DEPARTMENT OF THE TREASURY

Internal Revenue Service

26 CFR Part 1

[REG–130843–13]

RIN 1545–BL74

Net Investment Income Tax

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DATES: The proposed rule published December 5, 2012 (77 FR 72612), is withdrawn as of December 2, 2013.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 January 31, 2014.

ADDRESSES: Send submissions to: CC:PA:LPD:PR (REG–130843–13), room 5205, Internal Revenue Service, P.O. 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 January 31, 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 (Pub. L. 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 the Rules and Regulations section of this issue of the **Federal Register**, 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 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 through 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.

List of Subjects in 26 CFR Part 1

Income taxes, Reporting and recordkeeping requirements.

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 Register** 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) Tiered passthrough disposition. [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 (percent)	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

YEAR 1 ENDING CATEGORY AND CLASS BALANCES—Continued

Category	Class	Excluded/NII	Tax rate (percent)	Amount
	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 (percent)	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 (percent)	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 (percent)	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 (percent)	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 (percent)	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 (percent)	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 (percent)	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 (percent)	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 (percent)	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 (percent)	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 $1,810,000 ($1,800,000 income from activity X, $10,000 loss from activity Y, and $20,000 income from marketable securities). Thus, less than 5% ($30,000/1,810,000) 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 $1,810,000, 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). 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 10,000/1,810,000).

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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