasury Department and the IRS have further determined that allowing a transferee partner to adjust its basis in partnership property when the partnership is not otherwise required to do so could create unnecessary administrative complexity for the partnership. Thus, the Treasury Department and the IRS have decided that additional rules relating to section 743 for section 1411 purposes are not necessary.

A comment was received that recommended that a rule be added to the final regulations to require partnerships to provide their partners with the information needed by the partners to compute their tax under section 1411 with respect to CFCs and PFICs held by the partnerships. The Treasury Department and the IRS do not adopt this recommendation. Rather, the IRS is in the process of revising the relevant IRS forms and instructions (such as Form 1065, *U.S. Return of Partnership Income*, and the associated Schedule K-1) to require partnerships and S corporations to provide to their partners and shareholders the information necessary to compute their tax under section 1411 with respect to CFCs and PFICs held by partnerships and S corporations.

A commentator recommended that the final regulations include a rule to treat a section 751(c) amount corresponding to the amount included in income as a dividend under section 1248 for section 1411 purposes as net investment income under section 1411(c)(1)(A)(i) rather than under section 1411(c)(1)(A)(iii). In the alternative, the commentator requested that an example be added to the final regulations to illustrate the operation of section 751 (taking into account section 1248) when a partner sells an interest in a partnership that holds CFC stock. The Treasury Department and the IRS believe that the section 1411 characterization of the section 751(c) amount that corresponds to a section 1248 dividend should be consistent with the chapter 1 characterization and not treated as a dividend, and thus do not adopt the recommendation to treat the amount as net investment income under section 1411(c)(1)(A)(i) or add an example to the final regulation.

D. *Section 1.1411–10(g) election applicable to CFCs and QEFs*

The proposed regulations permitted individuals, estates, and trusts to make an election pursuant to §1.1411–10(g) to include section 951 inclusions and section 1293 inclusions in net investment income in the same manner and in the same taxable year as the amounts are included in income for chapter 1 purposes. Under the proposed regulations, the election was required to be made on or before the due date for filing the individual's, estate's, or trust's income tax return for the first taxable year that the individual, estate, or trust holds stock of a CFC or QEF and was subject to tax under section 1411 or would be subject to tax under section 1411 if the election were made. Under the proposed regulations the election, if made, applied to all CFCs and QEFs held directly or indirectly by the individual, estate, or trust, regardless of whether the interest in the CFC or QEF is held in the year the election is made or is acquired subsequently.

Commentators suggested that the §1.1411– 10(g) election should be permitted to be made on an entity-by-entity basis, rather than to all CFCs and QEFs held by the taxpayer, or subsequently acquired. The Treasury Department and the IRS adopt this recommendation, and these final regulations provide that the §1.1411–10(g) election is made on an entity-by-entity basis.

The Treasury Department and the IRS received comments recommending that domestic partnerships and S corporations be allowed to make the §1.1411–10(g) election. The commentators stated that the partner (or shareholder) level election would create an administrative burden for the partnership (or S corporation) because it would require the partnership (or S corporation) to maintain two sets of records with respect to its CFC and QEF investments: one for chapter 1 purposes and one for section 1411 purposes. In response to these comments, the final regulations include a rule that allows a domestic partnership, S corporation, or common trust fund to make the election in §1.1411–10(g) for taxable years that begin after December 31, 2013. In addition, a domestic partnership, S corporation, or common trust fund can make the election in §1.1411–10(g) for a taxable year beginning before January 1, 2014, if all of the partners, shareholders, or participants (as the case may be) consent to the election. The final regulations also provide that a §1.1411–10(g) election may be made with respect to interests in CFCs or QEFs held indirectly through certain domestic entities such as domestic partnerships or S corporations if the domestic entity does not make a §1.1411–10(g) election.

A commentator requested that the rule regarding the time for making an election under §1.1411–10(g) election be revised so that taxpayers would not have to make an election until the first year in which they have a section 951 inclusion or section 1293 inclusion. The commentator stated that a rule based on ownership of a CFC or QEF, rather than a chapter 1 income inclusion, created a trap for the unwary because taxpayers may not consider the rules in §1.1411–10 until they have a chapter 1 income inclusion. The Treasury Department and the IRS adopt this comment, and the final regulations revise the rules for making a §1.1411–10(g) election to provide, in relevant part, that the election must be made no later than the first taxable year beginning after December 31, 2013, in which a person both has a section

951 or section 1293 inclusion under chapter 1 with respect to a CFC or QEF and is subject to section 1411 (or would be subject to tax under section 1411 if the election were made with respect to the CFC or QEF). Therefore, the final regulations permit a taxpayer to make the election in a year before the first year in which there is a chapter 1 inclusion under sections 951 or 1293 and the person is subject to tax under section 1411 (or would be subject to tax under section 1411 if the election were made). In addition, the final regulations provide that individuals, estates and trusts may make the election for a taxable year beginning before January 1, 2014.

A commentator suggested that the regulations be revised to allow taxpayers to make the §1.1411–10(g) election on an amended return. The Treasury Department and the IRS adopt this suggestion, and these final regulations provide that the initial election can be made on an original or an amended return, provided that the year of the election, and all years affected by the election, are not closed by the period of limitations under section 6501.

The Treasury Department and the IRS also received comments suggesting the addition of certain procedural rules related to making §1.1411–10(g) elections. A comment requested that the final regulations set forth a procedure for taxpayers to make protective §1.1411–10(g) elections. In addition, a comment suggested that rules for making untimely §1.1411–10(g) elections should be added to the final regulations, and recommended that the rules be consistent with the rules for making untimely QEF elections. Moreover, a comment suggested that purging elections, similar to QEF purging elections, should be allowed with respect to §1.1411–10(g) elections. The Treasury Department and the IRS do not adopt these suggestions because they are not necessary in light of the changes these final regulations provide to increase the opportunities for the election to be made.

The §1.1411–10(g) election generally will be made by individuals, estates, and trusts on Form 8960, *Net Investment Income Tax – Individuals, Estates, and Trusts*. Domestic partnerships, S corporations, and common trust funds will make the election on attachments to their relevant partnership or income tax returns.

12. *Taxpayer Reliance on Proposed and Final Regulations*

These regulations are effective for taxable years beginning after December 31, 2013, except that §1.1411–3(d) applies to taxable years beginning after December 31, 2012. Taxpayers are reminded that section 1411 is effective for taxable years beginning after December 31, 2012.

Part 12 of the preamble to the proposed regulations stated that taxpayers may rely on the proposed regulations for purposes of compliance with section 1411 until the effective date of the final regulations. Furthermore, the preamble stated that any election made in reliance on the proposed regulations will be in effect for the year of the election, and will remain in effect for subsequent taxable years. In addition, taxpayers who opt not to make an election in reliance on the proposed regulations are not precluded from making that election pursuant to these final regulations.

For taxable years beginning before January 1, 2014, taxpayers may rely on either the proposed regulations or these final regulations for purposes of compliance with section 1411. See §1.1411–1(f). However, to the extent that taxpayers take a position in a taxable year beginning before January 1, 2014 that is inconsistent with these final regulations, and such position affects the treatment of one or more items in a taxable year beginning after December 31, 2013, then such taxpayer must make reasonable adjustments to ensure that their section 1411 tax liability in the taxable years beginning after December 31, 2013, is not inappropriately distorted. For example, reasonable adjustments may be required to ensure that no item of income or deduction is taken into account in computing net investment income more than once, and that carryforwards, basis adjustments, and other similar items are adjusted appropriately.

Effective/Applicability Date

These final regulations apply to taxable years beginning after December 31, 2013, except that §1.1411–3(d) applies to taxable years beginning after December 31, 2012.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It is hereby certified that the collection of information in §1.1411–10(g) of these final regulations will not have a significant economic impact on a substantial number of small entities. Although a number of small entities may be subject to the requirements of this rule, any economic impact is minimal. This certification is based on the fact that the time required to secure and maintain the required information is minimal and taxpayers would ordinarily already collect and retain much of this information for other income tax and business purposes. The minimal information should be readily available to the parties and the professional skills that would be necessary to make the election would be the same as those required to prepare a return for the small business. Accordingly, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required.

Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking preceding these regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small businesses, and no comments were received.

Drafting Information

The principal authors of these regulations are David H. Kirk and Adrienne M. Mikolashek of the Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the IRS and the Treasury Department participated in their development.

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Adoption of the Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 602 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par 2. Section 1.469–0 is amended by adding an entry for paragraph (b)(3)(iv) to the §1.469–11 the table of contents to read as follows:

§1.469–0 Table of contents.

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§1.469–11 Effective date and transition rules.

* * * * *

(b) * * *

(3) * * *

(iv) Regrouping for taxpayers subject to section 1411.

(A) In general.

(B) Eligibility criteria.

(C) Consequences of amended returns and examination adjustments.

(*1*) Taxpayers first subject to section 1411.

(*2*) Taxpayers ceasing to be subject to section 1411.

(*3*) Examples.

(D) Effective/applicability date.

* * * * *

Par 3. Section 1.469–11 is amended by adding paragraph (b)(3)(iv) to read as follows:

§1.469–11 Effective date and transition rules.

* * * * *

(b) * * *

(3) * * *

(iv) *Regrouping for taxpayers subject to section 1411*—(A) *In general*. If an individual, estate, or trust meets the Eligibility Criteria, as defined in paragraph (b)(3)(iv)(B) of this section, such individual, estate, or trust, in the first taxable year beginning after December 31, 2013, in which section 1411 would apply to such taxpayer, may regroup its activities without regard to the manner in which the activities were grouped in the preceding taxable year. For this purpose, the determination of whether a taxpayer meets the Eligibility Criteria is made without regard to the effect of regrouping. The regrouping must be made in the manner prescribed by forms, instructions, or in other guidance on an original return for the taxable year for which the regrouping is done. A taxpayer that is an individual, estate, or trust may regroup its activities for any taxable year that begins during 2013, if the individual, estate, or trust meets the Eligibility Criteria for such year. A taxpayer may regroup activities only once pursuant to this paragraph (b)(3)(iv), and a regrouping made pursuant to this paragraph (b)(3)(iv) will apply to the taxable year for which the regrouping is done and all subsequent years.

(B) *Eligibility criteria*. The term *Eligibility Criteria* means that an individual, estate, or trust has net investment income (as defined in §1.1411–4) and such individual's (as defined in §1.1411–2(a)) modified adjusted gross income (as defined in §1.1411–2(c)) exceeds 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 exceeds the amount described in §1.1411–3(a)(1)(ii)(B)(*2*).

(C) *Consequences of amended returns and examination adjustments*—(*1*) *Taxpayers first subject to section 1411*. An individual, estate, or trust also may regroup activities, in the matter described in paragraph (b)(3)(iv)(A) of this section, on an amended return only if the changes reported on such amended return cause the taxpayer to meet the Eligibility Criteria for the first time beginning in the taxable year for which the amended return is applicable and the taxable year is not closed by the period of limitations on assessments under section 6501. If the amended return is for a tax year that precedes a tax year for which a taxpayer had regrouped its activities pursuant to paragraph (b)(3)(iv)(A) of this section, the regrouping on such amended return must be consistent with the taxpayer's subsequent year's regrouping. If a regrouping on an amended return is inconsistent with a subsequent year's grouping, the subsequent year's grouping is invalid under §1.469-4(e)(1) unless a material change in facts and circumstances occurred in the subsequent year such that the subsequent year's grouping constitutes a permissible regrouping under §1.469–4(e)(2). Similar rules also apply for any taxable year that begins during 2013.

(*2*) *Taxpayers ceasing to be subject to section 1411*. In the event a taxpayer regroups activities pursuant to paragraphs (b)(3)(iv)(A) or (C) of this section and it is subsequently determined that such taxpayer does not meet the Eligibility Criteria for the year of such regrouping, such regrouping will have no effect for that year and all future years. Appropriate adjustments should be made to reflect the voiding of the ineffective regrouping. However, notwithstanding the previous sentence, if an individual, estate, or trust meets the Eligibility Criteria in a subsequent year, such taxpayer is deemed to treat such regrouping as being made in such subsequent year unless the taxpayer either regroups in a different manner (so long as such alternative regrouping is permissible under §1.469–4) or properly reflects the ineffective regrouping in the previous year. The subsequent year's regrouping may be made on an original or on an amended return for that year. This paragraph (b)(3)(iv)(C)(*2*) shall not apply if a taxpayer does not meet the Eligibility Criteria for the year of such regrouping as a result of the carryback of a net operating loss pursuant to section 172. Similar rules also apply for any taxable year that begins during 2013.

(*3*) *Examples*. The following examples illustrate the principles of paragraph (b)(3)(iv)(C) of this section. In each example, unless otherwise indicated, the taxpayer uses a calendar taxable year, the taxpayer is a United States citizen, and Year 1 is a taxable year in which section 1411 is in effect:

Example 1. In Year 1, X, a single individual, reports modified adjusted gross income (as defined in §1.1411– 2(c)) of $198,000 (including $12,000 of net investment income (as defined in §1.1411–4)); thus is not subject to 1411. After X filed his original return, X receives a corrected Form 1099-DIV, which increases his modified adjusted gross income (as defined in §1.1411–2(c)) and his net investment income by $2,500. X files an amended return for Year 1 in Year 2 reporting modified adjusted gross income of $200,500 and net investment income of $14,500. Pursuant to paragraph (b)(3)(iv)(C)(*1*) of this section, X may regroup his passive activities on an amended return, because X now has MAGI above the applicable threshold amount and net investment income.

Example 2. Same facts as *Example 1*, except that the $2,500 increase to modified adjusted gross income and net investment income was a result of an examination of X's Year 1 return. Pursuant to paragraph (b)(3)(iv)(C)(*1*) of this section, X may regroup his passive activities on an amended return.

Example 3. In Year 1, Y, a single individual reported modified adjusted gross income (as defined in §1.1411–2(c)) of $205,000 and net investment income (as defined in §1.1411–4) of $500. Pursuant to paragraph (b)(3)(iv)(A) of this section, Y regrouped his four passive activities, A, B, C, and D, into a single activity group. Prior to the Year 1 regrouping, Y had grouped A and B into one group, and treated each of C and D as separate activities. Y did not meet the Eligibly Criteria in any year prior to Year 1 or Year 2. In Year 3, Y's employer issued Y a corrected Year 1 Form W-2, which reduced Y's taxable wages by $6,000. As a result, Y no longer meets the Eligibility Criteria in Year 1 because Y's modified adjusted gross income is now $199,000. Therefore, Y's Year 1 regrouping is no longer effective and the prior groupings are in effect (that is, Activity A and B are one group and Activity C and Activity D separately). Appropriate adjustments should be made to reflect the ineffective regrouping. However, if Y had a material change in facts and circumstances such that Y could regroup in Year 1 or a subsequent year, as applicable, by reason of §1.469–4(e)(2), then the regrouping will be deemed to occur. Y could designate a different regrouping for the year of the material change in facts and circumstances.

Example 4. Same facts as *Example 3*, except that Y met the Eligibly Criteria in Year 2. In this case, Y's Year 1 regrouping is no longer effective and Y must report his income consistent with the pre-Year 1 groupings. In Year 2, Y has three options. First, without any action by Y, Y's activities are regrouped as originally reported in Year 1. In this case, the regrouping from the Year 1 return is deemed to occur on the Year 2 return. This option is the default option. Second, pursuant to paragraph (b)(3)(iv)(C)(*2*) of this section, Y may file an amended return to report his income consistent with groupings in effect prior to Year 1. Third, Y may file an original or an amended return to regroup in a manner different from groupings in effect prior to Year 1 and different from the Year 1 groupings (for example, Y could choose to group Activity C and D into single activity, thus causing Y to have two groups; Group A-B and Group C-D).

(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.

* * * * *

Par. 4. An undesignated center heading and §1.1411–0 are added immediately following §1.1403–1 to read as follows:

Net Investment Income Tax

§1.1411–0 Table of contents of provisions applicable to section 1411.

This section lists the table of contents for §§1.1411–1 through 1.1411–10.

§1.1411–1 General rules.

§1.1411–2 Application to individuals.

§1.1411–3 Application to estates and trusts.

(2) Undistributed net investment income.
(3) Distributions of net investment income to beneficiaries.
(4) Deduction for amounts paid or permanently set aside for a charitable purpose.
(5) Examples.
(f) Effective/applicability date.

§1.1411–4 Definition of net investment income.

(a) In general.
(b) Ordinary course of a trade or business exception.
(c) Other gross income from a trade or business described in §1.1411–5.
(d) Net gain.
(1) Definition of disposition.
(2) Limitation.
(3) Net gain attributable to the disposition of property.
(i) General rule.
(ii) Examples.
(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.
(B) Special rules for determining whether property is held in a trade or business.
(C) Examples.
(ii) Other gains and losses excluded from net investment income.
(iii) Adjustment for capital loss carryforwards for previously excluded income. [Reserved]
(e) Net investment income attributable to certain entities.
(1) Distributions from estates and trusts.
(i) In general.
(ii) Distributions of accumulated net investment income from foreign nongrantor trusts to United States beneficiaries. [Reserved]
(2) CFCs and PFICs.
(3) Treatment of income from common trust funds. [Reserved]
(f) Properly allocable deductions.
(1) General rule.
(i) In general.
(ii) Limitations.
(2) Properly allocable deductions described in section 62.
(i) Deductions allocable to gross income from rents and royalties.
(ii) Deductions allocable to gross income from trades or businesses described in §1.1411–5.
(iii) Penalty on early withdrawal of savings.
(iv) Net operating loss.
(v) Examples.
(3) Properly allocable deductions described in section 63(d).
(i) Investment interest expense.
(ii) Investment expenses.
(iii) Taxes described in section 164(a)(3).
(iv) Items described in section 72(b)(3).
(v) Items described in section 691(c).
(vi) Items described in section 212(3).
(vii) Amortizable bond premium.
(viii) Fiduciary expenses.
(4) Loss deductions.
(i) General rule.
(ii) Examples.
(5) Ordinary loss deductions for certain debt instruments.
(6) Other deductions.
(7) Application of limitations under sections 67 and 68.
(i) Deductions subject to section 67.
(ii) Deductions subject to section 68.
(iii) Itemized deductions.
(iv) Example.
(g) Special rules.
(1) Deductions allocable to both net investment income and excluded income.
(2) Recoveries of properly allocable deductions.
(i) General rule.
(ii) Recoveries of items allocated between net investment income and excluded income.
(iii) Recoveries with no prior year benefit.
(iv) Examples.
(3) Deductions described in section 691(b).
(4) Amounts described in section 642(h).
(5) Treatment of self-charged interest income.
(6) Treatment of certain nonpassive rental activities.
(i) Gross income from rents.
(ii) Gain or loss from the disposition of property.
(7) Treatment of certain real estate professionals.
(i) Safe harbor.
(ii) Definitions.
(A) Participation.
(B) Rental real estate activity.
(iii) Effect of safe harbor.
(8) Treatment of former passive activities.
(i) Section 469(f)(1)(A) losses.
(ii) Section 469(f)(1)(C) losses.
(iii) Examples.
(9) Treatment of section 469(g)(1) losses.
(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]
(h) Net operating loss.
(1) In general.
(2) Applicable portion of a net operating loss.
(3) Section 1411 NOL amount of a net operating loss carried to and deducted in a taxable year.
(4) Total section 1411 NOL amount of a net operating loss deduction.
(5) Examples.
(i) Effective/applicability date.

§1.1411–5 Trades and businesses to which tax applies.

(a) In general.
(b) Passive activity.
(1) In general.
(2) Application of income recharacterization rules.
(i) Income and gain recharacterization.
(ii) Gain recharacterization.
(iii) Exception for certain portfolio recharacterizations.
(3) Examples.
(c) Trading in financial instruments or commodities.
(1) Definition of financial instruments.
(2) Definition of commodities.
(d) Effective/applicability date.

§1.1411–6 Income on investment of working capital subject to tax.

(a) General rule.
(b) Example.
(c) Effective/applicability date.

§1.1411–7 Exception for dispositions of certain active interests in partnerships and S corporations. [Reserved]

§1.1411–8 Exception for distributions from qualified plans.

(a) General rule.
(b) Rules relating to distributions.
(1) Actual distributions.
(2) Amounts treated as distributed.
(3) Amounts includible in gross income.
(4) Amounts related to employer securities.
(i) Dividends related to employer securities.
(ii) Amounts related to the net unrealized appreciation in employer securities.
(c) Effective/applicability date.

§1.1411–9 Exception for self-employment income.

(a) General rule.
(b) Special rule for traders.
(c) Examples.
(d) Effective/applicability date.

§1.1411–10 Controlled foreign corporations and passive foreign investment companies.

(a) In general.
(b) Amounts derived from a trade or business described in §1.1411–5.
(1) In general.
(2) Coordination rule for changes in trade or business status.
(c) Calculation of net investment income.
(1) Dividends.
(i) Distributions of previously taxed earnings and profits.
(A) Rules when an election under paragraph (g) of this section is not in effect with respect to the shareholder.
(*1*) General rule.
(*2*) Exception for distributions attributable to earnings and profits previously taken into account for purposes of section 1411.
(B) Rule when an election under paragraph (g) of this section is in effect with respect to the shareholder.
(C) Special rule for certain distributions related to 2013 taxable years.
(*1*) Scope.
(*2*) Rule.
(*3*) Ordering rule.
(ii) Excess distributions that constitute dividends.
(2) Net gain.
(i) Gains treated as excess distributions.
(ii) Inclusions and deductions with respect to section 1296 mark to market elections.
(iii) Gain or loss attributable to the disposition of stock of CFCs and QEFs.
(iv) Gain or loss attributable to the disposition of interests in domestic partnerships or S corporations that own directly or indirectly stock of CFCs or QEFs.
(3) Application of section 1248.
(4) Amounts distributed by an estate or trust.
(5) Properly allocable deductions.
(i) General rule.
(ii) Additional rules.
(d) Conforming basis adjustments.
(1) Basis adjustments under sections 961 and 1293.
(i) Stock held by individuals, estates, or trusts.
(ii) Stock held by domestic partnerships or S corporations.
(A) Rule when an election under paragraph (g) of this section is not in effect.
(B) Rules when an election under paragraph (g) of this section is in effect.
(2) Special rules for partners that own interests in domestic partnerships that own directly or indirectly stock of CFCs or QEFs.
(3) Special rules for S corporation shareholders that own interests in S corporations that own directly or indirectly stock of CFCs or QEFs.
(4) Special rules for participants in common trust funds.
(e) Conforming adjustments to modified adjusted gross income and adjusted gross income.
(1) Individuals.
(2) Estates and trusts.
(f) Application to estates and trusts.
(g) Election with respect to CFCs and QEFs.
(1) Effect of election.
(2) Years to which election applies.
(i) In general.
(ii) Termination of interest in CFC or QEF.
(iii) Termination of partnership.
(3) Who may make the election.
(4) Time and manner for making the election.
(i) Individuals, estates, and trusts.
(A) General rule.
(B) Special rule for charitable remainder trusts (CRTs).
(ii) Certain domestic passthrough entities.
(iii) Taxable years that begin before January 1, 2014.
(A) Individuals, estates, or trusts.
(B) Certain domestic passthrough entities.
(iv) Time for making election.
(h) Examples.
(i) Effective/applicability date.

Par. 5. Sections 1.1411–1 through 1.1411–10 are added to read as follows:

* * * * *

Sec.
1.1411–1 General rules.
1.1411–2 Application to individuals.
1.1411–3 Application to estates and trusts.
1.1411–4 Definition of net investment income.
1.1411–5 Trades or businesses to which tax applies.
1.1411–6 Income on investment of working capital subject to tax.
1.1411–7 [Reserved]
1.1411–8 Exception for distributions from qualified plans.
1.1411–9 Exception for self-employment income.
1.1411–10 Controlled foreign corporations and passive foreign investment companies.

* * * * *

§1.1411–1 General rules.

(a) *General rule*. Except as otherwise provided, all Internal Revenue Code (Code) provisions that apply for chapter 1 purposes in determining taxable income (as defined in section 63(a)) of a taxpayer also apply in determining the tax imposed by section 1411.

(b) *Adjusted gross income*. All references to an individual's adjusted gross income are treated as references to adjusted gross income as defined in section 62, and all references to an estate's or trust's adjusted gross income are treated as references to adjusted gross income as defined in section 67(e). However, there may be additional adjustments to adjusted gross income because of investments in controlled foreign corporations (CFCs) or passive foreign investment companies (PFICs). See §1.1411–10(e).

(c) *Effect of section 1411 and the regulations thereunder for other purposes*. The inclusion or exclusion of items of income, gain, loss, or deduction in determining net investment income for purposes of section 1411, and the assignment of items of income, gain, loss, or deduction to a particular category of net investment income under section 1411(c)(1)(A), does not affect the treatment of any item of income, gain, loss, or deduction under any provision of the Code other than section 1411.

(d) *Definitions*. The following definitions apply for purposes of calculating net investment income under section 1411 and the regulations thereunder—

(1) The term *gross income from annuities* under section 1411(c)(1)(A) includes the amount received as an annuity under an annuity, endowment, or life insurance contract that is includible in gross income as a result of the application of section 72(a) and section 72(b), and an amount not received as an annuity under an annuity contract that is includible in gross income under section 72(e). In the case of a sale of an annuity, to the extent the sales price of the annuity does not exceed its surrender value, the gain recognized would be treated as gross income from an annuity within the meaning of section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i). However, if the sales price of the annuity exceeds its surrender value, the seller would treat the gain equal to the difference between the basis in the annuity and the surrender value as gross income from an annuity described in section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i) and the excess of the sales price over the surrender value as gain from the disposition of property included in section 1411(c)(1)(A)(iii) and §1.1411–4(a)(1)(iii). The term *gross income from annuities* does not include amounts paid in consideration for services rendered. For example, distributions from a foreign retirement plan that are paid in the form of an annuity and include investment income that was earned by the retirement plan does not constitute income from an annuity within the meaning of section 1411(c)(1)(A)(i).

(2) The term *controlled foreign corporation (CFC)* is as defined in section 953(c)(1)(B) or 957(a).

(3) The term *gross income from dividends* includes any item treated as a dividend for purposes of chapter 1. See also §1.1411– 10 for additional amounts that constitute gross income from dividends. The term *gross income from dividends* includes, but is not limited to, amounts treated as dividends—

(i) Pursuant to subchapter C that are included in gross income (including constructive dividends);

(ii) Pursuant to section 1248(a), other than as provided in §1.1411–10;

(iii) Pursuant to §1.367(b)–2(e)(2);

(iv) Pursuant to section 1368(c)(2); and

(v) Substitute dividends that represent payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction.

(4) The term *excluded income* means:

(i) Items of income excluded from gross income in chapter 1. For example, interest on state and local bonds excluded from gross income under section 103 and gain from the sale of a principal residence excluded from gross income under section 121.

(ii) Items of income not included in net investment income, as determined under §§1.1411–4 and 1.1411–10. For example, wages, unemployment compensation, Alaska Permanent Fund Dividends, alimony, and Social Security Benefits.

(iii) Items of gross income and net gain specifically excluded by section 1411, the regulations thereunder, or other guidance published in the Internal Revenue Bulletin. For example, gains from the disposition of property used in a trade of business not described in section 1411(c)(2) under §1.1411–4(d)(4)(i), distributions from certain Qualified Plans described in section 1411(c)(5) and §1.1411–8, income taken into account in determining self-employment income that is subject to tax under section 1401(b) described in section 1411(c)(6) and §1.1411–9, and section 951(a) inclusions from a CFC for which a §1.1411–10(g) election is not in effect.

(5) The term *individual* means any natural person.

(6) The term *gross income from interest* includes any item treated as interest income for purposes of chapter 1 and substitute interest that represents payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction.

(7) The term *married* and *married taxpayer* has the same meaning as in section 7703.

(8) The term *net investment income (NII)* means net investment income as defined in section 1411(c) and §1.1411–4, as adjusted pursuant to the rules described in §1.1411–10(c).

(9) The term *passive foreign investment company (PFIC)* is as defined in section 1297(a).

(10) The term *gross income from rents* includes amounts paid or to be paid principally for the use of (or the right to use) tangible property.

(11) The term *gross income from royalties* includes amounts received from mineral, oil, and gas royalties, and amounts received for the privilege of using patents, copyrights, secret processes and formulas, goodwill, trademarks, tradebrands, franchises, and other like property.

(12) The term *trade or business* refers to a trade or business within the meaning of section 162.

(13) The term *United States person* is as defined in section 7701(a)(30).

(14) The term *United States shareholder* is as defined in section 951(b).

(e) *Disallowance of certain credits against the section 1411 tax*. Amounts that may be credited against only the tax imposed by chapter 1 of the Code may not be credited against the section 1411 tax imposed by chapter 2A of the Code unless specifically provided in the Code. For example, the foreign income, war profits, and excess profits taxes that are allowed as a foreign tax credit by section 27(a), section 642(a), and section 901, respectively, are not allowed as a credit against the section 1411 tax.

(f) *Application to taxable years beginning before January 1, 2014*—(1) *Retroactive application of regulations*. Taxpayers that are subject to section 1411, and any other taxpayer to which these regulations may apply (such as partnerships and S corporations), may apply §§1.1411–1 through 1.1411–10 (including the ability to make any election(s) contained therein) in any taxable year that begins after December 31, 2012, but before January 1, 2014, for which the period of limitation under section 6501 has not expired.

(2) *Reliance and transitional rules*. For taxable years beginning before January 1, 2014, the Internal Revenue Service will not challenge a taxpayer's computation of tax under section 1411 if the taxpayer has made a reasonable, good faith effort to comply with the requirements of section 1411. For example, a taxpayer's compliance with the provisions of the proposed and final regulations under section 1411 (REG–130507–11 or REG–130843–13), generally, will be considered a reasonable, good faith effort to comply with the requirements of section 1411 if reliance on such regulation projects under section 1411 are applied in their entirety, and the taxpayer makes reasonable adjustments to ensure that their section 1411 tax liability in the taxable years beginning after December 31, 2013, is not inappropriately distorted by the positions taken in taxable years beginning after December 31, 2012, but before January 1, 2014. A similar rule applies to any other taxpayer to which these regulations may apply (such as partnerships and S corporations).

(g) *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 paragraph (f) of this section.

§1.1411–2 Application to individuals.

(a) *Individual to whom tax applies*—(1) *In general*. Section 1411 applies to an individual who is a citizen or resident of the United States (within the meaning of section 7701(a)(30)(A)). Section 1411 does not apply to nonresident alien individuals (within the meaning of section 7701(b)(1)(B)). See paragraph (a)(2)(vi) of this section for special rules regarding bona fide residents of United States territories.

(2) *Special rules*—(i) *Dual-resident individuals treated as residents of a foreign country under an income tax treaty*. A dual-resident taxpayer (as defined in §301.7701(b)–7(a)(1)) who determines that he or she is a resident of a foreign country for treaty purposes pursuant to an income tax treaty between the United States and the foreign country and who claims benefits of the treaty as a nonresident of the United States will be treated as a nonresident alien of the United States for purposes of paragraph (a)(1) of this section.

(ii) *Dual-status resident aliens*. A dual-status individual who is a resident of the United States for a portion of a taxable year and a nonresident alien for the other portion of the taxable year will not be subject to section 1411 with respect to the portion of the year for which that individual is treated as a nonresident alien. The only income the individual must take into account for purposes of section 1411 is the income he or she receives during the portion of the year for which he or she is treated as a resident of the United States. The threshold amount under paragraph (d)(1) of this section applies.

(iii) *Joint returns in the case of a nonresident alien individual married to a United States citizen or resident*—(A) *Default treatment*. In the case of a United States citizen or resident who is married to a nonresident alien individual, the spouses will be treated as married filing separately for purposes of section 1411. For purposes of calculating the tax imposed under section 1411(a)(1), the United States citizen or resident spouse will be subject to the threshold amount for a married taxpayer filing a separate return in paragraph (d)(1)(ii) of this section, and the nonresident alien spouse will not be subject to tax under section 1411. In accordance with the rules for married individuals filing separate returns, the spouse that is a United States citizen or resident must determine his or her own net investment income and modified adjusted gross income.

(B) *Taxpayer election*. Married taxpayers who file a joint Federal income tax return pursuant to a section 6013(g) election for purposes of chapter 1 and chapter 24 also may elect to be treated as making a section 6013(g) election for purposes of chapter 2A (relating to the tax imposed by section 1411).

(*1*) *Effect of election*. For purposes of calculating the tax imposed under section 1411(a)(1), the effect of an election under section 6013(g) is to include the combined income of the United States citizen or resident spouse and the nonresident spouse in the section 1411(a)(1) calculation and to apply the threshold amount for a taxpayer making a joint return as set out in paragraph (d)(1)(i) of this section.

(*2*) *Procedural requirements for making election*. Taxpayers with a section 6013(g) election in effect for chapter 1 and chapter 24 purposes for any taxable year beginning after December 31, 2012, or taxpayers making a section 6013(g) election for chapter 1 and chapter 24 purposes in any taxable year beginning after December 31, 2012, who want to apply their section 6013(g) election for purposes of chapter 2A must make the election for the first taxable year beginning after December 31, 2013, in which the United States taxpayer is subject to tax under section 1411. The determination of whether the United States taxpayer is subject to tax under section 1411 is made without regard to the effect of the section 6013(g) election described in paragraph (a)(2)(iii)(B) of this section. The election, if made, must be made in the manner prescribed by forms, instructions, or in other guidance on an original or amended return for the taxable year for which the election is made. An election can be made on an amended return only if the taxable year for which the election is made, and all taxable years that are affected by the election, are not closed by the period of limitations on assessments under section 6501. Further, once made, the duration and termination of the section 6013(g) election for chapter 2A is governed by the rules of section 6013(g)(2) through (g)(6) and the regulations thereunder.

(*3*) *Ineffective elections*. In the event a taxpayer makes an election described in paragraph (a)(2)(iii)(B) of this section and subsequently determines that such taxpayer does not meet the criteria for making such election in such tax year described in paragraph (a)(2)(iii)(B)(*2*) of this section, then such original election will have no effect for that year and all future years. In such a case, the taxpayer should make appropriate adjustments to properly reflect the ineffective election. However, notwithstanding the previous sentence, if a taxpayer meets the criteria for the same election in a subsequent year, such taxpayer is deemed to treat such original election as being made in that subsequent year unless the taxpayer files (or amends) the return for such subsequent year to report the taxpayer's net investment income tax without the original election. Furthermore, this paragraph (a)(2)(iii)(B)(*3*) shall not apply if a taxpayer does not meet the criteria described in paragraph (a)(2)(iii)(B)(*2*) of this section for making such election in such tax year solely as a result of the carryback of a net operating loss pursuant to section 172.

(iv) *Joint returns for a year in which nonresident alien married to a United States citizen or resident becomes a United States resident*—(A) *Default treatment*. In the case of a United States citizen or resident who is married to an individual who is a nonresident alien individual at the beginning of any taxable year, but is a United States resident at the close of such taxable year, each spouse will be treated as married filing separately for the entire year for purposes of section 1411. For purposes of calculating the tax imposed under section 1411(a)(1), each spouse will be subject to the threshold amount for a married taxpayer filing a separate return in paragraph (d)(1)(ii) of this section. The spouse who becomes a United States resident during the tax year will be subject to section 1411 only with respect to income received for the portion of the year for which he or she is treated as a United States resident. Each spouse must determine his or her own net investment income and modified adjusted gross income.

(B) *Taxpayer election*. Married taxpayers who file a joint Federal income tax return pursuant to a section 6013(h) election for purposes of chapter 1 and chapter 24 also may elect to be treated as making a section 6013(h) election for purposes of chapter 2A for such tax year.

(*1*) *Effect of election*. For purposes of calculating the tax imposed under section 1411(a)(1), the effect of an election under section 6013(h) is to include the combined income of the United States citizen or resident spouse and the dual-status resident spouse in the section 1411(a)(1) calculation and to apply the threshold amount for a taxpayer making a joint return as set out in paragraph (d)(1)(i) of this section.

(*2*) *Procedural requirements for making election*. Taxpayers who make a section 6013(h) election for purposes of chapter 1 and chapter 24 for any taxable year beginning after December 31, 2012, may elect to have their section 6013(h) election apply for purposes of chapter 2A. The election, if made, must be made in the manner prescribed by forms, instructions, or in other guidance on an original or amended return for the taxable year for which the election is made. An election can be made on an amended return only if the taxable year for which the election is made, and all taxable years that are affected by the election, are not closed by the period of limitations on assessments under section 6501. Further, in all cases, once made, the section 6013(h) election is governed by the rules of section 6013(h)(2) and the regulations thereunder.

(iv) *Grantor trusts*. For rules regarding the treatment of owners of grantor trusts, see §1.1411–3(b)(1)(v).

(v) *Bankruptcy estates*. A bankruptcy estate administered under chapter 7 (relating to liquidations) or chapter 11 (relating to reorganizations) of the Bankruptcy Code (Title 11 of the United States Code) of a debtor who is an individual is treated as a married taxpayer filing a separate return for purposes of section 1411. See §1.1411–2(d)(1)(ii).

(vi) *Bona fide residents of United States territories*—(A) *Applicability*. An individual who is a bona fide resident of a United States territory is subject to the tax imposed by section 1411(a)(1) only if the individual is required to file an income tax return with the United States upon application of section 931, 932, 933, or 935 and the regulations thereunder. With respect to an individual described in this paragraph (a)(2)(vi)(A), the amount excluded from gross income under section 931 or 933 and any deduction properly allocable or chargeable against amounts excluded from gross income under section 931 or 933, respectively, is not taken into account in computing modified adjusted gross income under paragraph (c) of this section or net investment income (within the meaning of §1.1411– 1(d)).

(B) *Coordination with exception for nonresident aliens*. An individual who is both a bona fide resident of a United States territory and a nonresident alien individual with respect to the United States is not subject to taxation under section 1411(a)(1).

(C) *Definitions*. For purposes of this section—

(*1*) *Bona fide resident*. The term *bona fide resident* has the meaning provided under section 937(a).

(*2*) *United States territory*. The term *United States territory* means American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, or the United States Virgin Islands. (b) *Calculation of tax*—(1) *In general*. In the case of an individual described in paragraph (a)(1) of this section, the tax imposed by section 1411(a)(1) for each taxable year is equal to 3.8 percent of the lesser of—

(i) Net investment income for such taxable year; or

(ii) The excess (if any) of—

(A) The modified adjusted gross income (as defined in paragraph (c) of this section) for such taxable year; over

(B) The threshold amount (as defined in paragraph (d) of this section).

(2) *Example*. During Year 1 (at year in which section 1411 is in effect), A, an unmarried United States citizen, has modified adjusted gross income (as defined in paragraph (c) of this section) of $190,000, which includes $50,000 of net investment income. A has a zero tax imposed under section 1411 because the threshold amount for a single individual is $200,000 (as provided in paragraph (d)(1)(iii) of this section). If during Year 2, A has modified adjusted gross income of $220,000, which includes $50,000 of net investment income, then the individual has a section 1411 tax of $760 (3.8% multiplied by $20,000, the lesser of $50,000 net investment income or $20,000 excess of modified adjusted gross income over the threshold amount).

(c) *Modified adjusted gross income*—(1) *General rule*. For purposes of section 1411, the term *modified adjusted gross income* means adjusted gross income increased by the excess of—

(i) The amount excluded from gross income under section 911(a)(1); over

(ii) The amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amounts described in paragraph (c)(1)(i) of this section.

(2) *Rules with respect to CFCs and PFICs*. Additional rules in §1.1411–10(e)(1) apply to an individual that is a United States shareholder of a controlled foreign corporation (CFC) or that is a United States person that directly or indirectly owns an interest in a passive foreign investment company (PFIC).

(d) *Threshold amount*—(1) *In general*. The term *threshold amount* means—

(i) In the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), $250,000;

(ii) In the case of a married taxpayer filing a separate return, $125,000; and

(iii) In the case of any other individual, $200,000.

(2) *Taxable year of less than twelve months*—(i) *General rule*. In the case of an individual who has a taxable year consisting of less than twelve months (short taxable year), the threshold amount under paragraph (d)(1) of this section is not reduced or prorated. For example, in the case of an unmarried decedent who dies on June 1, the threshold amount is $200,000 for the decedent's short taxable year that begins on January 1 and ends on June 1.

(ii) *Change of annual accounting period*. Notwithstanding paragraph (d)(2)(i) of this section, an individual who has a short taxable year resulting from a change of annual accounting period reduces the threshold amount to an amount that bears the same ratio to the full threshold amount provided under paragraph (d)(1) of this section as the number of months in the short taxable year bears to twelve.

(e) *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).

§1.1411–3 Application to estates and trusts.

(a) *Estates and trusts to which tax applies*—(1) *In general*—(i) *General application*. Section 1411 and the regulations thereunder apply to all estates and trusts that are subject to the provisions of part I of subchapter J of chapter 1 of subtitle A of the Internal Revenue Code, unless specifically exempted under paragraph (b) of this section.

(ii) *Calculation of tax*. The tax imposed by section 1411(a)(2) for each taxable year is equal to 3.8 percent of the lesser of—

(A) The estate's or trust's undistributed net investment income for such taxable year; or

(B) The excess (if any) of—

(*1*) The estate's or trust's adjusted gross income (as defined in section 67(e) and as adjusted under §1.1411– 10(e)(2), if applicable) for such taxable year; over

(*2*) The dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

(2) *Taxable year of less than twelve months*—(i) *General rule*. In the case of an estate or trust that has a taxable year consisting of less than twelve months (short taxable year), the dollar amount described in paragraph (a)(1)(ii)(B)(*2*) of this section is not reduced or prorated.

(ii) *Change of annual accounting period*. Notwithstanding paragraph (a)(2)(i) of this section, an estate or trust that has a short taxable year resulting from a change of annual accounting period (but not from an individual's death) reduces the dollar amount described in paragraph (a)(1)(ii)(B)(*2*) of this section to an amount that bears the same ratio to that dollar amount as the number of months in the short taxable year bears to twelve.

(3) *Rules with respect to CFCs and PFICs*. Additional rules in §1.1411– 10 apply to an estate or trust that holds an interest in a controlled foreign corporation (CFC) or a passive foreign investment company (PFIC).

(b) *Application to certain trusts and estates*—(1) *Exception for certain trusts and estates*. The following trusts are not subject to the tax imposed by section 1411:

(i) A trust or decedent's estate all of the unexpired interests in which are devoted to one or more of the purposes described in section 170(c)(2)(B).

(ii) A trust exempt from tax under section 501.

(iii) A charitable remainder trust described in section 664. However, see paragraph (d) of this section for special rules regarding the treatment of annuity or unitrust distributions from such a trust to persons subject to tax under section 1411.

(iv) Any other trust, fund, or account that is statutorily exempt from taxes imposed in subtitle A. For example, see sections 220(e)(1), 223(e)(1), 529(a), and 530(a).

(v) A trust, or a portion thereof, that is treated as a grantor trust under subpart E of part I of subchapter J of chapter 1. However, in the case of any such trust or portion thereof, each item of income or deduction that is included in computing taxable income of a grantor or another person under section 671 is treated as if it had been received by, or paid directly to, the grantor or other person for purposes of calculating such person's net investment income.

(vi) Electing Alaska Native Settlement Trusts subject to taxation under section 646.

(vii) Cemetery Perpetual Care Funds to which section 642(i) applies.

(viii) Foreign trusts (as defined in section 7701(a)(31)(B) and §301.7701–7(a)(2)) (but see §§1.1411–3(e)(3)(ii) and 1.1411–4(e)(1)(ii) for rules related to distributions from foreign trusts to United States beneficiaries).

(ix) Foreign estates (as defined in section 7701(a)(31)(A)) (but see §1.1411–3(e)(3)(ii) for rules related to distributions from foreign estates to United States beneficiaries).

(2) *Special rules for certain taxable trusts and estates*—(i) *Qualified funeral trusts*. For purposes of the calculation of any tax imposed by section 1411, section 1411 and the regulations thereunder are applied to each qualified funeral trust (within the meaning of section 685) by treating each beneficiary's interest in each such trust as a separate trust.

(ii) *Bankruptcy estates*. A bankruptcy estate in which the debtor is an individual is treated as a married taxpayer filing a separate return for purposes of section 1411. See §1.1411–2(a)(2)(v) and (d)(1)(ii).

(c) *Application to electing small business trusts (ESBTs)*—(1) *General application*. The S portion and non-S portion (as defined in §1.641(c)–1(b)(2) and (3), respectively) of a trust that has made an ESBT election under section 1361(e)(3) and §1.1361–1(m)(2) are treated as separate trusts for purposes of the computation of undistributed net investment income in the manner described in paragraph (e) of this section, but are treated as a single trust for purposes of determining the amount subject to tax under section 1411. If a grantor or another person is treated as the owner of a portion of the ESBT, the items of income and deduction attributable to the grantor portion (as defined in §1.641(c)-1(b)(1)) are included in the grantor's calculation of net investment income and are not included in the ESBT's computation of tax described in paragraph (c)(1)(ii) of this section.

(2) *Computation of tax*. This paragraph (c)(2) provides the method for an ESBT to compute the tax under section 1411.

(i) *Step one*. The S portion and non-S portion computes each portion's undistributed net investment income as separate trusts in the manner described in paragraph (e) of this section and then combine these amounts to calculate the ESBT's undistributed net investment income.

(ii) *Step two*. The ESBT calculates its adjusted gross income (as defined in paragraph (a)(1)(ii)(B)(*1*) of this section). The ESBT's adjusted gross income is the adjusted gross income of the non-S portion, increased or decreased by the net income or net loss of the S portion, after taking into account all deductions, carryovers, and loss limitations applicable to the S portion, as a single item of ordinary income (or ordinary loss).

(iii) *Step three*. The ESBT pays tax on the lesser of—

(A) The ESBT's total undistributed net investment income; or

(B) The excess of the ESBT's adjusted gross income (as calculated in paragraph (c)(2)(ii) of this section) over the dollar amount at which the highest tax bracket in section 1(e) begins for the taxable year.

(3) *Example*. (i) In Year 1 (a year that section 1411 is in effect), the non-S portion of Trust, an ESBT, has dividend income of $15,000, interest income of $10,000, and capital loss of $5,000. Trust's S portion has net rental income of $21,000 and a capital gain of $7,000. The Trustee's annual fee of $1,000 is allocated 60% to the non-S portion and 40% to the S portion. Trust makes a distribution from income to a single beneficiary of $9,000.

(ii) *Step one*. (A) Trust must compute the undistributed net investment income for the S portion and non-S portion in the manner described in paragraph (c) of this section.

The undistributed net investment income for the S portion is $20,600 and is determined as follows:

Net Rental Income	$21,000
Capital Gain	$7,000
Trustee Annual Fee	*($400)*
Total S portion undistributed net investment income	$27,600

(B) The undistributed net investment income for the non-S portion is $12,400 and is determined as follows:

Dividend Income	$15,000
Interest Income	$10,000
Deductible Capital Loss	($3,000)
Trustee Annual Fee	($600)
Distributable net income distribution	*($9,000)*
Total non-S portion undistributed net investment income	$12,400

(C) Trust combines the undistributed net investment income of the S portion and non-S portion from (ii)(A) and (B) to arrive at Trust's combined undistributed net investment income.

S portion's undistributed net investment income	$27,600
Non-S portion's undistributed net investment income	*$12,400*
Combined undistributed net investment income	$40,000

(iii) *Step two*. (A) The ESBT calculates its adjusted gross income. Pursuant to paragraph (c)(2)(ii) of this section, the ESBT's adjusted gross income is the non-S portion's adjusted gross income increased or decreased by the net income or net loss of the S portion.

(B) The adjusted gross income for the ESBT is $38,000 and is determined as follows:

Dividend Income	$15,000
Interest Income	$10,000
Deductible Capital Loss	($3,000)
Trustee Annual Fee	($600)
Distributable net income distribution	($9,000)
S Portion Income	*$27,600*
Adjusted gross income	$40,000

(C) The S portion's single item of ordinary income used in the ESBT's adjusted gross income calculation is $27,600. This item of income is determined by starting with net rental income of $21,000 and capital gain of $7,000 and reducing it by the S portion's $400 share of the annual trustee fee.

(iv) *Step three*. Trust pays tax on the lesser of—

(A) The combined undistributed net investment income ($40,000); or

(B) The excess of adjusted gross income ($40,000) over the dollar amount at which the highest tax bracket in section 1(e) applicable to a trust begins for the taxable year.

(d) *Application to charitable remainder trusts (CRTs)*—(1) *Operational rules*—(i) *Treatment of annuity or unitrust distributions*. If one or more items of net investment income comprise all or part of an annuity or unitrust distribution from a CRT, such items retain their character as net investment income in the hands of the recipient of that annuity or unitrust distribution.

(ii) *Apportionment among multiple beneficiaries*. In the case of a CRT with more than one annuity or unitrust beneficiary, the net investment income is apportioned among such beneficiaries based on their respective shares of the total annuity or unitrust amount paid by the CRT for that taxable year.

(iii) *Accumulated net investment income*. The accumulated net investment income of a CRT is the total amount of net investment income received by a CRT for all taxable years that begin after December 31, 2012, less the total amount of net investment income distributed for all prior taxable years of the trust that begin after December 31, 2012.

(2) *Application of Section 664*—(i) *General rule*. The Federal income tax rate of the item of net investment income, to be used to determine the proper classification of that item within the appropriate income category as described in §1.664–1(d)(1)(i)(b), is the sum of the income tax rate applicable to that item under chapter 1 and the tax rate under section 1411. Thus, the accumulated net investment income and excluded income (as defined in §1.1411–1(d)(4)) of a CRT in the same income category constitute separate classes of income within that category as described in §1.664–1(d)(1)(i)(b).

(ii) *Special rules for CRTs with income from CFCs or PFICs*. [Reserved]

(iii) *Examples*. The following examples illustrate the provisions of this paragraph (d)(2).

Example 1. (i) In 2009, A formed CRT as a charitable remainder annuity trust. The trust document requires an annual annuity payment of $50,000 to A for 15 years. For purposes of this example, assume that CRT is a valid charitable remainder trust under section 664 and has not received any unrelated business taxable income during any taxable year.

(ii) As of January 1, 2013, CRT has the following items of undistributed income within its §1.664–1(d)(1) categories and classes:

Category	*Class*	*Tax Rate*	*Amount*
Ordinary Income	Interest	39.6%	$4,000
	Net Rental Income	39.6%	$8,000
	Non-Qualified Dividend Income	39.6%	$2,000
	Qualified Dividend Income	20.0%	$10,000
Capital Gain	Short-Term	39.6%	$39,000
	Unrecaptured Section 1250 Gain	25.0%	$1,000
	Long-Term	20.0%	$560,000
Other Income			None
Total undistributed income as of January 1, 2013			$624,000

Pursuant to §1.1411– 3(d)(1)(iii), none of the $624,000 of undistributed income is accumulated net investment income (ANII) because none of it was received by CRT after December 31, 2012. Thus, the entire $624,000 of undistributed income is excluded income (as defined in §1.1411– 1(d)(4)).

(iii) During 2013, CRT receives $7,000 of interest income, $9,000 of qualified dividend income, $4,000 of short-term capital gain, and $11,000 of long-term capital gain. Prior to the 2013 distribution of $50,000 to A, CRT has the following items of undistributed income within its §1.664–1(d)(1) categories and classes after the application of paragraph (d)(2) of this section:

Category	*Class*	*Excluded / ANII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest	NII	43.4%	$7,000
	Interest	Excluded	39.6%	$4,000
	Net Rental Income	Excluded	39.6%	$8,000
	Non-Qualified Dividend Income	Excluded	39.6%	$2,000
	Qualified Dividend Income	NII	23.8%	$9,000
	Qualified Dividend Income	Excluded	20.0%	$10,000
Capital Gain				
	Short-Term	NII	43.4%	$4,000
	Short-Term	Excluded	39.6%	$39,000
	Unrecaptured Section 1250 Gain	Excluded	25.0%	$1,000
	Long-Term	NII	23.8%	$11,000
	Long-Term	Excluded	20.0%	$560,000
Other Income				None

(iv) The $50,000 distribution to A for 2013 will include the following amounts:

Category	*Class*	*Excluded / ANII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest	NII	43.4%	$7,000
	Interest	Excluded	39.6%	$4,000
	Net Rental Income	Excluded	39.6%	$8,000
	Non-Qualified Dividend Income	Excluded	39.6%	$2,000
	Qualified Dividend Income	NII	23.8%	$9,000
	Qualified Dividend Income	Excluded	20.0%	$10,000
Capital Gain				
	Short-Term	NII	43.4%	$4,000
	Short-Term	Excluded	39.6%	$6,000
	Unrecaptured Section 1250 Gain	Excluded	25.0%	None
	Long-Term	NII	23.8%	None
	Long-Term	Excluded	20.0%	None

The amount included in A's 2013 net investment income is $20,000. This amount is comprised of $7,000 of interest income, $9,000 of qualified dividend income, and $4,000 of short-term capital gain.

(v) As a result, as of January 1, 2014, CRT has the following items of undistributed income within its §1.664–1(d)(1) categories and classes:

Category	*Class*	*Excluded / ANII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest			None
	Net Rental Income			None
	Non-Qualified Dividend Income			None
	Qualified Dividend Income			None
Capital Gain				
	Short-Term	Excluded	39.6%	$33,000
	Unrecaptured Section 1250 Gain	Excluded	25.0%	$1,000
	Long-Term	ANII	23.8%	$11,000
	Long-Term	Excluded	20.0%	$560,000
Other Income				None

Example 2 [Reserved].

(3) *Elective simplified method*. [Reserved]

(e) *Calculation of undistributed net investment income*—(1) *In general*. This paragraph (e) provides special rules for the computation of certain deductions and for the allocation of net investment income between an estate or trust and its beneficiaries. Generally, an estate's or trust's net investment income is calculated in the same manner as that of an individual. See §1.1411–10(c) for special rules regarding CFCs, PFICs, and estates and trusts holding interests in such entities.

(2) *Undistributed net investment income*. An estate's or trust's undistributed net investment income is the estate's or trust's net investment income reduced by distributions of net investment income to beneficiaries and by deductions under section 642(c) in the manner described in paragraphs (e)(3) and (e)(4) of this section.

(3) *Distributions of net investment income to beneficiaries*. (i) In computing the estate's or trust's undistributed net investment income, net investment income is reduced by distributions of net investment income made to beneficiaries. The deduction allowed under this paragraph (e)(3) is limited to the lesser of the amount deductible to the estate or trust under section 651 or section 661, as applicable, or the net investment income of the estate or trust. In the case of a deduction under section 651 or section 661 that consists of both net investment income and excluded income (as defined in §1.1411–1(d)(4)), the distribution must be allocated between net investment income and excluded income in a manner similar to §1.661(b)–1 as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. See §1.661(c)–1 and *Example 1* in paragraph (e)(5) of this section.

(ii) If one or more items of net investment income comprise all or part of a distribution for which a deduction is allowed under paragraph (e)(3)(i) of this section, such items retain their character as net investment income under section 652(b) or section 662(b), as applicable, for purposes of computing net investment income of the recipient of the distribution who is subject to tax under section 1411.

The provisions of this paragraph (e)(3)(ii) also apply to distributions to United States beneficiaries of current year income described in section 652 or section 662, as applicable, from foreign estates and foreign nongrantor trusts.

(4) *Deduction for amounts paid or permanently set aside for a charitable purpose*. In computing the estate's or trust's undistributed net investment income, the estate or trust is allowed a deduction for amounts of net investment income that are allocated to amounts allowable under section 642(c). In the case of an estate or trust that has items of income consisting of both net investment income and excluded income, the allowable deduction under this paragraph (e)(4) must be allocated between net investment income and excluded income in accordance with §1.642(c)–2(b) as if net investment income constituted gross income and excluded income constituted amounts not includible in gross income. For an estate or trust with deductions under both sections 642(c) and 661, see §1.662(b)–2 and *Example 2* in paragraph (e)(5) of this section.

(5) *Examples*. The following examples illustrate the provisions of this paragraph (e). In each example, Year 1 is a year in which section 1411 is in effect and the taxpayer is not a foreign estate or trust:

Example 1. Calculation of undistributed net investment income (with no deduction under section 642(c)). (i) In Year 1, Trust has dividend income of $15,000, interest income of $10,000, capital gain of $5,000, and $75,000 of taxable income relating to a distribution from an individual retirement account (as defined under section 408). Trust has no expenses. Trust distributes $10,000 of its current year trust accounting income to A, a beneficiary of Trust.

(ii) Trust's distributable net income is $100,000 ($15,000 in dividends plus $10,000 in interest plus $75,000 of taxable income from an individual retirement account), from which the $10,000 distribution to A is paid. Trust's deduction under section 661 is $10,000. Under §1.662(b)–1, the deduction reduces each class of income comprising distributable net income on a proportional basis. The $10,000 distribution equals 10% of distributable net income ($10,000 divided by $100,000). Therefore, the distribution consists of dividend income of $1,500, interest income of $1,000, and ordinary income attributable to the individual retirement account of $7,500. Because the $5,000 of capital gain allocated to principal for trust accounting purposes did not enter into distributable net income, no portion of that amount is included in the $10,000 distribution, nor does it qualify for the deduction under section 661.

(iii) Trust's net investment income is $30,000 ($15,000 in dividends plus $10,000 in interest plus $5,000 in capital gain). Trust's $75,000 of taxable income attributable to the individual retirement account is excluded income under §1.1411–1(d)(4). Trust's undistributed net investment income under paragraph (e)(2) of this section is $27,500, which is Trust's net investment income ($30,000) less the amount of dividend income ($1,500) and interest income ($1,000) distributed to A. The $27,500 of undistributed net investment income is comprised of the capital gain allocated to principal ($5,000), the remaining undistributed dividend income ($13,500), and the remaining undistributed interest income ($9,000).

(iv) Under paragraph (e)(3) of this section and pursuant to §1.1411–4(a)(1), A's net investment income includes dividend income of $1,500 and interest income of $1,000, but does not include the $7,500 of ordinary income attributable to the individual retirement account because it is excluded from net investment income under §1.1411–8.

Example 2. Calculation of undistributed net investment income (with deduction under section 642(c)). (i) Same facts as *Example 1*, except Trust is required to distribute $30,000 to A. In addition, Trust has a $10,000 deduction under section 642(c) (deduction for amounts paid for a charitable purpose). Trust also makes an additional discretionary distribution of $20,000 to B, a beneficiary of Trust. As in *Example 1*, Trust's net investment income is $30,000 ($15,000 in dividends plus $10,000 in interest plus $5,000 in capital gain). In accordance with §§1.661(b)–2 and 1.662(b)–2, the items of income must be allocated between the mandatory distribution to A, the discretionary distribution to B, and the $10,000 distribution to a charity.

(ii) For purposes of the mandatory distribution to A, Trust's distributable net income is $100,000. See §1.662(b)–2, *Example* 1(b). Trust's deduction under section 661 for the distribution to A is $30,000. Under §1.662(b)–1, the deduction reduces each class of income comprising distributable net income on a proportional basis. The $30,000 distribution equals 30% of distributable net income ($30,000 divided by $100,000). Therefore, the distribution consists of dividend income of $4,500, interest income of $3,000, and ordinary income attributable to the individual retirement account of $22,500. A's mandatory distribution thus consists of $7,500 of net investment income and $22,500 of excluded income.

(iii) Trust's remaining distributable net income is $70,000. Trust's remaining undistributed net investment income is $22,500. The $10,000 deduction under section 642(c) is allocated in the same manner as the distribution to A, where the $10,000 distribution equals 10% of distributable net income ($10,000 divided by $100,000). For purposes of determining undistributed net investment income, Trust's net investment income is reduced by $2,500 under paragraph (e)(4) of this section (dividend income of $1,500, interest income of $1,000, but with no reduction for amounts attributable to the individual retirement account of $7,500).

(iv) With respect to the discretionary distribution to B, Trust's remaining distributable net income is $60,000. Trust's remaining undistributed net investment income is $20,000. Trust's deduction under section 661 for the distribution to B is $20,000. The $20,000 distribution equals 20% of distributable net income ($20,000 divided by $100,000). Therefore, the distribution consists of dividend income of $3,000, interest income of $2,000, and ordinary income attributable to the individual retirement account of $15,000. B's distribution consists of $5,000 of net investment income and $15,000 of excluded income.

(v) Trust's undistributed net investment income is $15,000 after taking into account distribution deductions and section 642(c) in accordance with paragraphs (e)(3) and (e)(4) of this section, respectively. To arrive at Trust's undistributed net investment income of $15,000, Trust's net investment income of $30,000 is reduced by $7,500 of the mandatory distribution to A, $2,500 of the section 642(c) deduction, and $5,000 of the discretionary distribution to B. The undistributed net investment income consists of the remaining dividend income of $6,000 ($15,000 less $4,500 less $1,500 less $3,000), interest income of $4,000 ($10,000 less $1,000 less $3,000 less $2,000), and the $5,000 of undistributed capital gain.

Example 3. *Fiscal Year Estate*. (i) D died in 2011. D's estate (Estate) filed its first return that established its fiscal year ending October 31, 2011. During Estate's fiscal year ending October 31, 2013, it earned $10,000 of interest, $1,000 of dividends, and $15,000 of short-term gains. The Estate distributed its interest and dividends to S, D's spouse and sole beneficiary, on a quarterly basis; the last quarter's payment for that taxable year was made to S on December 5, 2013. Pursuant to §1.662(c)–1, S is deemed to have received the first three payments for that taxable year, regardless of the actual payment dates, on October 31, 2013, the last day of Estate's taxable year. Estate makes a timely section 663(b) election to treat the fourth quarter distribution to S as having been made on October 31, 2013, the last day of Estate's preceding taxable year. Accordingly, S is deemed to have received $10,000 of interest and $1,000 of dividends on October 31, 2013.

(ii) Because Estate's fiscal year ending October 31, 2013, began on November 1, 2012, the Estate is not subject to section 1411 on income received during that taxable year. Therefore, none of the income received by Estate during its fiscal year ending October 31, 2013, is net investment income. Pursuant to paragraph (e)(3)(ii) of this section, because none of the distributed interest or dividend income constituted net investment income to Estate, the $10,000 of interest and $1,000 of dividends that Estate distributed to S does not constitute net investment income to S.

(f) *Effective/applicability date*. This section applies to taxable years beginning after December 31, 2013, except that paragraph (d) of this section applies to taxable years of CRTs that begin after December 31, 2012. However, taxpayers other than CRTs may apply this section to taxable years beginning after December 31, 2012, in accordance with §1.1411–1(f).

§1.1411–4 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.

(c) *Other gross income from a trade or business described in §1.1411–5*. For a trade or business described in §1.1411–5, paragraph (a)(1)(ii) of this section includes all other gross income (within the meaning of section 61) that is not gross income described in paragraph (a)(1)(i) of this section or net gain described in paragraph (a)(1)(iii) of this section.

(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, 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]

(e) *Net investment income attributable to certain entities*—(1) *Distributions from estates and trusts*—(i) *In general*. Net investment income includes a beneficiary's share of distributable net income, as described in sections 652(a) and 662(a), to the extent that, under sections 652(b) and 662(b), the character of such income constitutes gross income from items described in paragraphs (a)(1)(i) and (ii) of this section or net gain attributable to items described in paragraph (a)(1)(iii) of this section, with further computations consistent with the principles of this section, as provided in §1.1411–3(e).

(ii) *Distributions of accumulated net investment income from foreign nongrantor trusts to United States beneficiaries*. [Reserved]

(2) *CFCs and PFICs*. For purposes of calculating net investment income, additional rules in §1.1411–10(c) apply to an individual, an estate, or a trust that is a United States shareholder that owns an interest in a controlled foreign corporation (CFC) or that is a United States person that directly or indirectly owns an interest in a passive foreign investment company (PFIC).

(3) *Treatment of income from common trust funds*. [Reserved]

(f) *Properly allocable deductions*—(1) *General rule*—(i) *In general*. Unless provided elsewhere in §§1.1411–1 through 1.1411-10, only properly allocable deductions described in this paragraph (f) may be taken into account in determining net investment income.

(ii) *Limitations*. Any deductions described in this paragraph (f) in excess of gross income and net gain described in section 1411(c)(1)(A) are not taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1.

(2) *Properly allocable deductions described in section 62*—(i) *Deductions allocable to gross income from rents and royalties*. Deductions described in section 62(a)(4) allocable to rents and royalties described in paragraph (a)(1)(i) of this section are taken into account in determining net investment income.

(ii) *Deductions allocable to gross income from trades or businesses described in §1.1411–5*. Deductions described in section 62(a)(1) allocable to income from a trade or business described in §1.1411–5 are taken into account in determining net investment income to the extent the deductions have not been taken into account in determining self-employment income within the meaning of §1.1411–9.

(iii) *Penalty on early withdrawal of savings*. Deductions described in section

62(a)(9) are taken into account in determining net investment income.

(iv) *Net operating loss*. The total section 1411 NOL amount of a net operating loss deduction allowed under section 172 is allowed as a properly allocable deduction in determining net investment income for any taxable year. See paragraph (h) of this section for the calculation of the total section 1411 NOL amount of a net operating loss deduction.

(v) *Examples*. The following examples illustrate the provisions of this paragraph (f)(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. (i) A, an individual, is a 40% shareholder in SCo, an S corporation. SCo is engaged in a trade or business described in section 1411(c)(2)(A). SCo is the only passive activity owned by A. In Year 1, SCo reported a loss of $11,000 to A which was comprised of gross operating income of $29,000 and operating deductions of $40,000. A's at risk amount at the beginning of Year 1 is $7,000. There were no other events that affected A's at risk amount in Year 1.

(ii) For purposes of calculating A's net investment income, A's $29,000 distributive share of SCo's gross operating income is income within the meaning of section 1411(c)(1)(A)(ii).

(iii) As a result of A's at risk limitation, for chapter 1 purposes, A may only deduct $7,000 of the operating deductions in excess of the gross operating income. The remaining $4,000 deductions are suspended because A's amount at risk at the end of Year 1 is zero.

(iv) For purposes of section 469, A has passive activity gross income of $29,000 and passive activity deductions of $36,000 ($40,000 of operating deductions allocable to A less $4,000 suspended under section 465). Because A has no other passive activity income from any other source, section 469 limits A's passive activity deductions to A's passive activity gross income. As a result, section 469 allows A to deduct $29,000 of SCo's operating deduction and suspends the remaining $7,000.

(v) For purposes of calculating A's net investment income, A has $29,000 of properly allocable deductions allowed by section 1411(c)(1)(B) and paragraph (f)(2)(ii) of this section.

Example 2. (i) Same facts as *Example 1*. In Year 2, SCo reported net income of $13,000 to A, which was comprised of gross operating income of $43,000 and operating deductions of $30,000. There were no other events that affected A's at risk amount in Year 2.

(ii) For purposes of calculating A's net investment income, A's $43,000 distributive share of gross operating income is income within the meaning of section 1411(c)(1)(A)(ii).

(iii) Pursuant to section 465(a)(2), A's deductions attributable to the gross income of SCo include the $30,000 deduction allocable to A in Year 2 plus the $4,000 loss that was suspended and carried over to Year 2 from Year 1 pursuant to section 465(a)(2). Under section 465(a)(2), the $4,000 of losses from Year 1 are treated as deductions from the activity in Year 2. As a result, A net operating income from SCo in Year 2 is $9,000 ($43,000 - $30,000 - $4,000) in Year 2. A's amount at risk at the end of Year 2 is $9,000.

(iv) For purposes of section 469, A has passive activity gross income of $43,000. A's passive activity deductions attributable to SCo are the sum of the Year 2 operating deductions allocable to A from S ($30,000), deductions formerly suspended by section 465 ($4,000), and passive activity losses suspended by section 469 ($7,000). Therefore, in Year 2, A has passive activity deductions of $41,000. Because A's passive activity gross income exceeds A's passive activity deductions, section 469 does not limit any of the deductions in Year 2. At the end of Year 2, A has no suspended passive activity losses.

(v) Although A's distributive share of Year 2 deductions allocable to SCo's operating income was $30,000; the operative provisions of sections 465 and 469 do not change the character of the deductions when such amounts are suspended under either section. Furthermore, section 465(a)(2) and §§1.469-1(f)(4) and 1.469-2T(d)(1) treat amounts suspended from prior years as deductions in the current year. See §1.1411–1(a). Therefore, for purposes of calculating A's net investment income, A has $41,000 of properly allocable deductions allowed by section 1411(c)(1)(B) and paragraph (f)(2)(ii) of this section.

(3) *Properly allocable deductions described in section 63(d)*. In determining net investment income, the following itemized deductions are taken into account:

(i) *Investment interest expense*. Investment interest (as defined in section 163(d)(3)) to the extent allowed under section 163(d)(1). Any investment interest not allowed under section 163(d)(1) is treated as investment interest paid or accrued by the taxpayer in the succeeding taxable year. The following example illustrates the provisions of this paragraph. For purposes of this example, assume that the taxpayer uses a calendar taxable year, and Year 1 and all subsequent years are taxable years in which section 1411 is in effect:

(A) In Year 1, A, an unmarried individual, pays interest of $4,000 on debt incurred to purchase stock. Under §1.163-8T, this interest is allocable to the stock and is investment interest within the meaning of section 163(d)(3). A has no investment income as defined by section 163(d)(4). A has $10,000 of income from a trade or business that is a passive activity (as defined in §1.1411–5(a)(1)) with respect to A. For income tax purposes, under section 163(d)(1), A may not deduct the $4,000 investment interest in Year 1 because A does not have any section 163(d)(4) net investment income. Under section 163(d)(2), the $4,000 investment interest is a carryforward of disallowed interest that is treated as investment interest paid by A in the succeeding taxable year. Similarly, for purposes of determining A's Year 1 net investment income, A may not deduct the $4,000 investment interest.

(B) In Year 2, A has $5,000 of section 163(d)(4) net investment income. For both income tax purposes and for determining section 1411 net investment income, A's $4,000 carryforward of interest expense disallowed in Year 1 may be deducted in Year 2.

(ii) *Investment expenses*. Investment expenses (as defined in section 163(d)(4)(C)).

(iii) *Taxes described in section 164(a)(3)*. Taxes imposed on income described in section 164(a)(3) that are allocable to net investment income pursuant to paragraph (g)(1) of this section. Foreign income, war profits, and excess profits taxes are allowable as deductions under section 164(a)(3) in determining net investment income only if the taxpayer does not choose to take any foreign tax credits under section 901 with respect to the same taxable year. See section 275(a)(4). For rules applicable to refunds of taxes described in this paragraph, see paragraph (g)(2) of this section.

(iv) *Items described in section 72(b)(3)*. In the case of an amount allowed as a deduction to the annuitant for the annuitant's last taxable year under section 72(b)(3), such amount is allowed as a properly allocable deduction in the same taxable year if the income from the annuity (had the annuitant lived to receive such income) would have been included in net investment income under paragraph (a)(1)(i) of this section (and not excluded from net investment income by reason of §1.1411–8).

(v) *Items described in section 691(c)*. Deductions for estate and generation-skipping taxes allowed by section 691(c) that are allocable to net investment income; provided, however, that any portion of the section 691(c) deduction described in section 691(c)(4) is taken into account instead in computing net gain under paragraph (d) and not under this paragraph (f)(3)(v).

(vi) *Items described in section 212(3)*. Amounts described in section 212(3) and §1.212–1(l) to the extent they are allocable to net investment income pursuant to paragraph (g)(1) of this section.

(vii) *Amortizable bond premium*. A deduction allowed under section 171(a)(1) for the amortizable bond premium on a taxable bond (for example, see §1.171–2T(a)(4)(i)(C) for the treatment of a bond premium carryforward as a deduction under section 171(a)(1)).

(viii) *Fiduciary expenses*. In the case of an estate or trust, amounts described in §1.212-1(i) to the extent they are allocable to net investment income pursuant to paragraph (g)(1) of this section.

(4) *Loss deductions*—(i) *General rule*. Losses described in section 165, whether described in section 62 or section 63(d), are allowed as properly allocable deductions to the extent such losses exceed the amount of gain described in section 61(a)(3) and are not taken into account in computing net gain by reason of paragraph (d) of this section.

(ii) *Examples*. The following examples illustrate the provisions of this paragraph (f)(4). 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) A, an unmarried individual, owns an interest in PRS, a partnership for Federal income tax purposes. PRS is engaged in a trading business described in section 1411(c)(2)(B) and §1.1411–5(a)(2) and has made a valid and timely election under section 475(f)(2). A's distributive share from PRS in Year 1 consists of $125,000 of interest and dividends and $60,000 of ordinary losses from the trading business. In addition to A's investment in PRS, A sold undeveloped land in Year 1 for a long-term capital gain of $50,000. A has no capital losses carried over from a preceding year.

(ii) For purposes of chapter 1, A includes the $125,000 of interest and dividends, $60,000 of ordinary loss, and $50,000 of long-term capital gain in the computation of A's adjusted gross income.

(iii) For purposes of calculating net investment income, A includes the $125,000 of interest and dividends. Pursuant to paragraph (d) of this section, A takes into account the $60,000 ordinary loss from PRS and the $50,000 of long-term capital gain in the computation of A's net gain. A's losses ($60,000) exceed A's gains ($50,000). Therefore, A's net gain under paragraph (d) of this section is zero. Additionally, A is allowed a deduction under paragraph (f)(4)(i) of this section for $10,000 (the amount of ordinary losses that were allowable under chapter 1 in excess of the amounts taken into account in computing net gain). A's net investment income in Year 1 is $115,000.

Example 2. (i) In Year 1, T, a nongrantor trust, incurs a capital loss of $5,000 on the sale of publicly traded stocks. In addition, T receives $17,000 of interest and dividend income. T has no capital losses carried over from a preceding year.

(ii) For purposes of chapter 1, T includes the $17,000 of interest and dividends and only $3,000 of the capital loss in the computation of adjusted gross income. The remaining $2,000 capital loss is carried over to Year 2.

(iii) For purposes of calculating net investment income, T includes the $17,000 of interest and dividends in net investment income. Pursuant to paragraph (d) of this section, T takes into account the $3,000 capital loss allowed by chapter 1. T's losses ($3,000) exceed T's gains ($0). Therefore, T's net gain under paragraph (d) of this section is zero. However, T is allowed a deduction under paragraph (f)(4)(i) of this section for $3,000 (the amount of losses that were allowable under chapter 1 in excess of the amounts taken into account in computing net gain). T's net investment income in Year 1 is $14,000.

Example 3. (i) In Year 1, B, an unmarried individual, incurs a short-term capital loss of $15,000 on the sale of publicly traded stocks. B also receives annuity income of $50,000. In addition, B disposes of property used in his sole proprietorship (which is not a trade or business described in section 1411(c)(2) or §1.1411–5(a) for a gain of $21,000. Pursuant to section 1231, the gain of $21,000 is treated as a long-term capital gain for purposes of chapter 1. B has no capital losses carried over from a preceding year.

(ii) For purposes of chapter 1, B includes the $50,000 of annuity income in the computation of adjusted gross income. The $21,000 long-term capital gain is offset by the $15,000 short-term capital loss, so B includes $6,000 of net long-term capital gain in the computation of adjusted gross income.

(iii) For purposes of calculating net investment income, B includes the $50,000 of annuity income in net investment income. Pursuant to paragraph (d)(4)(i) of this section, B's net gain does not include the $21,000 long-term capital gain because it is attributable to property held in B's sole proprietorship (a nonpassive activity). Pursuant to paragraph (d) of this section, T takes into account the $15,000 capital loss allowed by chapter 1. B's losses ($15,000) exceed B's gains ($0). Therefore, A's net gain under paragraph (d) of this section is zero. However, B is allowed a deduction under paragraph (f)(4)(i) of this section for $15,000 (the amount of losses that were allowable under chapter 1 in excess of the amounts taken into account in computing net gain). B's net investment income in Year 1 is $35,000.

(5) *Ordinary loss deductions for certain debt instruments*. An amount treated as an ordinary loss by a holder of a contingent payment debt instrument under §1.1275–4(b) or an inflation-indexed debt instrument under §1.1275–7(f)(1).

(6) *Other deductions*. Any other deduction allowed by subtitle A that is identified in published guidance in the **Federal Register** or in the Internal Revenue Bulletin (see §601.601(d)(2)(ii)(*b*) of this chapter) as properly allocable to gross income or net gain under this section.

(7) *Application of limitations under sections 67 and 68*. Any deductions described in this paragraph (f) that are subject to section 67 (the 2-percent floor on miscellaneous itemized deductions) or section 68 (the overall limitation on itemized deductions) are allowed in determining net investment income only to the extent the items are deductible for chapter 1 purposes after the application of sections 67 and 68. For this purpose, section 67 applies before section 68. The amount of deductions subject to sections 67 and 68 that may be deducted in determining net investment income after the application of sections 67 and 68 is determined as described in paragraph (f)(7)(i) and (f)(7)(ii) of this section.

(i) *Deductions subject to section 67*. The amount of miscellaneous itemized deductions (as defined in section 67(b)) tentatively deductible in determining net investment income after applying section 67 (but before applying section 68) is the lesser of:

(A) The portion of the taxpayer's miscellaneous itemized deductions (before the application of section 67) that is properly allocable to items of income or net gain included in determining net investment income, or

(B) The taxpayer's total miscellaneous itemized deductions allowed after the application of section 67, but before the application of section 68.

(ii) *Deductions subject to section 68*. The amount of itemized deductions allowed in determining net investment income after applying sections 67 and 68 is the lesser of:

(A) The sum of the amount determined under paragraph (f)(7)(i) of this section and the amount of itemized deductions not subject to section 67 that are properly allocable to items of income or net gain included in determining net investment income, or

(B) The total amount of itemized deductions allowed after the application of sections 67 and 68.

(iii) *Itemized deductions*. For purposes of paragraph (f)(7)(ii), itemized deductions do not include any deduction described in section 68(c).

Example. The following example illustrates the provisions of this paragraph (f)(7). 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:

(A) A, an unmarried individual, has adjusted gross income in Year 1 as follows:

Wages	$1,600,000
Interest income	*400,000*
Adjusted gross income	$2,000,000

In addition, A has the following items of expense qualifying as itemized deductions:

Investment expenses	$70,000
Job-related expenses	30,000
Investment interest expense	75,000
State income taxes	120,000

A's investment expenses and job-related expenses are miscellaneous itemized deductions. In addition, A's investment interest expense and investment expenses are properly allocable to net investment income (within the meaning of this section). A's job-related expenses are not properly allocable to net investment income. Of the state income tax expense, A applied a reasonable method pursuant to paragraph (g)(1) of this section to properly allocate $20,000 to net investment income.

(B) A's 2-percent floor under section 67 is $40,000 (2% of $2,000,000). For Year 1, assume the section 68 limitation starts at adjusted gross income of $200,000. The section 68 overall limitation disallows $54,000 of A's itemized deductions that are subject to section 68 (3% of the excess of the $2,000,000 adjusted gross income over the $200,000 limitation threshold).

(C)(1) A's total miscellaneous itemized deductions allowable before the application of section 67 is $100,000 ($70,000 in investment expenses plus $30,000 in job-related expenses), and the total miscellaneous deductions allowed after the application of section 67 is $60,000 ($100,000 minus $40,000).

(2) The amount of the miscellaneous itemized deductions properly allocable to net investment income after the application of section 67 is $60,000 (the lesser of $70,000 in investment expenses that are deductible as a miscellaneous itemized deduction and properly allocable to net investment income or $60,000 of miscellaneous itemized deductions allocable to net investment income allowed after the application of section 67).

(D)(1) The amount of itemized deductions allocable to net investment income after applying section 67 to deductions that are also miscellaneous itemized deductions but before applying section 68 is $155,000. This amount is the sum of $60,000 of miscellaneous itemized deductions determined in (C)(2), plus $20,000 in state income tax properly allocable to net investment income, plus $75,000 of investment interest expense. However, under section 68(c)(2), the $75,000 deduction for investment interest expenses is not subject to the section 68 limitation on itemized deductions and is excluded from the computation under §1.1411–4(f)(7). Thus, the amount of itemized deductions allocable to net investment income and subject to section 68, after applying section 67 but before applying section 68, is $80,000.

(2) A's total itemized deductions allowed subject to the limitation under section 68 and after application of section 67, but before the application of section 68, are the following:

Miscellaneous itemized deductions	$60,000
State income tax	*$120,000*
Deductions subject to section 68	$180,000

(3) Of A's itemized deductions that are subject to the limitation under section 68, the amount allowed after the application of section 68 is $126,000 ($180,000 minus the $54,000 disallowed in (B)).

(E) Under paragraph (f)(7)(ii) of this section, the amount of itemized deductions allowed in determining net investment income after applying sections 67 and 68 is the lesser of $80,000 (the sum of $60,000 determined under paragraph (C)(2) and $20,000 state income tax allocable to net investment income) or $126,000 (determined under (D)(3)). Therefore, A's itemized deductions that are properly allocable to net investment income are $155,000 ($80,000 of properly allocable itemized deductions subject to section 67 or 68 plus $75,000 of investment interest expense (which is not subject to either section 67 or section 68 limitations)).

(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 x ($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 a rental real estate activity for

more than 500 hours during such year, or has participated in such real estate activity 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]

(h) *Net operating loss*—(1) *General rule*. For purposes of paragraph (f)(2)(iv) of this section, the total section 1411 NOL amount of a net operating loss deduction for a taxable year is calculated by first determining the applicable portion of the taxpayer's net operating loss for each loss year under paragraph (h)(2) of this section. Next, the applicable portion for each loss year is used to determine the section 1411 NOL amount for each net operating loss carried from a loss year and deducted in the taxable year as provided in paragraph (h)(3) of this section. The section

1411 NOL amounts of each net operating loss carried from a loss year and deducted in the taxable year are then added together as provided in paragraph (h)(4) of this section. This sum is the total section 1411 NOL amount of the net operating loss deduction for the taxable year that is allowed as a properly allocable deduction in determining net investment income for the taxable year. For purposes of this paragraph (h), both the amount of a net operating loss for a loss year and the amount of a net operating loss deduction refer to such amounts as determined for purposes of chapter 1.

(2) *Applicable portion of a net operating loss*. In any taxable year beginning after December 31, 2012 in which a taxpayer incurs a net operating loss, the applicable portion of such loss is the lesser of:

(i) The amount of the net operating loss for the loss year that the taxpayer would incur if only items of gross income that are used to determine net investment income and only properly allocable deductions are taken into account in determining the net operating loss in accordance with section 172(c) and (d); or

(ii) The amount of the taxpayer's net operating loss for the loss year.

(3) *Section 1411 NOL amount of a net operating loss carried to and deducted in a taxable year*. The section 1411 NOL amount of each net operating loss that is carried from a loss year that is allowed as a deduction is the total amount of such net operating loss carried from the loss year allowed as a deduction under section 172(a) in the taxable year multiplied by a fraction. The numerator of the fraction is the applicable portion of the net operating loss for that loss year, as determined under paragraph (h)(2) of this section. The denominator of the fraction is the total amount of the net operating loss for the same loss year.

(4) *Total section 1411 NOL amount of a net operating loss deduction*. The section 1411 NOL amounts of each net operating loss carried to and deducted in the taxable year as determined under paragraph (h)(3) of this section are added together to determine the *total* section 1411 NOL amount of the net operating loss deduction for the taxable year that is properly allocable to net investment income.

(5) *Examples*. The following examples illustrate the provisions of this paragraph (h). 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)(A) In Year 1, A, an unmarried individual, has the following items of income and deduction: $200,000 in wages, $50,000 in gross income from a trade or business of trading in financial instruments or commodities (as defined in §1.1411–5(a)(2)) (trading activity), $10,000 of dividends, $1,000,000 in loss from his sole proprietorship (which is not a trade or business described in §1.1411–5), $12,000 of non-business investment expenses, and $250,000 in trading loss deductions. As a result, for income tax purposes A sustains a section 172(c) net operating loss of $1,000,000. A makes an election under section 172(b)(3) to waive the carryback period for this net operating loss.

(B) For purposes of section 1411, A's net investment income for Year 1 is the excess (if any) of $60,000 ($50,000 trading activity gross income plus $10,000 dividend income) over $262,000 ($250,000 trading loss deductions plus $12,000 nonbusiness expenses).

(C) The amount of the net operating loss for Year 1 determined under section 172 that A would incur if only items of gross income that are used to determine net investment income and only properly allocable deductions are taken into account is $200,000. This amount is the excess of $250,000 trading loss deductions, over $50,000 trading activity gross income. Under section 172(d)(4), in determining the net operating loss, the $12,000 nonbusiness expenses are allowed only to the extent of the $10,000 dividend income. The $200,000 net operating loss determined using only properly allocable deductions and gross income items used in determining net investment income is less than A's actual net operating loss for Year 1 of $1,000,000, and accordingly the applicable portion for Year 1 is $200,000. The ratio used to calculate section 1411 NOL amounts of A's Year 1 net operating loss is $200,000 (net operating loss determined using only properly allocable deductions and gross income items used in determining net investment income)/$1,000,000 (net operating loss), or 0.2.

(ii) For Year 2, A has $250,000 of wages, no gross income from the trading activity, $300,000 of income from his sole proprietorship, and $10,000 in trading loss deductions. For income tax purposes, A deducts $540,000 of the net operating loss carried over from Year 1. In addition, under §1.1411–2(c), the $540,000 net operating loss will be allowed as a deduction in computing A's Year 2 modified adjusted gross income. Because A's modified adjusted gross income is $0, A is not subject to net investment income tax. For purposes of A's net investment income calculation, the section 1411 NOL amount of the $540,000 net operating loss from Year 1 that A deducts in Year 2 is $108,000 ($540,000 multiplied by .2 (the fraction determined based on the applicable portion of the net operating loss in the loss year)). The amount of the Year 1 net operating loss carried over to Year 3 is $460,000. For purposes of A's net investment income calculation, this net operating loss carryover amount includes a section 1411 NOL amount of $92,000 ($460,000 multiplied by 0.2). The section 1411 NOL amount may be applied in determining A's net investment income in Year 3.

(iii)(A) For Year 3, A has $400,000 of wages, $200,000 in trading gains which are gross income from the trading activity, $250,000 of income from his sole proprietorship, and $10,000 in trading loss deductions. For income tax purposes, A deducts the remaining $460,000 of the net operating loss from Year 1. In addition, under §1.1411–2(c), the $460,000 net operating loss deduction reduces A's Year 3 modified adjusted gross income to $380,000.

(B) A's section 1411 NOL amount of the net operating loss deduction for Year 3 is $92,000, which is the $460,000 net operating loss deduction for Year 3 multiplied by 0.2.

(C) A's net investment income for Year 3 before the application of paragraph (f)(2)(iv) of this section is $190,000 ($200,000 in gross income from the trading activity, minus $10,000 in trading loss deductions). After the application of paragraph (f)(2)(iv) of this section, A's net investment income for Year 3 is $98,000 ($190,000 minus $92,000, the total section 1411 NOL amount of the net operating loss deduction).

Example 2. (i) The facts for Year 1 are the same as in *Example 1*.

(ii) (A) For Year 2, A has $100,000 in wages, $200,000 in gross income from the trading activity, $15,000 of dividends, $250,000 in losses from the sole proprietorship, $10,000 of non-business investment expenses, and $355,000 in trading loss deductions. As a result, for income tax purposes A sustains a section 172(c) net operating loss of $300,000. A makes an election under section 172(b)(3) to waive the carryback period for the Year 2 net operating loss.

(B) For purposes of section 1411, A's net investment income for Year 2 is the excess (if any) of $215,000 ($200,000 trading activity gross income plus $15,000 dividend income) over $365,000 ($355,000 trading loss deductions plus $10,000 nonbusiness expenses).

(C) The amount of the net operating loss for Year 2 determined under section 172 that A would incur if only items of gross income that are used to determine net investment income and only properly allocable deductions are taken into account is $150,000. This amount is the excess of $365,000 ($355,000 trading loss deductions plus $10,000 nonbusiness expenses) over $215,000 ($200,000 trading activity gross income plus $15,000 dividend income). Under section 172(d)(4), in determining the net operating loss, the $10,000 nonbusiness expenses are allowed in full against the $15,000 dividend income. The $150,000 net operating loss determined using only properly allocable deductions and gross income items used in determining net investment income is less than A's actual net operating loss for Year 2 of $300,000, and accordingly the applicable portion is $150,000. The ratio used to calculate the section 1411 NOL amount of A's Year 2 net operating loss is $150,000 (the applicable portion)/$300,000 (net operating loss), or 0.5.

(iii) For Year 3, A has $250,000 of wages, no gross income from the trading activity, $300,000 of income from his sole proprietorship, and $10,000 in trading loss deductions. For income tax purposes, A deducts $540,000 of the net operating loss from Year 1. In addition, under §1.1411– 2(c), the $540,000 net operating loss will be allowed as a deduction in computing A's Year 3 modified adjusted gross income. Because A's modified adjusted gross income is $0, A is not subject to net investment income tax. The section 1411 NOL amount of the $540,000 net operating loss from Year 1 that A deducts in Year 3 is $108,000 ($540,000 multiplied by 0.2 (the fraction used to calculate the section 1411 NOL amount of the net operating loss)), and this is also the total section 1411 NOL amount for Year 3. The amount of the Year 1 net operating loss carried over to Year 4 is $460,000. This net operating loss carryover amount includes a section 1411 NOL amount of $92,000 ($460,000 multiplied by 0.2) that may be applied in determining net investment income in Year 4. None of the Year 2 net operating loss is deducted in Year 3 so that the $300,000 Year 2 net operating loss (including the section 1411 NOL amount of $150,000) is carried to Year 4.

(iv)(A) For Year 4, A has $150,000 of wages, $450,000 in trading gains which are gross income from the trading activity, $250,000 of income from his sole proprietorship, and $10,000 in trading loss deductions. For income tax purposes, A deducts the remaining $460,000 of the net operating loss carryover from Year 1 and the $300,000 net operating loss carryover from Year 2, for a total net operating loss deduction in Year 4 of $760,000. In addition, under §1.1411–2(c), the $760,000 net operating loss deduction reduces A's Year 4 modified adjusted gross income to $80,000.

(B) A's total section 1411 NOL amount of the net operating loss deduction for Year 4 is $242,000, which is the sum of the $92,000 ($460,000 net operating loss carryover from Year 1 and deducted in Year 4 multiplied by 0.2 (the ratio used to calculate the section 1411 NOL amount of the Year 1 net operating loss)) plus $150,000 ($300,000 net operating loss carryover from Year 2 and deducted in Year 4 multiplied by 0.5 (the ratio used to calculate the section 1411 NOL amount of the Year 2 net operating loss)).

(C) A's net investment income for Year 4 before the application of paragraph (f)(2)(iv) of this section is $440,000 ($450,000 in gross income from the trading activity, minus $10,000 in trading loss deductions). After the application of paragraph (f)(2)(iv) of this section, A's net investment income for Year 4 is $198,000 ($440,000 minus $242,000, the total section 1411 NOL amount of the Year 4 net operating loss deduction).

(i) *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).

§1.1411–5 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 §§1.469–2T(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 §1.469–2T(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).

§1.1411–6 Income on investment of working capital subject to tax.

(a) *General rule*. For purposes of section 1411, any item of gross income from the investment of working capital will be treated as not derived in the ordinary course of a trade or business, and any net gain that is attributable to the investment of working capital will be treated as not derived in the ordinary course of a trade or business. In determining whether any item is gross income from or net gain attributable to an investment of working capital, principles similar to those described in §1.469–2T(c)(3)(ii) apply. See §1.1411–4(f) for rules regarding properly allocable deductions with respect to an investment of working capital and §1.1411–7 for rules relating to the adjustment to net gain on the disposition of interests in a partnership or S corporation.

(b) *Example*. The following example illustrates the principles of this section. Assume for purposes of the example that 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. (i) A, an unmarried individual, operates a restaurant, which is a section 162 trade or business but is not a trade or business described in §1.1411–5(a)(1) with respect to A. A owns and conducts the restaurant business through S, an S corporation wholly-owned by A. S is able to pay all of the restaurant's current obligations with cash flow generated by the restaurant. S utilizes an interest-bearing checking account at a local bank to make daily deposits of cash receipts generated by the restaurant, and also to pay the recurring ordinary and necessary business expenses of the restaurant. The average daily balance of the checking account is approximately $2,500, but at any given time the balance may be significantly more or less than this amount depending on the short-term cash flow needs of the business. In addition, S has set aside $20,000 for the potential future needs of the business in case the daily cash flow into and from the checking account becomes insufficient to pay the restaurant's recurring business expenses. S does not currently need to spend or use the $20,000 capital to conduct the restaurant business, and S deposits and maintains the $20,000 in an interest-bearing savings account at a local bank.

(ii) Both the $2,500 average daily balance of the checking account and the $20,000 savings account balance constitute working capital under §1.469-2T(c)(3)(ii) and, pursuant to paragraph (a) of this section, the interest generated by this working capital will not be treated as derived in the ordinary course of S's restaurant business. Accordingly, the interest income derived by S from its checking and savings accounts and allocated to A under section 1366 constitutes gross income from interest under §1.1411–4(a)(1)(i).

(c) *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).

§1.1411–7 [Reserved]

§1.1411–8 Exception for distributions from qualified plans.

(a) *General rule*. Net investment income does not include any distribution from a qualified plan or arrangement. For this purpose, the term qualified plan or arrangement means any plan or arrangement described in section 401(a), 403(a), 403(b), 408, 408A, or 457(b).

(b) *Rules relating to distributions*. This paragraph (b) provides rules for purposes of paragraph (a) of this section. For purposes of section 1411(c)(5) and this section, a distribution means the following:

(1) *Actual distributions*. Any amount actually distributed from a qualified plan or arrangement, as defined in paragraph (a) of this section, is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. Examples include a rollover to an eligible retirement plan within the meaning of section 402(c)(8)(B), a distribution of a plan loan offset amount within the meaning of Q&A-13(b) of §1.72(p)-1, and certain corrective distributions under the Internal Revenue Code (Code).

(2) *Amounts treated as distributed*. Any amount that is treated as distributed from a qualified plan or arrangement under the Code for purposes of income tax is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. Examples include a conversion to a Roth IRA described in section 408A and a deemed distribution under section 72(p).

(3) *Amounts includible in gross income*. Any amount that is not treated as a distribution but is otherwise includible in gross income pursuant to a rule relating to amounts held in a qualified plan or arrangement described in paragraph (a) of this section is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. For example, any income of the trust of a qualified plan or arrangement that is applied to purchase a participant's life insurance coverage (the P.S. 58 costs) is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income.

(4) *Amounts related to employer securities*—(i) *Dividends related to employer securities*. Any dividend that is deductible under section 404(k) and is paid in cash directly to plan participants or beneficiaries is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. However, any amount paid as a dividend after the employer securities have been distributed from a qualified plan is not a distribution within the meaning of section 1411(c)(5), and thus is included in net investment income.

(ii) *Amounts related to the net unrealized appreciation in employer securities*. The amount of any net unrealized appreciation attributable to employer securities (within the meaning of section 402(e)(4)) realized on a disposition of those employer securities is a distribution within the meaning of section 1411(c)(5), and thus is not included in net investment income. However, any appreciation in value of the employer securities after the distribution from the qualified plan is not a distribution within the meaning of section 1411(c)(5), and is included in net investment income.

(c) *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).

§1.1411–9 Exception for self-employment income.

(a) *General rule*. Except as provided in paragraph (b) of this section, net investment income does not include any item taken into account in determining self-employment income that is subject to tax under section 1401(b) for such taxable year. For purposes of section 1411(c)(6) and this section, *taken into account* means income included and deductions allowed in determining net earnings from self-employment. However, amounts excepted in determining net earnings from self-employment under section 1402(a)(1)–(17), and thus excluded from self-employment income under section 1402(b), are not taken into account in determining self-employment income and thus may be included in net investment income if such amounts are described in §1.1411–4. Except as provided in paragraph (b) of this section, if net earnings from self-employment consist of income or loss from more than one trade or business, all items taken into account in determining the net earnings from self-employment with respect to these trades or businesses (see §1.1402(a)–2(c)) are considered taken into account in determining the amount of self-employment income that is subject to tax under section 1401(b) and therefore not included in net investment income.

(b) *Special rule for traders*. In the case of gross income described in §§1.1411–4(a)(1)(ii) and (a)(1)(iii) derived from a trade or business of trading in financial instruments or commodities (as described in §1.1411–5(a)(2)), the deductions described in §1.1411–4(f)(2)(ii) properly allocable to the taxpayer's trade or business of trading in financial instruments or commodities are taken into account in determining the taxpayer's self-employment income only to the extent that such deductions reduce the taxpayer's net earnings from self-employment (after aggregating under §1.1402(a)–2(c) the net earnings from self-employment from any trade or business carried on by the taxpayer as an individual or as a member of a partnership). Any deductions described in §1.1411–4(f)(2)(ii) that exceed the amount of net earnings from self-employment, in the aggregate (if applicable), are allowed in determining the taxpayer's net investment income under section 1411 and the regulations thereunder.

(c) *Examples*. The following examples illustrate the provisions of this section. 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. Exclusion from self-employment income. A is a general partner in PRS, a partnership carrying on a trade or business that is not a trade or business of trading in financial instruments or commodities (within the meaning of §1.1411–5(a)(2)). During Year 1, A's distributive share from PRS is $1 million, $300,000 of which is attributable to the gain on the sale of PRS's capital assets. Section 1402(a)(3)(A) provides an exclusion from net earnings from self-employment for any gain or loss from the sale or exchange of a capital asset. For Year 1, A has $700,000 self-employment income subject to self-employment tax. This $700,000 subject to self-employment tax is not included as part of net investment income under paragraph (a) of this section. However, the $300,000 attributable to the gain on PRS's sale of a capital asset is excluded from net earnings from self-employment, and from self-employment income, and thus is not covered by the exception in section 1411(c)(6). Therefore, the $300,000 attributable to the gain on PRS's sale of a capital asset is included as net investment income if the other requirements of section 1411 are satisfied.

Example 2. Two trades or businesses. B is an individual engaged in two trades or businesses, Business X and Business Y, neither of which is the trade or business of trading in financial instruments or commodities (as described in §1.1411–5(a)(2)). B carries on Business X as a sole proprietor and B is also a general partner in a partnership that carries on

Business Y. Business Y is a nonpassive activity of B. During Year 1, B had net earnings from self-employment consisting of the aggregate of a $50,000 loss (that is, after application of the exclusions under section 1402(a)(1)–(17)) from Business X, and $70,000 in income (after application of the exclusions under section 1402(a)(1)–(17)) from B's distributive share from the partnership from carrying on Business Y. Thus, B's net earnings from self-employment in Year 1 are $20,000. For Year 1, all of B's income, deductions, gains, and losses from Business X and distributive share from the partnership carrying on Business Y, other than those amounts excluded due to application of section 1402(a)(1)–(17), are taken into account in determining B's net earnings from self-employment and self-employment income for such taxable year. Accordingly, in calculating B's net investment income (as defined in §1.1411–4) for Year 1, B will not take into account the items of income, loss, gain, and deduction that comprise B's $50,000 loss attributable to Business X (after application of the exclusions under section 1402(a)(1)–(17)), and the items of income, loss, gain, and deduction that comprise B's $70,000 distributable share attributable to B's general partnership interest (after application of the exclusions under section 1402(a)(1)–(17)). Rather, only items of income, loss, gain, and deduction from the two separate businesses that were excluded from the calculation of B's net earnings from self-employment income due to the application of the exclusions under section 1402(a)(1)–(17), such as any capital gains and losses excluded under section 1402(a)(3), are considered for purposes of calculating B's net investment income for Year 1 in connection with these two trades or businesses.

Example 3. Special rule for trader with single trade or business. D is an individual engaged in the trade or business of trading in commodities (as described in §1.1411–5(a)(2)). D made a valid and timely election under section 475(f)(2). D derives $400,000 of trading gains, which are gross income described in §1.1411–4(a)(1) and $15,000 of expenses described in §1.1411–4(f)(2)(ii) from carrying on the trade or business. Pursuant to sections 475(f)(1)(D) and 1402(a)(3)(A), none of the gross income is taken into account in determining D's net earnings from self-employment and self-employment income. Therefore, under paragraph (a) of this section, the $400,000 of gross income is not covered by the exception in section 1411(c)(6). Because D had $0 net earnings from self-employment, the $15,000 of deductions did not reduce D's net earnings from self-employment under paragraph (b) of this section and §1.1411–(4)(f)(2)(ii). Therefore, the $15,000 of deductions may reduce D's gross income of $400,000 for purposes of section 1411.

Example 4. Special rule for trader with multiple trades or businesses. E is an individual engaged in two trades or businesses, Business X (which is not a trade or business of trading in financial instruments or commodities) and Business Y (which is a trade or business of trading in financial instruments or commodities (as described in §1.1411–5(a)(2)). E made a valid and timely election under section 475(f) with respect to Business Y. During Year 1, E had net earnings from self-employment from Business X of $35,000. During Year 1, E also had $300,000 of trading gains, which are gross income described in §1.1411–4(a)(1) and $40,000 of expenses described in §1.1411–4(f)(2)(ii) from Business Y. E's $300,000 of gross income from Business Y is excluded from net earnings from self-employment and self-employment income pursuant to sections 475(f)(1)(D) and 1402(a)(3)(A). E's $40,000 of deductions from Business Y reduce E's $35,000 of net earnings from self-employment from Business X to $0. Pursuant to paragraph (b) of this section and §1.1411–4(f)(2)(ii), the remaining $5,000 of deductions from Business Y are taken into account in determining E's net investment income (by reducing E's gross income of $300,000 from Business Y to $295,000) for purposes of section 1411.

(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).

§1.1411–10 Controlled foreign corporations and passive foreign investment companies.

(a) *In general*. This section provides rules that apply to an individual, estate, or trust that is a United States shareholder of a controlled foreign corporation (CFC), or that is a United States person that directly or indirectly owns an interest in a passive foreign investment company (PFIC). In addition, this section provides rules that apply to an individual, estate, or trust that owns an interest in a domestic partnership or an S corporation that is either a United States shareholder of a CFC or that has made an election under section 1295 to treat a PFIC as a qualified electing fund (QEF). References in this section to an election under paragraph (g) of this section being in effect relate to an election that is applicable to the person that is determining the section 1411 consequences with respect to holding a particular CFC or QEF.

(b) *Amounts derived from a trade or business described in §1.1411–5*—(1) *In general*. Except as provided in paragraph (b)(2) of this section, an amount included in gross income under section 951(a) or section 1293(a) that is also income derived from a trade or business described in section 1411(c)(2) and §1.1411–5 (applying the relevant rules in §1.1411–4(b)) is taken into account as net investment income under section 1411(c)(1)(A)(ii) and §1.1411–4(a)(1)(ii) for purposes of section 1411 and the regulations thereunder when it is taken into account for purposes of chapter 1, and the rules in paragraphs (c) through (g) of this section do not apply to that amount. For purposes of section 1411 and the regulations thereunder, an amount included in gross income under section 1296(a) that is also income derived from a trade or business described in section 1411(c)(2) and §1.1411–5 (applying the relevant rules in §1.1411–4(b)), is net investment income within the meaning of section 1411(c)(1)(A)(ii) and §1.1411–4(a)(1)(ii), and the rules in paragraph (c)(2)(ii) of this section do not apply to that amount.

(2) *Coordination rule for changes in trade or business status*. With respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, the rules in paragraphs (c) through (f) of this section apply to a distribution of earnings and profits described in paragraph (c)(1)(i)(A) of this section that was not taken into account as net investment income under paragraph (b) of this section.

(c) *Calculation of net investment income*—(1) *Dividends*. For purposes of section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i), net investment income is calculated by taking into account the amount of dividends described in this paragraph (c)(1).

(i) *Distributions of previously taxed earnings and profits*—(A) *Rules when an election under paragraph (g) of this section is not in effect with respect to the shareholder*—(*1*) *General rule*. Except as otherwise provided in this paragraph (c)(1)(i), with respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, a distribution of earnings and profits that is not treated as a dividend for chapter 1 purposes under section 959(d) or section 1293(c) is a dividend for purposes of section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i) if the distribution is attributable to amounts that are or have been included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) in a taxable year beginning after December 31, 2012. Solely, for this purpose, distributions of earnings and profits attributable to amounts that are or have been included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) are considered first attributable to those earnings and profits, if any, derived from the current taxable year, and then from prior taxable years beginning with the most recent prior taxable year, and with respect to amounts included under section 951(a), without regard to whether the earnings and profits are described in section 959(c)(1) or section 959(c)(2).

(*2*) *Exception for distributions attributable to earnings and profits previously taken into account for purposes of section 1411*. A distribution of earnings and profits that is not treated as a dividend for chapter 1 purposes under section 959(d) or section 1293(c) is not treated as a dividend for purposes of section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i), to the extent that an individual, estate, or trust establishes, by providing information that is similar to, and in the same manner as, the information described in §1.959-1(d) (relating to previously taxed earnings and profits), that the distribution is attributable to—

(*i*) Amounts included in gross income by any person for chapter 1 purposes under section 951(a) or section 1293(a) that have been taken into account by any person as net investment income by reason of paragraph (b) of this section or an election under paragraph (g) of this section; or

(*ii*) Amounts included in gross income by any person as a dividend pursuant to section 1248(a) that, by reason of paragraph (c)(3)(ii) of this section, have been taken into account by any person as net investment income under section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i).

(B) *Rule when an election under paragraph (g) of this section is in effect with respect to the shareholder*. Except as otherwise provided in this paragraph (c)(1)(i), if an election under paragraph (g) of this section is in effect, a distribution of earnings and profits that is not treated as a dividend for chapter 1 purposes under section 959(d) or section 1293(c) is not treated as a dividend for purposes of section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i).

(C) *Special rule for certain distributions related to 2013 taxable years*—(*1*) *Scope*. The rule in this paragraph (c)(1)(i)(C) applies to individuals, estates, and trusts that were subject to section 1411 during a taxable year that began after December 31, 2012, and before January 1, 2014, and that satisfy all of the conditions set forth in paragraph (c)(1)(i)(C)(*2*) of this section. This rule also applies to all domestic partnerships and S corporations that satisfy all of the conditions set forth in paragraph (c)(1)(i)(C)(*2*) of this section.

(*2*) *Rule*. A distribution of earnings and profits from a CFC or QEF, with respect to which an election under paragraph (g) is in effect, that is not treated as a dividend for chapter 1 purposes under section 959(d) or section 1293(c) is a dividend for purposes of section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i) to the extent that—

(*i*) The distribution of earnings and profits is attributable to an amount included by an individual, estate, trust, domestic partnership, S corporation or common trust fund in gross income for chapter 1 purposes under section 951(a) or section 1293(a) with respect to the CFC or QEF for a taxable year that began after December 31, 2012, and before January 1, 2014;

(*ii*) The individual, estate, trust, domestic partnership, S corporation, or common trust fund made the election under paragraph (g) of this section with respect to the CFC or QEF in a taxable year that began after December 31, 2013; and

(*iii*) The individual, estate, trust, domestic partnership, S corporation, or common trust fund did not make the election described in paragraph (g)(4)(iii) of this section (concerning making an election under paragraph (g) of this section for a taxable year that begins before January 1, 2014).

(*3*) *Ordering rule*. Solely, for purposes of this paragraph (c)(1)(i)(C)(*3*), distributions of earnings and profits attributable to amounts that have been included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) are considered first attributable to the earnings and profits derived from a taxable year that began after December 31, 2012, and before January 1, 2014.

(ii) *Excess distributions that constitute dividends*. To the extent an excess distribution within the meaning of section 1291(b) constitutes a dividend within the meaning of section 316(a), the amount is included in net investment income for purposes of section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i).

(2) *Net gain*. For purposes of section 1411(c)(1)(A)(iii) and §1.1411–4(a)(1)(iii), the rules in this paragraph (c)(2) apply in determining net gain attributable to the disposition of property.

(i) *Gains treated as excess distributions*. Gains treated as excess distributions under section 1291(a)(2) are included in determining net gain attributable to the disposition of property for purposes of section 1411(c)(1)(A)(iii) and §1.1411–4(a)(1)(iii).

(ii) *Inclusions and deductions with respect to section 1296 mark to market elections*. Amounts included in gross income under section 1296(a)(1) and amounts allowed as a deduction under section 1296(a)(2) are taken into account in determining net gain attributable to the disposition of property for purposes of section 1411(c)(1)(A)(iii) and §1.1411–4(a)(1)(iii).

(iii) *Gain or loss attributable to the disposition of stock of CFCs and QEFs*. With respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, for purposes of calculating the net gain under §§1.1411–4(a)(1)(iii) and 1.1411–4(d) that is attributable to the direct or indirect disposition of that stock (including for purposes of determining gain or loss on the direct or indirect disposition of that stock by a domestic partnership, S corporation, or common trust fund), basis is determined in accordance with the provisions of paragraph (d) of this section.

(iv) *Gain or loss attributable to the disposition of interests in domestic partnerships or S corporations that own directly or indirectly stock of CFCs or QEFs*. With respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, for purposes of calculating the net gain under §§1.1411–4(a)(1)(iii) and 1.1411–4(d) that is attributable to the disposition of an interest in a domestic partnership or S corporation that directly or indirectly owns that stock, basis is determined in accordance with the provisions of paragraph (d) of this section.

(3) *Application of section 1248*. With respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, for purposes of section 1411 and §1.1411–4—

(i) In determining the gain recognized on the sale or exchange of stock of a foreign corporation for section 1248(a) purposes, basis is determined in accordance with the provisions of paragraph (d) of this section; and

(ii) Section 1248(a) applies without regard to the exclusion for certain earnings and profits under sections 1248(d)(1) and (d)(6), except that those exclusions will apply with respect to the earnings and profits of a foreign corporation that are attributable to:

(A) Amounts taken into account as net investment income under paragraph (b) of this section; and

(B) Amounts previously included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) in a taxable year beginning before December 31, 2012, and that have not yet been distributed. For this purpose, the determination of whether earnings and profits that are attributable to amounts previously taxed in a taxable year beginning before December 31, 2012, have been distributed is determined based on the rules described in paragraph (c)(1)(i) of this section.

(4) *Amounts distributed by an estate or trust*. Net investment income of a beneficiary of an estate or trust includes the beneficiary's share of distributable net income, as described in sections 652 and 662 and as modified by paragraph (f) of this section, to the extent that the beneficiary's share of distributable net income includes items that, if they had been received directly by the beneficiary, would have been described in this paragraph (c).

(5) *Properly allocable deductions*—(i) *General rule*. For purposes of section 1411(c)(1)(B) and §1.1411–4(f), the section 163(d)(1) investment expense deduction may be calculated by—

(A) Increasing the amount of investment income determined for chapter 1 purposes under section 163(d)(4)(B) by the amount of dividends described in §1.1411– 10(c) that are derived from a CFC or QEF with respect to which an election under paragraph (g) of this section is not in effect;

(B) Decreasing the amount of investment income for determined chapter 1 purposes under section 163(d)(4)(B) by the amount included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) that is attributable to a CFC or QEF with respect to which an election under paragraph (g) of this section is not in effect; and

(C) Increasing or decreasing, as applicable, the amount of investment income for chapter 1 purposes under section 163(d)(4)(B) by the difference between the amount calculated with respect to a disposition under paragraphs (c)(2)(iii) and (c)(2)(iv) of this section and the amount of the gain or loss attributable to the relevant disposition as calculated for chapter 1 purposes.

(ii) *Additional rules*. For purposes of section 1411(c)(1)(B) and §1.1411–4(f), if the method of calculation described in paragraph (c)(5)(i) of this section is applied:

(A) The amount of investment interest not allowed as a deduction under section 163(d)(2) must be calculated consistent with the method of calculation described in paragraph (c)(5)(i).

(B) The method of calculation must be adopted by an individual, estate, or trust no later than the first year in which the individual, estate, or trust is subject to section 1411.

(C) The method of calculation must be applied with respect to all CFCs and QEFs for all taxable years with respect to which an election under paragraph (g) of this section is not in effect.

(D) A method of calculation under this paragraph is a method of accounting, which must be applied consistently, and may only be changed by the taxpayer by securing the consent of the Commissioner in accordance with §1.446-1(e) and following the administrative procedures issued under §1.446-1(e)(3)(ii).

(d) *Conforming basis adjustments*—(1) *Basis adjustments under sections 961 and 1293*—(i) *Stock held by individuals, estates, or trusts*. With respect to stock of a CFC or QEF which is held by an individual, estate, or trust, either directly or indirectly through one or more entities each of which is foreign, for which an election under paragraph (g) of this section is not in effect—

(A) The basis increases made pursuant to sections 961(a) and 1293(d) for amounts included in gross income for chapter 1 purposes under sections 951(a) and 1293(a) in taxable years beginning after December 31, 2012, are not taken into account for purposes of section 1411 and the regulations thereunder; and

(B) The basis decreases made pursuant to sections 961(b) and 1293(d) attributable to amounts treated as dividends for purposes of section 1411 under paragraph (c)(1)(i) of this section are not taken into account for purposes of section 1411 and the regulations thereunder.

(ii) *Stock held by domestic partnerships or S corporations*—(A) *Rule when an election under paragraph (g) of this section is not in effect*. The rules of this paragraph (d)(1)(ii)(A) apply with respect to stock of a CFC or QEF held directly by a domestic partnership or S corporation, or indirectly through one or more entities each of which is foreign, for which an election under paragraph (g) of this section is not in effect. If an individual, estate, or trust is a shareholder of an S corporation, or if an individual, estate, or trust directly, or through one or more tiers of passthrough entities (including an S corporation), owns an interest in a domestic partnership, the S corporation or domestic partnership, as the case may be, will not take into account for purposes of section 1411 and the regulations thereunder the basis increases made by the domestic partnership or S corporation pursuant to sections 961(a) and 1293(d) for amounts included in gross income for chapter 1 purposes under sections 951(a) and 1293(a) for taxable years beginning after December 31, 2012, and the basis decreases made by the domestic partnership or S corporation pursuant to sections 961(b) and 1293(d) attributable to amounts treated as dividends for purposes of section 1411 under paragraph (c)(1)(i) of this section (the section 1411 recalculated basis). If the domestic partnership or S corporation disposes of the stock of a CFC or QEF, the section 1411 recalculated basis will be used to determine the distributive share or pro rata share of the gain or loss for purposes of section 1411 for partners or shareholders.

(B) *Rules when an election under paragraph (g) of this section is in effect*. If an election under paragraph (g) of this section is in effect with respect to stock of a CFC or QEF held directly or indirectly by a domestic partnership or S corporation, the partner's distributive share or the shareholder's pro rata share of the gain or loss for purposes of section 1411 is the same as the distributive share or pro rata share of the gain or loss for purposes of chapter 1. See *Example 6* of paragraph (h) of this section.

(2) *Special rules for partners that own interests in domestic partnerships that own directly or indirectly stock of CFCs or QEFs*. The rules of this paragraph (d)(2) apply with respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, and that is held by a domestic partnership, either directly or indirectly through one or more entities each of which is foreign. In such a case, the basis increases provided under section 705(a)(1)(A) to the partners for purposes of chapter 1 that are attributable to amounts that the domestic partnership includes or included in gross income under section 951(a) or section 1293(a) for a taxable year beginning after December 31, 2012, are not taken into account for purposes of section 1411. Instead, each partner's adjusted basis in the partnership interest is increased by its share of any distributions to the partnership from the CFC or QEF that are treated as dividends for purposes of section 1411 under paragraph (c)(1)(i) of this section. Similar rules apply when the stock of the CFC or QEF is held in a tiered partnership structure. For purposes of determining net investment income under section 1411 and the regulations thereunder, the partner's adjusted basis in the partnership interest as calculated under this paragraph (d)(2) is used to determine all tax consequences related to tax basis (for example, loss limitation rules and the characterization of partnership distributions).

(3) *Special rules for S corporation shareholders that own interests in S corporations that own directly or indirectly stock of CFCs or QEFs*. The rules of this paragraph (d)(3) apply with respect to stock of a CFC or QEF for which an election under paragraph (g) of this section is not in effect, and that is held by an S corporation, directly or indirectly through one or more entities each of which is foreign. In such case, the basis increases provided in section 1367(a)(1)(A) to its shareholders for chapter 1 purposes that are attributable to amounts that the S corporation includes or included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) for taxable years beginning after December 31, 2012, are not taken into account for purposes of section 1411. Instead, each shareholder's adjusted basis of stock in the S corporation is increased by its share of the distributions to the S corporation from the CFC or QEF that are treated as dividends for purposes of section 1411 under paragraph (c)(1)(i) of this section. Similar rules apply when the S corporation holds an interest in a CFC or QEF through a partnership. For purposes of determining net investment income under section 1411 and the regulations thereunder, the shareholder's adjusted basis in the stock of the S corporation as calculated under this paragraph (d)(3) is used to determine all tax consequences related to tax basis (for example, loss limitation rules and the characterization of S corporation distributions).

(4) *Special rules for participants in common trust funds*. Rules similar to the rules in paragraphs (d)(2) and (3) of this section apply to ownership interests in common trust funds (as defined in section 584).

(e) *Conforming adjustments to modified adjusted gross income and adjusted gross income*—(1) *Individuals*. Solely for purposes of section 1411(a)(1)(B)(i) and the regulations thereunder, the term *modified adjusted gross income* means modified adjusted gross income as defined in §1.1411–2(c)(1)—

(i) Increased by amounts included in net investment income under paragraphs (c)(1)(i), (c)(1)(ii), (c)(2)(i), and (c)(4) of this section that are not otherwise included in gross income for chapter 1 purposes;

(ii) Increased or decreased, as applicable, by the difference between the amount calculated with respect to a disposition under paragraphs (c)(2)(iii) and (iv) of this section and the amount of the gain or loss attributable to the relevant disposition as calculated for chapter 1 purposes;

(iii) Decreased by any amount included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) attributable to a CFC or QEF with respect to which no election under paragraph (g) of this section is in effect; and

(iv) To the extent the section 163(d)(1) investment interest expense deduction is calculated using the method of calculation set forth in paragraph (c)(5) of this section and the deduction is taken into account under §1.1411–4(f)(2), increased or decreased, as appropriate, by the difference between the amount of the section 163(d)(1) investment interest expense deduction calculated under paragraph (c)(5) of this section and the amount calculated for chapter 1 purposes.

(2) *Estates and trusts*. Solely for purposes of section 1411(a)(2)(B)(i) and the regulations thereunder, the term *adjusted gross income* means adjusted gross income as defined in §1.1411–3(a)(1)(ii)(B)(*1*) adjusted by the following amounts to the extent those amounts are not distributed by the estate or trust—

(i) Increased by amounts included in net investment income under paragraphs (c)(1)(i), (c)(1)(ii), (c)(2)(i), and (c)(4) of this section that are not otherwise included in gross income for chapter 1 purposes;

(ii) Increased or decreased, as applicable, by the difference between the amount calculated with respect to a disposition under paragraphs (c)(2)(iii) and (iv) of this section and the amount of the gain or loss attributable to the relevant disposition as calculated for chapter 1 purposes;

(iii) Decreased by any amount included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) attributable to a CFC or QEF with respect to which no election under paragraph (g) of this section is in effect; and

(iv) To the extent the section 163(d)(1) investment interest expense deduction is calculated using the method of calculation set forth in paragraph (c)(5) of this section and taken into account under §1.1411–4(f)(2), increased or decreased, as appropriate, by the difference between the amount of the section 163(d)(1) investment interest expense deduction calculated under paragraph (c)(5) of this section and the amount calculated for chapter 1 purposes.

(f) *Application to estates and trusts*. All of the items described in paragraph (c) of this section are included in the net investment income of an estate or trust or its beneficiaries. The amounts described in paragraphs (e)(2)(i) through (iv) of this section, regardless of whether the estate or trust receives those amounts directly or indirectly through another estate or trust, increase or decrease, as applicable, the estate's or trust's distributable net income for purposes of section 1411. The estate or trust, or the beneficiaries thereof, must take those amounts into account in a manner reasonably consistent with the general operating rules for estates and trusts in §1.1411–3 and subchapter J in computing the undistributed net investment income of the estate or trust and the net investment income of the beneficiaries.

(g) *Election with respect to CFCs and QEFs*—(1) *Effect of election*. If an election under paragraph (g) of this section is made with respect to a CFC or QEF, amounts included in gross income for chapter 1 purposes under section 951(a) or section 1293(a)(1)(A) with respect to the CFC or QEF in taxable years beginning with the taxable year for which the election is made are treated as net investment income for purposes of §1.1411–4(a)(1)(i), and amounts included in gross income under section 1293(a)(1)(B) with respect to the QEF in taxable years beginning with the taxable year for which the election is made are taken into account in calculating net gain attributable to the disposition of property under §1.1411–4(a)(1)(iii). See paragraphs (c)(1)(i)(B) and (c)(1)(i)(C) of this section for the effect of this election on certain distributions of previously taxed earnings and profits.

(2) *Years to which election applies*—(i) *In general*. An election under paragraph (g) of this section applies to the taxable year for which it is made and all subsequent taxable years, and applies to all subsequently acquired interests in the CFC or QEF. An election under paragraph (g) of this section is irrevocable.

(ii) *Termination of interest in CFC or QEF*. Complete termination of a person's interest in the CFC or QEF does not terminate the person's election under paragraph (g) of this section with respect to the CFC or QEF. Thus, if the person reacquires stock of the CFC or QEF, that stock is considered to be stock for which an election under paragraph (g) of this section has been made and is in effect.

(iii) *Termination of partnership*. If a domestic partnership that makes the election under paragraph (g) of this section is terminated pursuant to section 708(b)(1)(B), the election is binding on the new partnership.

(3) *Who may make the election*. An individual, estate, trust, domestic partnership, S corporation, or common trust fund may make an election under paragraph (g) of this section with respect to each CFC or QEF that it holds directly or indirectly through one or more entities, each of which is foreign. In addition, an individual, estate, trust, domestic partnership, S corporation, or common trust fund may make an election under paragraph (g) of this section with respect to a CFC or QEF that it holds indirectly through a domestic partnership, S corporation, estate, trust, or common trust fund if the domestic partnership, S corporation, estate, trust, or common trust fund does not make the election. The election, if made, for an estate or trust must be made by the fiduciary of that estate or trust.

(4) *Time and manner for making the election*—(i) *Individuals, estates, and trusts*—(A) *General rule*. Except as otherwise provided in this paragraph, in order for an election under paragraph (g) of this section by an individual, estate, or trust (other than a CRT) with respect to a CFC or QEF to be effective, the election must be made no later than the first taxable year beginning after December 31, 2013, during which the individual, estate, or trust—

(*1*) Includes an amount in gross income for chapter 1 purposes under section 951(a) or section 1293(a) with respect to the CFC or QEF; and

(*2*) Is subject to tax under section 1411 or would be subject to tax under section 1411 if the election were made with respect to the stock of the CFC or QEF.

(B) *Special rule for charitable remainder trusts (CRTs)*. Except as otherwise provided in this paragraph, in order for an election under paragraph (g) of this section by a CRT with respect to a CFC or QEF to be effective, the election must be made no later than the first taxable year beginning after December 31, 2013, during which the CRT includes an amount in gross income for chapter 1 purposes under section 951(a) or section 1293(a) with respect to the CFC or QEF.

(ii) *Certain domestic passthrough entities*. Except as otherwise provided in this paragraph, in order for an election under paragraph (g) of this section by a domestic partnership, S corporation, or common trust fund with respect to a CFC or a QEF to be effective, the election must be made no later than the first taxable year beginning after December 31, 2013, during which the domestic partnership S corporation, or common trust fund—

(A) Includes an amount in gross income for chapter 1 purposes under section 951(a) or section 1293(a) with respect to the CFC or QEF; and

(B) Has a direct or indirect owner that is subject to tax under section 1411 or would be subject to tax under section 1411 if the election were made.

(iii) *Taxable years that begin before January 1, 2014*—(A) *Individuals, estates, or trusts*. An individual, estate, or trust may make an election under paragraph (g) of this section for a taxable year that begins before January 1, 2014.

(B) *Certain domestic passthrough entities*. A domestic partnership, S corporation, or common trust fund may make an election under paragraph (g) of this section for a taxable year that begins before January 1, 2014, provided that all of its partners, shareholders, or participants, as the case may be, consent to the election. In the case of a partner, shareholder, or participant that is a partnership, S corporation, or common trust fund, all of the partners, shareholders, and participants also must consent to the election.

(iv) *Time for making election*. In all cases, the election under paragraph (g) of this section must be made in the manner prescribed by forms, instructions, or in other guidance on the individual's, estate's, trust's, domestic partnership's, S corporation's, or common trust fund's original or amended return for the taxable year for which the election is made. An election can be made on an amended return only if the taxable year for which the election is made, and all taxable years that are affected by the election, are not closed by the period of limitations on assessments under section 6501. An individual, estate, trust, domestic partnership, S corporation, or common trust fund may not seek an extension of time to make the election under any other provision of the law, including §301.9100 of this chapter.

(h) *Examples*. The following examples illustrate the rules of this section. In each example, unless otherwise indicated, the individuals, the foreign corporation (FC), the QEF (QEF), and the partnership (PRS) use a calendar taxable year. Further, the gross income or gain with respect to an interest in FC is not derived in a trade or business described in §1.1411–5.

Example 1. (i) *Facts*. A, a United States citizen, is the sole shareholder of FC, a controlled foreign corporation (within the meaning of section 957). A is a United States shareholder (within the meaning of section 951(b)) with respect to FC. In 2012, A includes $40,000 in gross income for chapter 1 purposes under section 951(a)(1)(A) with respect to FC. On December 31, 2012, A's basis in the stock of FC for chapter 1 purposes is $500,000, which includes an increase to basis under section 961(a) of $40,000. The amount of FC's earnings and profits that are described in section 959(c)(2) is $40,000, the amount of FC's earnings and profits that are described in section 959(c)(3) is $20,000, and FC does not have any earnings and profits that are described in section 959(c)(1). No election is made under paragraph (g) of this section. During 2013, A does not include any amounts in income under section 951(a) with respect to FC, A does not receive any distributions from FC, and there is no change in the amount of FC's earnings and profits. In 2014, A includes $10,000 in gross income for chapter 1 purposes under section 951(a)(1)(A) with respect to FC. As a result, A's basis in the stock of FC for chapter 1 purposes increases by $10,000 to $510,000 pursuant to section 961(a). During 2015, FC distributes $30,000 to A, which is not treated as a dividend for purposes of chapter 1 under section 959(d). As a result, A's basis in the stock of FC for chapter 1 purposes is decreased by $30,000 to $480,000 pursuant to section 961(b).

(ii) *Results for section 1411 purposes*. In 2014, A does not include the $10,000 section 951(a) income inclusion in A's net investment income under section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i). Pursuant to paragraph (e)(1)(iii) of this section, A decreases A's modified adjusted gross income for section 1411 purposes by $10,000 in 2014, and pursuant to paragraph (d)(1)(i) of this section, A's adjusted basis is not increased by $10,000 and remains at $500,000. In 2015, pursuant to paragraph (c)(2)(i) of this section, A includes $10,000 of the distribution of previously taxed earnings and profits as a dividend for purposes of determining A's net investment income because $10,000 of the $30,000 distribution is attributable to amounts that A included in gross income for chapter 1 purposes under section 951(a) in a tax year that began after December 31, 2012. Pursuant to paragraph (e)(1)(i) of this section, A increases A's modified adjusted gross income for section 1411 purposes by $10,000 in 2015. Under paragraph (d)(1)(i) of this section, A's adjusted basis is not decreased by the $10,000 that is treated as a dividend for section 1411 purposes, and thus, A's adjusted basis in FC for section 1411 purposes is decreased under section 961 only by $20,000 to $480,000.

Example 2. (i) *Facts*. Same facts as *Example 1*. In addition, during 2016, A includes $15,000 in gross income for chapter 1 purposes under section 951(a)(1)(A) with respect to FC. As a result, A's basis in the stock of FC for chapter 1 purposes increases by $15,000 to $495,000 pursuant to section 961(a). During 2017, A sells all of A's shares of FC for $550,000 and, prior to the application of section 1248, recognizes $55,000 ($550,000 minus $495,000) of long-term capital gain for chapter 1 purposes. For purposes of calculating the amount included in income as a dividend pursuant to section 1248(a) for chapter 1 purposes, the earnings and profits of FC attributable to A's shares in FC which were accumulated after December 31,1962 and during the period which A held the stock while FC was a controlled foreign corporation is $55,000, $35,000 of which is excluded pursuant to section 1248(d)(1). Therefore, after the application of section 1248, for chapter 1 purposes, upon the sale of the FC stock, A recognizes $35,000 of long-term capital gain and a $20,000 dividend.

(ii) *Results for section 1411 purposes*. (A) In 2016, A does not include the $15,000 section 951(a)(1)(A) income inclusion in A's net investment income under section 1411(c)(1)(A)(i) and §1411(c)(1)(A)(i). Pursuant to paragraph (e)(1)(ii) of this section, A decreases A's modified adjusted gross income for section 1411 purposes by $15,000, and, pursuant to paragraph (d)(1)(i) of this section, A's adjusted basis remains at $480,000.

(B) During 2017, prior to the application of section 1248, A recognizes $70,000 ($550,000 minus $480,000) of gain for section 1411 purposes. Pursuant to paragraph (c)(3) of this section, for section 1411 purposes, section 1248(a) applies to the gain on the sale of FC calculated for section 1411 purposes ($70,000) and section 1248(d)(1) does not apply, except with respect to the $20,000 of earnings and profits of FC that are attributable to amounts previously included in income for chapter 1 purposes under section 951 for a taxable year beginning before December 31, 2012. Accordingly, for purposes of calculating the amount of income includible as a dividend under section 1248(a), A has $55,000 of earnings and profits, $20,000 of which is excluded pursuant to section 1248(d)(1). Therefore, after the application of section 1248, for section 1411 purposes A has $35,000 of long-term capital gain and a $35,000 dividend. For purposes of calculating net investment income in 2017, A includes $35,000 as a dividend under section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i) and $35,000 as a gain under section 1411(c)(1)(A)(iii) and §1.1411–4(a)(1)(iii).

Example 3. (i) *Facts*. Same facts as *Example 2*, except that A timely makes an election under paragraph (g)(4)(i) of this section for 2014 (and thus for all subsequent years).

(ii) *Results for section 1411 purposes*. A does not have any adjustments to A's modified adjusted gross income for section 1411 purposes for 2014, 2015, 2016 or 2017 because the election under paragraph (g)(4)(i) of this section was timely made. Pursuant to paragraph (g)(2) of this section, for purposes of calculating A's net investment income in 2014, the $10,000 that A included in income for chapter 1 purposes under section 951(a) is net investment income for purposes of section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i). A has no amount of net investment income with respect to FC in 2015. Pursuant to paragraph (g)(2) of this section, for purposes of calculating A's net investment income in 2016, the $15,000 that A included in income for chapter 1 purposes under section 951(a) is net investment income for purposes of section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i). For purposes of calculating A's net investment income in 2017, the amount of gain on the disposition of the FC shares is the same as the amount calculated for chapter 1 purposes. Applying section 1248, A includes $35,000 as a gain under section 1411(c)(1)(A)(iii) and §1.1411–4(a)(1)(iii), and $20,000 as a dividend under section 1411(c)(1)(A)(i) and §1.1411–4(a)(1)(i).

Example 4. *Domestic partnership holding QEF stock*. (i) *Facts*. (A) C, a United States citizen, owns a 50% interest in PRS, a domestic partnership. D, a United States citizen, and E, a United States citizen, each own a 25% interest in PRS. All allocations of partnership income and losses are pro rata based on ownership interests. PRS owns an interest in QEF, a foreign corporation that is a passive foreign investment company (within the meaning of section 1297(a)). PRS, a United States person, made an election under section 1295 with respect to QEF applicable to the first year of its holding period in QEF. As of December 31, 2012, for chapter 1 purposes, C's basis in his partnership interest is $100,000, D's basis in his partnership interest is $50,000, E's basis in his partnership interest is $50,000, and PRS's adjusted basis in its QEF stock is $80,000, which includes an increase in basis under section 1293(d) of $40,000. As of December 31, 2012, the amount of QEF's earnings that have been included in income by PRS under section 1293(a), but have not been distributed by QEF, is $40,000. PRS also has cash of $60,000 and domestic C corporation stock with an adjusted basis of $60,000. During 2013, PRS does not include any amounts in income under section 1293(a) with respect to QEF, PRS does not receive any distributions from QEF, and there are no adjustments to the basis of C, D, or E in their interests in PRS.

(B) During 2014, PRS has income of $40,000 under section 1293(a) with respect to QEF and has no other partnership income. PRS does not make an election under paragraph (g) of this section.

(C) During 2015, QEF distributes $60,000 to PRS. PRS has no income for the year.

(ii) *Results for 2014*. (A) For chapter 1 purposes, as a result of the $40,000 income inclusion under section 1293(a), PRS's basis in its QEF stock is increased by $40,000 under section 1293(d)(1) to $120,000. Under §1.1293–1(c)(1) and section 702, C's, D's, and E's distributive shares of the section 1293(a) income inclusion are $20,000, $10,000, and $10,000, respectively. Under section 705(a)(1)(A), C increases his adjusted basis in his partnership interest by $20,000 to $120,000, and D and E each increase his adjusted basis in his partnership interest by $10,000 to $60,000.

(B) For section 1411 purposes, pursuant to paragraph (d)(1)(ii) of this section, PRS's basis in QEF is not increased by the $40,000 income inclusion (it remains at $80,000). Because PRS did not make an election under paragraph (g) of this section, C, D and E do not have net investment income with respect to the income inclusion, and pursuant to paragraph (d)(2) of this section, they do not increase their adjusted bases in their interests in PRS (each remains at $50,000). Pursuant to paragraph (e)(1)(ii) of this section, C reduces his modified adjusted gross income by $20,000, and D and E each reduce their modified adjusted gross income by $10,000.

(iii) *Results for 2015*. (A) For chapter 1 purposes, the distribution of $60,000 from QEF to PRS is not a dividend under section 1293(c), and PRS decreases its basis in QEF by $60,000 under section 1293(d)(2) to $60,000.

(B) Pursuant to paragraph (c)(1)(i) of this section, $40,000 of the distribution is a dividend for section 1411 purposes because PRS included $40,000 in gross income for chapter 1 purposes under section 1293(a) in a tax year that began after December 31, 2012. For section 1411 purposes, pursuant to paragraph (d)(1)(ii) of this section, section 1293(d) will not apply to reduce PRS's basis in QEF to the extent of the $40,000 of the distribution that is treated as a dividend under paragraph (c)(2)(i) of this section. Thus, PRS's basis in QEF is decreased only by $20,000 for purposes of section 1411 and is $60,000. The $40,000 distribution of previously taxed earnings and profits that is treated as a dividend for section 1411 purposes is allocated $20,000 to C, $10,000 to D, and $10,000 to E. Because PRS did not make an election under paragraph (g) of this section, pursuant to paragraph (c)(2)(i) of this section, C has $20,000 of net investment income, and D and E each has $10,000 of net investment income as a result of the distribution by QEF, and pursuant to paragraph (d)(2) of this section, C increases his adjusted basis in PRS by $20,000 to $120,000, and D and E each increases his adjusted basis in PRS by $10,000 to $60,000. Pursuant to paragraph (e)(1)(i) of this section, C increases his modified adjusted gross income by $20,000, and D and E each increases his modified adjusted gross income by $10,000.

Example 5. *Sale of partnership interest*. (i) *Facts*. Same facts as *Example 4*. In addition, in 2016, D sells his entire interest in PRS to F for $100,000.

(ii) *Results for 2016*. For chapter 1 purposes, D has a gain of $40,000 ($100,000 minus $60,000). For section 1411 purposes, D has a gain of $40,000 ($100,000 minus $60,000), and thus, has net investment income of $40,000. No adjustments to modified adjusted gross income are necessary under paragraph (e) of this section.

Example 6. *Domestic partnership's sale of QEF stock*. (i) *Facts*. Same facts as *Example 4*. In addition, in 2016 PRS has income of $60,000 under section 1293(a) with respect to QEF, and in 2017, PRS sells its entire interest in QEF for $170,000.

(ii) *Results for 2016*. (A) For chapter 1 purposes, as a result of the $60,000 income inclusion under section 1293(a), PRS's basis in its QEF stock is increased by $60,000 under section 1293(d)(1) to $120,000. Under §1.1293-1(c)(1) and section 702, C's, D's, and E's distributive shares of the section 1293(a) income inclusion are $30,000, $15,000, and $15,000 respectively. Under section 705(a)(1)(A), C increases his adjusted basis in his partnership interest by $30,000 to $150,000, and D and E each increases his adjusted basis in his partnership interest by $15,000 to $75,000.

(B) For section 1411 purposes, pursuant to paragraph (d)(1)(ii) of this section, PRS's basis in QEF is not increased by the $60,000 income inclusion (it remains at $60,000). Because PRS did not make an election under paragraph (g) of this section, C, D and E do not have net investment income with respect to the income inclusion, and pursuant to paragraph (d)(2) of this section, they do not increase their adjusted bases in their interests in PRS (C remains at $120,000, and D and E each remain at $60,000). Pursuant to paragraph (e)(1)(ii) of this section, C reduces his modified adjusted gross income by $30,000, and D and E each reduce their modified adjusted gross income by $15,000.

(iii) *Results for 2017*. (A) For chapter 1 purposes, PRS has a gain of $50,000 ($170,000 minus $120,000), which is allocated 50% ($25,000) to C, 25% ($12,500) to D, and 25% ($12,500) to E.

(B) Based on PRS's basis in the stock of QEF for section 1411 purposes, PRS has a gain for section 1411 purposes of $110,000 ($170,000 minus $60,000), which in the absence of an election by PRS under paragraph (g) of this section, results in gain of $55,000 to C, $27,500 to D, and $27,500 to E. Therefore, C has net investment income of $55,000, and D and E each have net investment income of $27,500. Pursuant to paragraph (e)(1)(ii) of this section, C increases his modified adjusted gross income by $30,000, and D and E each increase their modified adjusted gross income by $15,000.

(i) *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).

PART 602 — OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 6. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805***

Par. 7. In § 602.101, paragraph (b) is amended by adding the following entry to the table in numerical order to read as follows:

§ 602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * * * *	
1.1411–10(g)	1545–2227
* * * * * * *	

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved November 14, 2013

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on November 26, 2013, 4:15 p.m., and published in the issue of the Federal Register for December 2, 2013, 78 F.R. 72394)

Section 3101.—Rate of Tax

T.D. 9645

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 1 and 31

Rules Relating to Additional Medicare Tax

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to Additional Hospital Insurance Tax on income above threshold amounts ("Additional Medicare Tax"), as added by the Affordable Care Act. Specifically, these final regulations provide guidance for employers and individuals relating to the implementation of Additional Medicare Tax, including the requirement to withhold Additional Medicare Tax on certain wages and compensation, the requirement to file a return reporting Additional Medicare Tax, the employer process for adjusting underpayments and overpayments of Additional Medicare Tax, and the employer and individual processes for filing a claim for refund for an overpayment of Additional Medicare Tax.

DATES: *Effective date*: These regulations are effective on November 29, 2013.

Applicability date: For dates of applicability, see §§1.1401–1(e), 31.3101–2(d), 31.3102–1(f), 31.3102–4(d), 31.3202–1(h), 31.6011(a)–1(h), 31.6011(a)–2(e), 31.6205–1(e), 31.6402(a)–2(c), 31.6413(a)–1(c), and 31.6413(a)–2(e).

FOR FUTHER INFORMATION CONTACT:

Andrew K. Holubeck at (202) 317-4774 (not a toll-free number).

SUPPLEMENTARY INFORMATION

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget in accordance with the Paperwork Reduction Act (PRA) of 1995 (44 U.S.C. 3507(d)) under control number 1545–2097. The collection of information in these regulations is in §§31.6011(a)–1, 31.6011(a)–2, 31.6205–1, 31.6402(a)–2, 31.6413(a)–1, and 31.6413(a)–2. This information is required by the IRS to verify compliance with return requirements under section 6011, employment tax adjustments under sections 6205 and 6413, and claims for refund of overpayments under section 6402. This information will be used to determine whether the amount of tax has been reported and calculated correctly. The likely respondents are employers and individuals.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by 26 U.S.C. 6103.

Background

These final regulations are issued in connection with the Additional Hospital Insurance Tax on income above threshold amounts ("Additional Medicare Tax"), as added by section 9015 of the Patient Protection and Affordable Care Act (PPACA), Public Law 111–148 (124 Stat. 119 (2010)), and as amended by section 10906 of the PPACA and section 1402(b) of the Health Care and Education Reconciliation Act of 2010, Public Law 111–152 (124 Stat. 1029 (2010)) (collectively, the "Affordable Care Act"). The final regulations include amendments to §1.1401–1 of the Income Tax Regulations, and §§31.3101–2, 31.3102–1, 31.3102–4, 31.3202–1, 31.6011(a)–1, 31.6011(a)–2, 31.6205–1, 31.6402(a)–2, 31.6413(a)–1, and 31.6413(a)–2 of the Employment Tax Regulations. The final regulations provide guidance for employers and individuals relating to the implementation of Additional Medicare Tax, including the requirement to withhold Additional Medicare Tax on certain wages and compensation, the requirement to file a return reporting Additional Medicare Tax, the employer process for adjusting underpayments and overpayments of Additional Medicare Tax, and the employer and individual processes for filing a claim for refund of Additional Medicare Tax.

A notice of proposed rulemaking (REG–130074–11) was published in the **Federal Register** (77 FR 72268) on December 5, 2012. A public hearing was scheduled for April 4, 2013. The IRS did not receive any requests to testify at the public hearing, and therefore the public hearing was cancelled. Comments responding to the proposed regulations were received. All comments were considered and are available for public inspection and copying at *http://www.regulations.gov* or upon request. After consideration of all the comments, the proposed regulations are adopted as amended by this Treasury decision. The public comments and revisions are discussed in this preamble.

Summary of Comments and Explanation of Revisions

The IRS received five comments in response to the proposed regulations. One commenter expressed concern that the 2013 Old Age, Survivors and Disability Insurance (OASDI) tax rate for employees of 6.2 percent was applied to wages for services performed in the last two weeks of 2012, when the OASDI tax rate for employees was 4.2 percent. This comment is outside the scope of these regulations.

Another commenter requested that the comment period for the proposed regulations be extended by 60 days. The Administrative Procedure Act does not set a time frame for a comment period on regulations. However, Executive Order (E.O.) 12866 provides that generally a comment period should be no less than 60 days. The public was given 90 days to comment on the proposed regulations, which exceeds the period required by E.O. 12866. The IRS received only five comments during the 90-day comment period, no comments were received after the 90-day comment period expired, and there is no indication that more comments would have been received if the comment period had been extended. Therefore, an extension of the comment period beyond the 90 days provided in the proposed regulations was not warranted.

One commenter noted that because Additional Medicare Tax will involve new recordkeeping and withholding procedures for employers and certain employees, there may be inadvertent errors involved with implementing the tax, especially in the first year of implementation. Therefore, the commenter requested that the IRS grant employers flexibility in correcting overpayments and underpayments of Additional Medicare Tax by allowing additional time to correct errors, allowing corrections for a certain period without penalty, and granting an exemption from penalties for *de minimis* errors.

No such changes were made in these final regulations. The regulations under §§31.6205-1(a) and 31.6413(a)-2 already allow employers flexibility in making interest-free adjustments of underpayments and overpayments and, to the extent an employer discovers an error in withholding, paying, or reporting Additional Medicare Tax, the regulations provide procedures for correcting that error on an adjusted employer return generally without imposition of interest. Further, under sections 6651 and 6656, penalties for failure to pay or deposit Additional Medicare Tax do not apply to the extent the failure is due to reasonable cause and not willful neglect.

To correct an overpayment of income tax or Additional Medicare Tax, an employer may make an adjustment only if it repays or reimburses the employee prior to the end of the calendar year in which the wages or compensation was paid. Similarly, to correct an underpayment of income tax or Additional Medicare Tax, an employer may make an interest-free adjustment only if the error is ascertained within the calendar year in which the wages or compensation was paid. Because employees will report Additional Medicare Tax on Form 1040, *U.S. Individual Tax Return*, allowing employers time beyond the end of the calendar year in which the error was made to correct overpayments and underpayments would create complexity and confusion for individuals filing individual income tax returns and would adversely affect tax administration. Accordingly, these final regulations do not include additional procedures specifically for correcting Additional Medicare Tax errors, but rather generally rely on existing procedures for correcting income tax withholding errors.

One commenter questioned how employers should treat repayment by an employee of wage payments received by the employee in a prior year for Additional Medicare Tax purposes (for example, sign on bonuses paid to employees that are subject to repayment if certain conditions are not satisfied). Employers cannot make an adjustment or file a claim for refund for Additional Medicare Tax withholding when there is a repayment of wages received by an employee in a prior year because the employee determines liability for Additional Medicare Tax on the employee's income tax return for the prior year; however, the employee may be able to file an amended return claiming a refund of the Additional Medicare Tax.

More specifically, under current employment tax adjustment procedures, if the repayment occurs within the period of limitations for refund, the employer can repay or reimburse the social security and Medicare taxes withheld from the wage payment to the employee and file a refund claim, or make an interest-free adjustment, for the social security and Medicare tax overwithholding. However, under §31.6413(a)–1(a)(2)(ii) of these regulations, an employer may adjust overpaid Additional Medicare Tax withheld from employees only in the calendar year in which the wages or compensation are paid, and only if the employer repays or reimburses the employee the amount of the overcollection prior to the end of the calendar year. Further, under §31.6402(a)–2(a)(1)(iii) of these regulations, employers may claim a refund of overpaid Additional Medicare Tax only if the employer did not deduct or withhold the overpaid Additional Medicare Tax from the employee's wages or compensation. Accordingly, these regulations at §31.6402(a)–2(b)(3)(ii) provide that, in the case of an overpayment of Additional Medicare Tax for a year for which an individual has filed Form 1040, a claim for refund should be made by the individual on Form 1040X, *Amended U.S. Individual Income Tax Return*. Since a wage repayment reduces the wages subject to Additional Medicare Tax for the period during which the wages were originally paid, the employee is entitled to file an amended return (on Form 1040X) to recover Additional Medicare Tax with respect to the repaid wages.[1]

Finally, one commenter expressed concern about the impact of the regulations on the small business and individual community. The commenter disagreed with the conclusion in the proposed regulations that no regulatory assessment was required under E.O. 12866 because the rulemaking is not a significant regulatory action. The commenter also disagreed with the conclusion in the proposed regulations that a regulatory flexibility analysis was not required under the Regulatory Flexibility Act (5 U.S.C. 601) (RFA) because the collection of information contained in the proposed regulations will not have a significant economic impact on a substantial number of small entities.

Section 3(a)(4)(B) of E.O. 12866 requires agencies to prepare a regulatory assessment for "significant regulatory actions" as defined in section 3(f) of E.O. 12866. As part of its definition of significant regulatory actions, section 3(f) includes economically significant regulations, that is, regulatory actions that are likely to have an annual effect on the economy of $100 million or more. The commenter contends that the skills equivalent to a junior associate accountant would be needed to comply with the regulations. The commentator contends that, assuming a junior associate reasonably bills for services at the rate of $100 per hour, and using the estimated annual reporting or recordkeeping burden for these regulations of 1,900,000 hours, the estimated annual effect on the economy is $190 million.

The Treasury Department and the IRS do not agree with the commenter's assertion that all individuals and entities subject to these regulations will require the services of an accountant. Many employers utilize payroll service providers that are equipped to comply with these regulations and that will include Additional Medicare Tax as part of the payroll services they provide. Other employers and individuals will be able to comply with these regulations without assistance by following the instructions that accompany tax forms and by utilizing other information provided by the IRS. Therefore, neither the proposed regulations, nor these final regulations, are significant regulatory actions within the meaning of E.O. 12866, and a regulatory assessment is not required.

The RFA requires agencies to prepare a regulatory flexibility analysis addressing the impact of proposed or final regulations on small entities. The proposed regulations certified that a regulatory flexibility analysis is not required because the collection of information contained in the regulations will not have a significant economic impact on a substantial number of small entities. The commenter challenged this certification.

A "collection of information" is defined in the RFA as a requirement that a small entity report information to the Federal Government, or maintain specified records, regardless of whether the information in those records is reported to the Federal Government. The regulations contain a collection of information requirement.

The RFA does not define "substantial number." In general, for purposes of the RFA, regulations with a broad effect on

[1]In this situation, Additional Medicare Tax is treated differently than federal income tax. For federal income tax purposes, wages paid in a year are considered income to the employee in that year, even when the wages are repaid by the employee to the employer in a subsequent year. If an employee repays wages to an employer in a year following the year in which the wages were originally paid, the employee cannot reduce the federal income tax for the prior year (i.e., the employee cannot file an amended income tax return for the prior year using Form 1040X). Instead, depending on the circumstances, the employee may be entitled to a deduction for the repaid wages (or in some cases, if the requirements of section 1341 are satisfied, a reduction of tax) on his or her income tax return for the year of repayment. By contrast, the Additional Medicare Tax is part of FICA and, similar to social security tax and Medicare tax, the repayment of wages reduces the employee's liability for Additional Medicare Tax for the prior year.

business are presumed to have an impact on a substantial number of small entities. Since these regulations have a broad effect on business, these regulations will have an impact on a substantial number of small entities.

The RFA also does not define "significant economic impact." As stated in connection with the discussion of E.O. 12866, the commenter assumed a billing rate of $100 per hour, and multiplied that rate by the estimated aggregate annual PRA reporting or recordkeeping burden for these regulations of 1,900,000 hours, to estimate the annual effect on the economy to be $190 million. Based on this calculation, the commenter concluded that the collection of information had a significant economic impact on a substantial number of small entities.

The commenter's approach is not an appropriate measure of the economic impact of these regulations on small entities. The 1,900,000 hours estimated to be the aggregate annual PRA burden for these regulations represents an estimated 1,900,000 respondents with an estimated average annual burden per respondent of 1 hour. The number of respondents comprises *all* respondents affected by these regulations, including individuals as well as entities. It is not an estimated number of affected entities only. The IRS estimates that approximately 325,000 entities report Medicare wages to one or more individuals in excess of the $200,000 Additional Medicare Tax withholding threshold. Thus, approximately 325,000 entities, encompassing both large and small entities, are affected by these regulations. Therefore, the reporting or recordkeeping burden of these regulations on small entities is estimated to be significantly less than 1,900,000 hours. The commenter's use of this number to assess the annual economic impact of these regulations on small entities is incorrect.

In addition, to the extent that there is a significant economic impact, the economic impact principally results directly from the underlying statutes. For example, the statute imposing Additional Medicare Tax requires the employer to withhold the tax from wages paid to the employee. Other provisions of the Internal Revenue Code (Code) require the employer to report and pay the correct amount of withheld tax to the government. Similarly, the collection of information required with regard to interest-free adjustments and claims for refund apply existing statutory rules to Additional Medicare Tax. The regulations implement the underlying statutes and provide guidance for employers and individuals relating to the requirement to file a return reporting Additional Medicare Tax, the employer process for making adjustments of underpayments and overpayments of Additional Medicare Tax, and the employer and individual processes for filing a claim for refund for an overpayment of Additional Medicare Tax. As a result, the estimated annual PRA burden per taxpayer for these regulations is very low. Consequently, the economic impact of these regulations is not expected to be significant, and neither the proposed regulations nor these final regulations will have a significant economic impact on a substantial number of small entities within the meaning of the RFA. Therefore a regulatory flexibility analysis is not required.

The proposed regulations provided that if the employer deducts less than the correct amount of Additional Medicare Tax, it is nevertheless liable for the correct amount of tax that it was required to withhold, unless and until the employee pays the tax. Consistent with section 3102(f)(3) of the Code, the proposed regulations also provided that if an employee subsequently pays the tax that the employer failed to deduct, the tax will not be collected from the employer. These final regulations further provide that an employer is not relieved of its liability for payment of any Additional Medicare Tax required to be withheld unless it can show that the tax has been paid by the employee. Section 3102(f)(3) contains language similar to section 3402(d) of the Code, and this provision of the final regulations is consistent with the approach used in the regulations under section 3402(d). Employers will use Form 4669, *Statement of Payments Received*, and Form 4670, *Request for Relief from Payment of Income Tax Withholding*, the same forms used for requesting federal income tax withholding relief, to request relief from paying Additional Medicare Tax that has already been paid by the employee.

The final regulations also amend the proposed regulations to comply with formatting requirements of the Office of the Federal Register.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in E.O. 12866, and supplemented by E.O. 13653. The regulations implement the underlying statutes and the economic impact is principally a result of the underlying statutes, rather than the regulations. Therefore, a regulatory assessment is not required. It has also been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations.

Sections 603 and 604 of the RFA (5 U.S.C. chapter 6) generally require agencies to prepare a regulatory flexibility analysis addressing the impact of proposed and final regulations, respectively, on small entities. Section 605(b) of the RFA, however, provides that sections 603 and 604 shall not apply if the head of the agency certifies that the rule will not have a significant economic impact on a substantial number of small entities. For the reasons discussed in the Summary of Comments section of the preamble, as well as the reasons set forth in the succeeding paragraphs, it is hereby certified that the collection of information requirements contained in these regulations will not have a significant economic impact on a substantial number of small entities.

The regulations under sections 6205, 6402, and 6413 affect all taxpayers that file employment tax returns or claims for refund of employment taxes. Many small entities fall into this category. Therefore, it has been determined that these regulations will affect a substantial number of small entities. It also has been determined, however, that the economic impact on entities affected by these regulations will not be significant.

As stated above, the regulations implement the underlying statutes and the economic impact is principally a result of the underlying statutes, rather than the regulations. The regulations require taxpayers that file employment tax returns and that make interest-free adjustments to the returns for underpayments or overpayments of Additional Medicare Tax, or that file claims for refund of an overpayment of

Additional Medicare Tax, to provide an explanation setting forth the basis for the correction or the claim in detail, designating the return period in which the error was ascertained and the return period being corrected, and setting forth such other information as may be required by the instructions to the form. In addition, for adjustments of overpayments of Additional Medicare Tax, employers must obtain and retain the written receipt of the employee showing the date and amount of the repayment to the employee or retain evidence of reimbursement. The requirement to collect this information is not newly imposed by these regulations. The regulations merely apply procedures from existing regulations, with appropriate modifications, to corrections of Additional Medicare Tax.

It is estimated that the annual PRA burden per taxpayer to comply with the collection of information requirements in these regulations is one hour. This minimal burden does not constitute a significant economic impact. Accordingly, a regulatory flexibility analysis is not required.

Pursuant to section 7805(f) of the Code, the proposed regulations preceding these regulations were submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Drafting Information

The principal author of the regulations is Andrew Holubeck of the Office of the Division Counsel/Associate Chief Counsel (Tax Exempt and Government Entities). However, other personnel from the IRS and the Treasury Department participated in their development.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR parts 1 and 31 are amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1401-1 is amended by revising paragraph (b) and adding paragraphs (d) and (e) to read as follows:

§1.1401–1 Tax on self-employment income.

* * * * *

(b) The rates of tax on self-employment income are as follows (these regulations do not reflect off-Code revisions to the following rates):

(1) For Old-age, Survivors, and Disability Insurance:

Taxable year	Percent
Beginning after December 31, 1983 and before January 1, 1988	11.40
Beginning after December 31, 1987 and before January 1, 1990	12.12
Beginning after December 31, 1989	12.40

(2) (i) For Hospital Insurance:

Taxable year	Percent
Beginning after December 31, 1983 and before January 1, 1985	2.60
Beginning after December 31, 1984 and before January 1, 1986	2.70
Beginning after December 31, 1985	2.90

(ii) For Additional Medicare Tax:

Taxable year	Percent
Beginning after December 31, 2012	0.9

* * * * *

(d) *Special rules regarding Additional Medicare Tax*. (1) *General rule*. An individual is liable for Additional Medicare Tax to the extent that his or her self-employment income exceeds the following threshold amounts.

Filling Status	Threshold
Married individual filing a joint return	$250,000
Married individual filing a separate return	$125,000
Any other case	$200,000

Note: These threshold amounts are specified under section 1401(b)(2)(A).

(2) *Coordination with Federal Insurance Contributions Act*. (i) *General rule*. Under section 1401(b)(2)(B), the applicable threshold specified under section 1401(b)(2)(A) is reduced (but not below zero) by the amount of wages (as defined in section 3121(a)) taken into account in determining Additional Medicare Tax under section 3101(b)(2) with respect to the taxpayer. This rule does not apply to Railroad Retirement Tax Act (RRTA) compensation (as defined in section 3231(e)).

(ii) *Examples*. The rules provided in paragraph (d)(2)(i) of this section are illustrated by the following examples:

Example 1. A, a single filer, has $130,000 in self-employment income and $0 in wages. A is not liable to pay Additional Medicare Tax.

Example 2. B, a single filer, has $220,000 in self-employment income and $0 in wages. B is liable to pay Additional Medicare Tax on $20,000 ($220,000 in self-employment income minus the threshold of $200,000).

Example 3. C, a single filer, has $145,000 in self-employment income and $130,000 in wages. C's wages are not in excess of $200,000 so C's employer did not withhold Additional Medicare Tax. However, the $130,000 of wages reduces the self-employment income threshold to $70,000 ($200,000 threshold minus the $130,000 of wages). C is liable to pay Additional Medicare Tax on $75,000 of self-employment income ($145,000 in self-employment income minus the reduced threshold of $70,000).

Example 4. E, who is married and files a joint return, has $140,000 in self-employment income. F, E's spouse, has $130,000 in wages. F's wages are not in excess of $200,000 so F's employer did not withhold Additional Medicare Tax. However, the $130,000 of F's wages reduces E's self-employment income threshold to $120,000 ($250,000 threshold minus the $130,000 of wages). E and F are liable to pay Additional Medicare Tax on $20,000 of E's self-employment income ($140,000 in self-employment income minus the reduced threshold of $120,000).

Example 5. D, who is married and files married filing separately, has $150,000 in self-employment income and $200,000 in wages. D's wages are not in excess of $200,000 so D's employer did not withhold Additional Medicare Tax. However, the $200,000 of wages reduces the self-employment income threshold to $0 ($125,000 threshold minus the $200,000 of wages). D is liable to pay Additional Medicare Tax on $75,000 of wages ($200,000 in wages minus the $125,000 threshold for a married filing separately return) and on $150,000 of self-employment income ($150,000 in self-employment income minus the reduced threshold of $0).

(e) *Effective/applicability date*. Paragraphs (b) and (d) of this section apply to quarters beginning on or after November 29, 2013.

PART 31—EMPLOYMENT TAXES AND COLLECTION OF INCOME TAX AT THE SOURCE

Par. 3. The authority citation for part 31 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 4. Revise §31.3101–2 to read as follows:

§31.3101–2 Rates and computation of employee tax.

(a) *Old-Age, Survivors, and Disability Insurance*. The rates of employee tax for Old-Age, Survivors, and Disability Insurance (OASDI) with respect to wages received in calendar years after 1983 are as follows (these regulations do not reflect off-Code revisions to the following rates):

Calendar year	Percent
1984, 1985, 1986, or 1987	5.7
1988 or 1989	6.06
1990 and subsequent years	6.2

(b)(1) *Hospital Insurance*. The rates of employee tax for Hospital Insurance (HI) with respect to wages received in calendar years after 1973 are as follows:

Calendar year	Percent
1974, 1975, 1976, or 1977	0.90
1978	1.00
1979 or 1980	1.05
1981, 1982, 1983, or 1984	1.30
1985	1.35
1986 and subsequent years	1.45

(2) *Additional Medicare Tax*. (i) The rate of Additional Medicare Tax with respect to wages received in taxable years beginning after December 31, 2012, is as follows:

Taxable year	Percent
Beginning after December 31, 2012	0.9

(ii) Individuals are liable for Additional Medicare Tax with respect to wages received in taxable years beginning after December 31, 2012, which are in excess of:

Filling Status	Threshold
Married individual filing a joint return	$250,000
Married individual filing a separate return	$125,000
Any other case	$200,000

(c) *Computation of employee tax*. The employee tax is computed by applying to the wages received by the employee the rates in effect at the time such wages are received.

Example. In 1989, A performed services for X which constituted employment (see §31.3121(b)-2). In 1990 A receives from X $1,000 as remuneration for such services. The tax is payable at the 6.2 percent OASDI rate and the 1.45 percent HI rate in effect for the calendar year 1990 (the year in which the wages are received) and not at the 6.06 percent OASDI rate and the 1.45 percent HI rate which were in effect for the calendar year 1989 (the year in which the services were performed).

(d) *Effective/applicability date*. Paragraphs (a), (b), and (c) of this section apply to quarters beginning on or after November 29, 2013.

Par. 5. Section 31.3102–1 is amended by adding a sentence at the end of paragraph (a) and adding paragraph (f) to read as follows:

§31.3102–1 Collection of, and liability for, employee tax; in general.

(a) * * * For special rules relating to Additional Medicare Tax imposed under section 3101(b)(2), see §31.3102–4.

* * * * *

(f) *Effective/applicability date*. Paragraph (a) of this section applies to quarters beginning on or after November 29, 2013.

Par. 6. Section 31.3102–4 is added to read as follows:

§31.3102–4 Special rules regarding Additional Medicare Tax.

(a) *Collection of tax from employee*. An employer is required to collect from each of its employees the tax imposed by section 3101(b)(2) (Additional Medicare Tax) with respect to wages for employment performed for the employer by the employee only to the extent the employer pays wages to the employee in excess of $200,000 in a calendar year. This rule applies regardless of the employee's filing status or other income. Thus, the employer disregards any amount of wages or Railroad Retirement Tax Act (RRTA) compensation paid to the employee's spouse. The employer also disregards any RRTA compensation paid by the employer to the employee or any wages or RRTA compensation paid to the employee by another employer.

Example. H, who is married and files a joint return, receives $100,000 in wages from his employer for the calendar year. I, H's spouse, receives $300,000 in wages from her employer for the same calendar year. H's wages are not in excess of $200,000, so H's employer does not withhold Additional Medicare Tax. I's employer is required to collect Additional Medicare Tax only with respect to wages it pays which are in excess of the $200,000 threshold (that is, $100,000) for the calendar year.

(b) *Collection of amounts not withheld*. To the extent the employer does not collect Additional Medicare Tax imposed on the employee by section 3101(b)(2), the employee is liable to pay the tax.

Example. J, who is married and files a joint return, receives $190,000 in wages from his employer for the calendar year. K, J's spouse, receives $150,000 in wages from her employer for the same calendar year. Neither J's nor K's wages are in excess of $200,000, so neither J's nor K's employers are required to withhold Additional Medicare Tax. J and K are liable to pay Additional Medicare Tax on $90,000 ($340,000 minus the $250,000 threshold for a joint return).

(c) *Employer's liability for tax*. If the employer deducts less than the correct amount of Additional Medicare Tax, or if it fails to deduct any part of Additional Medicare Tax, it is nevertheless liable for the correct amount of tax that it was required to withhold, unless and until the employee pays the tax. If an employee subsequently pays the tax that the employer failed to deduct, the tax will not be collected from the employer. The employer will not be relieved of its liability for payment of the tax required to be withheld unless it can show that the tax under section 3101(b)(2) has been paid. The employer, however, will remain subject to any applicable penalties or additions to tax resulting from the failure to withhold as required.

(d) *Effective/applicability date*. This section applies to quarters beginning on or after November 29, 2013.

Par. 7. Section 31.3202–1 is amended by adding paragraphs (g) and (h) to read as follows:

§31.3202–1 Collection of, and liability for, employee tax.

* * * * *

(g) *Special rules regarding Additional Medicare Tax*. (1) An employer is required to collect from each of its employees the portion of the tax imposed by section 3201(a) (as calculated under section 3101(b)(2)) (Additional Medicare Tax) with respect to compensation for employment performed for the employer by the employee only to the extent the employer pays compensation to the employee in excess of $200,000 in a calendar year. This rule applies regardless of the employee's filing status or other income. Thus, the employer disregards any amount of compensation or Federal Insurance Contributions Act (FICA) wages paid to the employee's spouse. The employer also disregards any FICA wages paid by the employer to the employee or any compensation or FICA wages paid to the employee by another employer.

Example. A, who is married and files a joint return, receives $100,000 in compensation from her employer for the calendar year. B, A's spouse, receives $300,000 in compensation from his employer for the same calendar year. A's compensation is not in excess of $200,000, so A's employer does not withhold Additional Medicare Tax. B's employer is required to collect Additional Medicare Tax only with respect to compensation it pays to B that is in excess of the $200,000 threshold (that is, $100,000) for the calendar year.

(2) To the extent the employer does not collect Additional Medicare Tax imposed on the employee by section 3201(a) (as calculated under section 3101(b)(2)), the employee is liable to pay the tax.

Example. C, who is married and files a joint return, receives $190,000 in compensation from her employer for the calendar year. D, C's spouse, receives $150,000 in compensation from his employer for the same calendar year. Neither C's nor D's compensation is in excess of $200,000, so neither C's nor D's employers are required to withhold Additional Medicare Tax. C and D are liable to pay Additional Medicare Tax on $90,000 ($340,000 minus the $250,000 threshold for a joint return).

(3) If the employer deducts less than the correct amount of Additional Medicare Tax, or if it fails to deduct any part of Additional Medicare Tax, it is nevertheless liable for the correct amount of tax that it was required to withhold, unless and until the employee pays the tax. If an employee subsequently pays the tax that the employer failed to deduct, the tax will not be collected from the employer. The employer will not be relieved of its liability for payment of the tax required to be withheld unless it can show that the tax under section 3201(a) (as calculated under section 3101(b)(2)) has been paid. The employer, however, will remain subject to any applicable penalties or additions to tax resulting from the failure to withhold as required.

(h) *Effective/applicability date*. Paragraph (g) of this section applies to quarters beginning on or after November 29, 2013.

Par. 8. Section 31.6011(a)–1 is amended by:

1. Designating paragraph (g) as paragraph (h) and adding a sentence to the end.

2. Adding new paragraph (g).

The additions read as follows:

§31.6011(a)–1 Returns under Federal Insurance Contributions Act.

* * * * *

(g) *Returns by employees in respect of Additional Medicare Tax*. An employee who is paid wages, as defined in section 3121(a), subject to the tax under section 3101(b)(2) (Additional Medicare Tax), must make a return for the taxable year in respect of such tax. The return shall be made on Form 1040, *U.S. Individual Income Tax Return*. The form to be used by residents of the U.S. Virgin Islands, Guam, American Samoa, or the Northern Mariana Islands is Form 1040-SS, *U.S. Self-Employment Tax Return (Including Additional Child Tax Credit for Bona Fide Residents of Puerto Rico)*. The form to be used by residents of Puerto Rico is either Form 1040-SS or Form 1040-PR, *Planilla para la Declaración de la Contribución Federal sobre el Trabajo por Cuenta Propia (Incluyendo el Crédito Tributario Adicional por Hijos para Residentes Bona Fide de Puerto Rico)*.

(h) * * * Paragraph (g) of this section applies to taxable years beginning on or after November 29, 2013.

Par. 9. Section 31.6011(a)–2 is amended by adding paragraphs (d) and (e) to read as follows:

§31.6011(a)–2 Returns under Railroad Retirement Tax Act.

* * * * *

(d) *Returns by employees and employee representatives in respect of Additional Medicare Tax*. An employee or employee representative who is paid compensation, as defined in section 3231(e), subject to the tax under sections 3201(a) (as calculated under section 3101(b)(2)) or section 3211(a) (as calculated under section 3101(b)(2)) (Additional Medicare Tax), must make a return for the taxable year in respect of such tax. The return shall be made on Form 1040, *U.S. Individual Income Tax Return*. The form to be used by residents of the U.S. Virgin Islands, Guam, American Samoa, or the Northern Mariana Islands is Form 1040-SS, *U.S. Self-Employment Tax Return (Including Additional Child Tax Credit for Bona Fide Residents of Puerto Rico)*. The form to be used by residents of Puerto Rico is either Form 1040-SS or Form 1040-PR, *Planilla para la Declaración de la Contribución Federal sobre el Trabajo por Cuenta Propia (Incluyendo el Crédito Tributario Adicional por Hijos para Residentes Bona Fide de Puerto Rico)*.

(e) *Effective/applicability date*. Paragraph (d) of this section applies to taxable years beginning on or after November 29, 2013.

Par. 10. Section 31.6205–1 is amended by:

1. Revising the first sentence in paragraph (b)(2)(i).

2. Adding a sentence after the first sentence in paragraphs (b)(2)(ii) and (iii).

3. Adding two sentences after the sixth sentence in paragraph (b)(3).

4. Adding paragraphs (b)(4) and (e).

5. Revising paragraph (d)(1).

The revisions and additions read as follows:

§31.6205-1 Adjustments of underpayments.

* * * * *

(b) * * *

(2) * * * (i) If an employer files a return on which FICA tax or RRTA tax is required to be reported, and reports on the return less than the correct amount of employee or employer FICA or RRTA tax with respect to a payment of wages or compensation, and if the employer ascertains the error after filing the return, the employer shall correct the error through an interest-free adjustment as provided in this section, except as provided in paragraph (b)(4) of this section for Additional Medicare Tax. * * *

(ii) * * * However, if the employer also reported less than the correct amount of Additional Medicare Tax, the employer shall correct the underwithheld and underpaid Additional Medicare Tax in accordance with paragraph (b)(4) of this section. * * *

(iii) * * * However, if the employer also reported less than the correct amount of Additional Medicare Tax, the employer shall correct the underwithheld and underpaid Additional Medicare Tax in accordance with paragraph (b)(4) of this section. * * *

(3) * * * However, an adjustment of Additional Medicare Tax required to be withheld under section 3101(b)(2) or section 3201(a) may only be reported pursuant to this section if the error is ascertained within the same calendar year that the wages or compensation were paid to the employee, or if section 3509 applies to determine the amount of the underpayment, or if the adjustment is reported on a Form 2504 or Form 2504-WC. See paragraph (b)(4) of this section. * * *

(4) *Additional Medicare Tax*. If an employer files a return on which FICA tax or RRTA tax is required to be reported, and reports on the return less than the correct amount of Additional Medicare Tax required to be withheld with respect to a payment of wages or compensation, and if the employer ascertains the error after filing the return, the employer shall correct the error through an interest-free adjustment as provided in this section. An adjustment of Additional Medicare Tax may only be reported pursuant to this paragraph (b)(4) if the error is ascertained within the same calendar year that the wages or compensation were paid to the employee, unless the underpayment is attributable to an administrative error (that is, an error involving the inaccurate reporting of the amount actually withheld), section 3509 applies to determine the amount of the underpayment, or the adjustment is reported on a Form 2504 or Form 2504-WC. The employer shall adjust the underpayment of Additional Medicare Tax by reporting the additional amount due on an adjusted return for the return period in which the wages or compensation were paid, accompanied by a detailed explanation of the amount being reported on the adjusted return and any other information as may be required by this section and by the instructions relating to the adjusted return. The reporting of the underpayment on an adjusted return constitutes an adjustment within the meaning of this section only if the adjusted return is filed within the period of limitations for assessment for the return period being corrected, and by the due date for filing the return for the return period in which the error is ascertained. For purposes of the preceding sentence, the due date for filing the adjusted return is determined by reference to the return being corrected, without regard to the employer's current filing requirements. For example, an employer with a current annual filing requirement who is correcting an error on a previously filed quarterly return must file the adjusted return by the due date for filing a quarterly return for the quarter in which the error is ascertained. The amount of the underpayment adjusted in accordance with this section must be paid to the IRS by the time the adjusted return is filed. If an adjustment is reported pursuant to this section, but the amount of the adjustment is not paid when due, interest accrues from that date (see section 6601).

* * * * *

(d) * * *

(1) * * * If an employer collects less than the correct amount of employee FICA or RRTA tax from an employee with respect to a payment of wages or compensation, the employer must collect the amount of the undercollection by deducting the amount from remuneration of the employee, if any, paid after the employer ascertains the error. If an employer collects less than the correct amount of Additional Medicare Tax required to be withheld under section 3101(b)(2) or section 3201(a), the employer must collect the amount of the undercollection on or before the last day of the calendar year by deducting the amount from remuneration of the employee, if any, paid after the employer ascertains the error. Such deductions may be made even though the remuneration, for any reason, does not constitute wages or compensation. The correct amount of employee tax must be reported and paid, as provided in paragraph (b) of this section, whether or not the undercollection is corrected by a deduction made as prescribed in this paragraph (d)(1), and even if the deduction is made after the return on which the employee tax must be reported is due. If such a deduction is not made, the obligation of the employee to the employer with respect to the undercollection is a matter for settlement between the employee and the employer. If an employer makes an erroneous collection of employee tax from two or more of its employees, a separate settlement must be made with respect to each employee. An overcollection of employee tax from one employee may not be used to offset an undercollection of such tax from another employee. For provisions relating to the employer's liability for the tax, whether or not it collects the tax from the employee, see §§31.3102–1(d), 31.3102–4(c), and 31.3202–1. This paragraph (d)(1) does not apply if section 3509 applies to determine the employer's liability.

* * * * *

(e) *Effective/applicability date*. Paragraphs (b) and (d) of this section apply to adjusted returns filed on or after November 29, 2013.

Par. 11. Section 31.6402(a)–2 is amended by:

1. Revising paragraph (a)(1)(i) and the first sentence in paragraph (a)(1)(ii).

2. Redesignating paragraphs (a)(1)(iii) through (vi), as paragraphs (a)(1)(iv) through (vii), respectively.

3. Revising newly-redesignated paragraphs (a)(1)(iv) and (a)(1)(v).

4. Adding new paragraph (a)(1)(iii).

5. Revising paragraph (b).

6. Adding paragraph (c).

The revisions and additions read as follows:

§31.6402(a)–2 Credit or refund of tax under Federal Insurance Contributions Act or Railroad Retirement Tax Act.

(a) * * *

(1) * * *

(i) Except as provided in paragraph (a)(1)(iii) of this section, any person may file a claim for credit or refund for an overpayment (except to the extent that the overpayment must be credited pursuant to §31.3503–1) if the person paid to the Internal Revenue Service (IRS) more than the correct amount of employee Federal Insurance Contributions Act (FICA) tax under section 3101 or employer FICA tax under section 3111, employee Railroad Retirement Tax Act (RRTA) tax under section 3201, employee representative RRTA tax under section 3211, or employer RRTA tax under section 3221, or interest, addition to the tax, additional amount, or penalty with respect to any such tax.

(ii) Except as provided in paragraph (a)(1)(iii) of this section, the claim for credit or refund must be made in the manner and subject to the conditions stated in this section. * * *

(iii) *Additional Medicare Tax*. No refund or credit to the employer will be allowed for the amount of any overpayment of Additional Medicare Tax imposed under section 3101(b)(2) or section 3201(a) (as calculated under section 3101(b)(2)), which the employer deducted or withheld from an employee.

(iv) For adjustments without interest of overpayments of FICA or RRTA taxes, including Additional Medicare Tax, see §31.6413(a)–2.

(v) For corrections of FICA and RRTA tax paid under the wrong chapter, see §31.6205–1(b)(2)(ii) and (b)(2)(iii) and §31.3503–1.

* * * * *

(b) *Claim by employee*—(1) *In general*. Except as provided in (b)(3) of this section, if more than the correct amount of employee tax under section 3101 or section 3201 is collected by an employer from an employee and paid to the IRS, the employee may file a claim for refund of the overpayment if—

(i) The employee does not receive repayment or reimbursement in any manner from the employer and does not authorize the employer to file a claim and receive refund or credit,

(ii) The overcollection cannot be corrected under §31.3503–1, and

(iii) In the case of overpaid employee social security tax due to having received wages or compensation from multiple employers, the employee has not taken the overcollection into account in claiming a credit against, or refund of, his or her income tax, or if so, such claim has been rejected. See §31.6413(c)–1.

(2) *Statements supporting employee's claim*. (i) Except as provided in (b)(3) of this section, each employee who makes a claim under paragraph (b)(1) of this section shall submit with such claim a statement setting forth (a) the extent, if any, to which the employer has repaid or reimbursed the employee in any manner for the overcollection, and (b) the amount, if any, of credit or refund of such overpayment claimed by the employer or authorized by the employee to be claimed by the employer. The employee shall obtain such statement, if possible, from the employer, who should include in such statement the fact that it is made in support of a claim against the United States to be filed by the employee for refund of employee tax paid by such employer to the IRS. If the employer's statement is not submitted with the claim, the employee shall make the statement to the best of his or her knowledge and belief, and shall include therein an explanation of his or her inability to obtain the statement from the employer.

(ii) Except as provided in paragraph (b)(3) of this section, each individual who makes a claim under paragraph (b)(1) of this section also shall submit with such claim a statement setting forth whether the individual has taken the amount of the overcollection into account in claiming a credit against, or refund of, his or her income tax, and the amount, if any, so claimed (see §31.6413(c)–1).

(3) *Additional Medicare Tax*. (i) If more than the correct amount of Additional Medicare Tax under section 3101(b)(2) or section 3201(a) (as calculated under section 3101(b)(2)), is collected by an employer from an employee and paid to the IRS, the employee may file a claim for refund of the overpayment and receive a refund or credit if the overcollection cannot be corrected under §31.3503–1 and if the employee has not received repayment or reimbursement from the employer in the context of an interest-free adjustment. The claim for refund shall be made on Form 1040, *U.S. Individual Income Tax Return*, by taking the overcollection into account in claiming a credit against, or refund of, tax. The form to be used by residents of the U.S. Virgin Islands, Guam, American Samoa, or the Northern Mariana Islands is Form 1040-SS, *U.S. Self-Employment Tax Return (Including Additional Child Tax Credit for Bona Fide Residents of Puerto Rico)*. The form to be used by residents of Puerto Rico is either Form 1040-SS or Form 1040-PR, *Planilla para la Declaración de la Contribución Federal sobre el Trabajo por Cuenta Propia (Incluyendo el Crédito Tributario Adicional por Hijos para Residentes Bona Fide de Puerto Rico)*. The employee may not authorize the employer to claim the credit or refund for the employee. See §31.6402(a)–2(a)(1)(iii).

(ii) In the case of an overpayment of Additional Medicare Tax under section 3101(b)(2) or section 3201(a) for a taxable year of an individual for which a Form 1040 (or other applicable return in the Form 1040 series) has been filed, a claim for refund shall be made by the individual on Form 1040X, *Amended U.S. Individual Income Tax Return*.

(c) *Effective/applicability date*. This section applies to claims for refund filed on or after November 29, 2013.

Par. 12. Section 31.6413(a)–1 is amended by:

1. Revising the first sentence in paragraph (a)(2)(i).

2. Redesignating paragraphs (a)(2)(ii) through (vii) as paragraphs (a)(2)(iii) through (viii), respectively.

3. Revising newly-designated paragraph (a)(2)(viii).

3. Adding paragraph (a)(2)(ii).

4. Adding a sentence after the first sentence in newly-redesignated paragraph (a)(2)(iv).

5. Adding a sentence at the end of newly-redesignated paragraph (a)(2)(v).

6. Adding paragraph (c).

The revisions and additions read as follows:

§31.6413(a)–1 Repayment or reimbursement by employer of tax erroneously collected from employee.

(a) * * *

(2) * * * (i) Except as provided in paragraph (a)(2)(ii) of this section, if an employer files a return for a return period on which FICA tax or RRTA tax is reported, collects from an employee and pays to the IRS more than the correct amount of the employee FICA or RRTA tax, and if the employer ascertains the error after filing the return and within the applicable period of limitations on credit or refund, the employer shall repay or reimburse the employee in the amount of the overcollection prior to the expiration of such limitations period. * * *

(ii) If an employer files a return for a return period on which Additional Medicare Tax under section 3101(b)(2) or section 3201(a) is reported, collects from an employee and pays to the IRS more than the correct amount of Additional Medicare Tax required to be withheld from wages or compensation, and if the employer ascertains the error after filing the return but before the end of the calendar year in which the wages or compensation were paid, the employer shall repay or reimburse the employee in the amount of the overcollection prior to the end of the calendar year. However, this paragraph does not apply to the extent that, after reasonable efforts, the employer cannot locate the employee.

* * * * *

(iv) * * * However, for purposes of overcollected Additional Medicare Tax under section 3101(b)(2) or section 3201(a), the employer shall reimburse the employee by applying the amount of the overcollection against the employee FICA or RRTA tax which attaches to wages or compensation paid by the employer to the employee in the calendar year in which the overcollection is made. * * *

(v) * * * This paragraph (a)(2)(v) does not apply for purposes of overcollected Additional Medicare Tax under section 3101(b)(2) or section 3201(a) which must be repaid or reimbursed to the employee in the calendar year in which the overcollection is made.

* * * * *

(viii) For corrections of FICA and RRTA tax paid under the wrong chapter, see §31.6205–1(b)(2)(ii) and (iii) and §31.3503–1.

* * * * *

(c) *Effective/applicability date*. Paragraph (a) of this section applies to adjusted returns filed on or after November 29, 2013.

Par. 13. Section 31.6413(a)-2 is amended by:

1. Adding a sentence after the first sentence in paragraph (a)(1).

2. Adding a sentence after the second sentence in paragraph (b)(2)(i).

3. Adding paragraph (e).

The additions read as follows:

§31.6413(a)–2 Adjustments of overpayments.

(a) * * *

(1) * * * However, this section only applies to overcollected or overpaid Additional Medicare Tax under section 3101(b)(2) or section 3201(a) if the employer has repaid or reimbursed the amount of the overcollection of such tax to the employee in the year in which the overcollection was made. * * *

* * * * *

(b) * * *

(2) * * *

(i) * * * However, for purposes of Additional Medicare Tax under section 3101(b)(2) or section 3201(a), if the amount of the overcollection is not repaid or reimbursed to the employee under §31.6413(a)–1(a)(2)(ii), there is no overpayment to be adjusted under this section and the employer may only adjust an overpayment of such tax attributable to an administrative error, that is, an error involving the inaccurate reporting of the amount withheld, pursuant to this section. * * *

* * * * *

(e) *Effective/applicability date*. Paragraphs (a) and (b) of this section apply to adjusted returns filed on or after November 29, 2013.

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved November 18, 2013

Mark J. Mazur,
Assistant Secretary of the Treasury.

(Filed by the Office of the Federal Register on November 26, 2013, 4:15 p.m., and published in the issue of the Federal Register for November 29, 2013, 78 F.R. 71468)

Section 6050H.—Returns Relating to Mortgage Interest Received in Trade or Business from Individuals

T.D. 9642

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Part 1

Information Reporting of Mortgage Insurance Premiums

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations and removal of temporary regulations.

SUMMARY: This document contains final regulations that require information reporting by persons who receive mortgage insurance premiums, including prepaid premiums, aggregating $600 or more during any calendar year. The final regulations implement reporting requirements that result from the extension of the treatment of mortgage insurance premiums made by the American Taxpayer Relief Act of 2012. These regulations will affect any person who, in the course of a trade or business, receives from an individual mortgage insurance premiums that in the aggregate total $600 or more during a calendar year.

DATES: *Effective Date*: These regulations are effective on November 27, 2013.

Applicability Date: For dates of applicability, see §1.6050H–3(g).

FOR FURTHER INFORMATION CONTACT: Janet Engel Kidd at (202) 317-6844 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Background

This document contains amendments to the Income Tax Regulations (26 CFR part 1) under section 6050H(h) of the Internal Revenue Code (Code) relating to reporting requirements for mortgage insurance premiums. Section 6050H(h)(1), enacted on December 20, 2006, by section 419(c) of the Tax Relief and Health Care Act of 2006, Public Law 109-432 (120 Stat. 2967), provides that the Secretary may, by regulations, require any person who, in the course of a trade or business, receives payments of mortgage insurance premiums from an individual aggregating $600 or more during any calendar year to file a return regarding those payments in the form, at the time, and containing the information prescribed by the Secretary. Under section 6050H(h)(2), on or before January 31 of the year following the year in which the premium is received, a person required to file an information return under section 6050H(h)(1) must send a written statement to the individual to whom the information return relates showing the information prescribed by the Secretary. Section 6050H(h)(3)(A) provides that rules similar to the rules in section 6050H(c), relating to the applicability of the section 6050H reporting requirements to governmental units, will apply with respect to mortgage insurance premiums. Section 6050H(h)(3)(B) defines the term "mortgage insurance" to mean mortgage insurance provided by the Veterans Administration (the predecessor to the Department of Veterans Affairs), the Federal Housing Administration, or the Rural Housing Administration (the predecessor to the Rural Housing Service), and private mortgage insurance (as defined by section 2 of the Homeowners Protection Act of 1998) (12 U.S.C. 4901), as in effect on the date of enactment of section 6050H(h), which is the same definition as "qualified mortgage insurance" in section 163(h)(4)(E).

In general, section 163(h)(3)(E) treats premiums paid for qualified mortgage insurance by a taxpayer during the taxable year in connection with acquisition indebtedness with respect to a qualified residence as qualified residence interest. Prior to amendment in 2013, section 163(h)(3)(E) was effective for amounts paid or accrued between January 1, 2007, and December 31, 2011, or properly allocable to any period ending on or before December 31, 2011, on mortgage insurance contracts issued on or after January 1, 2007. Section 204 of the American Taxpayer Relief Act of 2012 (ATRA), Public Law No. 112-240, 126 Stat. 2313, enacted on January 2, 2013, retroactively applied the tax treatment of qualified mortgage insurance premiums as qualified residence interest for 2012, and it extended that treatment to premiums paid or accrued on or before December 31, 2013, or properly allocable to any period ending on or before December 31, 2013, on mortgage insurance contracts issued on or after January 1, 2007. Unless extended or made permanent by further legislation, section 163(h)(3)(E) will not apply to amounts paid or accrued after 2013 or properly allocable to any period after 2013.

On May 7, 2009, the Treasury Department and the IRS published temporary regulations (TD 9449) under section 163 in the **Federal Register** (74 FR 21256) that explained how to allocate prepaid qualified mortgage insurance premiums to determine the amount of the prepaid premium that is treated as qualified residence interest each taxable year. The temporary regulations also provided guidance as to reporting requirements under section 6050H(h) to reporting entities receiving premiums, including prepaid premiums, for mortgage insurance. On the same day, the Treasury Department and the IRS published a notice of proposed rulemaking (REG-107271-08) cross-referencing the temporary regulations in the **Federal Register** (74 FR 21295). No public hearing was requested or held. No comments responding to the notice of proposed rulemaking were received.

On May 7, 2012, the Treasury Department and the IRS published final regulations (TD 9588) in the **Federal Register** (77 FR 26698) adopting the proposed regulations under section 163 relating to the allocation of prepaid qualified mortgage insurance premiums, as amended. Those final regulations did not finalize the proposed regulations relating to the reporting requirements under section 6050H(h) for entities receiving mortgage insurance premiums. At that time, the deduction for qualified mortgage insurance premiums under section 163 did not apply to amounts paid or accrued after December 31, 2011, and the Treasury Department and the IRS determined not to require the reporting of nondeductible premiums. The temporary regulations on the reporting requirements, which were in §1.6050H–3T, expired on May 4, 2012.

Explanation of Revisions

The final regulations adopt the proposed regulations under §1.6050H–3 with two minor revisions. The first is the addition of new paragraph (d), which cross-references §1.6050H–2 regarding the time, form, and manner of reporting qualified mortgage interest. The addition of this cross-reference is intended to clarify that rules similar to the rules applicable to the time, form, and manner of reporting interest received on qualified mortgages apply to amounts required to be reported under §1.6050H–3(a) . For instance, mortgage insurance premiums are reported on a Form 1098, *Mortgage Interest Statement*, if the premiums received from that individual in the aggregate total $600 or more.

The second revision relates to the effective date and applicability of these final regulations. On January 2, 2013, ATRA extended section 163(h) for premiums paid or accrued on or before December 31, 2013, or properly allocable to any period ending on or before December 31, 2013, on mortgage insurance contracts issued on or after January 1, 2007. In addition, ATRA extended section 163(h) retroactively for qualified mortgage insurance premiums paid or accrued during 2012. These final regulations under §1.6050H–3 require information reporting for mortgage insurance premiums received on or after January 1, 2013, and during periods to which section 163(h)(3)(E) is applicable. However, there were no final or temporary regulations requiring information reporting with respect to qualified mortgage insurance premiums paid or accrued during 2012. Therefore, information reporting with respect to qualified mortgage insurance premiums was not required for premiums paid or accrued during 2012.

Because information reporting with respect to mortgage insurance premiums received during 2012 was not required, no penalty under section 6721 or section 6722 will apply with respect to the failure to report mortgage insurance premiums received during 2012.

Further, the fact that an individual did not receive a Form 1098 reporting the amount of mortgage insurance premiums paid for 2012 does not affect whether the individual satisfied the requirements under section 163(h) to treat qualified mortgage insurance premiums as qualified residence interest. Accordingly, any individual who paid or accrued qualified mortgage insurance premiums in the calendar year ending December 31, 2012, or properly allocated these premiums to the calendar year ending December 31, 2012, on mortgage insurance contracts issued on or after January 1, 2007, and who did not previously treat those amounts as qualified residence interest, may, within the applicable period of limitations, file a Form 1040X, *Amended U.S. Individual Income Tax Return*, for 2012 to claim a refund based on the treatment of those amounts as qualified residence interest.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that this rule will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that this rule merely reinstates the mortgage insurance information reporting requirements on the Form 1098 that previously existed from 2007 through 2011. In addition, persons receiving mortgage insurance premiums already are required to file the Form 1098 to report interest received on qualified mortgages and completing the mortgage insurance premiums box imposes little or no incremental burden in time or expense. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. Chapter 6) is not required. Pursuant to section 7805(f) of the Code, the notice of proposed rulemaking that preceded these final regulations was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

Drafting Information

The principal author of these regulations is Janet Engel Kidd, Office of the Associate Chief Counsel, Procedure and Administration.

* * * * *

Adoption of Amendments to the Regulations

Accordingly, 26 CFR part 1 is amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 is amended by adding an entry in numerical order to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Section 1.6050H–3 is also issued under 26 U.S.C. 6050H(h).* * *

Par. 2. Section 1.6050H–3 is added to read as follows:

§1.6050H–3 Information reporting of mortgage insurance premiums.

(a) *Information reporting requirements*. Any person who, in the course of a trade or business, receives premiums, including prepaid premiums, for mortgage insurance (as described in paragraph (b) of this section) from any individual aggregating $600 or more for any calendar year, must make an information return setting forth the total amount received from that individual during the calendar year.

(b) *Scope*. Paragraph (a) of this section applies to mortgage insurance provided by the Federal Housing Administration, Department of Veterans Affairs, or the Rural Housing Service (or their successor organizations), or to private mortgage insurance (as defined by section 2 of the Homeowners Protection Act of 1998 (12 U.S.C. 4901) as in effect on December 20, 2006). The rule stated in paragraph (a) of this section applies to the receipt of all payments of mortgage insurance premiums, by cash or financing, without regard to source.

(c) *Aggregation*. Whether a person receives $600 or more of mortgage insurance premiums is determined on a mortgage-by-mortgage basis. A recipient need not aggregate mortgage insurance premiums received on all of the mortgages of an individual to determine whether the $600 threshold is met. Therefore, a recipient need not report mortgage insurance premiums of less than $600 received on a mortgage, even though it receives a total of $600 or more of mortgage insurance premiums on all of the mortgages for an individual for a calendar year.

(d) *Time, form, and manner of reporting*. Mortgage insurance premiums required to be reported under paragraph (a) of this section must be reported on the Form 1098 or successor form that is filed pursuant to §1.6050H–2(a) with respect to the mortgage of the individual who paid the mortgage insurance premiums. For the requirements for furnishing statements with respect to Forms 1098 filed with the Internal Revenue Service, see §1.6050H–2(b).

(e) *Cross reference*. For rules concerning the allocation of certain prepaid qualified mortgage insurance premiums, see §1.163–11 of this chapter.

(f) *Limitation on the reporting of mortgage insurance premiums*. This section applies to mortgage insurance premiums described in paragraph (b) of this section that are paid or accrued on or after January 1, 2013, and during periods to which section 163(h)(3)(E) applies. This section does not apply to any amounts of mortgage insurance premiums that are allocable to any periods to which section 163(h)(3)(E) does not apply.

(g) *Effective/applicability date*. This section applies to mortgage insurance premiums received on or after January 1, 2013. For regulations applicable before May 5, 2012, see §1.6050H–3T as contained in 26 CFR part 1 (revised as of April 1, 2012).

§1.6050H–3T [Removed]

Par. 3. Section 1.6050H-3T is removed.

John M. Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved October 1, 2013

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on November 26, 2013, 8:45 a.m., and published in the issue of the Federal Register for November 27, 2013, 78 F.R. 70856)

Section 9010 of the Affordable Care Act.—Imposition of Annual Fee on Health Insurance Providers

T.D. 9643

DEPARTMENT OF THE TREASURY
Internal Revenue Service
26 CFR Parts 57 and 602

Health Insurance Providers Fee

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Final regulations.

SUMMARY: This document contains final regulations relating to the annual fee imposed on covered entities engaged in the business of providing health insurance for United States health risks. This fee is imposed by section 9010 of the Patient Protection and Affordable Care Act, as amended. The regulations affect persons engaged in the business of providing health insurance for United States health risks.

DATES: *Effective Date*: These regulations are effective on November 29, 2013.

Applicability Date: For dates of applicability see §§57.10 and 57.6302-1.

FOR FURTHER INFORMATION CONTACT: Charles J. Langley, Jr. at (202) 317-6855 (not a toll-free number).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in these final regulations has been reviewed and approved by the Office of Management and Budget under control number 1545-2249. The collection of information in these final regulations is in §57.2(e)(2)(i). The information is required to be maintained, in the case of a controlled group, by the designated entity and each member of the controlled group. An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless the collection of information displays a valid control number. Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103.

Background

This document adds the Health Insurance Providers Fee Regulations to the Code of Federal Regulations (26 CFR part 57) under section 9010 of the Patient Protection and Affordable Care Act (PPACA), Public Law 111-148 (124 Stat. 119 (2010)), as amended by section 10905 of PPACA, and as further amended by section 1406 of the Health Care and Education Reconciliation Act of 2010, Public Law 111-152 (124 Stat. 1029 (2010)) (collectively, the Affordable Care Act or ACA). All references in this preamble to section 9010 are references to the ACA. Section 9010 did not amend the Internal Revenue Code (Code) but contains cross-references to specified Code sections.

A notice of proposed rulemaking (REG–118315–12, 78 FR 14034) was published in the **Federal Register** on March 4, 2013 (the proposed regulations). The Department of the Treasury (Treasury Department) and the IRS received over 80 written comments from the public in response to the proposed regulations. A public hearing was held on June 21, 2013. After considering the public written comments and hearing testimony, the proposed regulations are adopted as final regulations by this Treasury decision with certain changes as described in this preamble.

Unless otherwise indicated, all other references to subtitles, chapters, subchapters, and sections in this preamble are references to subtitles, chapters, subchapters, and sections in the Code and related regulations. All references to "fee" in the final regulations are references to the fee imposed by section 9010.

Explanation of Provisions and Summary of Comments

Covered Entities and Exclusions

In General

Section 9010(a) imposes an annual fee, beginning in 2014, on each covered entity engaged in the business of providing health insurance. Section 9010(c) provides that a covered entity is any entity that provides health insurance for any United States health risk during each year, subject to certain exclusions. The proposed regulations defined the term *covered entity* generally to mean any entity with net premiums written for United States health risks during the fee year that is: (1) a health insurance issuer within the meaning of section 9832(b)(2); (2) a health maintenance organization within the meaning of section 9832(b)(3); (3) an insurance company subject to tax under part I or II of subchapter L, or that would be subject to tax under part I or II of subchapter L but for the entity being exempt from tax under section 501(a); (4) an entity that provides health insurance under Medicare Advantage, Medicare Part D, or Medicaid; or (5) a non-fully insured multiple employer welfare arrangement (MEWA).

With respect to the first category of covered entity, the proposed regulations provided that a health insurance issuer within the meaning of section 9832(b)(2) means an insurance company, insurance service, or insurance organization that is required to be licensed to engage in the business of insurance in a State and that is subject to State law that regulates insurance. A commenter suggested that the final regulations eliminate any State licensing requirement for a covered entity because an entity may provide health insurance for a United States health risk and not be licensed. The final regulations do not adopt this suggestion. The final regulations modify this category of covered entity to more closely align with section 9832(b)(2), which provides that a health insurance issuer must be licensed to engage in the business of insurance in a State and not merely required to be licensed as stated in the proposed regulations. A health insurance issuer within the meaning of section 9832(b)(2) cannot lawfully engage in the business of selling insurance in a State unless it is licensed to engage in the business of insurance in that State.

Notwithstanding this licensing limitation for the first category of covered entity, the term *covered entity* is not limited to an entity that is a health insurance issuer within the meaning of section 9832(b)(2). An insurance company subject to tax under subchapter L, an entity providing health insurance under Medicare Advantage, Medicare Part D, or Medicaid, or a MEWA may also be a covered entity under these regulations, whether or not that entity is licensed to engage in the business of insurance in a State.

Multiple Employer Welfare Arrangements (MEWAs)

The proposed regulations provided that the term *covered entity* includes a MEWA within the meaning of section 3(40) of the Employee Retirement Income Security Act of 1974 (29 U.S.C. chapter 18) (ERISA), to the extent that the MEWA is not a fully-insured MEWA, regardless of whether the MEWA is subject to regulation under State insurance law. In the case of a fully-insured MEWA, the MEWA is not a covered entity because, even though the MEWA receives premiums, it applies those premiums to pay an insurance company to provide the coverage it purchases. If the MEWA is not fully insured, however, the MEWA is a covered entity to the extent that it uses the premiums it receives to provide the health coverage rather than to pay an insurance company to provide the coverage.

Commenters suggested that a MEWA not be treated as a covered entity, stating that Federal and State law do not support the interpretation that a MEWA offers "insurance." Commenters also stated that an employer who participates in a non-fully insured MEWA should be treated the same as an employer who offers a self-insured plan. The final regulations do not adopt these suggestions. By participating in a non-fully insured MEWA, a participating employer generally is pooling its health insurance risks, transferring those risks to the MEWA, or both, similar to the way an employer pools and transfers those risks by purchasing a group insurance policy from an insurance company. In a non-fully insured MEWA, the responsibility for a claim that a participant makes against it lies with the MEWA, and possibly with all of the contributing employers. Therefore, a MEWA is different from a self-insured plan in which responsibility for a participant's claim lies solely with the claimant's employer.

Moreover, section 514(b)(6) of ERISA provides that a MEWA is subject to State insurance law and regulation as an insurance provider, unlike non-MEWA ERISA-covered employee benefit plans which are not subject to State insurance law and regulation due to Federal preemption. For example, a non-fully insured multiemployer plan, defined under section 3(37) of ERISA, generally would not be subject to State insurance law, whereas an ERISA-covered MEWA, within the meaning of section 3(40) of ERISA, that is not fully insured (as defined in section 514(b)(6)(D) of ERISA) generally would be subject to State insurance law.

The Joint Committee on Taxation General Explanation also indicates that a MEWA is intended to be a covered entity under section 9010: "A covered entity does not include an organization that qualifies as a VEBA [voluntary employees' beneficiary association] under section 501(c)(9) that is established by an entity other than the employer (i.e., a union) for the purpose of providing health care benefits. This exclusion does not apply to multi-employer [sic] welfare arrangements ('MEWAs')." See General Explanation of Tax Legislation Enacted by the 111th Congress, JCS-2-11 (March 2011) (JCT General Explanation) at 330.

For these reasons, the Treasury Department and the IRS have concluded that a MEWA within the meaning of section 3(40) of ERISA is an entity that provides health insurance for purposes of section 9010 to the extent that the MEWA is not a fully-insured MEWA and regardless of whether the MEWA is subject to regulation under State insurance law. In addition, such a MEWA is not eligible for the exception from the fee under section 9010(c)(2)(A) for self-insured employers.

The proposed regulations excluded a MEWA that is exempt from Department of Labor (DOL) reporting requirements under 29 CFR 2520.101-2(c)(2)(ii)(B). This section of the DOL regulations generally excludes a MEWA that provides coverage to the employees of two or more employers due to a change in control of businesses (such as a merger or acquisition) that occurs for a purpose other than to avoid the reporting requirements and does not extend beyond a limited time. A commenter suggested that the final regulations also exclude a MEWA that is exempt from reporting under 29 CFR 2520.101-2(c)(2)(ii)(A), which generally applies to an entity that would not be a MEWA but for the fact that it provides coverage to two or more trades or businesses that share a common control interest of at least 25 percent (applying principles similar to the principles of section 414(c)) at any time during the plan year. The commenter also suggested that the final regulations exclude a MEWA that is exempt from reporting under 29 CFR 2520.101-2(c)(2)(ii)(C), which generally applies to an entity that would not be a MEWA but for the fact that it provides coverage to persons who are not employees or former employees of the plan sponsor (such as non-employee members of the board of directors or independent contractors), if coverage of such persons does not exceed one percent of the total number of employees or former employees covered by the arrangement, determined as of the last day of the year to be reported, or determined as of the 60th day following the date the MEWA began operating in a manner such that a filing is required pursuant to 29 CFR 2520.101-2(e)(2) or (3).

The final regulations adopt these suggestions and follow the DOL rules excepting these entities from the DOL reporting requirements under 29 CFR 2520.101-2 governing MEWAs. The reasons supporting the DOL's filing exemption also justify exempting these arrangements from section 9010 as more akin to health coverage provided by a self-insured employer. Similar to the filing exemption for certain temporary MEWAs, these two filing exemptions are intended to address situations in which the status as a MEWA derives not from the design of the arrangement but instead from the limited participation by individuals who are not the employees of a single employer or from a desire to have a single plan for entities sharing substantial common ownership (though not sufficient to be treated as a single employer under the controlled group rules). Accordingly, a MEWA will not be considered a covered entity if it satisfies the requirements of 29 CFR 2520.101-2(c)(2)(ii)(A), (B), or (C) for the plan year ending with or within the section 9010 data year.

The proposed regulations provided that, solely for purposes of section 9010, an Entity Claiming Exception (ECE)[1] is subject to the same regime addressing MEWAs. Commenters requested that an ECE not categorically be treated as a MEWA for purposes of section 9010. Commenters pointed out that some ECEs are multiemployer plans and coverage during the period of their status as an ECE would not be consistent with this status. In addition, as a practical matter, an entity's status as an ECE is only relevant for reporting during a limited period of time. For these reasons, the final regulations adopt this suggestion so that whether an entity is or is not an ECE is not relevant to whether the entity is subject to section 9010.

Voluntary Employees' Beneficiary Associations (VEBAs)

In accordance with section 9010(c)(2)(D), the proposed regulations explicitly excluded any VEBA that is established by an entity other than an employer or employers for the purpose of providing health care benefits. Further, the preamble to the proposed regulations stated that, if an employer provides self-insured employee health benefits through a VEBA, the VEBA is not a covered entity because the exclusion for employers with self-insured arrangements under section 9010(c)(2)(A) applies. The preamble also stated that, if a VEBA purchases health insurance to cover the beneficiaries of the VEBA, the VEBA is not a covered entity because the issuer providing the health insurance that the VEBA purchases is the covered entity subject to the fee rather than the VEBA. The preamble stated that the Treasury Department and the IRS were not aware of any VEBAs that would be covered entities under the proposed regulations and invited comments on the types of VEBAs, if any, that do not fall within the exclusions and therefore would be covered entities.

A commenter requested that the final regulations clarify that a VEBA established by a union qualifies for the section 9010(c)(2)(D) exclusion. Commenters also asked for clarification that the section 9010(c)(2)(D) exclusion applies to any VEBA established by a joint board of trustees in the case of a multiemployer plan within the meaning of section 3(37) of ERISA. The final regulations adopt these suggestions with respect to plans established by unions and joint boards of trustees because the union or joint board of trustees is an entity other than the employer or employers. Thus, in the case of a multiemployer plan that maintains a VEBA, neither the plan nor the VEBA is a covered entity.

Commenters also requested that the final regulations clarify the application of the section 9010(c)(2)(D) exclusion to a VEBA that is part of a single-employer plan established pursuant to a collective bargaining agreement and having a joint board of trustees. As in the case of a multiemployer plan, a VEBA that is, for example, part of a single-employer plan established by a joint board of trustees pursuant to section 302(c)(5) of the Labor Management Relations Act of 1947, is considered to be established by an entity other than the employer or employers and so is eligible for the section 9010(c)(2)(D) exclusion.

The preamble to the proposed regulations stated that, if a MEWA provides health benefits through a VEBA, the VEBA is not a covered entity. A commenter asked whether the section 9010(c)(2)(D) exclusion applies to a non-fully insured MEWA that is also a VEBA. The section 9010(c)(2)(D) exclusion does not apply to an entity that is both a non-fully insured MEWA and a VEBA because, for section 9010 purposes, the entity has been established by the employers whose employees participate in the MEWA, and the section 9010(c)(2)(D) exclusion does not apply to an employer-established VEBA. Additionally, the entity does not qualify as a self-insured arrangement that is eligible for the exclusion for self-insured employers under section 9010(c)(2)(A) because, as previously described in the section of this preamble titled "Multiple Employer Welfare Arrangements (MEWAs)," a non-fully insured MEWA is not a self-insured employer. Accordingly, a MEWA that is also a VEBA is a covered entity.

Section 9010(c)(2)(C) Exclusion

In accordance with section 9010(c)(2)(C)(i)-(iii), the proposed regulations excluded any entity (i) that is incorporated as a nonprofit corporation under State law; (ii) no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting to, influence legislation (except as provided in section 501(h)), and that does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office; and (iii) that receives more than 80 percent of its gross revenues from government programs that target low-income, elderly, or disabled populations under titles XVIII, XIX, and XXI of the Social Security Act (which include Medicare, Medicaid, the Children's Health Insurance Plan (CHIP), and dual eligible plans).

Commenters suggested that the final regulations exclude a for-profit entity that meets the section 9010(c)(2)(C)(ii) and (iii) requirements. According to the commenters, imposing the fee on these for-profit entities will effectively reduce benefits provided under Medicare and Medicaid, require the entities to pass the cost of the fee back to the government, and competitively disadvantage these entities in favor of excluded nonprofit corporations. Another commenter suggested that the final regulations permit an entity that is treated as a nonprofit entity under State law to satisfy the section 9010(c)(2)(C)(i) requirement even if it is not incorporated as a nonprofit corporation. Commenters also suggested that the final regulations exclude an entity

[1]An ECE is defined in 29 CFR 2520.101-2(b) as an entity that claims it is not a MEWA on the basis that the entity is established or maintained pursuant to one or more agreements that the Secretary of Labor finds to be collective bargaining agreements within the meaning of section 3(40)(A)(i) of ERISA and 29 CFR 2510.3-40. We also note that ERISA section 501(b) imposes criminal penalties on any person who is convicted of violating the prohibition in ERISA section 519 against making false statements or representations of fact in connection with the marketing or sale of a MEWA.

that meets the section 9010(c)(2)(C)(i) and (ii) requirements and that targets low-income, elderly, or disabled populations described in section 9010(c)(2)(C)(iii), but whose income is not derived from title XVIII, XIX, or XXI programs, but rather from similar types of programs that do not come under those titles. The final regulations do not adopt these suggested changes. The statutory language sets forth specific requirements for an entity to qualify for the exception, including that the entity be a nonprofit corporation and that the entity receive the required portion of its gross income from the enumerated Federal government programs.

Commenters suggested that the final regulations interpret the requirement set forth in section 9010(c)(2)(C)(iii), that the entity receive more than 80 percent of its gross revenues from enumerated Federal government programs to qualify for that exception, to apply only to revenues that relate to net premiums written. Because gross revenues include all revenues of the covered entity without taking into account their source, the final regulations do not adopt this suggestion.

As explained in the preamble to the proposed regulations, an entity is not required to be exempt from tax under section 501(a) to qualify for the section 9010(c)(2)(C) exclusion. However, because the provisions of section 9010(c)(2)(C)(ii) relating to private inurement, lobbying, and political campaign activity are the same as those provisions applicable to organizations described in section 501(c)(3), for purposes of applying these requirements, the proposed regulations adopted the standards set forth under section 501(c)(3) and the related regulations. Commenters generally agreed with this approach, which is adopted in the final regulations.

One commenter suggested that the final regulations incorporate a "safe harbor" under which a transaction will not violate the private inurement prohibition under section 9010(c)(2)(C)(ii) if either the transaction complies with applicable State insurance laws governing the reasonableness of transactions between a health insurance provider and its affiliates or the transaction is approved in accordance with certain procedures set forth in the regulations under section 4958 (relating to taxes on excess benefit transactions). The final regulations do not adopt this suggestion. The private inurement prohibition under section 501(c)(3) contains no exception for transactions that comply with State insurance laws or other applicable State or Federal laws. Similarly, while most situations that constitute inurement will also violate the general rules of section 4958, the two standards are not the same. See §1.501(c)(3)–1(f)(2) of the Income Tax Regulations and §53.4958–8(a) of the Foundation and Similar Excise Tax Regulations.

Agencies and Instrumentalities as Governmental Entities

Section 9010(c)(2)(B) excludes any governmental entity from the definition of covered entity. In defining the term *governmental entity*, the proposed regulations did not include instrumentalities. The preamble to the proposed regulations requested comments on the types of instrumentalities, if any, that would be considered covered entities under the general definition of covered entity and the extent to which those entities would qualify for other exclusions consistent with the statute.

Commenters suggested that the final regulations define governmental entity to include an instrumentality, citing statutory language that excludes "any" governmental entity and arguing that, in certain instances, an instrumentality that provides health insurance performs a governmental function and therefore should be excluded. For those reasons, the final regulations adopt this suggestion and define governmental entity to include any agency or instrumentality of the United States, a State, a political subdivision of a State, an Indian tribal government, or a subdivision of an Indian tribal government.

The final regulations also revise the governmental entity definition to delete the specific provision relating to any public agency that is created by a State or political subdivision thereof and contracts with the State to administer State Medicaid benefits through local providers or health maintenance organizations (HMOs). The Treasury Department and the IRS intend that such a public agency would qualify as an agency or instrumentality of a State or political subdivision thereof for purposes of the governmental entity definition. See JCT General Explanation at 330.

Determinations of whether an entity is an agency or instrumentality have typically been analyzed on a facts and circumstances basis. In determining whether an entity is an agency or instrumentality, courts have applied a test similar to the six-factor test in Revenue Ruling 57-128 (1957-1 CB 311), which generally provides guidance on whether an entity is an instrumentality for purposes of the exemption from employment taxes under sections 3121(b)(7) and 3306(c)(7). See, for example, *Bernini v. Federal Reserve Bank of St. Louis, Eighth District*, 420 F.Supp. 2d 1021 (E.D. Mo. 2005) and *Rose v. Long Island Railroad Pension Plan*, 828 F.2d 910, 918 (2d Cir. 1987), cert. denied, 485 U.S. 936 (1988). For further background information relating to agency or instrumentality determinations, see the "Background" section of the preamble in the section 414(d) draft general regulations in the Appendix to the ANPRM (REG–157714–06) relating to governmental plan determinations, 76 FR 69172 (November 8, 2011).

Applying principles similar to those described in Revenue Ruling 57-128, in determining whether an entity is an agency or instrumentality for purposes of section 9010, factors taken into consideration include whether the entity is used for a governmental purpose and performs a governmental function. The Treasury Department and the IRS question whether providing health insurance on a commercial market in direct competition with non-governmental commercial entities is a governmental function, absent particular circumstances. Accordingly, an entity may jeopardize its status as an agency or instrumentality if it engages in the business of providing insurance on the commercial market on a continuing and regular basis.

Further, section 9010(i) authorizes the IRS to prescribe such regulations as are necessary or appropriate to prevent avoidance of the purposes of section 9010, including inappropriate actions taken to qualify as an excluded entity under section 9010(c)(2). If the Treasury Department and the IRS conclude that agencies or instrumentalities have entered the commercial market in competition with commercial entities in a manner that makes it inappropriate to apply the governmental entity exclusion under section 9010(c)(2)(B), the Treasury Department and the IRS may reconsider the exclusion of agencies and instrumentalities and exercise the authority under section 9010(i) to address particular concerns in this area.

Educational Institutions

A commenter suggested that the final regulations exclude educational institutions from the definition of covered entity. The final regulations do not adopt this request. The statute does not exclude educational institutions from the definition of covered entity, but as noted in the preamble to the proposed regulations, other exceptions may apply. For example, if an educational institution uses the premiums it receives from students to purchase insurance from a separate, unrelated issuer, the issuer, and not the educational institution, will be the covered entity for purposes of section 9010. If an educational institution provides students with health coverage through a self-insured arrangement, the exclusion for self-insuring employers does not apply because the institution is not providing health coverage as an employer. However, other exclusions may apply. For example, the exclusion for governmental entities applies if an educational institution is a wholly-owned instrumentality of a State. In addition, although an educational institution that is a covered entity must report to the IRS its net premiums written, it will not be subject to the fee unless the institution (or its controlled group that is treated as a single covered entity) has net premiums written for United States health risks of more than $25 million pursuant to section 9010(b)(2)(A).

Other Entities

Commenters suggested that the final regulations exclude certain section 501(c)(5) labor organizations that provide health coverage under the Federal Employees Health Benefit Plan (FEHBP) on the basis that providing health coverage is part of their exempt function as a section 501(c)(5) entity. The commenters asserted that, although a section 501(c)(5) entity is not organized as a VEBA, it operates like a VEBA because of the various FEHBP rules (including, for example, on use of reserves) and therefore should be treated as a VEBA for section 9010 purposes. The final regulations do not adopt this suggestion. Congress identified specific exclusions from section 9010 and there is no statutory exclusion for section 501(c)(5) entities.

Another commenter suggested that the final regulations exclude high risk pools under section 1101 of the ACA, which will expire on December 31, 2013. Section 9010(c)(1) defines a covered entity to mean any entity that provides health insurance for a United States health risk in the year that the fee is due. The first year the fee is due is 2014. Therefore, for the first fee year, an entity is not a covered entity unless it provides health insurance for United States health risks in 2014. Because high risk pools will expire on December 31, 2013, they will not provide health insurance in 2014 and will not be covered entities. In the event a high risk pool provides health insurance for United States health risks in 2014, it will be a covered entity if it does not meet one of the exclusions described in section 9010(c)(2).

A commenter requested that the final regulations provide an exclusion for an entity that is selling or otherwise failing to continue the majority of its health insurance business by December 31, 2013, but is contractually required to provide some residual health insurance. The entity's fee liability for 2014 based on the 2013 data year will be significantly larger than the total amount of net premiums written that the entity will collect in 2014. The final regulations do not adopt this request because it is inconsistent with the statute, which bases the fee liability on net premiums written during the data year.

The proposed regulations defined the term *covered entity* to include an HMO, as defined in section 9832(b)(3). A commenter requested that the final regulations exclude an HMO that is a tax-exempt organization described in section 501(c)(3) or (4) on the basis that Congress did not intend to subject a tax-exempt HMO to the fee. The final regulations do not adopt this suggestion. Section 9010(c)(2) describes the entities that are excluded from the definition of covered entity. While section 9010(c)(2)(D) excludes certain types of VEBAs described in section 501(c)(9), there is no similar exclusion for an entity that qualifies as a tax-exempt organization under either section 501(c)(3) or (4). However, such a tax-exempt organization would be eligible for the partial exclusion under section 9010(b)(2)(B).

Disregarded Entities

Two commenters requested further guidance on how to treat disregarded entities for purposes of section 9010. One commenter suggested that the final regulations specifically state that the general rules for disregarded entities apply. A second commenter suggested that, solely for section 9010 purposes, a disregarded entity should always be regarded as a corporation. The final regulations do not adopt any special entity classification rules. Thus, if a covered entity is an eligible entity under §301.7701–3(a) of the Procedure and Administration Regulations, has a single owner, and does not elect to be classified as a corporation under §301.7701–3(c), then the covered entity is disregarded as an entity separate from its owner and its activities are treated in the same manner as a branch or division of its owner pursuant to §301.7701–2(a). Additionally, although §301.7701–2(c)(2)(v) treats a disregarded entity as a corporation for certain enumerated excise taxes, the fee under section 9010 is not among the enumerated excise taxes. However, an insurance company is a corporation under §301.7701–2(b)(4) and cannot be disregarded as an entity separate from its owner. See also Rev. Rul. 83-132 (1983-2 CB 270). Under sections 816(a) and 831(c), a company is an insurance company if more than half of its business during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Therefore, if the covered entity is an insurance company under sections 816(a) and 831(c), then it is a corporation and cannot be disregarded as an entity separate from its owner.

Controlled Groups

In accordance with section 9010(c)(3), the proposed regulations treated a controlled group as a single covered entity, and defined a controlled group as a group of two or more persons, including at least one person that is a covered entity, that are treated as a single employer under section 52(a), 52(b), 414(m), or 414(o).

Section 52(a) and (b) provide rules that treat all organizations that are members of a controlled group as a single entity. Generally, section 52(a) provides that the term *controlled group of corporations* has the meaning given to such term by section 1563(a), except that "more than 50 percent" is substituted for "at least 80 percent" each place it appears in section 1563(a)(1) and the determination is made without regard to section 1563(a)(4) (relating to special rules for certain insurance companies) and 1563(e)(3)(C) (relating to attribution rules for ownership interest held under a trust described in section 401(a) that is exempt from tax under section 501). Section 52(b) provides similar rules for determining whether trades or businesses (whether or not incorporated) are under common control. Section 414(m) requires that all members of an affiliated service group be treated as a single organization, and section 414(o) provides authority for additional rules that may be necessary to prevent the avoidance of certain requirements related to employee benefits.

A commenter suggested that the final regulations clarify the circumstances under which nonprofit organizations are included in controlled groups under section 9010(c)(3). The Treasury Department and the IRS are considering whether further guidance is needed under section 52(a) or (b) to address either organizations exempt from tax under section 501(a) or nonprofit organizations that, although not exempt from tax under section 501(a), do not have members or shareholders that are entitled to receive distributions of the organization's income or assets (including upon dissolution) or that otherwise retain equity interests similar to those generally held by owners of for-profit entities. Until further guidance is issued, those two types of organizations may either rely on a reasonable, good-faith application of section 52(a) and (b) (taking into account the reasons for which the controlled group rules are incorporated into section 9010) or apply the rules set forth in §1.414(c)–5(a) through (d) (but substituting "more than 50 percent" in place of "at least 80 percent" each place it appears in §1.414(c)–5).

Health Insurance

In General

Section 9010 does not define health insurance, providing in section 9010(h)(3) only that health insurance does not include coverage only for accident, or disability income insurance, or any combination thereof as described in section 9832(c)(1)(A); coverage only for a specified disease or illness and hospital indemnity or other fixed indemnity insurance as described in section 9832(c)(3); insurance for long-term care; or Medicare supplemental health insurance (as defined in section 1882(g)(1) of the Social Security Act). The proposed regulations generally defined the term *health insurance*, subject to certain exclusions, by reference to section 9832(b)(1)(A) to mean benefits consisting of medical care (provided directly, through insurance or reimbursement, or otherwise) under any hospital or medical service policy or certificate, hospital or medical service plan contract, or HMO contract offered by a health insurance issuer. The final regulations clarify that these benefits constitute health insurance when they are offered by any type of covered entity, and not solely by a health insurance issuer within the meaning of section 9832(b)(2).

Stop-Loss Coverage

Several comments requested that the final regulations clarify the treatment of stop-loss coverage. Employers that self-insure their employees' health benefits frequently purchase stop-loss coverage to mitigate risk. The stop-loss provider assumes the risk of claims above a certain agreed-upon threshold known as the attachment point. Some commenters suggested including stop-loss coverage in the definition of health insurance for purposes of section 9010, whereas other commenters suggested excluding it. The DOL, the Department of Health and Human Services (HHS), and the Treasury Department are concerned that more employers in small group markets with healthier employees may pursue self-insured arrangements with stop-loss arrangements that have low attachment points as a functionally equivalent alternative to an insured group health plan. As a result, the three agencies issued a Request for Information (RFI) regarding such practices, with a focus on the prevalence and consequences of stop-loss coverage at low attachment points. See 77 FR 25788 (May 1, 2012). Because the scope of stop-loss coverage that may constitute health insurance, if any, has not been determined, the final regulations do not expressly include stop-loss coverage in the definition of health insurance. Accordingly, section 9010 will not apply to stop-loss coverage until such time and only to the extent that future guidance addresses the issue of whether, and if so under what circumstances, stop-loss coverage constitutes health insurance.

Limited Scope Dental and Vision Benefits

The proposed regulations defined health insurance to include limited scope dental and vision benefits under section 9832(c)(2)(A). Commenters suggested revising the definition of health insurance to exclude limited scope dental and vision benefits (sometimes referred to as stand-alone dental and vision benefits). Alternatively, commenters suggested including only those dental and vision policies that can be offered on an Exchange, such as pediatric dental plans. The final regulations do not adopt these suggestions. The JCT General Explanation indicates that dental and vision benefits are intended to be included as health insurance for purposes of section 9010 and the comments received do not compel a different conclusion. See JCT General Explanation at 331. Accordingly, the final regulations retain the rule in the proposed regulations and provide that limited scope dental and vision benefits, including arrangements that may be sold on an Exchange (for example, pediatric dental coverage), are health insurance for purposes of section 9010.

Coverage Funded by Targeted Government Programs

Commenters suggested that the final regulations exclude coverage funded by government programs that target low-income, elderly, or disabled populations under titles XVIII, XIX, and XXI of the Social Security Act (which include Medicare, Medicaid, CHIP, and dual eligible plans) from the definition of health insurance or exclude revenues received from these government programs from net premiums written. The final regulations do not adopt these suggestions. A full exclusion for these types of coverage or associated revenues would not be consistent with section 9010. Section 9010(c)(2)(C) excludes a limited subset of entities that provide coverage funded by these governmental programs, which indicates that entities providing such coverage are otherwise providing health insurance that is subject to the fee. The JCT General Explanation further indicates that Medicare and Medicaid coverage is health insurance that is subject to the fee. Thus, an entity providing this type of coverage is a covered entity unless it qualifies for a statutory exclusion from the definition of a covered entity, such as the section 9010(c)(2)(C) exclusion. See JCT General Explanation at 330 and 331.

Indemnity Reinsurance

The proposed regulations provided that, solely for purposes of section 9010, health insurance does not include indemnity reinsurance, defined as an agreement between two or more insurance companies under which the reinsuring company agrees to accept, and to indemnify the issuing company for, all or part of the risk of loss under policies specified in the agreement and the issuing company retains its liability to, and its contractual relationship with, the individuals whose health risks are insured under the policies specified in the agreement. A commenter suggested that the final regulations clarify that the definition of indemnity reinsurance extends to reinsurance obtained by HMOs. The final regulations adopt this suggestion and clarify that the issuer of the policies specified in the indemnity reinsurance agreement may be any covered entity.

Commenters asked about the treatment of a "carve-out" arrangement or similar types of arrangement in which one insurer accepts responsibility for all or part of the health risk within a defined category of medical benefits that another insurer is obligated to provide. For example, a full-service insurer that includes dental benefits as part of its health insurance plan may contract with a dental insurer to provide those benefits to plan members, but still retain an exclusive contractual relationship with plan members and liability for benefits. The commenters expressed concern that premiums received by both the full-service insurer and the secondary services insurer for these benefits could be subject to the fee. Although the final regulations do not expressly address a carve-out arrangement, the secondary services insurer in such an arrangement is not providing health insurance for purposes of section 9010 to the extent the arrangement meets the definition of indemnity reinsurance.

Subcapitation

A commenter requested that the final regulations clarify the treatment of a subcapitation arrangement. Under a typical subcapitation arrangement, a Medicaid plan provider contracts with a separate service provider to provide certain services to the Medicaid plan participants and share some of the provider's risk. A Medicaid plan provider that enters into a subcapitation arrangement remains fully liable on the underlying plans, and any amounts paid to compensate the service provider for the subcapitation arrangement are not considered premiums for State regulatory purposes or reported as such. Therefore, although the final regulations do not directly address a subcapitation arrangement, amounts paid to a service provider under such an arrangement are not included in net premiums written for health insurance to the extent they are not treated as premiums for State regulatory and reporting purposes.

Employee Assistance Programs

Commenters requested that the final regulations exclude benefits under an employee assistance program (EAP) from the definition of health insurance, including an EAP that is treated as insurance in California or Nevada. Generally, an EAP does not exhibit the risk pooling and risk transferring characteristics of insurance, but certain States regulate benefits under an EAP as insurance in some situations. The Treasury Department, DOL, and HHS currently are considering guidance that would treat benefits under an EAP as an excepted benefit under section 9832(c) (as well as corresponding provisions of ERISA and the Public Health Service Act (42 U.S.C. chapter 6A) (PHSA)), and provided in Q&A 9 of Notice 2013–54 (2013–40 IRB 287; September 30, 2013) that until that separate rulemaking is finalized in other guidance, and through at least 2014, a taxpayer may treat an EAP that does not provide significant benefits in the nature of medical care or treatment as constituting excepted benefits. Whether and under what conditions an EAP provides health insurance coverage has been a longstanding issue that this other guidance is intended to address by defining an EAP and setting forth the conditions under which the benefits under an EAP will be treated as excepted benefits.

Because the extent to which benefits under an EAP may constitute health insurance has not been determined, the final regulations do not expressly define health insurance to include benefits under an EAP. If an EAP provides significant benefits in the nature of medical care or treatment, those benefits would meet the definition of health insurance for section 9010 purposes. Otherwise, benefits under an EAP will not be treated as health insurance for section 9010 purposes until such time and only to the extent that the Treasury Department, DOL and HHS determine such benefits do not qualify as an excepted benefit.

Commenters also requested that the final regulations exclude coverage under a disease management program or a wellness program from the definition of health insurance. The final regulations do not specifically address the treatment of a stand-alone wellness plan or disease management program. These programs generally do not exhibit the risk shifting and risk distribution characteristics of insurance. Additionally, a program of this type may be contained within an EAP that satisfies the standard in Q&A 9 of Notice 2013–54 for being an excepted benefit (taking into account the benefits provided under the programs in determining whether the EAP provides substantial benefits in the nature of medical treatment). For these reasons, the final regulations do not expressly define health insurance to include coverage under a disease management program or wellness program. If these programs provide significant benefits in the nature of medical care or treatment, those benefits would meet the definition of health insurance for section 9010 purposes. Otherwise, coverage under these programs will not be treated as health insurance for section 9010 purposes until such time and only to the extent that the three agencies determine these benefits do not qualify as an excepted benefit.

Long-Term Care

The proposed regulations excluded from the definition of health insurance any benefits for long-term care, nursing home care, home health care, community-based care, or any combination thereof, within the meaning of section 9832(c)(2)(B), and such other similar, limited benefits to the extent such benefits are specified in regulations under section 9832(c)(2)(C). A commenter questioned whether this exclusion applies to Medicaid managed long-term care premiums, such as those provided to covered entities that may participate in State Medicaid managed long-term care programs. To the extent Medicaid plan providers can separately identify premiums received for long-term care, these amounts are not for health insurance and are not included in net premiums written.

Medicare Advantage and Medicare Part D Plans

Some employers or unions provide Medicare Advantage or Medicare Part D benefits in connection with an Employer Group Waiver Plan (EGWP) for employees and retirees who are Medicare beneficiaries. According to commenters, an employer or union can provide these benefits on a self-insured basis. Commenters requested that the final regulations clarify whether a union or employer that provides Medicare Advantage and Medicare part D benefits under an EGWP or similar arrangement is a covered entity subject to section 9010 with respect to premiums received for the coverage. No change was made in the final regulations to specifically address this issue. However, while the benefits provided by these arrangements may constitute health insurance within the meaning of section 9010, an employer or union that provides benefits under an EGWP or similar arrangement is not a covered entity to the extent the arrangement is eligible for the self-insuring employer exception under section 9010(c)(2)(A).

Medicare Cost Contract Plans

A commenter asked that the final regulations clarify how section 9010 applies to the Medicare cost contract portion of an entity's business. A Medicare cost contract plan is a type of plan established by section 1876 of Title XVIII of the Social Security Act. Cost contract plans are paid based on the reasonable costs incurred by delivering Medicare-covered services to plan members. Although the final regulations do not specifically address the treatment of a Medicare cost contract plan, benefits under a Medicare cost contract plan are health insurance for section 9010 purposes if they meet the general definition of health insurance and do not qualify for a specific exclusion.

Section 9010(b)(2)(B) Partial Exclusion

After applying section 9010(b)(2)(A) to determine the amount of net premiums written for health insurance of United States health risks that are taken into account, the proposed regulations excluded under section 9010(b)(2)(B) 50 percent of the remaining net premiums written for health insurance of United States health risks that are attributable to the activities (other than activities of an unrelated trade or business as defined in section 513) of any covered entity qualifying under section 501(c)(3), (4), (26), or (29) and exempt from tax under section 501(a). Commenters requested that the final regulations apply this exclusion to a for-profit hospital health plan (HHP) that is owned and controlled by an entity exempt from tax under section 501(a) and further described in section 501(c). According to the commenters, an HHP functions like a nonprofit entity because it reinvests whatever profits it produces each year in its parent owner's charitable mission. The final regulations do not adopt this request. By statute, the partial exclusion only applies to a covered entity that is a section 501(c)(3), (4), (26), or (29) entity, and even then only with respect to premium revenue from its exempt activities.

One commenter suggested that the final regulations require any covered entity claiming the partial exclusion to submit an IRS determination letter recognizing it as tax-exempt under section 501(c)(3), (4), (26), or (29). Another commenter objected to this suggestion on the basis that the Code does not require all tax-exempt entities to apply to the IRS for recognition of tax-exempt status. The final regulations do not impose any additional requirements on entities claiming the partial exclusion. For purposes of section 9010, whether an entity qualifies as exempt from Federal income tax under section 501(a) as an organization described in section 501(c)(3), (4), (26), or (29) will be determined under the Code provisions applicable to those organizations. To provide greater certainty, the final regulations provide that an entity is eligible for the section 9010(b)(2)(B) partial exclusion if it meets the requirements for that exclusion as of December 31st of the data year.

Reporting and Penalties

Section 9010(g)(1) requires each covered entity to report to the IRS its net premiums written for health insurance for United States health risks during the data year. The proposed regulations required that this information be reported on Form 8963, *Report of Health Insurance Provider Information*. Commenters suggested that the final regulations require an entity that qualifies for an exclusion from the definition of covered entity to report its net premiums written to claim the exclusion. The final regulations do not adopt this suggestion. The required reporting under section 9010(g)(1) only applies to covered entities.

A commenter requested that each covered entity be required to report even if it receives no more than $25 million in net premiums written and therefore is not liable for the fee. The proposed regulations already imposed this requirement in accordance with the statute. The final regulations retain this requirement.

Section 9010(g)(2) imposes a penalty for failing to timely submit a report containing the required information unless the covered entity can show that the failure is due to reasonable cause. Section 9010(g)(3) imposes an accuracy-related penalty for any understatement of a covered entity's net premiums written. Commenters requested that the final regulations provide a reasonable cause exception for the accuracy-related penalty similar to the reasonable cause exception for the failure to report penalty. Unlike section 9010(g)(2), section 9010(g)(3) does not contain a reasonable cause exception. Therefore, the final regulations do not create a reasonable cause exception for the accuracy-related penalty. However, the final regulations require a covered entity to submit a corrected Form 8963 during the error correction period if the entity believes there are any errors in the preliminary fee calculation. The corrected Form 8963 will replace the original Form 8963 for all purposes, including for the purpose of determining whether an accuracy-related penalty applies, except that a covered entity remains subject to the failure to report penalty if it fails to timely submit the original Form 8963.

The proposed regulations clarified that the failure to report penalty and the accuracy-related penalty apply in addition to the fee. The final regulations retain this clarification and further clarify that a covered entity may be liable for both penalties.

A commenter suggested that the final regulations create a safe harbor for the failure to report penalty imposed by section 9010(g)(2) and waive or reduce the penalty for small businesses, or exclude small businesses altogether from the definition of covered entity so that the penalty does not apply. The final regulations do not adopt this suggestion. The statute does not exclude small businesses from either the definition of covered entity or the requirement to report. However, certain statutory provisions will mitigate the impact on small business. Although a small business that is a covered entity must report its net premiums written, it will not be subject to the fee if its net premiums written are $25 million or less pursuant to section 9010(b)(2)(A). Further, section 9010(g)(2) allows the IRS to waive the failure to report penalty if there is reasonable cause for such failure. The IRS will determine whether reasonable cause exists for a covered entity's failure to report based on the facts and circumstances.

Commenters requested that the IRS wait to assess the accuracy-related penalty until the error correction process is complete. Under section 9010(g)(3)(A), the amount of the accuracy-related penalty is equal to the excess of the amount of the covered entity's fee determined in the absence of the understatement (that is, the correct fee amount) over the amount of the fee determined based on the understatement (that is, the amount of the fee based on understated reporting). Because the fee is allocated among covered entities based on each entity's net premiums written, the IRS must determine the correct amount of net premiums written for all covered entities before it can determine the correct fee amount for a covered entity. Therefore, the IRS cannot compute and assess any accuracy-related penalties until the conclusion of the error correction process when the IRS computes the final bills. As stated earlier in this preamble, if the covered entity timely submits a corrected Form 8963 during the error correction period, the corrected Form 8963 will replace the original Form 8963 for the purpose of determining whether an accuracy-related penalty applies.

Fee Calculation and Error Correction Process

In General

The proposed regulations required each covered entity to report annually its net premiums written for health insurance of United States health risks during the data year to the IRS on Form 8963 by May 1st of the fee year. The proposed regulations also required the IRS to send each covered entity its final fee calculation no later than August 31st, and required the covered entity to pay the fee by September 30th by electronic funds transfer. In addition, the proposed regulations required the IRS to send preliminary fee calculations and give covered entities an opportunity to submit error correction reports, with the time and manner of error correction reporting to be specified in other guidance published in the Internal Revenue Bulletin.

The final regulations adopt April 15th as the date on which the Form 8963 is due, rather than May 1st, to provide additional time to prepare the preliminary fee calculation for each covered entity. Also, to ensure that any errors are timely corrected, the final regulations require a covered entity to review its preliminary fee calculation and, if it believes there are any errors, to timely submit to the IRS a corrected Form 8963 during the error correction period. As stated earlier in this preamble, the corrected Form 8963 will replace the original Form 8963. In the case of a controlled group, if the preliminary fee calculation for the controlled group contains one or more errors, the corrected Form 8963 must include all of the required information for the entire controlled group, including members that do not have corrections. Further rules regarding the manner for submitting Form 8963, the time and manner for notifying covered entities of their preliminary fee calculation, and the time and manner for submitting error correction reports for the error correction process are contained in other guidance in the Internal Revenue Bulletin being published concurrently with these final regulations.

Commenters suggested that the final regulations create a "true-up" process by which the fee will be continually adjusted from year to year. Because the fee is an allocated fee, allowing a true-up process for one covered entity will result in adjustments to the fee for all covered entities. In the interest of providing finality and certainty to fee liability, the final regulations do not adopt this suggestion.

Source of Data Used to Calculate the Fee

The proposed regulations defined the term *net premiums written* to mean premiums written, including reinsurance premiums written, reduced by reinsurance ceded, and reduced by ceding commissions and medical loss ratio (MLR) rebates with respect to the data year. The preamble to the proposed regulations explained that, for covered entities that file the Supplemental Health Care Exhibit (SHCE) with the National Association of Insurance Commissioners (NAIC), net premiums written for health insurance generally will equal the amount reported on the SHCE as direct premiums written minus MLR rebates with respect to the data year, subject to any applicable exclusions under section 9010 such as exclusions from the term *health insurance*.

Commenters suggested that the final regulations require a covered entity to use the SHCE and any equivalent forms as the basis for determining net premiums written if it is required to file the SHCE and any equivalent forms pursuant to State reporting requirements. The final regulations do not adopt this suggestion because forms can change. The instructions to Form 8963 provide additional information on how to determine net premiums written using the SHCE and any equivalent forms as the source of data, and can be updated to reflect changes in forms.

Medical Loss Ratio (MLR) Rebates

The proposed regulations invited comments on how to compute MLR rebates with respect to the data year using data reported on the SHCE. Commenters suggested that MLR rebates be computed on an accrual basis using lines 5.3, 5.4, and 5.5 of the 2012 SHCE. In response to this comment, the final regulations clarify that MLR rebates are computed on an accrual basis. The final regulations do not designate specific SHCE line numbers as the source of data for computing MLR rebates because forms can change. Instead, the instructions to Form 8963 provide this information.

Medicaid Bonuses

A commenter requested that the final regulations address the treatment of Medicaid bonuses in determining net premiums written. According to the commenter, Medicaid plans sometimes receive bonuses for meeting plan goals. In some cases, the bonuses are paid up front and must be returned if the plan does not meet its goals, and in other cases, bonuses are paid only after the plan meets its goals. The final regulations do not create a special rule for the treatment of Medicaid bonuses. The treatment of Medicaid bonuses in determining net premiums written depends on whether and when these amounts are treated as premiums written for State or other Federal regulatory and reporting purposes.

Amounts Taken Into Account

In accordance with section 9010(b)(2)(A), the proposed regulations provided that, for each covered entity (or each controlled group treated as a single covered entity), the IRS will not take into account the first $25 million of net premiums written. The IRS will take into account 50 percent of the net premiums written for amounts over $25 million and up to $50 million, and 100 percent of the net premiums written that are over $50 million. Thus, for any covered entity with net premiums written of $50 million or more, the IRS will not take into account the first $37.5 million of net premiums written. Additionally, after this reduction, the proposed regulations provided that, in accordance with section 9010(b)(2)(B), if the covered entity (or any member of the controlled group treated as a single covered entity) is exempt from tax under section 501(a) and is described in section 501(c)(3), (4), (26), or (29), the IRS will take into account only 50 percent of the remaining net premiums written of that entity (or member) that are attributable to its exempt activities.

A commenter asked how the fee will be calculated for a controlled group that is treated as a single covered entity when some but not all of the group's members qualify for the 50-percent exclusion under section 9010(b)(2)(B). The final regulations clarify that, in this circumstance, the section 9010(b)(2)(A) exclusion applies first to each member of the controlled group on a pro rata basis, and then the section 9010(b)(2)(B) exclusion applies only to eligible members of the group.

For example, if a controlled group consists of one member with $100 million in net premiums written and a second member with $50 million in net premiums written, two-thirds of the group's total $37.5 million reduction under section 9010(b)(2)(A), or $25 million, applies to the first member, and the remaining one-third, or $12.5 million, applies to the second member. Therefore, after this initial reduction, the first member has $75 million of net premiums written ($100 million minus $25 million), and the second member has $37.5 million of net premiums written ($50 million minus $12.5 million). If the second member is eligible for the 50-percent exclusion under section 9010(b)(2)(B), the 50-percent exclusion applies to this member's remaining net premiums written, resulting in $18.75 million (50 percent of $37.5 million) being taken into account. Thus, total net premiums written taken into account for this controlled group are $93.75 million ($150 million minus $37.5 million minus $18.75 million).

Designated Entities

The proposed regulations required each controlled group to have a designated entity, defined as a person within the controlled group that is designated to act on behalf of the controlled group with regard to the fee. The proposed regulations further provided that if the controlled group, without regard to foreign corporations included under section 9010(c)(3)(B), is also an affiliated group that files a consolidated return for Federal income tax purposes, the designated entity is the common parent of the affiliated group identified on the tax return filed for the data year. If the controlled group is not a part of an affiliated group that files a consolidated return, the proposed regulations allowed the controlled group to select its designated entity but did not require it to do so. The proposed regulations also required each member of a controlled group to maintain a record of its consent to the designated entity selection and required the designated entity to maintain a record of all member consents. Under the proposed regulations, if the controlled group did not select a person as its designated entity, the IRS would select a person as a designated entity for the controlled group and advise the designated entity accordingly.

The final regulations modify the proposed regulations, which provided that the common parent of a consolidated group was the designated entity in all cases. To better coordinate with the consolidated return regulations, the final regulations provide that the designated entity of a controlled group, without regard to foreign corporations included under section 9010(c)(3)(B), that is a consolidated group (within the meaning of §1.1502–1(h)) is the agent for the group (within the meaning of §1.1502–77). In the case of a controlled group that is not a part of an affiliated group that files a consolidated return, the Treasury Department and the IRS believe that the controlled group members are in the best position to determine which of its members should be the designated entity. To promote greater certainty and ease of administration in the fee reporting and determination process, the final regulations thus require, rather than permit, a controlled group that is not also a consolidated group to select its designated entity. The final regulations further provide that the IRS will select a member of the controlled group to be the designated entity for the controlled group if a controlled group fails to do so, but the controlled group may be liable for penalties for failure to meet its filing requirements. In the event the controlled group fails to select a designated entity and the IRS selects a designated entity for the controlled group, the final regulations deem all members of the controlled group that provide health insurance for a United States health risk to have consented to the IRS's selection of the designated entity.

Disclosure

Section 9010(g)(4) provides that section 6103 (relating to the confidentiality and disclosure of returns and return information) does not apply to any information reported by the covered entities under section 9010(g). The preamble to the proposed regulations stated that the Treasury Department and the IRS are considering making available to the public the information reported on Form 8963, including the identity of the covered entity and the amount of its net premiums written, at the time the notice of preliminary fee calculation is sent, and invited comments on which reported information the IRS should make publicly available. Numerous commenters requested that the IRS make all information reported on Form 8963 available to the public, and several commenters requested that this information be reported on the IRS website no later than 15 days after the reporting deadline to promote transparency and assist health insurers in determining whether an error correction request is necessary. One commenter requested that consumers have access to the information that shows how much each covered entity will pay. In response to comments, the final regulations provide that the information reported on each Form 8963 will be open for public inspection or available upon request. The Treasury Department and the IRS expect that, at a time to be determined, certain information will be made available on *www.irs.gov*, including the identity of each reporting entity and the amount of its reported net premiums written.

Expatriate Policies

In accordance with section 9010(d), the proposed regulations defined the term *United States health risk* to mean the health risk of any individual who is (1) a United States citizen, (2) a resident of the United States (within the meaning of section 7701(b)(1)(A)), or (3) located in the United States, with respect to the period such individual is so located. The preamble to the proposed regulations requested comments on how the final regulations should apply to expatriate policies. The medical loss ratio final rule issued by HHS (MLR final rule) defines expatriate policies as predominantly group health insurance policies that provide coverage to employees, substantially all of whom are: (1) working outside their country of citizenship; (2) working outside their country of citizenship and outside the employer's country of domicile; or (3) non-U.S. citizens working in their home country. 45 CFR 158.120(d)(4). The NAIC tracks the definition in the MLR final rule for purposes of State reporting requirements.

The proposed regulations did not provide specific rules for expatriate policies. However, the definitions of covered entity and health insurance in the proposed regulations only extended to entities and policies that are subject to State or Federal regulation. Commenters expressed the concern that the proposed regulations provided an unfair advantage to foreign health insurers. Not all foreign insurers issuing expatriate policies on United States health risks are subject to State regulation or to Federal regulation under ERISA. As a result, commenters asserted that a foreign insurance company that is not a covered entity will be able to charge less than a U.S. insurance company for nearly identical expatriate policies. Commenters suggested that the final regulations exclude expatriate policies (or defer their inclusion until more facts can be gathered). Alternatively, commenters suggested broadening the definition of covered entity to include a foreign insurer regardless of whether it is subject to State or Federal regulation.

The final regulations do not adopt these suggestions. Section 9010 defines a United States health risk to include the health risk of a U.S. citizen or a resident alien. An insurer that issues a policy to a U.S. citizen or resident living abroad is still providing coverage for a United States health risk, despite the fact that the individual may not be currently residing in the United States. Thus, excluding expatriate policies is inconsistent with the language of section 9010(d).

Alternatively, broadening the definition of covered entity to include a foreign insurer that does not do business in the United States is not in the interest of sound tax administration. Legal and practical restrictions significantly limit the ability of the IRS to compel an entity that does not do business in the United States to file a report and pay a tax or fee. Further, the Treasury Department and the IRS expect that, in the overwhelming majority of cases, foreign insurers that do not do business in the United States will not have more than $25 million in net premiums written for United States health risks and thus will not be subject to liability for the fee. Therefore, the final regulations do not expand the definition of covered entity to include a foreign insurer that does not do business in the United States.

The proposed regulations created a presumption under which the entire amount reported on the SHCE filed with the NAIC pursuant to State reporting requirements will be considered to be for United States health risks unless the covered entity can demonstrate otherwise. Commenters expressed concern that the data necessary to affirmatively establish that an individual is not a United States health risk will be difficult for covered entities to obtain because they will need to know the location of each insured individual at all times and that individual's nationality. Moreover, commenters contended that such information may not be clear or accurate because location or nationality can vary among multiple members of the same family (some of whom may hold dual citizenship), and that covered entities may simply be unable to obtain such information because of the constant mobility of those covered. Commenters suggested allowing a covered entity to determine expatriate net premiums written for United States health risks by multiplying its total expatriate net premiums written by the ratio of claims paid in the United States to claims paid worldwide. The final regulations do not adopt this suggestion. A ratio based on claims paid in the United States would not accurately represent the relative proportion of United States health risks because a United States health risk includes the health risks of U.S. citizens who are living abroad. The Treasury Department and the IRS also considered alternative methods for a covered entity to account for its expatriate policies, but were unable to identify any that would be verifiable and administrable. Therefore, the final regulations retain the presumption in the proposed regulations and allow a covered entity to demonstrate that certain net premiums written are not for a United States health risk.

United States Possessions

Commenters suggested that the fee should not apply to health insurance providers in Puerto Rico and Guam. The final regulations do not adopt this suggestion. Section 9010(h)(2) specifically states that the term *United States* includes the U.S. possessions. Section 9010(c)(1) defines a covered entity as any entity that provides health insurance for any United States health risk, and under section 9010(d)(3), a United States health risk includes coverage of the health risk of any individual located in the U.S. possessions. To aid in determining whether an entity qualifies as a covered entity, the proposed regulations incorporated the definition of health insurance issuer under section 9832(b)(2) as one category of covered entity. The only definition of health insurance issuer in the Code is the definition of health insurance issuer in section 9832(b)(2), and the language of this provision is substantially similar to the only definition of health insurance issuer referenced in the ACA.[2] Section 9832(b)(2) defines a health insurance issuer as an insurance company, insurance service, or insurance organization that is licensed to engage in the business of insurance in a State and that is subject to State laws that regulate insurance within the meaning of section 514(b)(2) of ERISA. Under section 514(b)(2) of ERISA, State law that regulates insurance generally means any State regulation. Section 3(10) of ERISA defines *State* for purposes of ERISA to include the U.S. possessions. Accordingly, the references to State and State law in section 9832(b)(2) encompass the 50 States, the District of Columbia, and the U.S. possessions.

Taxability and Other Treatment of the Fee

Section 9010(f)(2) treats the fee as a tax described in section 275(a)(6) (relating to taxes for which no deduction is allowed). Before issuing the proposed regulations, the Treasury Department and the IRS received comments stating that covered entities may attempt to pass on the cost of the fee to policyholders, either by a corresponding increase in premiums or by separately charging policyholders for a portion of the fee. The preamble to the proposed regulations stated that, under section 61(a), gross income means all income from whatever source derived unless a provision of the Code or other law specifically excludes the payment from gross income. Therefore, a covered entity's gross income includes amounts received from policyholders to offset the cost of the fee, whether or not separately stated on any bill. The preamble requested comments on whether the text of the regulations should be revised to clarify that recovered fee amounts are included in a covered entity's gross income. Numerous commenters disagreed with the preamble statement and requested that the final regulations permit covered entities to exclude from income any amounts collected from policyholders to offset the cost of the fee. One commenter alternatively suggested that the payment of income taxes on the fee should count towards the payment of the fee itself. The final regulations do not adopt these suggestions. The Treasury Department and the IRS will issue separate guidance to clarify that covered entities must include in income under section 61(a) any amounts they collect from policyholders to offset the cost of the fee.

Commenters suggested that the final regulations prohibit a covered entity from collecting amounts to offset the cost of the fee when they collect premiums from excluded entities such as governmental entities and VEBAs. The final regulations do not adopt this suggestion. The health insurance provider, and not the payor of premiums, is liable for the fee. Therefore, any exclusions apply at the health insurance provider level.

A commenter asked if a covered entity must disclose to its policyholders the extent to which the cost of the fee is included in a policyholder's premium. Because the health insurance provider, and not the policyholder, is liable for the fee, the final regulations do not require a covered entity to disclose to its policyholders any amounts included in premiums to offset the cost of the fee, although nothing in the final regulations prohibits a covered entity from disclosing these amounts. However, a covered entity may be subject to State or other Federal rules, if any, regarding disclosures of these amounts.

Availability of IRS Documents

The IRS revenue rulings cited in this preamble are published in the Internal Revenue Cumulative Bulletin and are available from the superintendent of Documents, United States Government Printing Office, Washington, D.C. 20402. The IRS notice cited in this preamble is available at *www.irs.gov*.

Special Analyses

It has been determined that this Treasury decision is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. This regulation merely implements the fee imposed by section 9010 and does not impose the fee itself. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to these regulations. It is hereby certified that the collection of information

[2] *See* ACA section 1301(b)(2), referencing section 2791(b) of the PHSA (42 USC 300gg-91). The definition of health insurance issuer in section 2791(b) of the PHSA is substantially similar to the definition in section 9832(b)(2) of the Code.

in these regulations will not have a significant economic impact on a substantial number of small entities. This certification is based on the fact that the only collection burden imposed by these regulations is the requirement to maintain a record of consent to the selection of a designated entity, and this collection burden applies only to designated entities of controlled groups, which tend to be large corporations, and their members. Therefore, a Regulatory Flexibility Analysis under the Regulatory Flexibility Act (5 U.S.C. chapter 6) is not required. Pursuant to section 7805(f), the notice of proposed rulemaking was submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business, and no comments were received.

Drafting Information

The principal author of these regulations is Charles J. Langley, Jr., Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

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Adoption of Amendments to the Regulations

Accordingly, 26 CFR chapter 1 is amended by adding part 57 to subchapter D and amending part 602 to read as follows:

Paragraph 1. Part 57 is added to read as follows:

Part 57 — Health Insurance Providers Fee

Authority: 26 U.S.C. 7805; sec. 9010, Public Law 111–148 (124 Stat. 119 (2010)).
Section 57.3 also issued under 26 U.S.C. 6071(a)
Section 57.7 also issued under 26 U.S.C. 6302(a).
Section 57.6302–1 also issued under 26 U.S.C. 6302(a).

§57.1 Overview.

(a) The regulations in this part 57 are designated "Health Insurance Providers Fee Regulations."

(b) The regulations in this part 57 provide guidance on the annual fee imposed on covered entities engaged in the business of providing health insurance by section 9010 of the Patient Protection and Affordable Care Act (PPACA), Public Law 111–148 (124 Stat. 119 (2010)), as amended by section 10905 of PPACA, and as further amended by section 1406 of the Health Care and Education Reconciliation Act of 2010, Public Law 111–152 (124 Stat. 1029 (2010)) (collectively, the Affordable Care Act or ACA). All references to section 9010 in this part 57 are references to section 9010 of the ACA. Unless otherwise indicated, all other references to subtitles, chapters, subchapters, and sections are references to subtitles, chapters, subchapters and sections in the Internal Revenue Code and the related regulations.

(c) Section 9010(e)(1) sets an applicable fee amount for each year, beginning with 2014, that will be apportioned among covered entities with aggregate net premiums written over $25 million for health insurance for United States health risks. Generally, each covered entity is liable for a fee in each fee year that is based on its net premiums written during the data year in an amount determined by the Internal Revenue Service (IRS) under the rules of this part.

§57.2 Explanation of terms.

(a) *In general*. This section explains the terms used in this part 57 for purposes of the fee.

(b) *Covered entity*—(1) *In general*. Except as provided in paragraph (b)(2) of this section, the term *covered entity* means any entity with net premiums written for health insurance for United States health risks in the fee year if the entity is—

(i) A health insurance issuer within the meaning of section 9832(b)(2), defined in section 9832(b)(2) as an insurance company, insurance service, or insurance organization that is licensed to engage in the business of insurance in a State and that is subject to State law that regulates insurance (within the meaning of section 514(b)(2) of the Employee Retirement Income Security Act of 1974 (ERISA));

(ii) A health maintenance organization within the meaning of section 9832(b)(3), defined in section 9832(b)(3) as—

(A) A Federally qualified health maintenance organization (as defined in section 1301(a) of the Public Health Service Act);

(B) An organization recognized under State law as a health maintenance organization; or

(C) A similar organization regulated under State law for solvency in the same manner and to the same extent as such a health maintenance organization;

(iii) An insurance company subject to tax under part I or II of subchapter L, or that would be subject to tax under part I or II of subchapter L but for the entity being exempt from tax under section 501(a);

(iv) An entity that provides health insurance under Medicare Advantage, Medicare Part D, or Medicaid; or

(v) A multiple employer welfare arrangement (MEWA), within the meaning of section 3(40) of ERISA, to the extent not fully insured, provided that for this purpose a covered entity does not include a MEWA that with respect to the plan year ending with or within the section 9010 data year satisfies the requirements to be exempt from reporting under 29 CFR 2520.101-2(c)(2)(ii)(A), (B), or (C).

(2) *Exclusions*—(i) *Self-insured employer*. The term *covered entity* does not include any entity (including a voluntary employees' beneficiary association under section 501(c)(9) (VEBA)) that is part of a self-insured employer plan to the extent that such entity self-insures its employees' health risks. The term *self-insured employer* means an employer that sponsors a self-insured medical reimbursement plan within the meaning of §1.105–11(b)(1)(i) of this chapter. Self-insured medical reimbursement plans include

plans that do not involve shifting risk to an unrelated third party as described in §1.105–11(b)(1)(ii) of this chapter. A self-insured medical reimbursement plan may use an insurance company or other third party to provide administrative or bookkeeping functions. For purposes of this section, the term *self-insured employer* does not include a MEWA.

(ii) *Governmental entity*. The term *covered entity* does not include any governmental entity. For this purpose, the term *governmental entity* means—

(A) The government of the United States;

(B) Any State or a political subdivision thereof (as defined for purposes of section 103) including, for example, a State health department or a State insurance commission;

(C) Any Indian tribal government (as defined in section 7701(a)(40)) or a subdivision thereof (determined in accordance with section 7871(d)); or

(D) Any agency or instrumentality of any of the foregoing.

(iii) *Certain nonprofit corporations*. The term *covered entity* does not include any entity—

(A) That is incorporated as a nonprofit corporation under a State law;

(B) No part of the net earnings of which inures to the benefit of any private shareholder or individual (within the meaning of §§1.501(a)–1(c) and 1.501(c)(3)–1(c)(2) of this chapter);

(C) No substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation (within the meaning of §1.501(c)(3)–1(c)(3)(ii) of this chapter) (or which is described in section 501(h)(3) and is not denied exemption under section 501(a) by reason of section 501(h));

(D) That does not participate in, or intervene in (including the publishing or distributing of statements), any political campaign on behalf of (or in opposition to) any candidate for public office (within the meaning of §1.501(c)(3)–1(c)(3)(iii) of this chapter); and

(E) More than 80 percent of the gross revenues of which is received from government programs that target low-income, elderly, or disabled populations under titles XVIII, XIX, and XXI of the Social Security Act.

(iv) *Certain voluntary employees' beneficiary associations (VEBAs)*. The term *covered entity* does not include any entity that is described in section 501(c)(9) that is established by an entity (other than by an employer or employers) for purposes of providing health care benefits. This exclusion applies to a VEBA that is established by a union or established pursuant to a collective bargaining agreement and having a joint board of trustees (such as in the case of a multiemployer plan within the meaning of section 3(37) of ERISA or a single-employer plan described in section 302(c)(5) of the Labor Management Relations Act, 29 U.S.C. 186(c)(5)). This exclusion does not apply to a MEWA.

(3) *State*. Solely for purposes of paragraph (b) of this section, the term *State* means any of the 50 States, the District of Columbia, or any of the possessions of the United States, including American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the Virgin Islands.

(c) *Controlled groups*—(1) *In general*. The term *controlled group* means a group of two or more persons, including at least one person that is a covered entity, that is treated as a single employer under section 52(a), 52(b), 414(m), or 414(o).

(2) *Treatment of controlled group*. A controlled group (as defined in paragraph (c)(1) of this section) is treated as a single covered entity for purposes of the fee.

(3) *Special rules*. For purposes of paragraph (c)(1) of this section (related to controlled groups)—

(i) A foreign entity subject to tax under section 881 is included within a controlled group under section 52(a) or (b); and

(ii) A person is treated as being a member of the controlled group if it is a member of the group at the end of the day on December 31st of the data year.

(d) *Data year*. The term *data year* means the calendar year immediately before the fee year. Thus, for example, 2013 is the data year for fee year 2014.

(e) *Designated entity*—(1) *In general*. The term *designated entity* means the person within a controlled group that is designated to act on behalf of the controlled group regarding the fee with respect to—

(i) Filing Form 8963, *Report of Health Insurance Provider Information*;

(ii) Receiving IRS communications about the fee for the group;

(iii) Filing a corrected Form 8963 for the group, if applicable, as described in §57.6; and

(iv) Paying the fee for the group to the government.

(2) *Selection of designated entity*—(i) *In general*. Except as provided in paragraph (e)(2)(ii) of this section, each controlled group must select a designated entity by having that entity file the Form 8963 in accordance with the form instructions. The designated entity must state under penalties of perjury that all persons that provide health insurance for United States health risks that are members of the group have consented to the selection of the designated entity. Each member of a controlled group must maintain a record of its consent to the controlled group's selection of the designated entity. The designated entity must maintain a record of all member consents.

(ii) *Requirement for consolidated groups; common parent*. If a controlled group, without regard to foreign corporations included under section 9010(c)(3)(B), is also an affiliated group the common parent of which files a consolidated return for Federal income tax purposes, the designated entity is the agent for the group (within the meaning of §1.1502–77 of this chapter) for the data year.

(iii) *Failure to select a designated entity*. Excepted as provided in paragraph (e)(2)(ii) of this section, if a controlled group fails to select a designated entity as provided in paragraph (e)(2)(i) of this section, then the IRS will select a member of the controlled group to be the designated entity. If the IRS selects the designated entity, then all members of the controlled group that provide health insurance for a United States health risk will be deemed to have consented to the IRS's selection of the designated entity.

(f) *Fee*. The term *fee* means the fee imposed by section 9010 on each covered entity engaged in the business of providing health insurance.

(g) *Fee year*. The term *fee year* means the calendar year in which the fee must be paid to the government. The first fee year is 2014.

(h) *Health insurance*—(1) *In general*. Except as provided in paragraph (h)(2) of this section, the term *health insurance* generally has the same meaning as the term *health insurance coverage* in section

9832(b)(1)(A), defined to mean benefits consisting of medical care (provided directly, through insurance or reimbursement, or otherwise) under any hospital or medical service policy or certificate, hospital or medical service plan contract, or health maintenance organization contract, when these benefits are offered by an entity that is one of the types of entities described in paragraph (b)(1)(i) through (b)(1)(v) of this section. The term *health insurance* includes limited scope dental and vision benefits under section 9832(c)(2)(A) and retiree-only health insurance.

(2) *Exclusions*. The term *health insurance* does not include—

(i) Coverage only for accident, or disability income insurance, or any combination thereof, within the meaning of section 9832(c)(1)(A);

(ii) Coverage issued as a supplement to liability insurance within the meaning of section 9832(c)(1)(B);

(iii) Liability insurance, including general liability insurance and automobile liability insurance, within the meaning of section 9832(c)(1)(C);

(iv) Workers' compensation or similar insurance within the meaning of section 9832(c)(1)(D);

(v) Automobile medical payment insurance within the meaning of section 9832(c)(1)(E);

(vi) Credit-only insurance within the meaning of section 9832(c)(1)(F);

(vii) Coverage for on-site medical clinics within the meaning of section 9832(c)(1)(G);

(viii) Other insurance coverage that is similar to the insurance coverage in paragraph (h)(2)(i) through (vii) of this section under which benefits for medical care are secondary or incidental to other insurance benefits, within the meaning of section 9832(c)(1)(H), to the extent such insurance coverage is specified in regulations under section 9832(c)(1)(H);

(ix) Benefits for long-term care, nursing home care, home health care, community-based care, or any combination thereof, within the meaning of section 9832(c)(2)(B), and such other similar, limited benefits to the extent such benefits are specified in regulations under section 9832(c)(2)(C);

(x) Coverage only for a specified disease or illness within the meaning of section 9832(c)(3)(A);

(xi) Hospital indemnity or other fixed indemnity insurance within the meaning of section 9832(c)(3)(B);

(xii) Medicare supplemental health insurance (as defined under section 1882(g)(1) of the Social Security Act), coverage supplemental to the coverage provided under chapter 55 of title 10, United States Code, and similar supplemental coverage provided to coverage under a group health plan, within the meaning of section 9832(c)(4);

(xiii) Coverage under an employee assistance plan, a disease management plan, or a wellness plan, if the benefits provided under the plan constitute excepted benefits under section 9832(c)(2) (or do not otherwise provide benefits consisting of health insurance under paragraph (h)(1) of this section);

(xiv) Student administrative health fee arrangements, as defined in paragraph (h)(3);

(xv) Travel insurance, as defined in paragraph (h)(4) of this section; or

(xvi) Indemnity reinsurance, as defined in paragraph (h)(5)(i) of this section.

(3) *Student administrative health fee arrangement*. For purposes of paragraph (h)(2)(xiv) of this section, the term *student administrative health fee arrangement* means an arrangement under which an educational institution, other than through an insured arrangement, charges student administrative health fees to students on a periodic basis to help cover the cost of student health clinic operations and care delivery (regardless of whether the student uses the clinic and regardless of whether the student purchases any available student health insurance coverage).

(4) *Travel insurance*. For purposes of paragraph (h)(2)(xv) of this section, the term *travel insurance* means insurance coverage for personal risks incident to planned travel, which may include, but is not limited to, interruption or cancellation of trip or event, loss of baggage or personal effects, damages to accommodations or rental vehicles, and sickness, accident, disability, or death occurring during travel, provided that the health benefits are not offered on a stand-alone basis and are incidental to other coverage. For this purpose, the term *travel insurance* does not include major medical plans that provide comprehensive medical protection for travelers with trips lasting 6 months or longer, including, for example, those working overseas as an expatriate or military personnel being deployed.

(5) *Reinsurance*—(i) *Indemnity reinsurance*. For purposes of paragraphs (h)(2)(xvi) and (k) of this section, the term *indemnity reinsurance* means an agreement between one or more reinsuring companies and a covered entity under which—

(A) The reinsuring company agrees to accept, and to indemnify the issuing company for, all or part of the risk of loss under policies specified in the agreement; and

(B) The covered entity retains its liability to, and its contractual relationship with, the individuals whose health risks are insured under the policies specified in the agreement.

(ii) *Assumption reinsurance*. For purposes of paragraph (k) of this section, the term *assumption reinsurance* means reinsurance for which there is a novation and the reinsurer takes over the entire risk of loss pursuant to a new contract.

(i) *Located in the United States*. The term *located in the United States* means present in the United States (within the meaning of paragraph (m) of this section) under section 7701(b)(7) (for presence in the 50 States and the District of Columbia) or §1.937–1(c)(3)(i) of this chapter (for presence in a possession of the United States).

(j) *NAIC*. The term *NAIC* means the National Association of Insurance Commissioners.

(k) *Net premiums written*—The term *net premiums written* means premiums written, including reinsurance premiums written, reduced by reinsurance ceded, and reduced by ceding commissions and medical loss ratio (MLR) rebates with respect to the data year. For this purpose, MLR rebates are computed on an accrual basis in determining net premiums written. Because indemnity reinsurance within the meaning of paragraph (h)(5)(i) of this section is not health insurance under paragraph (h)(1) of this section, the term *net premiums written* does not include premiums written for indemnity reinsurance and is not reduced by indemnity reinsurance ceded. However, in the case of assumption reinsurance within the meaning of paragraph (h)(5)(ii) of this section, the term *net premiums written* does include premiums written for assumption reinsurance and is reduced by assumption reinsurance premiums ceded.

(l) *SHCE*. The term *SHCE* means the Supplemental Health Care Exhibit. The SHCE is a form published by the NAIC that most covered entities are required to file annually under State law.

(m) *United States*. For purposes of paragraph (i) of this section, the term *United States* means the 50 States, the District of Columbia, and any possession of the United States, including American Samoa, Guam, the Northern Mariana Islands, Puerto Rico, and the Virgin Islands.

(n) *United States health risk*. The term *United States health risk* means the health risk of any individual who is—

(1) A United States citizen;

(2) A resident of the United States (within the meaning of section 7701(b)(1)(A)); or

(3) Located in the United States (within the meaning of paragraph (i) of this section) during the period such individual is so located.

§57.3 Reporting requirements and associated penalties.

(a) *Reporting requirement*—(1) *In general*. Annually, each covered entity, including each controlled group that is treated as a single covered entity, must report its net premiums written for health insurance of United States health risks during the data year to the IRS by April 15th of the fee year on Form 8963, *Report of Health Insurance Provider Information*, in accordance with the instructions for the form. A covered entity that has net premiums written during the data year is subject to this reporting requirement even if it does not have any amount taken into account as described in §57.4(a)(4). If an entity is not in the business of providing health insurance for any United States health risk in the fee year, it is not a covered entity and does not have to report.

(2) *Manner of reporting*. The IRS may provide rules in guidance published in the Internal Revenue Bulletin for the manner of reporting by a covered entity under this section, including rules for reporting by a designated entity on behalf of a controlled group that is treated as a single covered entity.

(3) *Disclosure of reported information*. Pursuant to section 9010(g)(4), the information reported on each original and corrected Form 8963 will be open for public inspection or available upon request.

(b) *Penalties*—(1) *Failure to report*—(i) *In general*. A covered entity that fails to timely submit a report containing the information required by paragraph (a) of this section is liable for a failure to report penalty in the amount described in paragraph (b)(1)(ii) of this section in addition to its fee liability and any other applicable penalty, unless the failure is due to reasonable cause as defined in paragraph (b)(1)(iii) of this section.

(ii) *Amount*. The amount of the failure to report penalty described in paragraph (b)(1)(i) of this section is—

(A) $10,000, plus

(B) The lesser of—

(*1*) An amount equal to $1,000 multiplied by the number of days during which such failure continues; or

(*2*) The amount of the covered entity's fee for which the report was required.

(iii) *Reasonable cause*. The failure to report penalty described in paragraph (b)(1)(i) of this section is waived if the failure is due to reasonable cause. A failure is due to reasonable cause if the covered entity exercised ordinary business care and prudence and was nevertheless unable to submit the report within the prescribed time. In determining whether the covered entity was unable to submit the report timely despite the exercise of ordinary business care and prudence, the IRS will consider all the facts and circumstances surrounding the failure to submit the report.

(iv) *Treatment of penalty*. The failure to report penalty described in this paragraph (b)(1)—

(A) Is treated as a penalty under subtitle F;

(B) Must be paid on notice and demand by the IRS and in the same manner as a tax under the Internal Revenue Code; and

(C) Is a penalty for which only civil actions for refund under procedures of subtitle F apply.

(2) *Accuracy-related penalty*—(i) *In general*. A covered entity that understates its net premiums written for health insurance of United States health risks in the report required under paragraph (a)(1) of this section is liable for an accuracy-related penalty in the amount described in paragraph (b)(2)(ii) of this section, in addition to its fee liability and any other applicable penalty.

(ii) *Amount*. The amount of the accuracy-related penalty described in paragraph (b)(2)(i) of this section is the excess of—

(A) The amount of the covered entity's fee for the fee year that the IRS determines should have been paid in the absence of any understatement; over

(B) The amount of the covered entity's fee for the fee year that the IRS determined based on the understatement.

(iii) *Understatement*. An understatement of a covered entity's net premiums written for health insurance of United States health risks is the difference between the amount of net premiums written that the covered entity reported and the amount of net premiums written that the IRS determines the covered entity should have reported.

(iv) *Treatment of penalty*. The accuracy-related penalty is subject to the provisions of subtitle F that apply to assessable penalties imposed under chapter 68.

(3) *Controlled groups*. Each member of a controlled group that is required to provide information to the controlled group's designated entity for purposes of the report required to be submitted by the designated entity on behalf of the controlled group is jointly and severally liable for any penalties described in this paragraph (b) for any reporting failures by the designated entity.

§57.4 Fee calculation.

(a) *Fee components*—(1) *In general*. For every fee year, the IRS will calculate a covered entity's allocated fee as described in this section.

(2) *Calculation of net premiums written*. Each covered entity's allocated fee for any fee year is equal to an amount that bears the same ratio to the applicable amount as the covered entity's net premiums written for health insurance of United States health risks during the data year taken into account bears to the aggregate net premiums written for health insurance of United States health risks of all covered entities during the data year taken into account.

(3) *Applicable amount*. The applicable amounts for fee years are—

Fee year	Applicable amount
2014	$ 8,000,000,000
2015	$ 11,300,000,000
2016	$ 11,300,000,000
2017	$ 13,900,000,000
2018	$ 14,300,000,000
2019 and thereafter	The applicable amount in the preceding fee year increased by the rate of premium growth (within the meaning of section 36B(b)(3)(A)(ii)).

(4) *Net premiums written taken into account*—(i) *In general*. A covered entity's net premiums written for health insurance of United States health risks during any data year are taken into account as follows:

Covered entity's net premiums written during the data year that are:	Percentage of net premiums written taken into account is:
Not more than $25,000,000	0
More than $25,000,000 but not more than $50,000,000	50
More than $50,000,000	100

(ii) *Controlled groups*. In the case of a controlled group, paragraph (a)(4)(i) of this section applies to all net premiums written for health insurance of United States health risks during the data year, in the aggregate, of the entire controlled group, except that any net premiums written by any member of the controlled group that is a nonprofit corporation meeting the requirements of §57.2(b)(2)(iii) or a voluntary employees' beneficiary association meeting the requirements of §57.2(b)(2)(iv) are not taken into account.

(iii) *Partial exclusion for certain exempt activities*. After the application of paragraph (a)(4)(i) of this section, if the covered entity (or any member of a controlled group treated as a single covered entity) is exempt from Federal income tax under section 501(a) and is described in section 501(c)(3), (4), (26), or (29) as of December 31st of the data year, then only 50 percent of its remaining net premiums written for health insurance of United States health risks that are attributable to its exempt activities (and not to activities of an unrelated trade or business as defined in section 513) during the data year are taken into account. If an entity to which this partial exclusion applies is a member of a controlled group, then the partial exclusion applies to that entity after first applying paragraph (a)(4)(i) on a pro rata basis to all members of the controlled group.

(b) *Determination of net premiums written*—(1) *In general*. The IRS will determine net premiums written for health insurance of United States health risks for each covered entity based on the Form 8963, *Report of Health Insurance Provider Information*, submitted by each covered entity, together with any other source of information available to the IRS. Other sources of information that the IRS may use to determine net premiums written for each covered entity include the SHCE, which supplements the annual statement filed with the NAIC pursuant to State law, the annual statement itself or the Accident and Health Policy Experience filed with the NAIC, the MLR Annual Reporting Form filed with the Center for Medicare & Medicaid Services' Center for Consumer Information and Insurance Oversight of the U.S. Department of Health and Human Services, or any similar statements filed with the NAIC, with any State government, or with the Federal government pursuant to applicable State or Federal requirements.

(2) *Presumption for United States health risks*. For any covered entity that files the SHCE with the NAIC, the entire amount reported on the SHCE as direct premiums written will be considered to be for health insurance of United States health risks as described in §57.2(n) (subject to any applicable exclusions for amounts that are not health insurance as described in §57.2(h)(2)) unless the covered entity can demonstrate otherwise.

(c) *Determination of amounts taken into account*. (1) For each fee year and for each covered entity, the IRS will calculate the net premiums written for health insurance of United States health risks taken into account during the data year. The resulting number is the numerator of the fraction described in paragraph (d)(1) of this section.

(2) For each fee year, the IRS will calculate the aggregate net premiums written for health insurance of United States health risks taken into account for all covered entities during the data year. The resulting number is the denominator of the fraction described in paragraph (d)(2) of this section.

(d) *Allocated fee calculated*. For each covered entity for each fee year, the IRS will calculate the covered entity's allocated fee by multiplying the applicable amount from paragraph (a)(3) of this section by a fraction—

(1) The numerator of which is the covered entity's net premiums written for health insurance of United States health risks during the data year taken into account (described in paragraph (c)(1) of this section); and

(2) The denominator of which is the aggregate net premiums written for health insurance of United States health risks for all covered entities during the data year taken into account (described in paragraph (c)(2) of this section).

§57.5 Notice of preliminary fee calculation.

(a) *Content of notice*. Each fee year, the IRS will make a preliminary calculation of the fee for each covered entity as described in §57.4. The IRS will notify each covered entity of its preliminary fee calculation for that fee year. The notification to a covered entity of its preliminary fee calculation will include—

(1) The covered entity's allocated fee;

(2) The covered entity's net premiums written for health insurance of United States health risks;

(3) The covered entity's net premiums written for health insurance of United States health risks taken into account after the application of §57.4(a)(4);

(4) The aggregate net premiums written for health insurance of United States health risks taken into account for all covered entities; and

(5) Instructions for how to submit a corrected Form 8963, *Report of Health Insurance Provider Information*, to correct any errors through the error correction process.

(b) *Timing of notice*. The IRS will specify in other guidance published in the Internal Revenue Bulletin the date by which it will send each covered entity a notice of its preliminary fee calculation.

§57.6 Error correction process.

(a) *In general*. Upon receipt of its preliminary fee calculation, each covered entity must review this calculation during the error correction period. If the covered entity identifies one or more errors in its preliminary fee calculation, the covered entity must timely submit to the IRS a corrected Form 8963, *Report of Health Insurance Provider Information*, during the error correction period. The corrected Form 8963 will replace the original Form 8963 for all purposes, including for the purpose of determining whether an accuracy-related penalty applies, except that a covered entity remains subject to the failure to report penalty if it fails to timely submit the original Form 8963. In the case of a controlled group, if the preliminary fee calculation for the controlled group contains one or more errors, the corrected Form 8963 must include all of the required information for the entire controlled group, including members that do not have corrections.

(b) *Time and manner*. The IRS will specify in other guidance published in the Internal Revenue Bulletin the time and manner by which a covered entity must submit a corrected Form 8963. The IRS will provide its final determination regarding the covered entity's submission no later than the time the IRS provides a covered entity with a final fee calculation.

(c) *Finality*. Covered entities must assert any basis for contesting their preliminary fee calculation during the error correction period. In the interest of providing finality to the fee calculation process, the IRS will not accept a corrected Form 8963 after the end of the error correction period or alter final fee calculations on the basis of information provided after the end of the error correction period.

§57.7 Notification and fee payment.

(a) *Content of notice*. Each fee year, the IRS will make a final calculation of the fee for each covered entity as described in §57.4. The IRS will base its final fee calculation on each covered entity's original or corrected Form 8963, *Report of Health Insurance Provider Information*, as adjusted by other sources of information described in §57.4(b)(1). The notification to a covered entity of its final fee calculation will include—

(1) The covered entity's allocated fee;

(2) The covered entity's net premiums written for health insurance of United States health risks;

(3) The covered entity's net premiums written for health insurance of United States health risks taken into account after the application of §57.4(a)(4);

(4) The aggregate net premiums written for health insurance of United States health risks taken into account for all covered entities; and

(5) The final determination on the covered entity's corrected Form 8963, *Report of Health Insurance Provider Information*, if any.

(b) *Timing of notice*. The IRS will send each covered entity a notice of its final fee calculation by August 31st of the fee year.

(c) *Differences in preliminary fee calculation and final calculation*. A covered entity's final fee calculation may differ from the covered entity's preliminary fee calculation because of changes made pursuant to the error correction process described in §57.6 or because the IRS discovered additional information relevant to the fee calculation through other information sources as described in §57.4(b)(1). Even if a covered entity did not file a corrected Form 8963 described in §57.6, a covered entity's final fee may differ from a covered entity's preliminary fee because of information discovered about that covered entity through other information sources. In addition, a change in aggregate net premiums written for health insurance of United States health risks can affect every covered entity's fee because each covered entity's fee is equal to a fraction of the aggregate fee collected from all covered entities.

(d) *Payment of final fee*. Each covered entity must pay its final fee by September 30th of the fee year. For a controlled group, the payment must be made using the designated entity's Employer Identification Number as reported on Form 8963. The fee must be paid by electronic funds transfer as required by §57.6302–1. There is no tax return to be filed with the payment of the fee.

(e) *Controlled groups*. In the case of a controlled group that is liable for the fee, all members of the controlled group are jointly and severally liable for the fee. Accordingly, if a controlled group's fee is not paid, the IRS may separately assess each member of the controlled group for the full amount of the controlled group's fee.

§57.8 Tax treatment of fee.

(a) *Treatment as an excise tax*. The fee is treated as an excise tax for purposes of subtitle F (sections 6001-7874). Thus, references in subtitle F to "taxes imposed by this title," "internal revenue tax," and similar references, are also references to the fee. For example, the fee is assessed (section 6201), collected (sections 6301, 6321, and 6331), enforced (section 7602), and subject to examination and summons (section 7602) in the same manner as taxes imposed by the Code.

(b) *Deficiency procedures*. The deficiency procedures of sections 6211-6216 do not apply to the fee.

(c) *Limitation on assessment*. The IRS must assess the amount of the fee for any fee year within three years of September 30th of that fee year.

(d) *Application of section 275*. The fee is treated as a tax described in section 275(a)(6) (relating to taxes for which no deduction is allowed).

§57.9 Refund claims.

Any claim for a refund of the fee must be made by the entity that paid the fee to the government and must be made on Form 843, *Claim for Refund and Request for Abatement*, in accordance with the instructions for that form.

§57.10 Effective/applicability date.

Sections 57.1 through 57.9 apply to any fee that is due on or after September 30, 2014.

§57.6302–1 Method of paying the health insurance providers fee.

(a) *Fee to be paid by electronic funds transfer*. Under the authority of section 6302(a), the fee imposed on covered entities engaged in the business of providing health insurance for United States health risks under section 9010 and §57.4 must be paid by electronic funds transfer as defined in §31.6302–1(h)(4)(i) of this chapter, as if the fee were a depository tax. For the time for paying the fee, see §57.7.

(b) *Effective/Applicability date*. This section applies with respect to any fee that is due on or after September 30, 2014.

PART 602 — OMB CONTROL NUMBERS UNDER THE PAPERWORK REDUCTION ACT

Par. 2. The authority citation for part 602 continues to read as follows:

Authority: 26 U.S.C. 7805.

Par. 3. In §602.101, paragraph (b) is amended by adding the following entry in numerical order to the table to read as follows:

§602.101 OMB Control numbers.

* * * * *

(b) * * *

CFR part or section where identified and described	Current OMB control No.
* * * * *	
57.2(e)(2)(i)	1545–2249
* * * * *	

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

Approved November 13, 2013

Mark J. Mazur,
Assistant Secretary of the Treasury (Tax Policy).

(Filed by the Office of the Federal Register on November 26, 2013, 4:15 p.m., and published in the issue of the Federal Register for November 29, 2013, 78 F.R. 71476)

Part III. Administrative, Procedural, and Miscellaneous

Health Insurance Providers Fee; Procedural and Administrative Guidance

Notice 2013–76

Purpose

This notice provides guidance on the health insurance providers fee related to (1) the time and manner for submitting Form 8963, *Report of Health Insurance Provider Information*, (2) the time and manner for notifying covered entities of their preliminary fee calculation, (3) the time and manner for submitting a corrected Form 8963 for the error correction process, and (4) the time for notifying covered entities of their final fee calculation.

Background

Section 9010 of the Patient Protection and Affordable Care Act (PPACA), Public Law 111–148 (124 Stat. 119 (2010)), as amended by section 10905 of PPACA, and as further amended by section 1406 of the Health Care and Education Reconciliation Act of 2010, Public Law 111–152 (124 Stat. 1029 (2010)) (collectively, the Affordable Care Act or ACA), imposes an annual fee on covered entities engaged in the business of providing health insurance for United States health risks.

The Health Insurance Providers Fee Regulations in 26 CFR Part 57, issued on November 29, 2013, provide the method by which each covered entity's annual fee is calculated. Those regulations provide that the Internal Revenue Service (IRS) will issue additional guidance in the Internal Revenue Bulletin relating to the reporting and fee determination processes. This notice provides that guidance.

Section 57.3(a)(1) provides that each covered entity, including each controlled group that is treated as a single covered entity, must report its net premiums written for health insurance of United States health risks during the data year to the IRS by April 15th of the fee year on Form 8963 in accordance with the instructions for the form. Section 57.2(g) defines *fee year* as the calendar year in which the fee must be paid to the government, and § 57.2(d) defines *data year* as the calendar year immediately before the fee year.

Section 57.3(a)(2) authorizes the IRS to provide rules in guidance published in the Internal Revenue Bulletin for the manner of reporting by a covered entity under this section, including rules for reporting by a designated entity on behalf of a controlled group that is treated as a single covered entity. Section 57.2(c)(1) defines *controlled group* as a group of two or more persons, including at least one person that is a covered entity, that is treated as a single employer under § 52(a), 52(b), 414(m), or 414(o). Section 57.2(c)(2) provides that a controlled group is treated as a single covered entity for purposes of the fee. Section 57.2(e)(1) defines a designated entity as the person within the controlled group that is designated to act on behalf of the controlled group regarding the fee with respect to filing Form 8963, receiving IRS communications about the fee for the group, filing a corrected Form 8963 for the group, if applicable, and paying the fee for the group to the government.

Section 57.3(a)(3) provides that, pursuant to section 9010(g)(4), the information reported on each Form 8963 will be open for public inspection or available upon request.

Section 57.5 provides that, for each fee year, the IRS will make a preliminary fee calculation for each covered entity and will notify each covered entity of this calculation by the date prescribed in guidance published in the Internal Revenue Bulletin. Section 57.5(a) provides that the notification will include (1) the covered entity's allocated fee; (2) the covered entity's net premiums written for health insurance of United States health risks; (3) the covered entity's net premiums written for health insurance of United States health risks taken into account after application of § 57.4(a)(4); (4) the aggregate net premiums written for health insurance of United States health risks taken into account for all covered entities; and (5) instructions for how to submit a corrected Form 8963 to correct any errors through the error correction process. Section 57.6(a) requires each covered entity to review the preliminary fee calculation and submit a corrected Form 8963 if there are any errors. Section 57.6(b) provides that the IRS will specify in other guidance published in the Internal Revenue Bulletin the time and manner by which a covered entity must submit a corrected Form 8963.

Section 57.7(b) requires the IRS to send each covered entity its final fee calculation no later than August 31st of each fee year. Section 57.7(d) requires each covered entity to pay its fee by September 30th of each fee year.

Time and manner for submitting Form 8963

In accordance with § 57.3(a)(1), each covered entity (or, in the case of a controlled group, each designated entity) must file its Form 8963 by April 15th of each fee year. The Form 8963 must be filed in accordance with the instructions to the form. The form and the instructions will be electronically available at *www.irs.gov*.

Time and manner for notifying covered entities of their preliminary fee calculation

The IRS will mail each covered entity (or, in the case of a controlled group, each designated entity) a notice of its preliminary fee calculation by June 15th of each fee year. The notice of preliminary fee calculation will include all of the information required by § 57.5(a).

Time and manner for submitting an error correction report

If the covered entity believes that the notice of preliminary fee calculation contains one or more errors in the mathematical calculation of the fee, the net premiums written data, the net premiums written after taking into account the application of § 57.4(a)(4), or any other error, the covered entity (or, in the case of a controlled group, the designated entity) must provide a corrected report to the IRS by July 15th of each fee year. The covered entity will make an error correction report by completing in full a new Form 8963 and checking the "Corrected Report" box on the form. The corrected Form 8963 will replace the original Form 8963. Therefore, the corrected report must contain all of the information required by the form's instructions. In the case of a controlled group, if the notice of preliminary fee calculation contains one or more errors, the corrected Form 8963 must include all of the information required by the form's instructions for the entire controlled group, including members that do not have corrections. Additionally, a covered entity may include attachments with the corrected Form 8963 if any corrected item requires further explanation.

The IRS will validate the data submitted on the corrected Form 8963 to ensure accuracy and completeness. Section 9010(b)(3) authorizes the IRS to use any other source of information to determine each covered entity's net premiums written for health insurance of United States health risks in addition to the information reported by each covered entity. Section 57.4(b)(1) provides that other sources of information that the IRS may use to determine net premiums written include the Supplemental Health Care Exhibit, which supplements the annual statement filed with the National Association of Insurance Commissioners (NAIC) pursuant to State law, the annual statement itself or the Accident and Health Policy Experience filed with the NAIC, the Medical Loss Ratio Annual Reporting Form filed with the Center for Medicare & Medicaid Services' Center for Consumer Information and Insurance Oversight of the U.S. Department of Health and Human Services, or any similar statements filed with the NAIC, with any State government, or with the Federal government pursuant to applicable State or Federal requirements. To the extent any covered entity's preliminary fee calculation changes as a result of the error correction process, the final fee calculation for one or more covered entities may differ from the preliminary fee calculations that those entities previously received. Any such changes will be reflected in each covered entity's final fee calculation.

Notification and Payment of Final Fee Calculation

In accordance with § 57.7(b), the IRS will notify each covered entity (or each designated entity of a controlled group that is treated as a single covered entity) of its final fee calculation on or before August 31st of each fee year. In accordance with § 57.7(d), each covered entity (or designated entity, if applicable) must pay this fee by September 30th of each fee year.

Disclosure

The information submitted on both original and corrected Forms 8963 is not confidential. Although, generally, tax returns and return information are confidential, as required by § 6103, in accordance with § 57.3(a)(3), the information on Form 8963 is not subject to § 6103. All information on Form 8963 will be open for public inspection or available upon request. Do not include personal information other than that requested on Form 8963.

Drafting Information

The principal author of this notice is Charles J. Langley, Jr. of the Office of Associate Chief Counsel (Passthroughs & Special Industries). For further information regarding this notice, please contact Mr. Langley at (202) 317-6855 (not a toll-free call).

Part IV. Items of General Interest

Notice of Proposed Rulemaking

Net Investment Income Tax

REG.–130843–13

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Withdrawal of notice of proposed rulemaking and notice of proposed rulemaking.

SUMMARY: This document contains proposed regulations under section 1411 of the Internal Revenue Code (Code). These regulations provide guidance on the computation of net investment income. The regulations affect individuals, estates, and trusts whose incomes meet certain income thresholds.

DATES: The proposed rule published December 5, 2012 (77 FR 72612), is withdrawn as of December 2, 2013. Comments on this proposed rule must be received by March 3, 2014. Comments on the collection of information for this proposed rule should be received by February 3, 2014.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG-130843-13), room 5205, Internal Revenue Service, PO Box 7604, Ben Franklin Station, Washington, DC 20044. Submissions may be hand-delivered Monday through Friday between the hours of 8 a.m. and 4 p.m. to CC:PA:LPD:PR (REG-130843-13), Courier's Desk, Internal Revenue Service, 1111 Constitution Avenue, NW., Washington, DC, or sent electronically, via the Federal eRulemaking portal at *www.regulations.gov* (IRS REG-130843-13).

FOR FURTHER INFORMATION CONTACT: Concerning the proposed regulations, David H. Kirk or Adrienne M. Mikolashek at (202) 317-6852; concerning submissions of comments or to request a hearing, Oluwafunmilayo Taylor, (202) 317-6901 (not toll-free numbers).

SUPPLEMENTARY INFORMATION:

Paperwork Reduction Act

The collection of information contained in this notice of proposed rulemaking has been submitted to the Office of Management and Budget for review in accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. 3507(d)) under control number 1545-2227. Comments on the collection of information should be sent to the **Office of Management and Budget**, Attn: Desk Officer for the Department of the Treasury, Office of Information and Regulatory Affairs, Washington, DC 20503, with copies to the **Internal Revenue Service**, Attn: IRS Reports Clearance Officer, SE:W:CAR:MP:T:T:SP, Washington, DC 20224. Comments on the collection of information should be received by February 3, 2014. Comments are specifically requested concerning:

Whether the proposed collection of information is necessary for the proper performance of the functions of the IRS, including whether the information will have practical utility;

The accuracy of the estimated burden associated with the proposed collection of information; and

Estimates of capital or start-up costs and costs of operation, maintenance, and purchase of services to provide information.

The collection of information in these proposed regulations is in §1.1411–7(g).

The information collected in proposed §1.1411–7(g) is required by the IRS to verify the taxpayer's reported adjustment under section 1411(c)(4). This information will be used to determine whether the amount of tax has been reported and calculated correctly. The likely respondents are owners of interests in partnerships and S corporations.

The burden for the collection of information contained in these proposed regulations will be reflected in the burden on Form 8960 or another form that the IRS designates, which will request the information in the proposed regulations.

An agency may not conduct or sponsor, and a person is not required to respond to, a collection of information unless it displays a valid control number assigned by the Office of Management and Budget.

Books or records relating to a collection of information must be retained as long as their contents may become material in the administration of any internal revenue law. Generally, tax returns and tax return information are confidential, as required by section 6103.

Background

I. *Statutory Background*

Section 1402(a)(1) of the Health Care and Education Reconciliation Act of 2010 (Public Law 111-152, 124 Stat. 1029) added section 1411 to a new chapter 2A of subtitle A (Income Taxes) of the Code effective for taxable years beginning after December 31, 2012. Section 1411 imposes a 3.8 percent tax on certain individuals, estates, and trusts.

In the case of an individual, section 1411(a)(1) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the individual's net investment income for such taxable year, or (B) the excess (if any) of: (i) the individual's modified adjusted gross income for such taxable year, over (ii) the threshold amount. Section 1411(b) provides that the threshold amount is: (1) in the case of a taxpayer making a joint return under section 6013 or a surviving spouse (as defined in section 2(a)), $250,000; (2) in the case of a married taxpayer (as defined in section 7703) filing a separate return, $125,000; and (3) in the case of any other individual, $200,000. Section 1411(d) defines modified adjusted gross income as adjusted gross income increased by the excess of: (1) the amount excluded from gross income under section 911(a)(1), over (2) the amount of any deductions (taken into account in computing adjusted gross income) or exclusions disallowed under section 911(d)(6) with respect to the amount excluded from gross income under section 911(a)(1).

In the case of an estate or trust, section 1411(a)(2) imposes a tax (in addition to any other tax imposed by subtitle A) for each taxable year equal to 3.8 percent of the lesser of: (A) the estate's or trust's undistributed net investment income, or (B) the excess (if any) of (i) the estate's or trust's adjusted gross income (as defined in section 67(e)) for such taxable year, over (ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.

Section 1411(c)(1) provides that net investment income means the excess (if any) of: (A) the sum of (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income derived in the ordinary course of a trade or business to which the tax does not apply, (ii) other gross income derived from a trade or business to which the tax applies, and (iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property other than property held in a trade or business to which the tax does not apply; over (B) the deductions allowed by subtitle A that are properly allocable to such gross income or net gain.

II. *Regulatory Background*

This document contains proposed amendments to 26 CFR part 1 under section 1411 of the Code. On December 5, 2012, the Treasury Department and the IRS published a notice of proposed rulemaking in the **Federal Register** (REG-130507–11; 77 FR 72612) relating to the Net Investment Income Tax. On January 31, 2013, corrections to the proposed regulations were published in the **Federal Register** (78 FR 6781) (collectively, the "2012 Proposed Regulations"). Final regulations, issued contemporaneously with these proposed regulations in this issue of the Bulletin, contain amendments to the Income Tax Regulations (26 CFR Part 1), which finalize the 2012 Proposed Regulations (the "2013 Final Regulations"). However, the Treasury Department and the IRS also are proposing amendments to the 2013 Final Regulations to provide additional clarification and guidance with respect to the application of section 1411 to certain specific types of property. Furthermore, the Treasury Department and the IRS are also interested in receiving comments about other aspects of section 1411 that are not addressed in the 2013 Final Regulations or these proposed regulations. If such comments are received, the Treasury Department and the IRS will consider them for inclusion on future Guidance Priority Lists.

The Treasury Department and the IRS received comments on the 2012 Proposed Regulations requesting that they address the treatment of section 707(c) guaranteed payments for capital, section 736 payments to retiring or deceased partners for section 1411 purposes, and certain capital loss carryovers. After consideration of all comments received, the Treasury Department and the IRS believe that it is appropriate to address the treatment of these items in regulations. Because such guidance had not been proposed in the 2012 Proposed Regulations, it is being issued for notice and comment in these new proposed regulations.

The Treasury Department and the IRS also received comments on the simplified method for applying section 1411 to income recipients of charitable remainder trusts (CRTs) that was proposed in the 2012 Proposed Regulations. The comments recommended that the section 1411 classification incorporate the existing category and class system under section 664. These proposed regulations provide special rules for the application of the section 664 system to CRTs that derive income from controlled foreign corporations (CFCs) or passive foreign investment companies (PFICs) with respect to which an election under §1.1411–10(g) is not in place. Specifically, these proposed regulations coordinate the application of the rules applicable to shareholders of CFCs and PFICs in §1.1411–10 with the section 664 category and class system adopted in §1.1411–3(d)(2) of the 2013 Final Regulations.

Furthermore, these proposed regulations allow CRTs to elect to apply the section 664 system adopted in the 2013 Final Regulations or the simplified method set forth in the 2012 Proposed Regulations. Some comments responding to the 2012 Proposed Regulations requested that we provide an election. The Treasury Department and the IRS request comments with regard to whether or not taxpayers believe this election is preferable to the section 664 system adopted in the 2013 Final Regulations. If it appears that there is no significant interest in having the election, the Treasury Department and the IRS may omit it from the regulations when finalized, and the simplified method contained in the 2012 Proposed Regulations would no longer be an option.

These proposed regulations also address the net investment income tax characterization of income and deductions attributable to common trust funds (CTFs), residual interests in real estate mortgage investment conduits (REMICs), and certain notional principal contracts.

The Treasury Department and the IRS also received comments on the 2012 Proposed Regulations questioning the proposed regulation's methodology for adjusting a transferor's gain or loss on the disposition of its partnership interest or S corporation stock. In view of these comments, the 2013 Final Regulations removed §1.1411–7 of the 2012 Proposed Regulations and reserved §1.1411–7 in the 2013 Final Regulations. This notice of proposed rulemaking proposes revised rules regarding the calculation of net gain from the disposition of a partnership interest or S corporation stock (each a "Passthrough Entity") to which section 1411(c)(4) may apply.

Explanation of Provisions

1. *Overview of Proposed Regulations*

These proposed regulations propose additions and modifications to the 2013 Final Regulations, including guidance with respect to certain paragraphs that were reserved in the 2013 Final Regulations.

To coordinate these proposed regulations with the 2013 Final Regulations, the proposed regulations are proposed to have the same effective date as the 2013 Final Regulations. However, any provisions adopted when these proposed regulations are finalized that are more restrictive than these proposed regulations would apply prospectively only. Taxpayers may rely on these proposed regulations for purposes of compliance with section 1411 until the issuance of these regulations as final regulations. See §1.1411–1(f).

2. *Special Rules for Certain Partnership Payments*

Section 731(a) treats gain from distributions as gain from the sale or exchange of a partnership interest. In general, the section 1411 treatment of gain to a partner under section 731 is governed by the rules of section 1411(c)(1)(A)(iii). Such gain is thus generally treated as net investment income for purposes of section 1411 (other than as determined under section 1411(c)(4)). However, certain partnership payments to partners are treated as not from the sale or exchange of a partnership interest. These payments include section 707(c) guaranteed payments for services or the use of capital and certain section 736 distributions to a partner in liquidation of that partner's partnership interest. Because these payments are not treated as from the sale or exchange of a partnership interest, their treatment under section 1411 may differ from the general rule of section 1411(c)(1)(A)(iii). The proposed regulations therefore provide rules for the section 1411 treatment of these payments.

A. *Section 707(c) payments*

Section 707(c) provides that a partnership payment to a partner is a "guaranteed payment" if the payment is made for services or the use of the capital, and the payment amount does not depend on partnership income. Section 1.707-1(c) provides that guaranteed payments to a partner for services are considered as made to a person who is not a partner, but only for the purposes of section 61(a) (relating to gross income) and, subject to section 263, section 162(a) (relating to trade or business expenses). Section 1.704-1(b)(2)(iv)(*o*) provides that guaranteed payments are not part of a partner's distributive share for purposes of section 704(b).

The proposed regulations' treatment of section 707(c) guaranteed payments under section 1411 depends on whether the partner receives the payment for services or the use of capital. The proposed regulations exclude all section 707(c) payments received for services from net investment income, regardless of whether these payments are subject to self-employment tax, because payments for services are not included in net investment income.

The Treasury Department and the IRS believe that guaranteed payments for the use of capital share many of the characteristics of substitute interest, and therefore should be included as net investment income. This treatment is consistent with existing guidance under section 707(c) and other sections of the Code in which guaranteed payments for the use of capital are treated as interest. See, for example, §§1.263A–9(c)(2)(iii) and 1.469-2(e)(2)(ii).

B. *Treatment of section 736 payments*

i. In General

Section 736 applies to payments made by a partnership to a retiring partner or to a deceased partner's successor in interest in liquidation of the partner's entire interest in the partnership. Section 736 does not apply to distributions made to a continuing partner, distributions made in the course of liquidating a partnership entirely, or to payments received from persons other than the partnership in exchange for the partner's interest. Section 736 categorizes liquidating distributions based on the nature of the payment as in consideration for either the partner's share of partnership property or the partner's share of partnership income. Section 736(b) generally treats a payment in exchange for the retiring partner's share of partnership property as a distribution governed by section 731. Section 736(a) treats payments in exchange for past services or use of capital as either distributive share or a guaranteed payment. Section 736(a) payments also include payments to retiring general partners of service partnerships in exchange for unrealized receivables (other than receivables described in the flush language of section 751(c)) or for goodwill (other than payments for goodwill provided for in the partnership agreement) (collectively, "Section 736(a) Property").

Because the application of section 1411 depends on the underlying nature of the payment received, the section 736 categorization controls whether a liquidating distribution is treated as net investment income for purposes of section 1411. Thus, the treatment of the payment for purposes of section 1411 differs depending on whether the distribution is a section 736(b) distribution in exchange for partnership property or a section 736(a) distribution in exchange for past services, use of capital, or Section 736(a) Property. Among section 736(a) payments, the proposed regulations further differentiate the treatment of payments depending on: (i) whether or not the payment amounts are determined with regard to the income of the partnership and (ii) whether the payment relates to Section 736(a) Property or relates to services or use of capital.

Section 1.469–2(e)(2)(iii) contains rules pertaining to whether section 736 liquidating distributions paid to a partner will be treated as income or loss from a passive activity. Where payments to a retiring partner are made over a period of years, the composition of the assets and the status of the partner as passive or nonpassive may change. Section 1.469–2(e)(2)(iii) contains rules on the extent to which those payments are classified as passive or nonpassive for purposes of section 469. The proposed regulations generally align the section 1411 characterization of section 736 payments with the treatment of the payments as passive or nonpassive under §1.469–2(e)(2)(iii).

ii. Treatment of Section 736(b) Payments

Section 736(b) payments to retiring partners in exchange for partnership property (other than payments to retiring general partners of service partnerships in exchange for Section 736(a) Property) are governed by the rules generally applicable to partnership distributions. Thus, gain or loss recognized on these distributions is treated as gain or loss from the sale or exchange of the distributee partner's partnership interest under section 731(a).

The proposed regulations provide that section 736(b) payments will be taken into account as net investment income for section 1411 purposes under section 1411(c)(1)(A)(iii) as net gain or loss from the disposition of property. If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply §1.1411–7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4). Gain or loss relating to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) regardless of whether the payments are classified as capital gain or ordinary income (for example, by reason of section 751).

In the case of section 736(b) payments that are paid over multiple years, the proposed regulations provide that the characterization of gain or loss as passive or nonpassive is determined for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced and is not retested annually. The proposed regulations thus adopt for section 1411 purposes the section 469 treatment of section 736(b) payments paid over multiple years as set forth in §1.469–2(e)(2)(iii)(A).

iii. Treatment of Section 736(a) Payments

As described in part 2.B.i., section 736 provides for several different categories of liquidating distributions under section 736(a). Payments received under section 736(a) may be an amount determined with regard to the income of the partnership taxable as distributive share under section 736(a)(1) or a fixed amount taxable as a guaranteed payment under section 736(a)(2). The categorization of the payment as distributive share or guaranteed payment will govern the treatment of the payment for purposes of section 1411.

The determination of whether section 736(a) payments received over multiple years are characterized as passive or nonpassive depends on whether the payments are received in exchange for Section 736(a) Property. With respect to section 736(a)(1) payments in exchange for Section 736(a) Property, §1.469–2(e)(2)(iii)(B) provides a special rule that computes a percentage of passive income that would result if the partnership sold the retiring partner's entire share of Section 736(a) Property at the time that the liquidation of the partner's interest commenced. The percentage of passive income is then applied to each payment received. See §1.469–2(e)(2)(iii)(B)(*1*). These rules apply to section 736(a)(1) and section 736(a)(2) payments for Section 736(a) Property. The proposed regulations adopt this treatment as set forth in section 469 for purposes of section 1411.

a. Section 736(a)(1) payments taxable as distributive share

Section 736(a)(1) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined with regard to the partnership's income, then the payment is treated as a distributive share of income to the retiring partner. For purposes of section 1411, the items of income, gain, loss, and deduction attributable to the distributive share are taken into account in computing net investment income under section 1411(c)(1) in a manner consistent with the item's chapter 1 character and treatment. For example, if the partner's distributive share includes income from a trade or business not described in section 1411(c)(2), that income will be excluded from net investment income. However, if the distributive share includes, for example, interest income from working capital, then that income is net investment income.

The proposed regulations treat section 736(a)(1) payments unrelated to Section 736(a) Property as characterized annually as passive or nonpassive by applying the general rules of section 469 to each payment in the year received. To the extent that any payment under section 736(a)(1) is characterized as passive income under the principles of section 469, that payment also will be characterized as passive income for purposes of section 1411.

b. Section 736(a)(2) payments taxable as guaranteed payments

Section 736(a)(2) provides that if the amount of a liquidating distribution (other than a payment for partnership property described in section 736(b)) is determined without regard to the partnership's income, then the payment is treated as a guaranteed payment as described in section 707(c). Payments under section 736(a)(2) might be in exchange for services, use of capital, or Section 736(a) Property. The section 1411 treatment of guaranteed payments for services or the use of capital follows the general rules for guaranteed payments set forth in part 2.A of this preamble. Thus, section 736(a)(2) payments for services are not included as net investment income, and section 736(a)(2) payments for the use of capital are included as net investment income.

Section 736(a)(2) payments in exchange for Section 736 Property are treated as gain or loss from the disposition of a partnership interest, which is generally included in net investment income under section 1411(c)(1)(A)(iii). If the retiring partner materially participates in a partnership trade or business, then the retiring partner must also apply §1.1411–7 of these proposed regulations to reduce appropriately the net investment income under section 1411(c)(4). To the extent that section 736(a)(2) payments exceed the fair market value of Section 736(a) Property, the proposed regulations provide that the excess will be treated as either interest income or as income in exchange for services, in a manner consistent with the treatment under §1.469–2(e)(2)(iii).

iv. Application of Section 1411(c)(4) to Section 736 Payments

The proposed regulations provide that section 1411(c)(4) applies to section 736(a)(2) and section 736(b) payments. Thus, the inclusion of these payments as net investment income may be limited if the retiring partner materially participated in all or a portion of the partnership's trade or business. The extent of any limitation is determined under the rules of §1.1411–7.

The proposed regulations provide that, when section 736 payments are made over multiple years, the characterization of gain or loss as passive or nonpassive and the values of the partnership assets are computed for all payments as though all payments were made at the time that the liquidation of the exiting partner's interest commenced, similar to the treatment in §1.469–2(e)(2)(iii)(A).

If a partner's net investment income is reduced pursuant to section 1411(c)(4), then the difference between the amount of gain recognized for chapter 1 and the amount includable in net investment income after the application of section 1411(c)(4) is treated as an addition to basis, in a manner similar to an installment sale for purposes of calculating the partner's net investment income attributable to these payments.

v. Additional Public Comments

Commentators to the 2012 Proposed Regulations requested that the Treasury Department and the IRS issue guidance under section 1411 regarding the treatment of section 736 payments to retiring and deceased partners. Some commentators sought clarification regarding the interaction between section 736 payments and the net investment income exclusions in sections 1411(c)(5) and 1411(c)(6).

Section 1411(c)(5) provides that net investment income shall not include certain items of income attributable to distributions from specifically enumerated qualified plans. One commentator suggested that section 736 payments should be excluded from net investment income under section 1411(c)(5) as analogous to qualified plan distributions. The Treasury Department and the IRS believe that section 1411(c)(5) does not apply to section 736 payments because these payments do not originate from a qualified plan described in section 1411(c)(5). Therefore, section 736 payments are not excluded by reason of section 1411(c)(5).

Section 1411(c)(6) provides that net investment income does not include any item taken into account in determining self-employment income for a taxable year on which a tax is imposed by section 1401(b). In the context of section 1411(c)(6), §1.1411–9(a) of the 2013 Final Regulations provides that the term "taken into account" for self-employment tax purposes does not include amounts excluded from net earnings from self-employment under sections 1402(a)(1)-(17). Commentators suggested that certain section 736 payments are excluded from net earnings from self-employment by reason of section 1402(a)(10) and §1.1402(a)–17, and therefore should be excluded from net investment income under section 1411(c)(6) for similar policy reasons. The Treasury Department and the IRS believe that section 1411(c)(6) does not apply to section 736 payments, except to the extent that such payments are taken into account, within the meaning of §1.1411–9(a), in determining net earnings from self-employment. In such a case, the section 736 payment would be subject to self-employment tax and therefore is not included in net investment income by reason of section 1411(c)(6) and §1.1411–9(a).

Commentators also recommended special rules for the interaction between section 736 payments and the section 469 material participation rules solely for purposes of section 1411. As discussed in this part of the preamble, the proposed section 1411 rules rely heavily on the chacterization of the section 736 payments under section 469. Therefore, the Treasury Department and the IRS do not believe that special section 469 rules are necessary solely for purposes of section 1411.

3. *Treatment of Certain Capital Loss Carryforwards*

In general, under chapter 1, capital losses that exceed capital gains are allowed as a deduction against ordinary income only to the extent allowed by section 1211(b). In the case of capital losses in excess of the amounts allowed by section 1211(b), section 1212(b)(1) treats these losses as incurred in the following year. Section 1.1411–4(d) adopts these principles when computing net gain under section 1411(c)(1)(A)(iii). Therefore, capital losses incurred in a year prior to the effective date of section 1411 may be taken into account in the computation of section 1411(c)(1)(A)(iii) net gain by reason of the mechanics of section 1212(b)(1). However, certain capital losses may not be taken into account in determining net investment income within the meaning of section 1411(c)(1)(A)(iii) or by reason of the exception in section 1411(c)(4)(B) (generally, an "excluded capital loss"). In the case of section 1411(c)(1)(A)(iii), §1.1411–4(d)(4)(i) provides that capital losses attributable to the disposition of property used in a trade or business not described in section 1411(c)(2) and §1.1411–5 are excluded from the computation of net gain. In the case of section 1411(c)(4)(B), some or all of a capital loss resulting from the disposition of certain partnerships or S corporations is excluded from the determination of net gain. Although these capital losses are excluded from the calculation of net gain in the year of recognition by reason of §1.1411–4(d)(4), such losses may not be fully offset by capital gains for chapter 1 purposes in the same year. In that case, some (or all) of the capital loss carryforward will constitute excluded capital losses in the subsequent year(s) by reason of the mechanics of section 1212(b)(1). Several commentators identified this issue and requested that the Treasury Department and the IRS provide guidance on the identification, tracking, and use of embedded, excluded capital losses within a capital loss carryforward.

In response to these comments, proposed §1.1411–4(d)(4)(iii) creates an annual adjustment to capital loss carryforwards to prevent capital losses excluded from the net investment income calculation in the year of recognition from becoming deductible losses in future years. The annual adjustment in §1.1411–4(d)(4)(iii) provides a method of identification and an ordering rule that eliminate the need for taxpayers to maintain a separate set of books and records for this item to comply with section 1411. However, the rule requires that taxpayers perform the calculation annually, regardless of whether they have a section 1411 tax liability in a particular year, to maintain the integrity of the rule's carryforward adjustment amounts for a subsequent year in which they are subject to liability under section 1411.

The rule provides that, for purposes of computing net gain in §1.1411–4(d) and any properly allocable deduction for excess losses in §1.1411–4(f)(4) (if any), the taxpayer's capital loss carryforward from the previous year is reduced by the lesser of: (A) the amount of capital loss taken into account in the current year by reason of section 1212(b)(1), or (B) the amount of net capital loss excluded from net investment income in the immediately preceding year. For purposes of (B), the amount of net capital loss excluded from net investment income in the previous year includes amounts excluded by reason of §1.1411–4(d)(4) (amount of capital losses recognized in the preceding year) plus the amount of the previous year's adjustment required by this rule. Section 1.1411-4(d)(4)(iii) provides a multi-year example to illustrate the application of the rule.

The mechanics of the capital loss adjustment accomplishes several objectives. First, the rule causes all capital losses incurred prior to 2013 to be allowable losses for the computation of net gain under §1.1411–4(d) and any properly allocable deduction for excess losses in §1.1411–4(f)(4) (if any). This result is accomplished by the application of part (B) of the rule described in the preceding paragraph. Since the adjustment is based on the lesser of (A) or (B), the amount of excluded capital losses in the year immediately before the effective date of section 1411 is zero, so the loss adjustment in the year following the effective date of section 1411 will also be zero. Second, the rule only requires an adjustment when a taxpayer has excluded losses embedded within a capital loss carryforward. Therefore, taxpayers with no excluded capital losses do not have to make any adjustment. Third, the rule also provides a mechanism for ordering the use of capital losses to offset gains. The rule causes excluded capital gains recognized in the current year to be offset by excluded capital losses that are embedded in the capital loss carryforward from the previous year. This matching is accomplished by the use of the term "net capital loss" in §1.1411–4(d)(4)(iii)(B). If the excluded gain exceeds the amount of excluded capital loss included in the carryforward amount and any excluded capital loss amounts recognized in the current year, the amount of adjustment will be zero in the subsequent year because there was no "net capital loss" in the preceding year. In this situation, no adjustment is required because the previous year's excluded gains were fully absorbed by the excluded losses. Finally, the rule allows taxpayers to use capital non-excluded losses for purposes of the excess loss deduction in §1.1411–4(f)(4) before subjecting excluded losses to the limitation.

4. *Treatment of Income and Deductions from Common Trust Funds (CTFs)*

Section 584(c) provides that each participant in a CTF shall include in its taxable income, whether or not distributed and whether or not distributable, its proportionate share of: (1) short-term capital gain or loss, (2) long-term capital gain or loss, and (3) ordinary taxable income or the ordinary net loss of the CTF. The flush language of section 584(c) further provides that "the proportionate share of each participant in the amount of dividends received by the CTF and to which section 1(h)(11) applies shall be considered for purposes of such paragraph as having been received by such participant."

Section 584(d) provides, in relevant part, that "[t]he taxable income of a common trust fund shall be computed in the same manner and on the same basis as in the case of an individual, except . . . after excluding all items of gain and loss from sales or exchanges of capital assets, there shall be computed (A) an ordinary taxable income which shall consist of the excess of the gross income over deductions; or (B) an ordinary net loss which shall consist of the excess of the deductions over the gross income."

The Treasury Department and the IRS have become aware that taxpayers may be considering the use of CTFs to recharacterize income items that otherwise would be includable in net investment income under section 1411. Because section 584(c)(3) simply requires the participant to include in its income its share of "net ordinary income or loss," taxpayers may attempt to claim that section 584(c)(3) ordinary income or loss inclusions are not explicitly section 1411(c)(1)(A)(i) net investment income, and therefore escape taxation under section 1411.

Using a CTF to recharacterize the underlying character of CTF income for section 1411 purposes is closely analogous to the past use of CTFs to cleanse unrelated business taxable income (UBTI) for tax-exempt participants. In 1984, the Treasury Department and the IRS promulgated §1.584–2(c)(3), which created a special look-through rule to prevent taxpayers from using CTFs to recharacterize UBTI. Section 1.584–2(c)(3) provides, in relevant part, that "any amount of income or loss of the common trust fund which is included in the computation of a participant's taxable income for the taxable year shall be treated as income or loss from an unrelated trade or business to the extent that such amount would have been income or loss from an unrelated trade or business if such participant had made directly the investments of the common trust fund."

Similarly, proposed §1.1411–4(e)(3) includes a rule that provides income or loss from a CTF is net investment income or deduction to the extent that such amount would have been net investment income or deduction if the participant had made directly the investments of the CTF.

5. *Treatment of Income and Deductions Related to Residual Interests in REMICs*

The 2012 Proposed Regulations did not explicitly address income and deductions related to residual interests in REMICs. A REMIC residual interest represents an equity-like interest in a REMIC. A REMIC is not treated as carrying on a trade or business for purposes of section 162, and a REMIC's taxable income or net loss generally is derived from dispositions of qualified mortgages or permitted investments, interest income from the mortgages, and interest expense from the regular interests (treated as debt) issued by the REMIC. Section 860C(a)(1) generally requires the holder of a REMIC residual interest to take into account the daily portion of the REMIC's taxable income or net loss. One commentator suggested that the regulations expressly include income from a REMIC residual interest in determining net investment income. The Treasury Department and the IRS agree with this comment because, if a taxpayer directly held the underlying assets of the REMIC, the items of income, gain, loss, and deductions attributable to those assets would be taken income account in computing net investment income. Therefore, the proposed regulations provide that a holder of a residual interest in a REMIC takes into account the daily portion of taxable income (or net loss) under section 860C in determining net investment income.

6. *Treatment of Income and Deductions from Certain Notional Principal Contracts (NPCs)*

Under the 2012 Proposed Regulations (and the 2013 Final Regulations), gain on the disposition of an NPC is included in net investment income, and any other gross income from an NPC (including net income attributable to periodic payments on an NPC) is included in net investment income if it is derived from a trade or business described in §1.1411–5. Several commentators on the 2012 Proposed Regulations suggested that the proper treatment of periodic payments on an NPC should not turn solely upon whether the NPC was entered into as part of a trading business and recommended that NPC periodic payments should be included in net investment income. One commentator indicated that the omission of NPC periodic income seems unusual and inconsistent with the portions of the 2012 Proposed Regulations (and 2013 Final Regulations) that provide for the inclusion in net investment income of substitute interest and substitute dividends.

After consideration of the comments, the Treasury Department and the IRS agree that periodic payments on an NPC should be included in net investment income even if the net income from such payments is not derived in a trade or business described in §1.1411–5. As a result, the proposed regulations provide that net income (or net deduction) attributable to periodic and nonperiodic payments on an NPC under §1.446–3(d) is taken into account in determining net investment income. However, the proposed regulations only apply to the net income (or net deduction) on an NPC described in §1.446–3(c)(1) that is referenced to property (including an index) that produces (or would produce if the property were to produce income) interest, dividends, royalties, or rents if the property were held directly by the taxpayer. The proposed regulations would not affect the treatment of net income attributable to periodic and nonperiodic payments on any NPC derived in a trade or business described in §1.1411–5, that is net investment income under section 1411(c)(1)(A)(ii).

7. *Charitable Remainder Trusts (CRTs) with Income from Controlled Foreign Corporations (CFCs) or Passive Foreign Investment Companies (PFICs)*

Section 1.1411–3(d)(2) of the 2013 Final Regulations provides rules on the categorization and distribution of net investment income from a CRT based on the existing section 664 category and class system. In general, §1.1411–3(d)(2) provides that, if a CRT has both excluded income and accumulated net investment income (ANII) in an income category, such excluded income and ANII constitute separate classes of income for purposes of §1.664–1(d)(1)(i)(b). Section 1.1411-10 of the 2013 Final Regulations provides rules for calculating net investment income when a taxpayer owns a direct or indirect interest in a CFC or PFIC.

The 2013 Final Regulations reserve paragraph §1.1411–3(d)(2)(ii) for special rules that the Treasury Department and the IRS believe are necessary to apply the section 664 category and class system contained in §1.664–1(d), and adopted by §1.1411–3(d)(2), to CRTs that own interests in certain CFCs or PFICs. The special rules generally apply to taxpayers that: (i) own CFCs or qualified electing funds (QEFs) with respect to which an election under §1.1411–10(g) is not in place; or (ii) are subject to the rules of section 1291 with respect to a PFIC. These proposed regulations provide those special rules and are proposed to apply to taxable years beginning after December 31, 2013. There are no special rules necessary for a United States person that has elected to mark to market its PFIC stock under section 1296. See §1.1411–10(c)(2)(ii).

A. *CFCs and QEFs*

For purposes of chapter 1, a United States shareholder (as defined in section 951(b)) of a CFC is required to include certain amounts in income currently under section 951(a) (section 951 inclusions). Similarly, a U.S. person that owns shares of a PFIC also is required to include amounts in income currently under section 1293(a) (section 1293 inclusions) if the person makes a QEF election under section 1295 with respect to the PFIC.

For purposes of chapter 1, a CRT's section 951 inclusions and section 1293 inclusions are included in the appropriate section 664 category and class for the year in which those amounts are includable in the CRT's income for purposes of chapter 1. The application of the ordering rules in §1.664–1(d)(1) determines the tax character of the annuity or unitrust distributions to the CRT's income beneficiary. These ordering rules are equally applicable for purposes of section 1411 under the 2013 Final Regulations. In the case of a CRT that directly or indirectly owns an interest in a CFC or QEF, some portion of the annual distribution(s) may consist of current or previous years' section 951 inclusions or section 1293 inclusions.

As discussed in the preamble to the 2013 Final Regulations, §1.1411–10 generally provides that distributions of previously taxed earnings and profits attributable to section 951 inclusions and section 1293 inclusions that are not treated as dividends for purposes of chapter 1 under section 959(d) or section 1293(c) are dividends for purposes of section 1411, absent an election under §1.1411–10(g). Without that election, taxpayers generally do not include section 951 inclusions or section 1293 inclusions in net investment income for purposes of section 1411. As a result, the timing of income derived from an investment in a CFC or QEF may be different for purposes of chapter 1 and section 1411. Thus, §1.1411–10(e) provides adjustments to a taxpayer's modified adjusted gross income (MAGI), or to the adjusted gross income (AGI) of an estate or trust, when the taxpayer owns a CFC or QEF with respect to which an election is not in place to coordinate the rules in §1.1411–10 with the calculation of the section 1411 tax, the applicability of which is based, in part, on MAGI or AGI.

B. *Section 1291 funds*

The Final 2013 Regulations also provide special rules that apply to a United States shareholder of a PFIC who is subject to the tax and interest charge applicable to excess distributions under section 1291. Accordingly, §1.1411–10(e) also provides adjustments to a taxpayer's MAGI, or to the AGI of an estate or trust, when the taxpayer owns a PFIC and is subject to these special rules. In particular, MAGI (or AGI for an estate or trust) is increased by: (i) the amount of any excess distribution to the extent the distribution is a dividend under section 316(a) and is not otherwise included in income for purposes of chapter 1 under section 1291(a)(1)(B), and (ii) any gain treated as an excess distribution under section 1291(a)(2) to the extent not otherwise included in income for purposes of chapter 1 under section 1291(a)(1)(B).

C. *Rules in proposed regulation §1.1411–3(d)(2)(ii)*

The rules in proposed §1.1411–3(d)(2)(ii) coordinate the rules of §1.1411–10 with the section 664 category and class system. These proposed regulations contain three rules that generally apply when a CRT directly or indirectly owns an interest in a CFC or QEF and a §1.1411–10(g) election is not in effect with respect to the CFC or QEF. First, §1.1411–3(d)(2)(ii)(A) provides that section 951 inclusions and section 1293 inclusions that are included in gross income for purposes of chapter 1 for a calendar year and in one or more categories described in §1.664–1(d)(1) are considered excluded income (within the meaning of §1.1411–1(d)) in the year the amount is included in income for purposes of chapter 1.

Second, proposed §1.1411–3(d)(2)(ii)(B) provides that, when a CRT receives a distribution of previously taxed earnings and profits that is not treated as a dividend for purposes of chapter 1 under section 953(d) and 1293(c) but that is taken into account as net investment income for purposes of section 1411 (referred to as an *NII Inclusion Amount*), the CRT must allocate such amounts among the categories described in section 664(b)(1)-(3). For this purpose, the NII Inclusion Amount includes net investment income described in §1.1411–10(c)(1)(i) (certain distributions from a CFC or QEF), §1.1411–10(c)(1)(ii) (certain distributions from a section 1291 fund), §1.1411–10(c)(2)(i) (gain derived from the disposition of a section 1291 fund), and §1.1411–10(c)(4) (distributions from an estate or trust attributable to income or gain derived from a CFC or QEF with respect to which an election under §1.1411–10(g) is not in effect). Specifically, proposed §1.1411–3(d)(2)(ii)(B) provides that, to the extent the CRT has amounts of excluded income in the Ordinary Income Category and the Capital Gain Category under §1.664–1(d)(1), the NII Inclusion Amount is allocated to the CRT's classes of excluded income in the Ordinary Income Category, and then to the classes of excluded income in the Capital Gain Category, in turn, until exhaustion of each such class, beginning with the class of excluded income within a category with the highest Federal income tax rate. Any remaining NII Inclusion Amount not so allocated to classes within the Ordinary Income and Capital Gain Categories shall be placed in the category described in section 664(b)(3) (the Other Income Category). To the extent the CRT distributes amounts from this Other Income Category, that distribution shall constitute a distribution described in §1.1411–10(c)(4) and thus §1.1411–10(e)(1) causes the beneficiary to increase its MAGI (or AGI for an estate or trust) by the same amount.

The third rule in proposed §1.1411–3(d)(2)(ii) addresses the differential in gain or loss associated with tax basis disparities between chapter 1 and section 1411 that are caused by the recognition of income under chapter 1 and of the corresponding net investment income in different taxable years. See §1.1411–10(d) for special basis calculation rules for CFC, QEFs, and partnerships and S corporations that own interests in CFCs or QEFs. The proposed rules for the allocation of such gain or loss within the section 664 categories and classes generally are consistent with the allocation rules for NII Inclusions Amounts, except that the Capital Gain Category is the first category to which the gain or loss is to be allocated, and then the Ordinary Income Category. The order of the categories is changed for gains and losses to more closely match the adjustments to the income that produced the net investment income, and to minimize the need for adjustments to MAGI or AGI.

Proposed §1.1411–3(d)(2)(ii)(C)(*1*) provides rules similar to proposed §1.1411–3(d)(2)(ii)(B) for gains that are higher for section 1411 purposes than they are for chapter 1 purposes. The difference between the rule for gains in proposed §§1.1411–3(d)(2)(ii)(C)(*1*) and 1.1411–3(d)(2)(ii)(B) is that proposed §1.1411–3(d)(2)(ii)(C)(*1*) requires this additional gain to be allocated within the Capital Gain Category before any allocation within the Ordinary Income Category. The Treasury Department and the IRS believe this difference more accurately reflects the nature of the net investment income within the section 664 category and class system because this NII Inclusion Amount is attributable to a transaction that generated capital gain or loss (rather than ordinary income inclusions and dividends attributable to proposed §1.1411–3(d)(2)(ii)(B) items).

Proposed §1.1411–3(d)(2)(ii)(C)(*2*) provides rules similar to proposed §1.1411–3(d)(2)(ii)(C)(*1*) for losses (and gains that are lower for section 1411 purposes than they are for chapter 1), but with a different ordering rule. In these cases, the tax basis is higher for section 1411 (generating a smaller gain or larger loss for 1411 purposes). However, unlike dividends and gains addressed in proposed §§1.1411–3(d)(2)(ii)(B) and 1.1411–3(d)(2)(ii)(C)(*1*), respectively, which can require an increase in MAGI (or AGI for an estate or trust), losses are accompanied by a reduction in MAGI (or AGI for an estate or trust) under §1.1411–10(e). Therefore, proposed §1.1411–3(d)(2)(ii)(C)(*2*) generally follows the ordering rule for gains with one exception. The loss ordering rule in proposed §1.1411–3(d)(2)(ii)(C)(*2*) begins with allocating the decrease to the Other Income Category that was created or increased in the current or previous year, presumably due to an allocation under §1.1411–3(d)(2)(ii)(B). The purpose of the different ordering rule is to eliminate the ANII within Other Income Category first in an effort to reduce the incidence of required MAGI (or AGI for an estate or trust) adjustments by the beneficiary. Once this income is eliminated, the CRT or beneficiary will not have to separately account for a MAGI (or AGI for an estate or trust) increase because the timing differences caused by §1.1411–10 may have been corrected within the 664 class and category system before such income is distributed to the beneficiary.

8. *Simplified Method for Charitable Remainder Trusts*

The 2012 Proposed Regulations provided a method for the CRT to track net investment income received after December 31, 2012, and later distributed to the beneficiary. Section 1.1411–3(c)(2)(i) of the 2012 Proposed Regulations provided that distributions from a CRT to a beneficiary for a taxable year consist of net investment income in an amount equal to the lesser of the total amount of the distributions for that year, or the current and accumulated net investment income of the CRT.

As discussed in part 4.C of the preamble to the 2013 Final Regulations, multiple commentators asked that the final regulations follow the existing rules under section 664 that create subclasses in each category of income as the tax rates on certain types of income are changed from time to time. However, some of the commentators suggested that the final regulations allow the trustee to elect between the method described in the 2012 Proposed Regulations and the existing rules under section 664.

These proposed regulations provide CRTs with a choice of methods. Section 1.1411–3(d)(2) of the 2013 Final Regulations, along with the proposed additions in these proposed regulations, provide guidance on the application of the section 664 method of tracking net investment income. Proposed §1.1411–3(d)(3) allows the CRT to elect to use the simplified method included in the 2012 Proposed Regulations, with one modification. Proposed §1.1411–3(d)(3)(ii) provides that a CRT that elects to use the simplified method is not limited by the general excess deduction rule in §1.1411–4(f)(1)(ii). Section 1.1411–4(f)(1)(ii) provides that section 1411(c)(1)(B) deductions in excess of gross income and net gain described in section 1411(c)(1)(A) are not taken into account in determining net investment income in any other taxable year, except as allowed under chapter 1. In the case of CRTs, for chapter 1 purposes, the section 664(d) regulations allow for losses within each income class to be carried forward to offset income earned by the CRT within the same class in a future year. Therefore, this provision of the simplified method retains the chapter 1 principle that a CRT's losses are carried forward and offset income in future years. For example, if a CRT has a long-term capital loss of $10,000 in year 1 and a $11,000 long-term capital gain in year 2, the section 664(d) regulations provide that the CRT will have $1,000 of long-term gain available for distribution in year 2. Proposed §1.1411–3(d)(3)(ii) is intended to provide the same result such that the CRT would have $1,000 of accumulated net investment income available for distribution in year 2.

In the case of a CRT established after December 31, 2012, the CRT's election must be made on its income tax return for the taxable year in which the CRT is established. In the case of a CRT established before January 1, 2013, the CRT's election must be made on its income tax return for its first taxable year beginning on or after January 1, 2013. Additionally, the CRT may make the election on an amended return for that year only if neither the taxable year for which the election is made, nor any taxable year that is affected by the election, for both the CRT and its beneficiaries, is closed by the period of limitations on assessments under section 6501. Once made, the election is irrevocable.

If, after consideration of all comments received in response to these proposed regulations, it appears that there is no significant interest among taxpayers in having the option of using the simplified method, the Treasury Department and the IRS may omit this election from the regulations when finalized.

9. *Calculation of Gain or Loss Attributable to the Disposition of Certain Interests in Partnerships and S Corporations*

Section 1411(c)(4)(A) provides that, in the case of a disposition of an interest in a partnership or of stock in an S corporation (either, a "*Passthrough Entity*"), gain from the disposition shall be taken into account under section 1411(c)(1)(A)(iii) only to the extent of the net gain which would be taken into account by the transferor if the Passthrough Entity sold all of its property for fair market value immediately before the disposition of the interest. Section 1411(c)(4)(B) provides a similar rule for losses from dispositions.

The 2012 Proposed Regulations required that a transferor of a partnership interest or S corporation stock first compute its gain (or loss) from the disposition of the interest in the Passthrough Entity to which section 1411(c)(4) may apply, and then reduce that gain (or loss) by the amount of non-passive gain (or loss) that would have been allocated to the transferor upon a hypothetical sale of all of the Passthrough Entity's assets for fair market value immediately before the transfer. The Treasury Department and the IRS received several comments questioning this approach based on the commentators' reading of section 1411(c)(4) to include gain/loss from the disposition of a partnership interest or S corporation stock *only to the extent of* the transferor's share of gain/loss from the Passthrough Entity's passive assets.

The 2013 Final Regulations do not provide rules regarding the calculation of net gain from the disposition of an interest in a Passthrough Entity to which section 1411(c)(4) may apply. After considering the comments received, the Treasury Department and the IRS have withdrawn the 2012 Proposed Regulations implementing section 1411(c)(4) and are issuing this notice of proposed rulemaking to propose revised rules for the implementation of section 1411(c)(4) adopting the commentators' suggestion. Accordingly, the 2013 Final Regulations reserve on this issue.

Proposed §1.1411–7(b) provides a calculation to determine how much of the gain or loss that is recognized for chapter 1 purposes is attributable to property owned, directly or indirectly, by the Passthrough Entity that, if sold, would give rise to net gain within the meaning of section 1411(c)(1)(A)(iii) ("*Section 1411 Property*"). Section 1411 Property is any property owned by, or held through, the Passthrough Entity that, if sold, would result in net gain or loss allocable to the partner or shareholder that is includable in determining the partner or shareholder's net investment income under §1.1411–4(a)(1)(iii). This definition recognizes that the items of property inside the Passthrough Entity that constitute Section 1411 Property might vary among transferors because a transferor may or may not be "passive" with respect to the property.

Proposed §1.1411–7(c) provides an optional simplified reporting method that qualified transferors may use in lieu of the calculation described in proposed §1.1411–7(b). Proposed §1.1411–7(d) contains additional rules that apply when a transferor disposes of its interest in the Passthrough Entity in a deferred recognition transaction to which section 1411 applies. Proposed §1.1411–7(f) provides rules for adjusting the amount of gain or loss computed under this paragraph for transferors subject to basis adjustments required by §1.1411–10(d). Proposed §1.1411–7(g) provides rules for information disclosures by a Passthrough Entity to transferors and for information reporting by individuals, trusts, and estates.

A. *Applicability of section 1411(c)(4)*

In the case of an individual, trust, or estate, the proposed regulations provide that section 1411(c)(4) applies to "*Section 1411(c)(4) Dispositions*." A Section 1411(c)(4) Disposition is the disposition of an interest in a Passthrough Entity by an individual, estate, or trust if: (i) the Passthrough Entity is engaged in one or more trades or businesses, or owns an interest (directly or indirectly) in another Passthrough Entity that is engaged in one or more trades or businesses, other than the business of trading in financial instruments or commodities (within the meaning of §1.1411–5(a)(2)); and (ii) one or more of the trades or businesses of the Passthrough Entity is not a passive activity (within the meaning of §1.1411–5(a)(1)) of the transferor. Thus, if the transferor materially participates in one or more of the Passthrough Entity's trades or businesses (other than a trade or business of trading in financial instruments or commodities), then the transferor must use section 1411(c)(4) to calculate how much of the chapter 1 gain or loss from the disposition to include under section 1411(c)(1)(A)(iii). Section 1411(c)(4) only applies to dispositions of equity interests in partnerships and stock in S corporations, and does not apply to gain or loss recognized on, for example, indebtedness owed to the taxpayer by a partnership or S corporation.

Proposed §1.1411–7(a)(3) also addresses dispositions by Passthrough Entities of interests in lower-tier Passthrough Entities (a "*Subsidiary Passthrough Entity*"). Proposed §1.1411–7(a)(3)(ii) provides a "look through rule" that treats a partner or shareholder as owning a proportionate share of any Subsidiary Passthrough Entity, as if the partner or shareholder owned the interest directly. Thus, each partner of the upper-tier Passthrough Entity must determine whether the disposition of the Subsidiary Passthrough Entity is a Section 1411(c)(4) Disposition based on whether the disposition would qualify as a Section 1411(c)(4) Disposition if that owner owned its interest in the Subsidiary Passthrough Entity directly.

The Treasury Department and the IRS anticipate that taxpayers who dispose of an interest in a partial recognition transaction or partial disposition transaction will apply the principles of this section by including a pro rata amount of gain or loss from the Passthrough Entity's Section 1411 Property. In addition, the Treasury Department and the IRS believe that the application of section 1411(c)(4) to gain or loss on distributions from a Passthrough Entity is adequately addressed in section 469, which is incorporated into section 1411(c)(4) through the general definition of passive activity contained in section 1411(c)(2)(A). Thus, the proposed regulations do not include special rules on partial recognition, partial disposition, and distribution transactions. However, the Treasury Department and the IRS request comments on whether additional rules on these topics are required.

B. *Definitions and special rules*

Proposed §1.1411–7(a)(2) contains certain definitions and special rules that are unique to determining gain or loss under section 1411(c)(4) and apply only for purposes of proposed §1.1411–7.

i. Definitions

Proposed §1.1411–7 refers to partnerships or S corporations collectively as "Passthrough Entities" and the disposition of an interest in one of these entities is referred to as a "Section 1411(c)(4) Disposition." The purpose of section 1411(c)(4) is to allow gain attributable to non-passive activities to be excluded from the calculation of section 1411 tax upon the disposition of an interest in a Passthrough Entity. To accomplish this, section 1411(c)(4)(A) provides that gain from the disposition of an interest in a Passthrough Entity shall be taken into account in computing net investment income only to the extent of the amount of gain the transferor would have included under section 1411(c)(1)(A)(iii) if the Passthrough Entity sold all of its assets immediately before the Section 1411(c)(4) Disposition. The proposed regulations refer to the property that would generate gain for inclusion in section 1411(c)(1)(A)(iii) as "Section 1411 Property."

ii. Rules for Certain Liquidations

Proposed §1.1411–7(a)(4)(i) provides that if a fully taxable disposition of the Passthrough Entity's assets is followed by the 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. Thus, no additional gain or loss is included in net investment income under §1.1411–4(a)(1)(iii) on the subsequent liquidation of the Passthrough Entity by any transferor provided that the transferor would have satisfied proposed §1.1411–7(a)(3) prior to the sale. The proposed regulations also state that, when an S corporation makes a section 336(e) or section 338(h)(10) election on the sale of its stock, the transaction will be treated under section 1411 as a fully taxable asset sale by the Passthrough Entity followed by a liquidation of the entity. Thus, no additional gain or loss is included in net investment income on the subsequent liquidation of the S corporation stock, provided a section 336(e) or section 338(h)(10) election is in effect.

iii. Rules for S Corporation Shareholders

Proposed §1.1411–7(a)(4) provides two special rules for S corporation shareholders. First, proposed §1.1411–7(a)(4)(ii) provides that the Passthrough Entity will be considered an S corporation for purposes of section 1411 and proposed §1.1411–7 even though §1.1362–3(a) treats the day of the transfer as the first date of the Passthrough Entity's C corporation short year (as defined therein). Second, proposed §1.1411–7(a)(4)(iii) provides that the calculation under proposed §1.1411–7(b) does not take into account any adjustment resulting from the hypothetical imposition of tax under section 1374 as a result of the proposed §1.1411–7(b) deemed sale. This provision was also included in the 2012 Proposed Regulations. See also part 9.H of this preamble for a discussion of the application of section 1411(c)(4) to Qualified Subchapter S Trusts.

C. *Calculation of gain or loss includable in net investment income*

i. Primary Method — Proposed §1.1411–7(b)

Proposed §1.1411–7(b) provides the calculation for determining the amount of the transferor's gain or loss under section

1411(c)(1)(A)(iii) from the disposition of an interest in a Passthrough Entity. For dispositions resulting in chapter 1 gain, the transferor's gain equals the lesser of: (i) the amount of gain the transferor recognizes for chapter 1 purposes, or (ii) the transferor's allocable share of net gain from a deemed sale of the Passthrough Entity's Section 1411 Property (in other words, property which, if sold, would give rise to gain or loss that is includable in determining the transferor's net investment income under §1.1411–4(a)(1)(iii)). The proposed regulations contain a similar rule when a transferor recognizes a loss for chapter 1 purposes.

The 2012 Proposed Regulations required that a transferor of an interest in a Passthrough Entity in which the transferor materially participated value each asset held by the Passthrough Entity to determine the total amount of gain or loss to include under section 1411(c)(4). Commentators indicated that this valuation requirement imposed undue administrative burdens on the transferor. The Treasury Department and the IRS acknowledge that for transferors of certain active interests in Passthrough Entities this property-by-property valuation requirement could be burdensome. Accordingly, these proposed regulations instead direct the transferor to rely on the valuation requirements under §1.469–2T(e)(3), which the materially participating transferor should already be applying for purposes of chapter 1. These valuation requirements allow the transferor to compute gain or loss activity-by-activity.

Section 1.469–2T(e)(3) addresses dispositions of partnership interests and S corporation stock in the context of the passive activity loss rules for purposes of chapter 1. Section 1.469–2T(e)(3) provides guidance on allocating disposition gains or losses among the activities of the entity. These rules require the taxpayer to determine the overall gain or loss from each activity (regardless of whether or not the taxpayer materially participates in the activity). For this purpose, §1.469–2T(e)(3)(ii)(B)(*1*)(*i*) requires the taxpayer to compute for each activity "the amount of net gain. . . that would have been allocated to the holder of such interest with respect thereto if the passthrough entity had sold its entire interest in such activity for its fair market value on the applicable valuation date." Section 1.469–2T(e)(3)(ii)(B)(*2*)(*i*) contains a corollary rule for dispositions at a loss.

Thus, the proposed regulations require a materially participating transferor to calculate its section 1411(c)(4) gain or loss by reference to the activity gain and loss amounts computed for chapter 1 purposes under §§1.469–2T(e)(3)(ii)(B)(*1*)(*i*) and (e)(3)(ii)(B)(*2*)(*i*). Specifically for purposes of section 1411, the transferor's allocable share of gain or loss from a deemed sale of the Passthrough Entity's Section 1411 Property equals the sum of the transferor's allocable shares of net gains and net losses (as determined under the section 469 principles described above) from a hypothetical deemed sale of the activities in which the transferor does not materially participate.

Because section 1411(c)(4) applies to all activities in which a transferor in a Section 1411(c)(4) Disposition does not materially participate (whether held at a gain or a loss), certain provisions under 469 do not apply for purposes of these rules. Proposed §1.1411–7(b)(1)(i)(B) and (b)(1)(ii)(B) both apply §1.469–2T(e)(3) without the recharacterization rule of §1.469–2T(e)(3)(iii) because the recharacterization rule in §1.469–2T(e)(3)(iii) is intended to recharacterize gains in certain circumstances as not being from a passive activity, and is thus not relevant in the context of section 1411.

The Treasury Department and the IRS request comments on other possible methods that would implement section 1411(c)(4) for dispositions described in proposed §1.1411–7(a)(3)(i) (individuals, estates, and trusts) and proposed §1.1411–7(a)(3)(ii) (tiered Passthrough Entity structures) in a manner consistent with the statute while reducing the administrative burden to the transferor and the Passthrough Entity.

ii. Optional Simplified Reporting Method – Proposed §1.1411–7(c)

The proposed regulations also allow certain transferors to apply an optional simplified method in proposed §1.1411–7(c) for calculating gain or loss for purposes of §1.1411–4(a)(1)(iii). The Treasury Department and the IRS believe a simplified method is warranted when the amount of gain associated with passive assets owned by the Passthrough Entity is likely to be relatively small. To use the optional simplified reporting method, the transferor must meet certain qualifications under proposed §1.1411–7(c)(2) and not be otherwise excluded under proposed §1.1411–7(c)(3). Use of this simplified method is not mandatory for qualifying transferors. However, as discussed in part 10.G of this preamble, the Passthrough Entity may not be required under proposed §1.1411–7(g) to provide (but is not precluded from providing) a transferor who qualifies to use the simplified method with information that the transferor would need to report under the primary method described in proposed §1.1411–7(g).

The simplified reporting method is intended to limit the information sharing burden on Passthrough Entities by allowing transferors to rely on readily available information to calculate the amount of gain or loss included in net investment income under section 1411(c)(4). For this purpose, the optional simplified method relies on historic distributive share amounts received by the transferor from the Passthrough Entity to extrapolate a percentage of the assets within the Passthrough Entity that are passive with respect to the transferor for purposes of section 1411(c)(4). For example, if ten percent of the income reported on the applicable Schedules K-1 is of a type that would be included in net investment income, then the simplified reporting method presumes that ten percent of the chapter 1 gain on the disposition of the transferor's interest relates to Section 1411 Property of the Passthrough Entity for purposes of section 1411(c)(4).

a. Qualifications

To qualify for the optional simplified reporting method, a transferor in a Section 1411(c)(4) Disposition must meet at least one of two requirements. A transferor satisfies the first requirement if: (i) the sum of the transferor's allocable share during the "*Section 1411 Holding Period*" (as defined in the following paragraph, but generally the year of the disposition and the preceding two years) of separately stated items of income, gain, loss, and deduction (with any separately stated loss and deduction items included as positive numbers) of a type that the transferor would take into account in calculating net investment income is five percent or less of the sum of all separately stated items of income, gain, loss, and deduction (with any separately stated loss and deduction items included as positive numbers) allocated to the transferor during the Section 1411 Holding Period, and (ii) the gain recognized under chapter 1 by the transferor from the disposition of the Passthrough Entity is $5 million or less (including gains from multiple dispositions as part of a plan). A transferor satisfies the second alternative requirement if the gain recognized under chapter 1 by the transferor from the disposition of the Passthrough Entity is $250,000 or less (including gains from multiple dispositions as part of a plan). All dispositions of interests in the Passthrough Entity that occur during the transferor's taxable year will be presumed to be part of a plan.

Section 1411 Holding Period is defined to mean 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. Where the transferor acquires its interest from another Passthrough Entity in a nonrecognition transaction during the year of disposition or the prior two taxable years, the transferor must include in its Section 1411 Holding Period the period that the previous owner or owners held the interest. Also, where the transferor transferred an interest in a Subsidiary Passthrough Entity to a Passthrough Entity in a nonrecognition transaction during the year of the disposition or the prior two taxable years, the transferor must include in its Section 1411 Holding Period that period that it held the interest in the Subsidiary Passthrough Entity.

b. Nonavailability of optional simplified reporting method

Proposed §1.1411–7(c)(4) provides certain exceptions for situations in which a transferor is ineligible to use the optional simplified reporting method. These exceptions include situations in which the transferor's historical distributive share amounts are less likely to reflect the gain in the Passthrough Entity's Section 1411 Property on the date of the transferor's disposition. The proposed regulations provide five exceptions for this purpose: (i) transferors that have held the interest for less than 12 months, (ii) certain contributions and distributions during the Section 1411 Holding Period, (iii) Passthrough Entities that have significantly modified the composition of their assets, (iv) S corporations that have recently converted from C corporations, and (v) partial dispositions.

The first exception requires that the transferor has held directly the interest in the Passthrough Entity (or held the interest indirectly in the case of a Subsidiary Passthrough Entity) for the twelve-month period preceding the Section 1411(c)(4) Disposition.

The second exception provides that a transferor is ineligible to use the optional simplified reporting method if the transferor transferred Section 1411 Property (other than cash or cash equivalents) to the Passthrough Entity, or received a distribution of property (other than Section 1411 property) from the Passthrough Entity, as part of a plan that includes the transfer of the interest in the Passthrough Entity. A transferor who contributes, directly or indirectly, Section 1411 Property (other than cash or cash equivalents) within 120 days of the disposition of the interest in the Passthrough Entity is presumed to have made the contribution as part of a plan that includes the transfer of the interest in the Passthrough Entity.

The third exception focuses on changes to the composition of the Passthrough Entity's assets during the Section 1411 Holding Period. Under this exception, the transferor is ineligible to use the optional simplified reporting method if the transferor knows or has reason to know that the percentage of the Passthrough Entity's gross assets that consists of Section 1411 Property (other than cash or cash equivalents) has increased or decreased by 25 percentage points or more during the transferor's Section 1411 Holding Period due to contributions, distributions, or asset acquisitions or dispositions in taxable or nonrecognition transactions.

The fourth exception provides that the optional simplified reporting method is not available if the Passthrough Entity was a C corporation during the Section 1411 Holding Period, and elected under section 1361 during that period to be taxed as an S corporation.

The final exception provides that a transferor partner cannot use the optional simplified reporting method if the transferor transfers only a partial interest that does not represent a proportionate share of all of the partner's economic rights in the partnership. For example, a partner who transfers a preferred interest in a partnership while retaining a common interest in that partnership cannot use the optional simplified reporting method.

iii. Request for Comments

The Treasury Department and the IRS request comments on the proposed section 1411(c)(4) calculation and on the optional simplified reporting method, including recommendations for other simplified means of calculating the gain or loss under section 1411(c)(4). The Treasury Department and the IRS also request comments regarding all aspects of the provisions relating to eligibility for the simplified method, including whether the 25 percentage point threshold for changes in the asset composition of a Passthrough Entity is appropriate.

D. *Tiered passthrough dispositions*

The Treasury Department and the IRS have reserved proposed §1.1411–7(e) to further consider a simplified method for determining the section 1411(c)(4) gain resulting from the disposition by a Passthrough Entity of an interest in a Subsidiary Passthrough Entity as illustrated by the following example: A holds an interest in UTP, a Passthrough Entity that owns a 50-percent interest in LTP, a Subsidiary Passthrough Entity that is a real estate development company. A is a real estate developer and elected to group his real estate activities under §1.469–9. When UTP sells its interest in LTP, any gain from the sale of that interest allocable to A through UTP may qualify under proposed §1.1411–7(a)(2). However, A lacks access to the books of LTP that would allow A to compute its section 1411(c)(4) inclusion under the general rule of proposed §1.1411–7(b). Additionally, A receives insufficient information from UTP to allow A to determine whether A qualifies to apply the Optional Simplified Reporting Method of proposed §1.1411–7(c) or to undertake that computation. The Treasury Department and the IRS request comments regarding a simplified method for determining the section 1411(c)(4) gain resulting in such cases, including a detailed technical analysis with examples.

E. *Deferred recognition transactions*

To address the application of proposed §1.1411–7 to deferred recognition transactions, such as installment sales and certain private annuities, the proposed regulations provide that the calculations under proposed §§1.1411–7(b)(1), 1.1411–7(c)(2) and 1.1411–7(c)(4) (as applicable) are performed in the year of disposition as though the entire gain was recognized and taken into account in that year. For this purpose, it is assumed that any contingencies potentially affecting consideration to the transferor that are reasonably expected to occur will occur, and in the case of annuities based on the life expectancy of one or more individuals, the present value of the annuity (using existing Federal tax valuation methods) is used to determine the estimated gain. This approach allows the transferor to determine its section 1411 inclusion for each future installment. If under this approach no gain or loss from the disposition would be included in net investment income, then the transferor excludes each payment received from the deferred recognition transaction from net investment income. If under this approach only a portion of the chapter 1 gain on the disposition would be included in net investment income, then the difference between the gain recognized for chapter 1 purposes and the gain recognized for section 1411 purposes is considered an addition to basis, and after taking those basis adjustments into account, gain amounts are included in net investment income under §1.1411–4(a)(1)(iii) as payments are received in accordance with the existing rules for installment sales or private annuities.

F. *Adjustment to gain or loss due to section 1411 basis differences*

In addition to the calculation of gain or loss included in net investment income by reason of section 1411(c)(4) and proposed §1.1411–7, proposed §1.1411–7(f)(2) adjusts the gain or loss to take into account any disparities in the transferor's interest in the Passthrough Entity as a result of §1.1411–10(d) (relating to certain income from controlled foreign corporations and passive foreign investment companies where no §1.1411–10(g) election is made). These adjustments apply after applying the calculations set forth in paragraphs (b) through (e) of proposed §1.1411–7. Because the proposed §1.1411–7(f)(2) adjustments operate independently of the rules in paragraphs (b) through (e) of proposed §1.1411–7, they may result in gain for section 1411 purposes that exceeds chapter 1 gain (or a loss that exceeds the chapter 1 loss), or may result in a section 1411 loss when the transferor recognizes a chapter 1 gain (or vice versa).

G. *Information reporting*

Several commentators to the 2012 Proposed Regulations requested revisions to the proposed information reporting requirements. Other commentators expressed concern that 2012 Proposed Regulations lacked provisions to compel a Passthrough Entity to provide the transferor with information required to comply with the 2012 Proposed Regulations §1.1411–7. In response, these proposed regulations simplify the information reporting requirements for transferors of interests in Passthrough Entities and impose information reporting requirements on certain Passthrough Entities to ensure that the transferor has sufficient information to comply with the computational requirements of proposed §1.1411–7.

i. Information Reporting by the Passthrough Entity

To compute the amount of gain or loss under proposed §1.1411–7(b), the transferors that compute section 1411(c)(4) gain or loss under the primary computation method of proposed §1.1411–7(b) must generally obtain from the Passthrough Entity the transferor's allocable share of the net gain or loss from the deemed sale of the Passthrough Entity's Section 1411 Property. However, the proposed regulations only require the Passthrough Entity to provide this information to transferors that are ineligible for the optional simplified reporting method in proposed §1.1411–7(c).

If a transferor qualifies to use the optional simplified reporting method in proposed §1.1411–7(c), but prefers to determine net gain or loss under proposed §1.1411–7(b), then the transferor must negotiate with the Passthrough Entity the terms under which the information will be supplied.

ii. Information Reporting by the Seller

Any transferor applying proposed §1.1411–7, including in reliance on the proposed regulations, must attach a statement to the transferor's income tax return for the year of disposition. That statement must include: (1) the taxpayer's name and taxpayer identification number; (2) the name and taxpayer identification number of the Passthrough Entity in which the interest was transferred; (3) the amount of the transferor's gain or loss on the disposition of the interest under chapter 1; and (4) the amount of adjustment to gain or loss by reason of basis differences for chapter 1 and section 1411 purposes. The transferor must also attach a copy of any information provided by the Passthrough Entity to the transferor relating to the transferor's allocable share of gain or loss from the deemed sale of the Passthrough Entity's Section 1411 Property.

H. *Qualified subchapter S trusts (QSSTs)*

The preamble to the 2012 Proposed Regulations requested comments on whether special coordination rules are necessary to address dispositions of stock in an S corporation held by a QSST. Specifically, the request for comments deals with the application of section 1411(c)(4) to the existing QSST stock disposition mechanics in §1.1361–1(j)(8).

In general, if an income beneficiary of a trust that meets the QSST requirements under section 1361(d)(3) makes a QSST election, the income beneficiary is treated as the section 678 owner with respect to the S corporation stock held by the trust. Section 1.1361–1(j)(8), however, provides that the trust, rather than the income beneficiary, is treated as the owner of the S corporation stock in determining the income tax consequences of the disposition of the stock by the QSST. Section 1361(d)(1)(C) and the last sentence of §1.1361–1(j)(8) provide that, solely for purposes of applying sections 465 and 469 to the income beneficiary, a disposition of S corporation stock by a QSST is treated as a disposition by the income beneficiary. However, in this special case, the QSST beneficiary, for chapter 1 purposes, does not have any passive activity gain from the disposition. Therefore, the entire suspended loss (to the extent not allowed by reason of the beneficiary's other passive net income in the disposition year) is a section 469(g)(1) loss, and is considered a loss from a nonpassive activity.

For purposes of section 1411, the inclusion of the operating income or loss of an S corporation in the beneficiary's net investment income is determined in a manner consistent with the treatment of a QSST beneficiary in chapter 1 (as explained in the preceding paragraph), which includes the determination of whether the S corporation is a passive activity of the beneficiary under section 469. However, because gain or loss resulting from the sale of S corporation stock by the QSST will be reported by the QSST and taxed to the trust by reason of §1.1361–1(j)(8), it is not clear whether the beneficiary's section 469 status with respect to the S corporation is attributed to the trust.

One commentator recommended that the disposition of S corporation stock by a QSST should be treated as a disposition of the stock by the income beneficiary for purposes of determining material participation for purposes of section 1411. In addition, the commentator recommended that the final regulations confirm that the special rule stated in the last sentence of §1.1361–1(j)(8) applies for purposes of section 1411 as it does for section 469 and 465.

After consideration of the comments, these proposed regulations provide that, in the case of a QSST, the application of section 1411(c)(4) is made at the trust level. This treatment is consistent with the chapter 1 treatment of the QSST by reason of §1.1361–1(j)(8). However, these proposed regulations do not provide any special computational rules for QSSTs within the context of section 1411(c)(4) for two reasons. First, the treatment of the stock sale as passive or nonpassive income is determined under section 469, which involves the issue of whether there is material participation by the trust. As discussed in part 4.F of the preamble to the 2013 Final Regulations, the Treasury Department and the IRS believe that the issue of material participation by estates and trusts, including QSSTs, is more appropriately addressed under section 469.

Additionally, one commentator noted that the IRS has addressed the treatment of certain asset sales as the functional equivalent of stock sales for purposes of §1.1361–1(j)(8) in a limited number of private letter rulings. In these cases, the private letter rulings held that gain from the sale of assets, which was followed by a liquidation, would be taxed at the trust level under §1.1361–1(j)(8) rather than being taxed at the beneficiary level. The commentator recommended that an asset sale followed by a liquidation, within the context of §1.1361–1(j)(8), should have a similar result under section 1411(c)(4). Similar to the issue of material participation by QSSTs discussed in the preceding paragraph, the Treasury Department and the IRS believe that the issue of whether an asset sale (deemed or actual) is the equivalent of a stock sale for purpose of the QSST rules should be addressed under the §1.1361–1(j) QSST regulations, rather than in §1.1411–7. However, the Treasury Department and the IRS believe that proposed §1.1411–7(a)(4)(i), which provides that asset sales followed by a liquidation is a disposition of S corporation stock for purposes of section 1411(c)(4), address the commentator's QSST issue.

Second, with respect to the section 1411 treatment of the disposition by the beneficiary by reason of section 1361(d)(1)(C) and the last sentence of §1.1361–1(j)(8), the Treasury Department and the IRS believe that the general administrative principles enumerated in §1.1411–1(a), when combined with the general treatment of section 469(g) losses within §1.1411–4, provide an adequate framework for the treatment of QSSTs beneficiaries without the need for a special computational rule within §1.1411–7.

Proposed Applicability Date

These regulations are proposed to apply for taxable years beginning after December 31, 2013, except that §1.1411–3(d)(3) is proposed to apply to taxable years beginning after December 31, 2012.

Special Analyses

It has been determined that this notice of proposed rulemaking is not a significant regulatory action as defined in Executive Order 12866, as supplemented by Executive Order 13563. Therefore, a regulatory assessment is not required. It also has been determined that section 553(b) of the Administrative Procedure Act (5 U.S.C. chapter 5) does not apply to the proposed regulations. Pursuant to the Regulatory Flexibility Act (RFA) (5 U.S.C. chapter 6), it is hereby certified that the proposed regulations will not have a significant economic impact on a substantial number of small entities. The applicability of the proposed regulations are limited to individuals, estates, and trusts, that are not small entities as defined by the RFA (5 U.S.C. 601). Accordingly, the RFA does not apply. Therefore, a regulatory flexibility analysis is not required. Pursuant to section 7805(f) of the Code, the proposed regulations have been submitted to the Chief Counsel for Advocacy of the Small Business Administration for comment on its impact on small business.

Comments and Requests for a Public Hearing

Before these proposed regulations are adopted as final regulations, consideration will be given to any comments that are submitted timely to the IRS as prescribed in this preamble under the "Addresses" heading. The Treasury Department and the IRS specifically request comments on all aspects of the proposed rules. All comments will be available at *www.regulations.gov* or upon request. A public hearing will be scheduled if requested in writing by any person that timely submits written comments. If a public hearing is scheduled, notice of the date, time, and place for the public hearing will be published in the **Federal Register**.

Drafting Information

The principal authors of the proposed regulations are David H. Kirk and Adrienne M. Mikolashek, IRS Office of the Associate Chief Counsel (Passthroughs and Special Industries). However, other personnel from the Treasury Department and the IRS participated in their development.

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Partial Withdrawal of Notice of Proposed Rulemaking

Accordingly, under the authority of 26 U.S.C. 7805, §1.1411–7 of the notice of proposed rulemaking (REG–130507–11) that was published in the **Federal Regis-**

ter on December 5, 2012 (77 FR 72612) is withdrawn.

Proposed Amendments to the Regulations

Accordingly, 26 CFR part 1 is proposed to be amended as follows:

PART 1—INCOME TAXES

Paragraph 1. The authority citation for part 1 continues to read in part as follows:

Authority: 26 U.S.C. 7805 * * *

Par. 2. Section 1.1411–0 is amended by:

1. Revising the entries under §1.1411–3 for paragraphs (d)(2)(ii), (d)(3) and adding entries (d)(3)(i) through (iii).
2. Revising the entries under §1.1411–4 for paragraphs (d)(4)(iii), (e)(3), and (g)(10) through (13).
3. Adding entries to §1.1411–7.

The revisions and additions to read as follows:

§1.1411–0 Table of contents.

* * * * *

§1.1411–3 Application to estates and trusts.

* * * * *

(d) * * *

(2) * * *

(ii) Special rules for CRTs with income from certain CFCs or PFICs.

(3) Elective simplified method.

(i) Treatment of annuity or unitrust distributions.

(ii) Properly allocable deductions in excess of gross income.

(iii) Procedural requirements for making election.

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§1.1411–4 Definition of net investment income.

* * * * *

(d) * * *

(4) * * *

(iii) Adjustment for capital loss carryforwards for previously excluded income

* * * *

(e) * * *

(3) Treatment of income from common trust funds.

* * * * *

(g) * * *

(10) Treatment of section 707(c) guaranteed payments.

(11) Treatment of section 736 payments.

(i) In general.

(ii) Treatment of section 736(a)(1) payments.

(A) General rule.

(B) Examples.

(iii) Treatment of section 736(a)(2) payments.

(A) Payments for unrealized receivables and goodwill.

(B) Payments not for unrealized receivables or goodwill.

(iv) Treatment of section 736(b) payments.

(v) Application of section 1411(c)(4) to section 736 payments.

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

(i) In general.

(ii) Notional principal contracts.

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

* * * * *

§1.1411–7 Exception for dispositions of certain active interests in partnerships and S corporations

(a) In general.

(1) General application.

(2) Definitions.

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

(i) Transfers by individuals, estates, and trusts.

(ii) Transfers by passthrough entities.

(4) Special rules.

(i) Certain liquidations.

(ii) Excluded gain or loss.

(iii) Rules applicable to S corporation shareholders.

(A) Certain S corporation dispositions.

(B) S corporations subject to section 1374.

(C) Treatment of Qualified Subchapter S Trusts (QSSTs).

(b) Calculation.

(1) In general.

(i) Gain on disposition of interest.

(ii) Loss on disposition of interest.

(2) Examples.

(c) Optional simplified reporting.

(1) In general.

(2) Qualifications.

(i) Minimal section 1411 property.

(ii) Minimal gain or loss.

(3) Nonapplicability.

(4) Optional simplified reporting calculation.

(5) Examples.

(d) Deferred recognition transactions.

(e) Disposition of tiered Passthrough Entities. [Reserved]

(f) Adjustment to net gain or loss.

(g) Information reporting.

(1) Information to be provided by passthrough entity to transferor.

(2) Information reporting by transferors.

(h) Effective/applicability date.

Par 3. Section 1.1411–3 is amended by:

1. Revising paragraph (d)(2)(ii).
2. Revising paragraph (d)(2)(iii) by adding *Example 2* through *Example 5*.
3. Revising paragraph (d)(3).
4. Revising paragraph (f).

The revisions and additions read as follows:

§1.1411–3 Application to estates and trusts.

* * * * *

(d) * * *

(2) * * *

(ii) *Special rules for CRTs with income from certain CFCs or PFICs*. If a CRT is a trust described in §1.1411–10(a), and the CRT includes an amount in gross income under section 951(a) or section 1293(a) from a CFC or QEF that is not also income derived from a trade or business described in section 1411(c)(2) and §1.1411–5 (except as provided in §1.1411–10(b)(2)) and an election under §1.1411–10(g) is not in effect with respect to the CFC or QEF, or the CRT is treated as receiving an excess distribution within the meaning of section 1291(b) or recognizing gain treated as an excess distribution under section 1291(a)(2), then the following rules apply for purposes of section 1411 with regard to income derived from the CFC, QEF, or PFIC—

(A) Amounts included in gross income for chapter 1 purposes under section 951(a) or section 1293(a) in a calendar year with respect to the CFC or QEF, and in one or more categories described in

§1.664–1(d)(1) are considered excluded income in that calendar year;

(B) For the year in which the CRT is treated as receiving any of the items of net investment income described in paragraphs (c)(1)(i), (c)(1)(ii), (c)(2)(i), and (c)(4) of §1.1411–10 that otherwise are not included in gross income for purposes of chapter 1 for that year ("*NII Inclusion Amount*") with respect to the CFC, QEF, or PFIC, the rules of this paragraph (d)(2)(ii)(B) apply; and

(*1*) For purposes of determining the character under section 664 of a distribution to the unitrust or annuity recipient of a CRT, the NII Inclusion Amount treated as received by the CRT shall be allocated among the categories described in section 664(b)(1) through (b)(3), and among the classes within each category as described in §1.664–1(d)(1), in the manner described in this paragraph (d)(2)(ii)(B). Specifically, to the extent the CRT has amounts of excluded income in the categories described in section 664(b)(1) (the Ordinary Income Category) or section 664(b)(2) (the Capital Gain Category), the NII Inclusion Amount shall be allocated to the CRT's classes of excluded income in the Ordinary Income Category, and then to the classes of excluded income in the Capital Gain Category, in turn, until exhaustion of each such class, beginning with the class of excluded income within a category with the highest Federal income tax rate.

(*2*) Any remaining NII Inclusion Amount not so allocated to classes within the Ordinary Income and Capital Gain Categories shall be placed in the category described in section 664(b)(3) (the Other Income Category). To the extent the CRT distributes amounts from this Other Income Category, that distribution shall constitute a distribution described in §1.1411–10(c)(4).

(*3*) A distribution by the CRT of excluded income first is deemed to carry out net investment income to the extent of the NII Inclusion Amount that has been allocated to excluded income in that class.

(*4*) As a result, a distribution of excluded income will carry out to the unitrust or annuity recipient net investment income attributable to the items described in this paragraph (d)(2)(ii)(B).

(C) In the case of a difference between the amount calculated with respect to a disposition under paragraph (c)(2)(iii) or (c)(2)(iv) of §1.1411–10 and the amount attributable to the relevant disposition for purposes of chapter 1, the following rules apply—

(*1*) If the amount of the gain from the disposition for purposes of section 1411 is higher (or the loss smaller) than the amount of the gain (or loss) calculated for purposes of chapter 1, such difference shall be considered an NII Inclusion Amount and shall be allocated as described in paragraph (d)(2)(ii)(B) of this section. However, in applying paragraph (d)(2)(ii)(B) of this section to this increase, the order of the classes and categories to which the allocation is made shall be changed as follows: the increase shall be allocated first to the class in the Capital Gain Category that reflects the nature of the increase (short-term or long-term), then to other classes in that category, in turn until exhausted, then to the classes in the Ordinary Income Category, and finally to the Other Income Category.

(*2*) If the amount of the gain from the disposition for purposes of section 1411 is smaller (or the loss higher) than the amount of the gain (or loss) calculated for purposes of chapter 1, such difference shall reduce accumulated net investment income in the CRT's categories and their respective classes as follows—

(*i*) To the extent that the CRT has amounts in the Other Income Category by reason of the application of paragraph (d)(2)(ii)(B) or (d)(2)(ii)(C)(*1*) of this section for the current or prior years, to the Other Income Category; and

(*ii*) Any excess difference in the same order as specified in paragraph (d)(2)(ii)(C)(*1*) of this section.

(iii) * * *

Example 2. (i) In 2010, A creates a net income with makeup CRT (NIMCRUT). A is the sole income beneficiary of the NIMCRUT for 15 years. As of December 31, 2012, the NIMCRUT had $2,000 of dividend income and $180,000 of long-term capital gain within the Ordinary Income and Capital Gain Categories, respectively. Because both of these amounts were received by the NIMCRUT during a taxable year beginning before 2013, both constitute excluded income within the meaning of §1.1411-1(d). In Year 1, the NIMCRUT acquires an interest in a CFC. The NIMCRUT does not make the §1.1411–10(g) election with respect to the CFC. In Year 1, the NIMCRUT receives a section 951(a) inclusion of $5,000 and makes no distributions to A. For all years, income derived with respect to the CFC is not income derived in a trade or business described in section 1411(c)(2) and §1.1411–5.

(ii) In Year 1, §1.1411–3(d)(2)(ii)(A) treats the section 951 inclusion as excluded income and allocates it to the class of non-NII with a 39.6% tax rate in the Ordinary Income Category under §1.664–1(d)(1).

Year 1 ending Category and Class Balances

Category	*Class*	*Excluded / NII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest and Other Income (including section 951 Inclusions)	Excluded	39.6%	$5,000
	Qualified Dividends	Excluded	20.0%	$2,000
Capital Gain				
	Long-Term	NII	23.8%	$ 0
	Long-Term	Excluded	20.0%	$180,000
Other Income				None

(iii) The NIMCRUT makes no distributions to its sole income beneficiary in Year 2. In Year 3, the CFC distributes $4,000 to the NIMCRUT (which constitutes net investment income under §1.1411–10(c)(1)(i)), the NIMCRUT has a total of $800 of post-2012 interest, and the NIMCRUT distributes $4,000 to the beneficiary.

Category and Class Balances immediately before both the CFC distribution and the NIMCRUT's Year 3 distribution to A				
Category	*Class*	*Excluded / NII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest (post-2012)	NII	43.4%	$800
	Interest and Other Income (including section 951 Inclusions)	Excluded	39.6%	$5,000
	Qualified Dividends	Excluded	20.0%	$2,000
Capital Gain				
	Long-Term	NII	23.8%	$ 0
	Long-Term	Excluded	20.0%	$180,000
Other Income				None

Section 1.1411–3(d)(2)(ii)(B) will cause the $4,000 distribution from the CFC to be allocated first to the class of excluded income within the Ordinary Income Category with the highest Federal tax rate (the Interest and Other Income class). The distribution to A consists of $800 of post-2012 interest (subject to section 1411) and $3,200 from the Interest and Other Income class, of which all $3,200 constitutes NII by reason of the allocation under §1.1411–3(d)(2)(ii)(B). Of the $1,800 remaining in that category after the distribution to A, $800 will carry out NII to A, and will be includable in A's net investment income, when it is distributed to A in the future. Because the $3,200 distributed to A from this class is subject to both income tax and tax under section 1411 for Year 3, the timing differential attributable to the rules in §1.1411–10 has been corrected within the NIMCRUT before the income is distributed to A.

Year 3 ending Category and Class Balances (immediately following the distribution to A)				
Category	*Class*	*Excluded / NII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest (post-2012)	NII	43.4%	$0
	Interest & Other Income (including section 951 Inclusions)	Excluded	39.6%	$1,800*
	Qualified Dividends	Excluded	20.0%	$2,000
Capital Gain				
	Long-Term	NII	23.8%	$0
	Long-Term	Excluded	20.0%	$180,000
Other Income				None
		*Of which $800 will carry out NII to A when distributed		

Example 3. (i) Assume the same facts as in *Example 2*, except that, in Year 2, the NIMCRUT has a section 951 inclusion in the amount of $4,000, taxable interest income of $800, tax exempt interest of $4,000. Assume the CRT has $1,100 undistributed capital gain from a taxable year ending before December 31, 2012.

Category and Class Balances immediately before the Year 2 distribution to A				
Category	*Class*	*Excluded / NII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest (post-2012)	NII	43.4%	$800
	Interest and Other Income (including section 951 Inclusions)	Excluded	39.6%	$9,000
	Qualified Dividends	Excluded	20.0%	$2,000
Capital Gain				
	Long-Term	NII	23.8%	$ 0
	Long-Term	Excluded	20.0%	$1,100
Other Income		Excluded		$4,000

(ii) In Year 2, the NIMCRUT made a $4,800 distribution to A in that same year (leaving a net balance in the Interest and Other Income class of $5,000 at the end of Year 2).

Category and Class Balances as of December 31, Year 2 (immediately following the distribution to A)				
Category	*Class*	*Excluded / NII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest (post-2012)	NII	43.4%	$0
	Interest and Other Income (including section 951 Inclusions)	Excluded	39.6%	$5,000
	Qualified Dividends	Excluded	20.0%	$2,000
Capital Gain				
	Long-Term	NII	23.8%	$0
	Long-Term	Excluded	20.0%	$1,100
Other Income		Excluded		$4,000

A's net investment income in Year 2 will include $800 of taxable interest income, but will not include the $4,000 of other ordinary income.

(iii) In Year 3, the NIMCRUT received a distribution from the CFC of $9,000, and assume, for purposes of this example, that the NIMCRUT distributes $6,000 to A. Section 1.1411–3(d)(2)(ii)(B) will cause the $9,000 distribution from the CFC to be allocated first to the class of excluded income within the Ordinary Income Category with the highest Federal tax rate (thus, $5,000 to the Other Income class and $2,000 to Qualified Dividends). The $2,000 balance of the Year 3 distribution from the CFC is allocated under §1.1411–3(d)(2)(ii)(B) as follows: $1,100 to the Long-Term Capital Gain class of non-NII (so the distribution to A from this class in the future will carry out $1,100 of NII to A), and the remaining $900 to the Other Income Category (so the distribution to A from this class in the future will carry out $900 of NII to A).

The distribution to A consists of $5,000 of Interest and Other Income class and $1,000 of Qualified Dividends, all of which constitutes NII by reason of the allocation under §1.1411–3(d)(2)(ii)(B).

Category and Class Balances as of December 31, Year 3 (immediately following the distribution to A)				
Category	*Class*	*Excluded / NII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest (post-2012)	NII	43.4%	$0
	Interest & Other Income (section 951 inclusion)	Excluded	39.6%	$0
	Qualified Dividends	Excluded	20.0%	$1,000*
Capital Gain				
	Long-Term	NII	23.8%	$0
	Long-Term	Excluded	20.0%	$1,100*
Other Income		NII	3.8%	$900
Other Income		Excluded	0.0%	$3,100

*All of which will carry out NII to A when distributed in the future

A's net investment income in Year 3 will include $5,000 of other ordinary income and $1,000 of qualified dividend income.

Example 4. (i) Same facts as in *Example 2*, except that the NIMCRUT distributes $7,000 to A in Year 2. This distribution consists of the section 951 inclusion and the accumulated qualified dividends.

(ii) In Year 2, the NIMCRUT will report $5,000 of ordinary income and $2,000 of qualified dividends to A. Both amounts will constitute excluded income to A. In this case, A does not have to adjust MAGI because the section 951 inclusion is treated in the same way as any other type of excluded income within the Ordinary Income Category.

Year 2 ending Category and Class Balances (immediately following the distribution to A)				
Category	*Class*	*Excluded / NII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest and Other Income (including section 951 Inclusions)	Excluded	39.6%	$0
	Qualified Dividends	Excluded	20.0%	$0
Capital Gain				
	Long-Term	NII	23.8%	$0
	Long-Term	Excluded	20.0%	$180,000
Other Income				None

(iii) When the CFC distributes $4,000 to the NIMCRUT in Year 3, §1.1411–3(d)(2)(ii)(B)(*1*) requires the NIMCRUT to allocate that $4,000 to the NIMCRUT's accumulated balance of long-term capital gains recognized by the NIMCRUT prior to December 31, 2012, so that the first $4,000 of the NIMCRUT's long-term capital gains distributed to A in the future will carry out NII to A.

Category and Class Balances immediately before the Year 3 distribution to A				
Category	*Class*	*Excluded / NII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest and Other Income (including section 951 Inclusions)	Excluded	39.6%	$0
	Qualified Dividends	Excluded	20.0%	$0
Capital Gain				
	Long-Term	Excluded	20.0%	$180,000*
Other Income				None
		*Of which $4,000 will carry out NII to A when distributed in the future		

When the NIMCRUT distributes the $4,000 to A in the future, the NIMCRUT will report $4,000 of long-term capital gain to A that also constitutes net investment income. No MAGI adjustments associated with that distribution will be required by A.

Year 3 ending Category and Class Balances (immediately following the distribution to A)				
Category	*Class*	*Excluded / NII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest and Other Income (including section 951 Inclusions)	Excluded	39.6%	$0
	Qualified Dividends	Excluded	20.0%	$0
Capital Gain				
	Long-Term	Excluded	20.0%	$176,000
Other Income				None

Example 5. (i) Same facts as in *Example 4*, except that the NIMCRUT's entire balance of accumulated long-term capital gain was received after 2012 and thus is ANII.

(ii) When the CFC distributes $4,000 to the NIMCRUT in Year 3, §1.1411–3(d)(2)(ii)(B)(*1*) requires the NIMCRUT to allocate that $4,000 to excluded income within the Ordinary Income or Capital Gain Categories. In this case, the NIMCRUT does not have any excluded income remaining within those categories. As a result, §1.1411–3(d)(2)(ii)(B)(*2*) requires the excess portion of the CFC distribution not allocable to excluded income in the Ordinary Income or Capital Gain Categories ($4,000 in this case) to be allocated to the Other Income Category.

Category and Class Balances immediately before the Year 3 distribution to A				
Category	*Class*	*Excluded / NII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest and Other Income (including section 951 Inclusions)	Excluded	39.6%	$0
	Qualified Dividends	Excluded	20.0%	$0
Capital Gain				
	Long-Term	NII	23.8%	$180,000
	Long-Term	Excluded	20.0%	$0
Other Income		NII	3.8%	$4,000

When the NIMCRUT distributes the $4,000 to A, the NIMCRUT will report $4,000 of long-term capital gains to A that also constitute net investment income. No MAGI adjustments associated with the distribution are required by A.

Year 3 ending Category and Class Balances (immediately following the distribution to A)				
Category	*Class*	*Excluded / NII*	*Tax Rate*	*Amount*
Ordinary Income				
	Interest and Other Income (including section 951 Inclusions)	Excluded	39.6%	$0
	Qualified Dividends	Excluded	20.0%	$0
Capital Gain				
	Long-Term	NII	23.8%	$176,000
	Long-Term	Excluded	20.0%	$0
Other Income		NII	3.8%	$4,000

After the NIMCRUT distributes all income within the Ordinary and Capital Gain categories, the NIMCRUT will distribute the $4,000 of Other Income to A. Such income will have a zero percent tax rate for chapter 1 purposes but will constitute net investment income. In this case, §1.1411–3(d)(2)(ii)(B)(*2*) provides that the future distribution will be considered a distribution of net investment income from a trust within the meaning of §1.1411–10(c)(4). As a result, §1.1411–10(e) requires A to increase MAGI for the year of that distribution.

(3) *Elective simplified method*—(i) *Treatment of annuity or unitrust distributions*. If a CRT makes a valid election under this paragraph (d)(3), the rules of paragraph (d)(2) of this section shall not apply, and the net investment income of the beneficiary attributable to the beneficiary's annuity or unitrust distribution from the CRT shall include an amount equal to the lesser of—

(A) The beneficiary's share of the total amount of the distributions for that year; or

(B) The beneficiary's same share of the accumulated net investment income (as defined in paragraph (d)(1)(iii) of this section) of the CRT.

(ii) *Properly allocable deductions in excess of gross income*. In computing the amount described in paragraph (d)(3)(i)(B) of this section, notwithstanding §1.1411–4(f)(1)(ii) (limitations on deductions in excess of income), if in a taxable year a CRT's properly allocable deductions described in section 1411(c)(1)(B) and the regulations thereunder exceed the gross investment income and net gain described in section 1411(c)(1)(A) and the regulations thereunder, then such excess deductions shall reduce the amount described in paragraph (d)(3)(i)(B) of this section for that taxable year and, to the extent of any remaining excess deductions, for subsequent taxable years of the CRT.

(iii) *Procedural requirements for making election*. In the case of a CRT established after December 31, 2012, a CRT wanting to make the election under paragraph (d)(3) of this section must do so on its income tax return for the taxable year in which the CRT is established. In the case of a CRT established before January 1, 2013, the CRT wanting to make the election under paragraph (d)(3) of this section must do so on the return for its first taxable year beginning on or after January 1, 2013. Once made, the election is irrevocable. In lieu of the relief provisions under §301.9100–3, the CRT may make the election on an amended return for that year only if the taxable year for which the election is made, and all taxable years that are affected by the election, for both the CRT and its beneficiaries, are not closed by the period of limitations on assessments under section 6501.

* * * * *

(f) *Effective/applicability date*. This section applies to taxable years beginning after December 31, 2013, except that paragraphs (d)(1), (d)(2)(i), *Example 1* of (d)(2)(iii), and (d)(3) of this section applies to taxable years of CRTs that begin after December 31, 2012. However, taxpayers may apply this section to taxable years beginning after December 31, 2012, in accordance with §1.1411–1(f).

* * * * *

Par 4. Section 1.1411–4 is amended by revising paragraphs (d)(4)(iii), (e)(3), and (g)(10) through (13) to read as follows:

§1.1411–4 Definition of net investment income.

* * * * *

(d) * * *

(4) * * *

(iii) *Adjustment for capital loss carryforwards for previously excluded income*—(A) *General rule*. For purposes of calculating net gain in paragraph (d) of this section (and any allowable loss described in paragraph (f)(4) of this section, if applicable), capital losses are reduced by the lesser of—

(*1*) The amount of capital loss taken into account in the current year by reason of section 1212(b)(1); or

(*2*) The amount of net capital loss excluded from net investment income in the preceding year by reason of paragraph (d)(4) of this section.

(B) *Example*. The following example illustrates the provisions of this paragraph (d)(4)(iii). For purposes of this example, 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. (i)(A) In Year 1, A, an unmarried individual, disposes of 100 shares of publicly traded stock for a short-term capital gain of $4,000. In addition, A disposes of a partnership interest and recognizes a long-term capital loss of $19,000. Assume that the entire amount of $19,000 loss is not allowed against net investment income pursuant to section 1411(c)(4)(B), §1.1411–7, and paragraph (d)(4)(ii) of this section. A has no capital loss carryovers from the year preceding Year 1.

(B) For purposes of chapter 1, A reports net capital loss of $15,000, of which $3,000 is allowed as a deduction in computing taxable income under section 1211(b)(1), and the remaining $12,000 is carried forward into Year 2 as a long-term capital loss pursuant to section 1212(b)(1).

(C) For purposes of calculating net investment income, A reports $4,000 of net gain. The $19,000 loss taken into account in computing A's taxable income in Year 1 is not taken into account in computing net gain. Therefore, there are no losses in excess of gains in Year 1 for which a deduction is allowed under paragraph (f)(4) of this section.

(ii)(A) In Year 2, A has no capital gain or loss transactions.

(B) For purposes of chapter 1, A reports net capital loss of $12,000, of which $3,000 is allowed as a deduction in computing taxable income under section 1211(b)(1), and the remaining $9,000 is carried forward into Year 3 as a long-term capital loss pursuant to section 1212(b)(1).

(C) For purposes of calculating net investment income, A must adjust the $12,000 capital loss carryover from Year 1 pursuant to paragraph (d)(4)(iii) of this section. The amount of the adjustment is the lesser of—

(*1*) The amount of capital loss taken into account in the current year by reason of section 1212(b)(1) ($12,000), or

(*2*) The amount of net capital loss excluded from net investment income in Year 1 by reason of paragraph (d)(4) of this section ($19,000). The $19,000 loss was the amount disallowed by reason of paragraph (d)(4)(ii) of this section, and there were no other adjustments under paragraphs (d)(4)(i) or (d)(4)(iii) of this section in Year 1.

(D) The amount of capital loss carryover that is taken into account by A in computing net investment income in Year 2 is $0 ($12,000 carryover amount less the adjustment of $12,000). Accordingly, when calculating net investment income, A has no losses in excess of gains, and no deduction is available to A under paragraph (f)(4) of this section.

(iii)(A) In Year 3, A recognizes a $5,000 short-term capital gain from the disposition of property described in paragraph (d)(4)(i) of this section, and a $1,000 short-term capital loss from the disposition of publicly traded stock.

(B) For purposes of chapter 1, A reports net capital loss carryover from Year 2 of $9,000. In addition, the short-term capital gain of $5,000 and $1,000 short-term capital loss net to produce $4,000 of short-term capital gain. A reports a net capital loss of $5,000 ($5,000 - $1,000 - $9,000), of which $3,000 is allowed as a deduction in computing taxable income under section 1211(b)(1), and the remaining $2,000 is carried forward into Year 4 as a long-term capital loss pursuant to section 1212(b)(1).

(C) For purposes of calculating net investment income, A may exclude the $5,000 capital gain from the calculation of net gain pursuant to paragraph (d)(4)(i) of this section. In addition, A must adjust the $9,000 capital loss carryover from Year 2 pursuant to paragraph (d)(4)(iii) of this section. The amount of the adjustment is the lesser of—

(*1*) The amount of capital loss taken into account in the current year by reason of section 1212(b)(1) ($9,000); or

(*2*) The amount of net capital loss excluded from net investment income in Year 2 by reason of paragraph (d)(4) of this section ($12,000). The $12,000 loss was the amount disallowed by reason of paragraph (d)(4)(iii) of this section, and there were no other adjustments under paragraphs (d)(4)(i) or (d)(4)(ii) of this section in Year 2.

(D) The amount of capital loss carryover that is taken into account by A in computing net investment income in Year 3 is $0 ($9,000 carryover amount less the adjustment of $9,000). Accordingly, when calculating net investment income, A excludes $5,000 of gain under paragraph (d)(4)(i) of this section and the $9,000 capital loss carryover under paragraph (d)(4)(iii) of this section. The amount of losses taken into account for purposes of computing net gain is $1,000 (attributable to the $1,000 short-term capital loss from the disposition of publicly traded stock). Pursuant to paragraph (f)(4) of this section, A is entitled to a deduction of $1,000 because the $1,000 capital loss exceeds the gains, and the loss is less than the amount of allowable loss for chapter 1 purposes ($3,000).

(iv)(A) In Year 4, A recognizes a $8,000 long-term capital loss on the disposition of raw land to which paragraph (d)(4)(i) of this section does not apply.

(B) For purposes of chapter 1, A reports net capital loss carryover from Year 3 of $2,000. The $8,000 long-term capital loss is added to the $2,000 capital loss carryforward to produce a $10,000 long-term capital loss, of which $3,000 is allowed as a deduction in computing taxable income under section 1211(b)(1), and the remaining $7,000 is carried forward into Year 5 as a long-term capital loss pursuant to section 1212(b)(1).

(C) For purposes of calculating net investment income, A takes into account the $8,000 capital loss from the sale of the land. In addition, A must adjust the $2,000 capital loss carryover from Year 3 pursuant to paragraph (d)(4)(iii) of this section. The amount of the adjustment is the lesser of—

(*1*) The amount of capital loss taken into account in the current year by reason of section 1212(b)(1) ($2,000); or

(*2*) The amount of net capital loss excluded from net investment income in Year 3 by reason of paragraph (d)(4) of this section ($4,000). The $4,000 loss is the sum of the $5,000 gain disallowed by reason of paragraph (d)(4)(i) of this section and the $9,000 loss disallowed by reason of paragraph (d)(4)(iii) of this section, and there were no other adjustments under paragraph (d)(4)(ii) of this section in Year 3.

(D) The amount of capital loss carryover that is taken into account by A in computing net investment income in Year 3 is $0 ($2,000 carryover amount less the adjustment of $2,000). The amount of losses taken into account for purposes of computing net gain is $8,000 (attributable to the $8,000 capital loss from the disposition of raw land). Pursuant to paragraph (f)(4) of this section, A is entitled to a deduction of $3,000 because the $8,000 capital loss exceeds the gains, and only $3,000 of the loss is allowable for chapter 1 purposes under section 1211(b)(1).

(v)(A) In Year 5, A has no capital gain or loss transactions.

(B) For purposes of chapter 1, A reports net capital loss carryover from Year 4 of $7,000: $3,000 is allowed as a deduction in computing taxable income under section 1211(b)(1), and the remaining $4,000 is carried forward into Year 6 as a long-term capital loss pursuant to section 1212(b)(1).

(C) For purposes of calculating net investment income, A must adjust the $7,000 capital loss carryover from Year 4 pursuant to paragraph (d)(4)(iii) of this section. The amount of the adjustment is the lesser of—

(*1*) The amount of capital loss taken into account in the current year by reason of section 1212(b)(1) ($7,000); or

(*2*) The amount of net capital loss excluded from net investment income in Year 4 by reason of paragraph (d)(4) of this section ($2,000). The $2,000 loss was the amount disallowed by reason of paragraph (d)(4)(iii) of this section, and there were no other adjustments under paragraphs (d)(4)(i) or (d)(4)(ii) of this section in Year 4.

(D) The amount of capital loss carryover that is taken into account by A in computing net investment income in Year 5 is $5,000 ($7,000 carryover amount less the adjustment of $2,000). The amount of losses taken into account for purposes of computing net gain is $5,000 carried over from Year 4. Pursuant to paragraph (f)(4) of this section, A is entitled to a deduction of $3,000 because the $5,000 capital loss exceeds the gains, and only $3,000 of the loss is allowable for chapter 1 purposes under section 1211(b)(1).

(vi)(A) In Year 6, A has no capital gain or loss transactions.

(B) For purposes of chapter 1, A reports net capital loss carryover from Year 5 of $4,000: $3,000 is allowed as a deduction in computing taxable income under section 1211(b)(1), and the remaining $1,000 is carried forward into Year 7 as a long-term capital loss pursuant to section 1212(b)(1).

(C) For purposes of calculating net investment income, A must adjust the $4,000 capital loss carryover from Year 5 pursuant to paragraph (d)(4)(iii) of this section. The amount of the adjustment is the lesser of—

(*1*) The amount of capital loss taken into account in the current year by reason of section 1212(b)(1) ($4,000); or

(*2*) The amount of net capital loss excluded from net investment income in Year 5 by reason of paragraph (d)(4) of this section ($2,000). The $2,000 loss was the amount disallowed by reason of paragraph (d)(4)(iii) of this section, and there were no other adjustments under paragraphs (d)(4)(i) or (d)(4)(ii) of this section in Year 5.

(D) The amount of capital loss carryover that is taken into account by A in computing net investment income in Year 6 is $2,000 ($4,000 carryover amount less the adjustment of $2,000). The amount of losses taken into account for purposes of computing net gain is $2,000 carried over from Year 5. Pursuant to paragraph (f)(4) of this section, A is entitled to a deduction of $2,000 because the $2,000 capital loss exceeds the gains, and the loss is less than the amount of allowable loss for chapter 1 purposes ($3,000). As a result, the entire $8,000 loss from the raw land has been taken into account in computing A's net investment income ($3,000 in Years 4 and 5, and $2,000 in Year 6).

(vii)(A) In Year 7, A has no capital gain or loss transactions.

(B) For purposes of chapter 1, A reports net capital loss carryover from Year 6 of $1,000. The entire $1,000 is allowed as a deduction in computing taxable income under section 1211(b)(1). A has no capital losses to carry over to Year 8.

(C) For purposes of calculating net investment income, A must adjust the $1,000 capital loss carryover from Year 6 pursuant to paragraph (d)(4)(iii) of this section. The amount of the adjustment is the lesser of—

(*1*) The amount of capital loss taken into account in the current year by reason of section 1212(b)(1) ($1,000); or

(*2*) The amount of net capital loss excluded from net investment income in Year 6 by reason of paragraph (d)(4) of this section ($2,000). The $2,000 loss was the amount disallowed by reason of paragraph (d)(4)(iii) of this section, and there were no other adjustments under paragraphs (d)(4)(i) or (d)(4)(ii) of this section in Year 6.

(D) The amount of capital loss carryover that is taken into account by A in computing net investment income in Year 6 is $0 ($1,000 carryover amount less the adjustment of $1,000). Therefore, when calculating net investment income, A has no losses in excess of gains, and no deduction is available to A under paragraph (f)(4) of this section.

(e) * * *

(3) *Treatment of income from common trust funds*. If a taxpayer is a participant in a common trust fund and the taxpayer includes under section 584 any item of income, deduction, gain, or loss, then section 1411 and the regulations thereunder apply to that item to the same extent as if the participant had made directly the investments of the common trust fund to which the items are attributable.

* * * * *

(g) * * *

(10) *Treatment of section 707(c) guaranteed payments*. Net investment income does not include section 707(c) payments received for services. Except to the extent provided in paragraph (g)(11)(iii)(A) of this section, section 707(c) payments received for the use of capital are net investment income within the meaning of section 1411(c)(1)(A)(i) and paragraph (a)(1)(i) of this section.

(11) *Treatment of section 736 payments*—(i) *In general*. The treatment of payments received by a retiring partner or a deceased partner's successor in interest described in section 736 is determined under the rules of this paragraph (g)(11). Section 736 payments are not distributions from a plan or arrangement described in section 1411(c)(5) and §1.1411–8. To the extent that any portion of a section 736 payment is taken into account in computing a taxpayer's net earnings from self-employment (within the meaning of §1.1411–9), then such amount is not taken into account in computing net investment income by reason of section 1411(c)(6) and §1.1411–9.

(ii) *Treatment of section 736(a)(1) payments*—(A) *General rule*. In the case of a payment described in section 736(a)(1) as a distributive share of partnership income, the items of income, gain, loss, and deduction attributable to such distributive share are taken into account in computing net investment income in section 1411(c) in a manner consistent with the item's character and treatment for chapter 1 purposes. See §1.469–2(e)(2)(iii) for rules concerning the item's character and treatment for chapter 1.

(B) *Examples*. The following examples illustrate the provisions of this paragraph (g)(11)(ii). 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. Distributive share for goodwill. (i) A retires from PRS, a business entity classified as a partnership for Federal income tax purposes, and is entitled, pursuant to the partnership agreement, to receive 10% of PRS's net income for 60 months commencing immediately following A's retirement in exchange for A's fair market value share of PRS's unrealized receivables. PRS is not engaged in a trade or business described in section 1411(c)(2)(B) (a trading business). A will provide no services to PRS for the 60-month period following A's retirement. Prior to A's retirement, A materially participated in PRS's trade or business within the meaning of §1.469–5T. As a result, PRS is characterized by A as a nonpassive activity for section 469 purposes. For purposes of section 1411, PRS was not a trade or business described in section 1411(c)(2)(A) prior to A's retirement.

(ii) In Year 3, pursuant to the partnership agreement, A received a cash payment of $20,000. A's distributive share of PRS income in Year 3 included $70,000 of gross income from operations and $50,000 of deductions from operations. PRS's status as a passive or nonpassive activity is determined under §1.469–2(e)(2)(iii) at the time the liquidation of A's partnership interest commenced, and remains fixed for the duration of A's liquidation payments. Therefore, PRS is a nonpassive activity with respect to A in Year 3 pursuant to §1.469–2(e)(2)(iii). As a result, the gross income is not attributable to a trade or business described in section 1411(c)(2)(A) or §1.1411–5(a)(1). Accordingly, A's distributive share of $70,000 of gross income and $50,000 of associated deductions are not includable in A's net investment income in Year 3.

(iii) If PRS's distributive share of operational income and deductions was attributable to a trade or business described in section 1411(c)(2)(B) or §1.1411–5(a)(2), the $70,000 of gross income amounts would be included in A's net investment income under section 1411(c)(1)(A)(ii) and paragraph (c) of this section and the $50,000 of associated deductions would be properly allocable to such income under section 1411(c)(1)(B) and §1.1411–4(f)(2)(ii).

Example 2. Excess distributive share payments. Assume the same facts as in *Example 1* except that PRS provides A an additional 2% of PRS's net income for 48 months commencing immediately following A's retirement as an incentive for A to retire earlier than planned. In the case of the additional 2% distributive share, the section 736(a) income characterization rule in §1.469–2(e)(2)(iii) does not apply because the payment exceeds the value of PRS's unrealized receivables (which was established to equal 10% of PRS's income for 60 months in *Example 1*). As a result, A must determine whether PRS is a trade of business described in section 1411(c)(2)(A) and §1.1411–5(a)(1) in Year 3 in order to determine whether the distributive share of operating income and deductions is includable in net investment income. If PRS is engaged in a trade or business described in section 1411(c)(2)(A) and §1.1411–5(a)(1) with respect to A in Year 3, then the distributive share will be taken into account in computing A's net investment income.

(iii) *Treatment of section 736(a)(2) payments*—(A) *Payments for unrealized receivables and goodwill*. In the case of a payment described in section 736(a)(2), the portion (if any) of the payment that is allocable to the unrealized receivables (within the meaning of section 751(c)) and goodwill of the partnership (as described and calculated in §1.469–2(e)(2)(iii)(B)) is included in net investment income under section 1411(c)(1)(A)(iii) and paragraphs (a)(1)(iii) and (d) of this section as gain from the disposition of a partnership interest.

(B) *Payments not for unrealized receivables or goodwill*. In the case of a section 736(a)(2) payment not described in paragraph (g)(11)(iii)(A) of this section, the payment is characterized as a payment for services or as the payment of interest in a manner consistent with the payment's characterization under §1.469–2(e)(2)(ii). See paragraph (g)(9) of this section.

(iv) *Treatment of section 736(b) payments*. Gain or loss attributable to section 736(b) payments is included in net investment income under section 1411(c)(1)(A)(iii) and paragraphs (a)(1)(iii) and (d) of this section as gain or loss from the disposition of a partnership interest. A taxpayer who elects under §1.736–1(b)(6) must apply the principles that are applied to installment sales in §1.1411–7(d).

(v) *Application of section 1411(c)(4) to section 736 payments*. Section 1411(c)(4) and §1.1411–7 apply to gain or loss attributable to section 736 payments described in paragraphs (g)(11)(iii)(A) and (g)(11)(iv) of this section. In the case of section 736 payments that are received in more than one taxable year, the rules for calculating gain or loss under section 1411(c)(4) and §1.1411–7 are applied at the time the liquidation of the partner's interest commenced. The principles that are applied to installment sales in §1.1411–7(d) also apply for purposes of this section.

(12) *Income and deductions from certain notional principal contracts*—(i) *In general*. Net income for a taxable year taken into account by a taxpayer under §1.446–3(d) that is attributable to a notional principal contract described in paragraph (g)(12)(ii) of this section is net investment income described in section 1411(c)(1)(A) and paragraph (a)(1) of this section. A net deduction for a taxable year taken into account by a taxpayer under §1.446–3(d) that is attributable to a notional principal contract described in paragraph (g)(12)(ii) of this section is a properly allocable deduction described in section 1411(c)(1)(B) and paragraph (f) of this section.

(ii) *Notional principal contracts*. For purposes of paragraph (g)(12)(i) of this section, a notional principal contract is any notional principal contract described in §1.446–3(c)(1) that is referenced to property (including an index) that produces (or would produce if the property were to produce income) interest, dividends, royalties, or rents if the property were held directly by the taxpayer. For purposes of the preceding sentence, an interest rate swap, cap, or floor is treated as a notional principal contract that is referenced to a debt instrument.

(13) *Treatment of income or loss from REMIC residual interests*. The daily portion of taxable income determined under section 860C(a)(2) taken into account in determining tax under chapter 1 by the holder of a residual interest in a REMIC and any inducement fee included in income under §1.446–6(a) are treated as net investment income under section 1411(c)(1)(A) and paragraph (a)(1) of this section. The daily portion of net loss determined under section 860C(a)(2) taken into account in determining tax under Chapter 1 by the holder of a residual interest in a REMIC is a properly allocable deduction described in section 1411(c)(1)(B) and paragraph (f) of this section.

* * * * *

Par. 5. Section 1.1411–7 is added to read as follows:

§1.1411–7 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.

(b) *Calculation*—(1) *In general*. A transferor of an interest in a Passthrough Entity who disposes of that interest in a Section 1411(c)(4) Disposition may use the simplified calculation in paragraph (c) of this section if it meets the eligibility requirements set forth in paragraph (c)(2) of this section. Any other transferor who disposes of an interest in a Passthrough Entity in a Section 1411(c)(4) Disposition must include gain or loss under §1.1411–4(a)(1)(iii) determined in accordance with this paragraph (b).

(i) *Gain on disposition of interest*. If the transferor recognized a gain from the disposition, the amount of the net gain included in §1.1411–4(a)(1)(iii) is the lesser of—

(A) the transferor's gain on the disposition of the interest in the Passthrough Entity as determined in accordance with chapter 1; or

(B) the transferor's allocable share of the chapter 1 net gain from a deemed sale of the Passthrough Entity's Section 1411 Property as determined using the principles of §1.469–2T(e)(3) (allocation of gain or loss to activities of the Passthrough Entity) where the net gain is the sum of the amounts of net gain and net loss allocable to the transferor as determined under §§1.469–2T(e)(3)(ii)(B)(*1*)(*i*) and 1.469–2T(e)(3)(ii)(B)(*2*)(*i*) that would constitute income to the transferor for purposes of section 1411 if sold by the Passthrough Entity. The general rules of §1.469–2T(e)(3) apply in calculating the transferor's allocable share of the net gain under this section; however, the gain recharacterization rule of §1.469–2T(e)(3)(iii) shall not apply in any case. The calculation of net gain in this paragraph (b)(1)(i) shall not be less than zero.

(ii) *Loss on disposition of interest*. If the transferor recognizes a loss from the disposition, the amount of the net loss included in §1.1411–4(a)(1)(iii) is the lesser of—

(A) The transferor's loss (expressed as a positive number) on the disposition of the interest in the Passthrough Entity as determined in accordance with chapter 1; or

(B) The transferor's allocable share of the chapter 1 net loss (expressed as a positive number) from the deemed sale of the entity's Section 1411 Property as determined in accordance with §1.469–2T(e)(3) (allocation of gain or loss to activities of the Passthrough Entity) where the net loss is the sum of the amounts of net gain and net loss allocable to the transferor as determined under §§1.469–2T(e)(3)(ii)(B)(*1*)(*i*) and 1.469–2T(e)(3)(ii)(B)(*2*)(*i*) that would constitute income or loss to the transferor for purposes of section 1411 if sold by the Passthrough Entity. The general rules of §1.469–2T(e)(3) apply in calculating the transferor's allocable share of the net gain under this section; however, the gain recharacterization rule of §1.469–2T(e)(3)(iii) shall not apply in any case. The calculation of net gain in this paragraph (b)(1)(ii) shall not be less than zero. For purposes of this paragraph (b)(1)(ii), the loss limitation provisions imposed by sections 704(d) and 1366(d) shall not apply.

(2) *Examples*. The following examples illustrate the principles of paragraph (b)(1) of this section. 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. (i) *Facts*. A owns a one-half interest in P, a calendar year partnership. In Year 1, A sells its interest for $200,000. A's adjusted basis for the interest sold is $120,000. Thus, A recognizes $80,000 of gain from the sale (chapter 1 gain). P is engaged in three trade or business activities, X, Y, and Z, none of which are §1.1411–5(a)(2) (trading in financial instruments or commodities) trades or businesses. P also owns marketable securities. For Year 1, A materially participates in activity Z, thus it is not a §1.1411–5(a)(1) (passive activity) trade or business of A. A, however, does not materially participate in activities X and Y, so these activities are §1.1411–5(a)(1) trades or businesses of A. Because P is engaged in at least one trade or business and at least one of those trades or businesses is not passive to the transferor A, A determines its amount of §1.1411–4(a)(1)(iii) gain or loss from net investment income under §1.1411–7. Assume for purposes of this example, A is not eligible to compute its §1.1411–4(a)(1)(iii) gain or loss under the optional simplified reporting method discussed in paragraph (c) of this section. The fair market value and adjusted basis of the gross assets used in P's activities are as follows:

	Adjusted basis	Fair market value	Gain/Loss	A's Share Gain/Loss
X (Passive as to A)	$136,000	$96,000	($40,000)	($20,000)
Y (Passive as to A)	60,000	124,000	64,000	32,000
Z (Non-passive as to A)	40,000	160,000	120,000	60,000
Marketable securities	4,000	20,000	16,000	8,000
Total	240,000	400,000	160,000	80,000

(ii) *Analysis*. Under paragraph (b)(1) of this section, A must determine the portion of gain or loss from the sale of P's Section 1411 Property allocable to A. Under paragraph (b)(1)(ii) of this section, A's allocable share of gain from P's Section 1411 Property is $20,000 (($20,000) from X + $32,000 from Y + $8,000 from the marketable securities). Because the $20,000 allocable to A from a deemed sale of P's Section 1411 Property is less than A's $80,000 chapter 1 gain, A will include $20,000 under §1.1411–4(a)(1)(iii).

Example 2. Assume the same facts as *Example 1*, but A materially participates in activities Y and Z and does not materially participate in activity X. Under paragraph (b)(1)(i) of this section, A's allocable share of P's Section 1411 Property is ($12,000) (($20,000) from X + $8,000 from the marketable securities). Because A sold its interest for a chapter 1 gain, the amount allocable to A from a deemed sale of P's Section 1411 Property cannot be less than zero. Accordingly, A includes no gain or loss under §1.1411–4(a)(1)(iii).

(c) *Optional simplified reporting*—(1) *In general*. A transferor of an interest in a Passthrough Entity in a Section 1411(c)(4) Disposition may use the simplified reporting rules of paragraph (c)(4) of this section if it satisfies the eligibility requirements set forth in paragraph (c)(2) of this section and is not described in paragraph (c)(3) of this section. All other transferors of interests in Passthrough Entities in Section 1411(c)(4) Dispositions must use the calculation set forth in paragraph (b) of this section. Paragraph (d) of this section contains additional rules for Section 1411(c)(4) Dispositions in deferred recognition transactions.

(2) *Qualifications*. Unless described in paragraph (c)(3) of this section, a transferor of an interest in a Passthrough Entity in a Section 1411(c)(4) Disposition may determine the amount of net gain or net loss that is taken into account under §1.1411–4(a)(1)(iii) in accordance with paragraph (c)(4) of this section if either or both of the requirements in paragraph (c)(2)(i) or (c)(2)(ii) of this section are satisfied:

(i) *Five percent threshold*. The sum of separately stated income, gain, loss, and deduction items (with any separately stated loss and deduction items included as positive numbers) of a type the transferor would take into account in calculating net investment income (as defined in §1.1411–1(d)) that are allocated to the transferor in respect of the transferred interest is five percent or less of the sum of all separately stated items of income, gain, loss, and deduction (with any separately stated loss and deduction items included as positive numbers) allocated to the transferor in respect of the transferred interest during the Section 1411 Holding Period, and the total amount of chapter 1 gain or loss recognized by the transferor from the disposition of interests in the Passthrough Entity does not exceed $5 million (including gains or losses from multiple dispositions as part of a plan). All dispositions of interests in the Passthrough Entity that occur during the taxable year will be presumed to be part of a plan. In calculating the percentage described in the first sentence of this paragraph (c)(2)(i), if the transferor acquired the transferred interest in a transaction described in paragraph (a)(2)(iii)(A) or (a)(2)(iii)(C) of this section, then items of income, gain, loss, or deduction allocated to the transferor include any such items allocated to the transferor's predecessor (or predecessors) in interest during the Section 1411 Holding Period. If the transferor transferred an interest in a Subsidiary Passthrough Entity to the Passthrough Entity in a transaction described in paragraph (a)(2)(iii)(B) of this section, then items of income, gain, loss or deduction allocated to the transferor include any items allocated to the transferor during the Section 1411 Holding Period in respect of the interest in the Subsidiary Passthrough Entity.

(ii) *$250,000 gain or loss threshold*. The total amount of chapter 1 gain or loss recognized by the transferor from the disposition of interests in the Passthrough Entity does not exceed $250,000 (including gains or losses from multiple dispositions as part of a plan). All dispositions of interests in the Passthrough Entity that occur during the taxable year will be presumed to be part of a plan.

(3) *Nonapplicability*. A transferor is not eligible to use the simplified reporting method of paragraph (c)(4) of this section if any of the following conditions are met:

(i) The transferor has held directly the interest in the Passthrough Entity (or held the interest indirectly in the case of a Subsidiary Passthrough Entity) for less than twelve months preceding the Section 1411(c)(4) Disposition.

(ii) The transferor transferred, directly or indirectly, Section 1411 Property (other than cash or cash equivalents) to the Passthrough Entity (or a Subsidiary Passthrough Entity described in paragraph (a)(2)(v) of this section), or received a distribution of property (other than Section 1411 property) from the Passthrough Entity (or a Subsidiary Passthrough Entity described in paragraph (a)(2)(v) of this section), during the Section 1411 Holding

Period as part of a plan that includes the transfer of the transferor's interest in the Passthrough Entity. A transferor who contributed, directly or indirectly, Section 1411 Property (other than cash or cash equivalents) within 120 days of the disposition of the interest in the Passthrough Entity is presumed to have made the contribution as part of a plan that includes the transfer of the interest in the Passthrough Entity.

(iii) The Passthrough Entity is a partnership, and the transferor transfers a partial interest that represents other than a proportionate share of all of the transferring partner's economic rights in the partnership.

(iv) The transferor knows or has reason to know that the percentage of the Passthrough Entity's gross assets that consist of Section 1411 Property has increased or decreased by 25 percentage points or more during the transferor's Section 1411 Holding Period due to contributions, distributions, or asset acquisitions or dispositions in taxable or nonrecognition transactions.

(v) The Passthrough Entity, which is the subject of the Section 1411(c)(4) Disposition, was taxable as a C corporation during the Section 1411 Holding Period, but during that period elects under section 1362 to be taxable as an S corporation under section 1361.

(4) *Optional simplified reporting calculation*. The amount of net gain or loss from the transferor's Section 1411(c)(4) Disposition that is includable in §1.1411–4(a)(1)(iii) is determined by multiplying the transferor's chapter 1 gain on the disposition by a fraction, the numerator of which is the sum of income, gain, loss, and deduction items (with any separately stated loss and deduction items netted as negative numbers) of a type that are taken into account in the calculation of net investment income (as defined in §1.1411–1(d)) that are allocated to the transferor during the Section 1411 Holding Period and the denominator of which is the sum of all items of income, gain, loss, and deduction allocated to the transferor during the Section 1411 Holding Period (with any separately stated loss and deduction items netted as negative numbers). If the quotient of the fraction is either greater than one or less than zero, then the fraction shall be one; provided, however, that if the numerator is a negative amount in connection with a computation of overall chapter 1 gain on the sale or a positive amount in connection with a computation of overall chapter 1 loss on the sale, then the fraction shall be zero. In calculating the fraction described in the first sentence of this paragraph (c)(4), if the transferor acquired the transferred interest in a transaction described in paragraph (a)(2)(iii)(A) or (C) of this section, then items of income, gain, loss, or deduction allocated to the transferor include any such items allocated to the transferor's predecessor (or predecessors) in interest during the Section 1411 Holding Period. If the transferor transferred an interest in a Subsidiary Passthrough Entity to the Passthrough Entity in a transaction described in paragraph (a)(2)(iii)(B) of this section, then items of income, gain, loss or deduction allocated to the transferor include any items allocated to the transferor during the Section 1411 Holding Period in respect of the interest in the Subsidiary Passthrough Entity.

(5) *Examples*. The following examples illustrate the principles of paragraph (c)(4) of this section. 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. *Facts*. A owns a one-half interest in P, a partnership. In Year 1, A sells the interest for $2,000,000. A's adjusted basis for the interest sold is $1,100,000. Because P is engaged in at least one trade or business and at least one of those trades or businesses is not passive to the transferor A, A determines its amount of §1.1411–4(a)(1)(iii) gain or loss from net investment income under §1.1411–7. None of the nonapplicability conditions set forth in section 1.1411–7(c)(3) apply. The aggregate net income from P's activities allocable to A for the year of disposition and the two preceding tax years are as follows:

	Aggregate Income/ (loss)
X (Non-Passive as to A)	$1,800,000
Y (Passive as to A)	(10,000)
Marketable securities	20,000

(ii) *Analysis*. During A's Section 1411 Holding Period, A was allocated $30,000 of gross items of a type taken into account in the calculation of net investment income ($10,000 of loss from activity Y and $20,000 of income from marketable securities). The total amount of A's allocated net items during the Section 1411 Holding Period equals $1,830,000 ($1,800,000 income from activity X, $10,000 loss from activity Y, and $20,000 income from marketable securities). Thus, less than 5% ($30,000/ 1,830,000) of A's allocations during the Section 1411 Holding Period are of a type that are taken into account in the computation of net investment income, and because A's chapter 1 gain recognized of $2,000,000 is less than $5,000,000, A qualifies under §1.1411–7(c)(2)(ii) to use the optional simplified method.

(iii) Under paragraph (c)(4) of this section, A's percentage of Section 1411 Property is determined by dividing A's allocable shares of income and loss of a type that are taken into account in the calculation of net investment income (as defined in §1.1411–1(d)) that are allocated to the transferor by the Passthrough Entity during the Section 1411 Holding Period is $10,000 ($10,000 loss from Y + $20,000 income from marketable securities) by $1,830,000, which is the sum of A's share of income and loss from all of P's activities ($1,800,000 + ($10,000) + 20,000). Thus, A's gain for purposes of §1.1411–4(a)(1)(iii) is $4,972.32 ($900,000 chapter 1 gain multiplied by the fraction 10,000/1,830,000).

Example 2. Assume the same facts as *Example 1*, but A sells the interest in P for $900,000. Under paragraph (c)(3) of this section, A's percentage of Section 1411 Property is determined by dividing A's allocable share of income and loss of a type that are taken into account in the calculation of net investment income (as defined in §1.1411–1(d)) that are allocated to the transferor by the Passthrough Entity during the Section 1411 Holding Period is $10,000 ($10,000 loss from Y + $20,000 income from marketable securities) by $1,810,000, which is the sum of A's share of income and loss from all of P's activities ($1,800,000 + ($10,000) + 20,000). Because A's allocable share during the Section 1411 Holding Period of income and loss of a type that is taken into account in calculating net investment income was a positive amount, and A sells its interest for an overall chapter 1 loss, A uses a fraction of 0 to compute its net investment income under paragraph (c)(4) of this section. Thus, A has no gain or loss for purposes of §1.1411–4(a)(1)(iii) ($200,000 chapter 1 loss multiplied by a fraction of 0).

(d) *Deferred recognition transactions*. In the case of a disposition of a Passthrough Entity in an installment sale under section 453 (or in exchange for an annuity contract), the calculations described in paragraphs (b) and (c) of this section shall be applied in the year of the disposition as if the entire amount of gain recognized for chapter 1 is taken into account by the transferor in the year of the disposition. For this purpose, it is assumed that any contingencies potentially affecting consideration to the transferor that are reasonably expected to occur will occur, and in the case of annuities based on the life expectancy of one or more individuals, the present value of the annuity (using existing Federal tax valuation methods) is used to determine the estimated gain. If the calculations in this section result in a transferor excluding only a portion of the chapter 1 gain from net investment income, the amount of excluded gain will constitute an addition to basis for purposes of applying section 453 to determine the amount of gain is includable in net investment income under §1.1411–4(a)(1)(iii) as payments are received.

(e) *Disposition of tiered Passthrough Entities*. [Reserved]

(f) *Adjustment to net gain or loss*. In the case of a disposition of an interest in a Passthrough Entity where the transferor's basis in the interest for section 1411 purposes does not equal the transferor's basis for chapter 1 purposes due to basis adjustments required by §1.1411–10(d), then the following rules apply:

(i) If the transferor's basis for section 1411 purposes is higher than the transferor's basis for chapter 1 purposes, then the difference reduces the amount of gain or increases the amount of loss, as applicable, that is includable in net investment income under this section.

(ii) If the transferor's basis for section 1411 purposes is lower than the transferor's basis for chapter 1 purposes, then the difference increases the amount of gain or reduces the amount of loss, as applicable, that is includable in net investment income under this section.

(iii) The adjustments to gain or loss includable in net investment income under this paragraph (f) are taken into account by the transferor immediately following the calculation of gain or loss under paragraphs (a)(4)(i), (b)(1) or (c)(4) of this section, as applicable.

(g) *Information reporting*—(1) *Information to be provided by passthrough entity to transferor*. Where the Passthrough Entity knows, or has reason to know, that the transferor satisfies paragraph (a)(3)(i) of this section but does not satisfy paragraph (c) of this section, then the Passthrough Entity shall provide the transferor with information as to the transferor's allocable share of the net gain or loss from the deemed sale of the Passthrough Entity's Section 1411 Property as described in paragraph (b)(1) of this section and such other information as may be required by forms, instructions, or in other guidance to allow the transferor to compute gain or loss under this section.

(2) *Information reporting by transferors.* Any transferor making a calculation under this section must attach a statement to the transferor's return for the year of disposition containing certain information as required by this paragraph (g)(2) and any other information required by guidance and applicable forms and instructions issued by the Commissioner to allow the transferor to compute gain or loss under this section. In the case of a disposition in a transaction described in paragraph (d) of this section, the information required by this paragraph (g)(2) shall apply in the year of the disposition, or in the first year the taxpayer is subject to section 1411 (determined without regard to the effect of this section), whichever is later. The statement must include—

(i) The name and taxpayer identification number of the Passthrough Entity of which the interest was transferred;

(ii) The amount of the transferor's gain or loss on the disposition of the interest for purposes of chapter 1;

(iii) The information provided by the Passthrough Entity to the transferor by reason of paragraph (g)(1) of this section; and

(iv) The amount of adjustment to gain or loss by reason of paragraph (f) of this section, if any.

(h) *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).

John Dalrymple,
Deputy Commissioner for Services and Enforcement.

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Definition of Terms

Suspended is used in rare situations to show that the previous published rulings will not be applied pending some future action such as the issuance of new or amended regulations, the outcome of cases in litigation, or the outcome of a Service study.

Revenue rulings and revenue procedures (hereinafter referred to as "rulings") that have an effect on previous rulings use the following defined terms to describe the effect:

Amplified describes a situation where no change is being made in a prior published position, but the prior position is being extended to apply to a variation of the fact situation set forth therein. Thus, if an earlier ruling held that a principle applied to A, and the new ruling holds that the same principle also applies to B, the earlier ruling is amplified. (Compare with modified, below).

Clarified is used in those instances where the language in a prior ruling is being made clear because the language has caused, or may cause, some confusion. It is not used where a position in a prior ruling is being changed.

Distinguished describes a situation where a ruling mentions a previously published ruling and points out an essential difference between them.

Modified is used where the substance of a previously published position is being changed. Thus, if a prior ruling held that a principle applied to A but not to B, and the new ruling holds that it applies to both A and B, the prior ruling is modified because it corrects a published position. (Compare with amplified and *clarified*, above).

Obsoleted describes a previously published ruling that is not considered determinative with respect to future transactions. This term is most commonly used in a ruling that lists previously published rulings that are obsoleted because of changes in laws or regulations. A ruling may also be obsoleted because the substance has been included in regulations subsequently adopted.

Revoked describes situations where the position in the previously published ruling is not correct and the correct position is being stated in a new ruling.

Superseded describes a situation where the new ruling does nothing more than restate the substance and situation of a previously published ruling (or rulings). Thus, the term is used to republish under the 1986 Code and regulations the same position published under the 1939 Code and regulations. The term is also used when it is desired to republish in a single ruling a series of situations, names, etc., that were previously published over a period of time in separate rulings. If the new ruling does more than restate the substance of a prior ruling, a combination of terms is used. For example, modified and *superseded* describes a situation where the substance of a previously published ruling is being changed in part and is continued without change in part and it is desired to restate the valid portion of the previously published ruling in a new ruling that is self contained. In this case, the previously published ruling is first modified and then, as modified, is superseded.

Supplemented is used in situations in which a list, such as a list of the names of countries, is published in a ruling and that list is expanded by adding further names in subsequent rulings. After the original ruling has been supplemented several times, a new ruling may be published that includes the list in the original ruling and the additions, and supersedes all prior rulings in the series.

Abbreviations

The following abbreviations in current use and formerly used will appear in material published in the Bulletin.

A—Individual.
Acq.—Acquiescence.
B—Individual.
BE—Beneficiary.
BK—Bank.
B.T.A.—Board of Tax Appeals.
C—Individual.
C.B.—Cumulative Bulletin.
CFR—Code of Federal Regulations.
CI—City.
COOP—Cooperative.
Ct.D.—Court Decision.
CY—County.
D—Decedent.
DC—Dummy Corporation.
DE—Donee.
Del. Order—Delegation Order.
DISC—Domestic International Sales Corporation.
DR—Donor.
E—Estate.
EE—Employee.
E.O.—Executive Order.
ER—Employer.
ERISA—Employee Retirement Income Security Act.
EX—Executor.
F—Fiduciary.
FC—Foreign Country.
FICA—Federal Insurance Contributions Act.
FISC—Foreign International Sales Company.
FPH—Foreign Personal Holding Company.
F.R.—Federal Register.
FUTA—Federal Unemployment Tax Act.
FX—Foreign corporation.
G.C.M.—Chief Counsel's Memorandum.
GE—Grantee.
GP—General Partner.
GR—Grantor.
IC—Insurance Company.
I.R.B.—Internal Revenue Bulletin.
LE—Lessee.
LP—Limited Partner.
LR—Lessor.
M—Minor.
Nonacq.—Nonacquiescence.
O—Organization.
P—Parent Corporation.
PHC—Personal Holding Company.
PO—Possession of the U.S.
PR—Partner.
PRS—Partnership.
PTE—Prohibited Transaction Exemption.
Pub. L.—Public Law.
REIT—Real Estate Investment Trust.
Rev. Proc.—Revenue Procedure.
Rev. Rul.—Revenue Ruling.
S—Subsidiary.
S.P.R.—Statement of Procedural Rules.
Stat.—Statutes at Large.
T—Target Corporation.
T.C.—Tax Court.
T.D.—Treasury Decision.
TFE—Transferee.
TFR—Transferor.
T.I.R.—Technical Information Release.
TP—Taxpayer.
TR—Trust.
TT—Trustee.
U.S.C.—United States Code.
X—Corporation.
Y—Corporation.
Z—Corporation.

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[1]A cumulative list of current actions on previously published items in Internal Revenue Bulletins 2013–1 through 2013–26 is in Internal Revenue Bulletin 2013–26, dated June 24, 2013.

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