Report No. 1284

NEW YORK STATE BAR ASSOCIATION TAX SECTION

REPORT ON

THE PROPOSED REGULATIONS UNDER SECTION 1411

May 15, 2013

Table of Contents

I. Overview of Section 1411 1
II. Overview of the Proposed Regulations 2
a. Proposed Regulation § 1.1411-1: General Rules and the Interaction with Chapter 1 2
b. Proposed Regulation § 1.1411-2: Application to Individuals 4
c. Proposed Regulation § 1.1411-4: Definition of Net Investment Income 4
1. Category 1 Income 6
2. Category 3 Net Gain 6
3. Category 2 Income 7
4. Ordinary Course of a Trade or Business Exception 7
d. Properly Allocable Deductions 8
e. Proposed Regulation § 1.1411-5: Trades or Businesses to Which Tax Applies 9
1. Section 1411 469 Business 9
2. Regrouping under Section 1411 10
3. Section 1411 Trading Business 10
f. Proposed Regulation § 1.1411-6: Income From Investment of Working Capital 11
g. Proposed Regulation § 1.1411-7: Dispositions of Interests in Partnerships and S Corporations 11
h. Proposed Regulation § 1.1411-9: Exception for Income Subject to Section 1401 Tax 14
III. Summary of Recommendations 14
IV. Discussion of Issues and Recommendations 18
a. The Preamble 18
b. General Approach to Definition of NII 19
c. Scope of the Incorporation of the Section 469 Regulations 20
1. The Ordinary Course of a Trade or Business Exception for Category 1-Type Income 20
2. Determining Whether an Activity is a Section 1411 469 Business As To the Taxpayer and Determining the Income From That Business 23
3. Self-Charged Interest 25
4. Section 707(c) Guaranteed Payments for the Use of Capital 26
d. Treatment of Trading Gains and Losses of a Section 1411 Trading Business 27
e. Section 1411 Treatment of Certain Losses and Deductions 28
1. The Computation of Category 3 Net Gains: Capital Loss Carryforwards and Limitations on the Use of Capital Losses 28
2. Comments On the Proposed Disallowance of NOL Deductions in Determining NII 30
3. Deductions Recognized in Different Years than the Related Income 32
4. Comments Regarding Losses Triggered under Section 469(g)(1) 32
f. Foreign Income Taxes and the Chapter 1 Foreign Tax Credit 33
g. Section 1411 Treatment of Certain Income Items 38
1. Notional Principal Contract Income and Securities Lending Fee Income 38
2. Amounts Treated as Dividends Under Chapter 1 40
h. Determining Whether An Activity Conducted Through an Entity is a Trade or Business 40
i. Regrouping under Section 1411 40
j. Gain on Disposition of Interests in Partnerships and S Corporations 41
1. Computation of Amount Included in Category 3 Net Gains 41
2. Valuing Goodwill For Purposes of the Deemed Asset Sale 45

3. Reporting Requirements for a Disposition of an Interest in a Partnership or S Corporation 46
k. How The Code's Three 3.8% Medicare Hospital Insurance Taxes Apply to Different Types of Income and Types of Income That Are Not Subject to Any of These Taxes 48
1. Income From Ownership of S Corporation Shares 49
2. Income From Owning a General Partner Interest 50
3. Income of Limited Partners under Section 1402(a)(13) 50
4. Retirement Payments to Partners 52
5. Covenant Not to Compete Income 53
l. Application of Section 1411 to Funds 53
1. Private Equity and Hedge Funds 53
2. Applying Section 1411 to Managers of Private Equity Funds and Hedge Funds 54
3. Interaction of Sections 1411 and 1401 in the Case of Fund Managers 56
4. The Management Fee Paid to the Management Company 56
5. The Carried Interest Allocated to the GP Entity 57
6. Possible Options Available to Treasury and the IRS 57
V. Closing Comments 60

New York State Bar Association Tax Section

Report on the Proposed Regulations under Section 1411

This report (the "Report")[1] comments on the proposed regulations under section 1411 of the Internal Revenue Code of 1986, as amended (the "Code"),[2] issued on December 3, 2012 (the "Proposed Regulations").[3] Section 1411 was enacted in 2010 and is effective for taxable years beginning on or after January 1, 2013. Section 1411's statutory scheme raises some complex and difficult issues; the Department of the Treasury ("Treasury") and the Internal Revenue Service (the "IRS") faced a formidable challenge in drafting regulations to implement it. We commend the Treasury and the IRS for issuing the Proposed Regulations before the beginning of 2013. We hope that our comments, and those of other commentators, assist the Treasury and the IRS in issuing final regulations (or temporary regulations) (the "Final Regulations") prior to the end of 2013. The Report is organized into four parts. Part I describes section 1411. Part II provides an overview of the Proposed Regulations and relevant portions of the preamble to the Proposed Regulations (the "Preamble").[4] Part III provides a summary of our recommendations. Part IV discusses these recommendations in detail and also comments on various portions of the Preamble.

I. Overview of Section 1411

Section 1411 was enacted as part of the Health Care and Education Reconciliation Act of 2010.[5] Generally, section 1411 imposes a new 3.8% "Medicare contribution tax" on the unearned income of individuals, estates and trusts.[6] This tax is intended to be an analog to the Medicare hospital insurance taxes imposed on wages by sections 3101 and 3111 and on self-employment income by section 1401 (*i.e.*, on "earned" income).[7] Consistent with that, section 1411 was titled "Unearned Income Medicare Contribution" and was added to the Code as a new Chapter 2A within Subtitle A ("Chapter 2A"). Subtitle A of the Code (entitled "Income Taxes") includes sections 1 through 1564; Chapter 1 of Subtitle A ("Chapter 1") consists of sections 1

---

[1] The principal drafter of this Report was Joel Scharfstein, Co-Chair of the Committee on Complexity and Administrability. Significant contributions were made by Bryan Lee, Stuart Rosow, Amy Sutton, Guy Inbar and Diana Wollman. Helpful comments were provided by Elizabeth Kessenides, Willard Taylor, Lee Allison, Kim Blanchard, Jonathan Brose, James Brown, Peter Connors, Mike Farber, Steve Foley, David Kahen, Andrew Needham, Amanda Nussbaum, Andrew Oringer, Elliot Pisem, David Sicular, Eric Sloan, Richard Upton and Kirk Wallace.

[2] All references to "sections" herein are references to sections of the Code unless otherwise expressly indicated, and all references to regulations are to the Treasury Regulations issued under the Code.

[3] Prop. Reg. § 1.1411-0 to -10, 77 Fed. Reg. 234,72633-52 (Dec. 5, 2012). This Report does not address the provisions of the Proposed Regulations relating to investments in controlled foreign corporations and passive foreign investment companies, which are being addressed in a separate New York State Bar Association Tax Section report. This Report also does not address provisions of the Proposed Regulations that are specific to estates and trusts.

[4] Preamble to the Proposed Regulations, 77 Fed. Reg. 234,72612-32 (Dec. 5, 2012).

[5] Pub. L. No. 111-152, 124 Stat. 1029 (2010).

[6] Section 1411(a). Excluded from the application of section 1411 are non-resident alien individuals and trusts in which all of the unexpired interests are devoted to one or more of the purposes described in section 170(c)(2)(B). Section 1411(e).

[7] This is discussed in more detail below.

8862824

through 1400U-3, and Chapter 2 of Subtitle A consists of the provisions relating to the self-employment tax (sections 1401 and 1402).[8]

The specifics of section 1411 as applied to individuals are as follows:

Section 1411 imposes a 3.8% tax upon the lesser of

(A) an individual's "net investment income" ("NII") for the taxable year, and

(B) the excess (if any) of (i) the individual's modified adjusted gross income ("MAGI") for the taxable year,[9] over (ii) the threshold amount.[10]

The threshold amount is (i) for an individual filing a joint return or a surviving spouse, $250,000; (2) for a married individual filing a separate return, $125,000; and (3) for any other individuals, $200,000.[11]

The only guidance in the nature of legislative history to section 1411 are discussions found in three reports by the Joint Committee on Taxation,[12] and these provide little guidance to the application of section 1411 beyond what is in the statutory text.

II. Overview of the Proposed Regulations[13]

a. Proposed Regulation § 1.1411-1: General Rules and the Interaction with Chapter 1

Section 1411 imposes a net income tax on a base that differs from the base to which the Chapter 1 net income tax applies. Section 1411 is a short statutory provision with a limited number of definitions. Yet, as a net income tax, it raises many of the same interpretive and definitional issues presented by the provisions in Chapter 1 (and which have been resolved in the Chapter 1 context through hundreds of pages of statutory text and regulations). A key issue is to what extent the application of section 1411 can be based on Chapter 1 concepts and definitions,

---

[8] As discussed further below, the placement of section 1411 in chapter 2A, as opposed to Chapter 1, of Subtitle A has led to some of the complexities faced by Treasury and the IRS in interpreting and implementing section 1411.

[9] Section 1411(d). An individual's MAGI is the individual's 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 amounts excluded from gross income under section 911(a)(1). Thus, in the case of any taxpayer not subject to section 911, MAGI is equal to the taxpayer's AGI.

[10] Section 1411(a)(1).

[11] Section 1411(b).

[12] Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 111th Congress,* JCS-2-11, at 260-72; 363-65 (March 23, 2011); Staff of the Joint Committee on Taxation, *Description of the Social Security Tax Base*, JCX-36-11 (June 21, 2011); Staff of the Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of the "Reconciliation Act of 2010," as amended, in combination with the "Patient Protection and Affordable Care Act,"* JCX-18-10 (March 21, 2010).

[13] The Proposed Regulations are generally proposed to be effective for taxable years beginning after December 31, 2013, but taxpayers may rely on them for purposes of compliance with section 1411 until the effective date of the Final Regulations. Preamble at 72632.

and to what extent new concepts and definitions at variance from those in Chapter 1 are required or appropriate.

The Proposed Regulations provide that "except as otherwise provided, all Internal Revenue Code provisions that apply for purposes of Chapter 1 in determining taxable income (as defined in section 63(a)) of a taxpayer, including recognition and non-recognition rules, also apply in determining the tax imposed by section 1411."[14] The Preamble adds: "Under these proposed regulations, except as otherwise provided, [Chapter 1] principles and rules apply in determining the tax under section 1411."[15] The Preamble explains that this means that deferral and disallowance provisions of Chapter 1 for determining adjusted gross income apply to the determination of net investment income.[16] The Preamble also clarifies that this means ordinary deductions carried over to a taxable year under section 163(d), 465(a)(2), 469(b), 704(d), 1212(b) or 1366(d)(2) and allowed in determining adjusted gross income in the carry-over year for Chapter 1 purposes are also allowed in determining net investment income in the carry-over year, regardless of whether the taxable year from which the deduction is carried predates the effective date of section 1411.[17]

The Preamble explains that the Proposed Regulation's approach to terms used in section 1411 but not defined in section 1411 is somewhat different. The Preamble acknowledges that section 1411's undefined terms are terms commonly used in federal income taxation, but then goes on to state:[18]

> [T]here is no indication in the legislative history of section 1411 that Congress intended, in every event, that a term used in section 1411 would have the same meaning as ascribed for other federal income tax purposes (such as [Chapter 1]). Accordingly, the definitional rules set forth in the [Proposed Regulations] are designed to promote the fair administration of section 1411 while preventing circumvention of the purposes of the statute.[19]

The Proposed Regulations provide that all references to an individual's adjusted gross income are treated as references to adjusted gross income as defined in section 62 (subject to certain modifications under the Proposed Regulations in respect to investments in CFCs and PFICs).[20]

---

[14] Prop. Reg. § 1.1411-1(a).
[15] Preamble at 72613.
[16] *Id.* These include, for example, section 163(d) (limitation on investment interest), section 265 (expenses and interest relating tax exempt income), section 465(a)(2) (at risk limitations), section 469(b) (passive loss limitations), section 704(d) (partner loss limitation), section 1212(b) (capital loss limitations) and section 1366(d)(2) (S corporation shareholder loss limitations).
[17] *Id.*
[18] Most definitions provided in Chapter 1 are *limited* to a part, subchapter, or section. *See, e.g.*, sections 2, 21, 22, 23, and 25 (providing that such definitions are provided "for purposes of section 1").
[19] Preamble at 72613.
[20] Prop. Reg. § 1.1411-1(b).

b. Proposed Regulation § 1.1411-2: Application to Individuals

The Proposed Regulations follow the statutory language of section 1411 for the purpose of calculating the 3.8% net investment income tax for individuals, including the use of the definitions of MAGI and the threshold amount described earlier.[21] The Proposed Regulations also address the calculation of the threshold amount for taxable years of less than twelve months.[22]

c. Proposed Regulation § 1.1411-4: Definition of Net Investment Income

The Proposed Regulations define net investment income ("NII") as

the excess of

(A) the sum of

(i) gross income from interest, dividends, annuities, royalties, rents, substituted interest and dividend payments, except to the extent derived in the ordinary course of a trade or business not described in Prop. Reg. § 1.1411-5 ("Category 1 Income"),

(ii) other gross income derived from a trade or business described in Prop. Reg. § 1.1411-5 ("Category 2 Income"), and

(iii) net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, except to the extent attributable to property held in a trade or business not described in Prop. Reg. § 1.1411-5 ("Category 3 Net Gains"),

over

(B) the deductions allowed by subtitle A which are properly allocable to such gross income or net gain.[23]

The definition of NII is confusing for several reasons, including its use of double negatives and non-intuitive terms. A simpler way to approach the definition of NII is to focus on all trades or business falling into one of two categories:

(i) trades or businesses the income from which is subject to section 1411 ("Section 1411 Businesses") (these are the trades or businesses described in Prop. Reg. § 1.1411-5), and

(ii) trades or businesses the income from which is not subject to section 1411 ("Non-Section 1411 Businesses").

[21] See Prop. Reg. §§ 1.1411-2(b)-(d).
[22] Prop. Reg. § 1.1411-2(d)(2).
[23] Section 1411(c); Prop. Reg. § 1.1411-4 and § 1.1411-5.

There are two different types of Section 1411 Businesses:

(i) a trade or business within the meaning of section 162[24] that is a passive activity with respect to the taxpayer (within the meaning of section 469 or the regulations thereunder) (a "Section 1411 469 Business"), and

(ii) a trade or business of trading in financial instruments[25] or commodities (as defined in section 475(e)(2)) (a "Section 1411 Trading Business").[26]

If the trade or business is not a Section 1411 Trading Business and the individual taxpayer is a material participant (within the meaning of section 469) as to the business (and the business is a section 162 trade or business), the business is a Non-Section 1411 Business. So, all financial instrument and commodities trading businesses are Section 1411 Business and all other businesses are either within section 1411 or without it depending upon the degree of participation by the individual taxpayer in the business.

Using these concepts, NII can be restated as

(A) the sum of

(i) Category 1 Income: interest (and substitute interest), dividends (and substitute dividends), annuities, royalties, and rents, except to the extent derived in the ordinary course of a Non-Section 1411 Business,

(ii) Category 2 Income: other gross income derived from a Section 1411 Business, and

(iii) Category 3 Net Gains: net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, except to the extent attributable to property held in a Non-Section 1411 Business,

---

[24] "Trade or business" is not defined in section 162 or the regulations thereunder, and the determination of whether an activity amounts to a trade or business has been left to development under common law. Even under common law, there is no authoritative judicial definition. *See* Bittker & Lokken, Federal Taxation of Income, Estates, and Gifts, at ¶20.1.2.

[25] Prop. Reg. § 1.1411-5(c)(1). Prop. Reg. § 1.1411-5 defines financial instruments as including stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives, or any evidence of interests in the prior mentioned items, which includes but is not limited to short positions or partial units. This definition mirrors the section 731(c)(2)(C) definition of "financial instruments."

[26] Prop. Reg. § 1.1411-5(c)(2). The Proposed Regulations follows the statute with respect to the definition of commodities as items described in section 475(e)(2). Section 475(e)(2) defines commodities as any commodity which is actively traded (within the meaning of section 1092(d)(1)); any notional principal contract with respect to any commodity described in section 475(e)(2)(A); any evidence of an interest in, or a derivative instrument in, any commodity described in section 475(e)(2)(A) or (B), including any option, forward contract, futures contract, short position, and any similar instrument in such a commodity; and any position which is not a commodity described in section 475(e)(2)(A), (B), or (C), is a hedge with respect to such a commodity, and is clearly identified in the taxpayer's records as being described in section 475(e)(2)(D) before the close of the day on which it was acquired or entered into (or such other time as the Secretary may by regulations prescribe).

over

(B) the deductions allowed by subtitle A which are properly allocable to such gross income or net gain.[27]

1. Category 1 Income

The Proposed Regulations do not elaborate on the meaning of the terms used to describe the components of Category 1 Income. The Preamble states that gross income from interest includes any item treated as interest under Chapter 1 and that gross income from dividends includes any item treated as a dividend under Chapter 1 including amounts treated as dividends pursuant to subchapter C and amounts treated as dividends under section 1248.[28] The Proposed Regulations also add to the statutory definition of Category 1 Income substitute dividends and substitute interest.[29] The Preamble explains that these were added because, if they were not included as Category 1 Income, taxpayers could easily avoid the section 1411 tax with respect to interest or dividend income by lending their securities over a payment date. The Preamble states that "[t]he Treasury Department and the IRS do not believe that Congress intended the imposition of the section 1411 tax to turn on transactional formalities that are so readily manipulated by well-advised taxpayers."[30]

2. Category 3 Net Gain

The Proposed Regulations define Category 3 Net Gain as (i) gain described in section 61(a)(3) recognized from the disposition of property reduced, but not below zero, by (ii) losses deductible under section 165. For this purpose, disposition is broadly defined as "a sale, exchange, transfer, conversion, cash settlement, cancellation, termination, lapse, expiration, or other disposition."[31] Losses deductible under section 165 are losses from the sale or exchange of property.[32] The Preamble states that except as otherwise provided, the income tax rules of Chapter 1 generally will apply to determine net gain for purposes of section 1411.[33]

---

[27] Section 1411(c); Prop. Reg. §§ 1.1411-4 and 1.1411-5.

[28] It also includes amounts treated as dividends under Treas. Reg. § 1.367(b)-2(e)(2), amounts treated as dividends under section 1368(c)(2), earnings and profits within the meaning of section 959(d) or 1293(c), and certain excess distributions within the meaning of section 1291(b). Preamble at 72618.

[29] These are generally payments made to the transferor of a security in a securities lending transaction or a sale-repurchase transaction as a substitute for interest and dividends received by the transferee during the period of securities loan or while the repurchase transaction is open. *Id.*

[30] *Id.*

[31] Prop. Reg. § 1.1411-4(d)(1).

[32] In the case of an individual, losses are deductible under section 165 if (i) incurred in a trade or business, (ii) incurred in a transaction entered into for profit or (iii) from casualty or theft. *See also* Prop. Reg. § 1.1411-4(d)(3)(i).

[33] The Preamble states that Category 3 Net Gain includes gain recognized by a partner in a partnership under Section 731(a) or shareholder of an S corporation under 1368(b)(2) or as result of a section 338(h)(10) election with respect to the S corporation. It also includes capital gain dividends from regulated investment companies and real estate investment trusts described in sections 852(b)(3)(C) and 857(b)(3)(C), respectively, and undistributed capital gains described in sections 852(b)(3)(D) and 857(b)(3)(D) passed through to shareholders. Preamble at 72620.

The Proposed Regulations also provide that (i) Category 3 Net Gain cannot be less than zero and (ii) losses allowable under section 1211(b)[34] are permitted to offset Category 3 Net Gains taxable as ordinary income under Chapter 1 (but not gross income in Categories 1 or 2).[35] Following the statute, the calculation of Category 3 Net Gain takes into account all gains or losses from disposition of working capital.[36] The Proposed Regulations provide (consistent with the statute) that gains and losses attributable to a Non Section 1411 Business are not taken into account in computing Category 3 Net Gain (other than any such gains or losses attributable to the investment of working capital).[37] Prop. Reg. § 1.1441-4(d) states that since a partnership interest or S corporation stock is generally not property held in a trade or business, gain on the disposition of a partnership interest or S corporation stock is generally taken into account in computing NII, subject to the special rules of Prop. Reg. § 1.1411-7 (discussed below).[38]

Under a special rule in the Proposed Regulations, all gains from a Section 1411 Trading Business are treated as Category 2 Income instead of Category 3 Net Gains even if the gain was derived from the disposition of property.[39]

3. Category 2 Income

Category 2 Income is all gross income from a Section 1411 Business, other than gross income which is in Category 1 or Category 3.[40] The Preamble indicates that this means that if any income would be in both Category 3 and Category 2, it will be in Category 3.[41]

The Proposed Regulations specifically provide that gains and section 165 losses from the disposition of property held in a Section 1411 469 Business are taken into account in computing Category 3 Net Gains[42] (rather than Category 2 Income).

Under a special rule, all gains derived in a Section 1411 Trading Business (other than gains from the investment of working capital) are treated as Category 2 Income, even if they are derived from the disposition of property held for use in that business.

4. Ordinary Course of a Trade or Business Exception

Income that would otherwise be in Category 1 ("Category 1-Type Income") is excluded if derived in the ordinary course of a Non-Section 1411 Business.[43] As described in the Preamble, the ordinary course of a trade or business exception is a two-step inquiry.[44] First, it

---

[34] Section 1211(b) permits non corporate taxpayers to deduct, in each taxable year, up to $3,000 of net capital losses against ordinary income ($1,500 in the case of married individuals filing separate returns).
[35] Prop. Reg. § 1.1411-4(d)(2).
[36] As a result, gains from working capital of a Section 1411 Trading Business is treated as Category 3 Net Gain, instead of Category 2 Income.
[37] Prop. Reg. § 1.1411-4(d)(3).
[38] Special rules under Prop. Reg. § 1.1411-7 apply when an entity is engaged in at least one trade or business that is a Non-Section 1411 Business.
[39] Prop. Reg. § 1.1411-4(c)(2).
[40] Prop. Reg. §§ 1.1411-4(a)(1)(ii) and 1.1411-4(c).
[41] Preamble part 5.b, at 72620.
[42] Prop. Reg. § 1.1411-4(c)(1).
[43] Prop. Reg. § 1.1411-4(a)(1)(i).
[44] Preamble at 72618.

must be determined whether the item is "derived in" a trade or business that is a Non-Section 1411 Business. If so, the second step is to determine whether the item was derived in the "ordinary course" of that trade or business.[45]

As to the first step of the inquiry (*i.e.*, the "derived in" prong), the Proposed Regulations provide guidance for making that determination if an individual owns an interest in a trade or business through pass-through entities or tiers of pass-through entities.[46] As to the second step of the inquiry, the Proposed Regulations give no guidance as to the meaning of "ordinary course." The Preamble states that taxpayers should look to other regulations and case law for guidance on whether income is derived in the ordinary course of a trade or business, specifically referring to *Lilly v Comm'r* and the section 469 regulations.[47]

d. Properly Allocable Deductions

The Proposed Regulations explain that in computing NII, the gross income or net gains included in the computation are reduced by "deductions allowed by subchapter A that are properly allocable to such gross income or net gains." The Proposed Regulations then provide a list of the deductions that are allowed.[48] The deductions listed are (i) deductions described in section 62(a)(4) allocable to rents and royalties that are included as Category 1 Income, (ii) deductions described in section 62(a)(1) allocable to Category 2 Income and not taken into account in determining NESE, (iii) deductions described in section 62(a)(9) relating to the penalty on early withdrawal of savings and (iv) investment interest expense allowed under section 163(d)(1), investment expenses described in section 163(d)(4)(C), and taxes described in section 164(a)(3).[49]

Under the Proposed Regulations, itemized deductions are allowable for NII purposes only to the extent that such deductions are allowable for Chapter 1 purposes and are therefore are subject to section 67's 2% floor on miscellaneous itemized deductions or to section 68's overall limitation on itemized deductions.[50] The Proposed Regulations include rules on apportioning these limitations between deductions properly allocable to, on the one hand, gross income and net gains taken into account in computing NII and, on the other hand, all other gross income and gains. Properly allocable deductions do not include losses described in section 165, regardless of whether described in section 62 or 63(d).[51] Such losses are deductible only in the computation of Category 3 Net Gain.[52] The Proposed Regulations also provide that (i) any excess of properly allocable deductions over gross income and net gain (taken into account in computing NII) for a taxable year may not be taken into account in any subsequent taxable year except as provided in

[45] *Id.*
[46] Prop. Reg. §§ 1.1411-4(b) and -4(d)(3)(B).
[47] Preamble at 72619 (providing specific references to *Lilly v Comm'r*, 343 U.S. 90, 93 (1953) (holding that expenses incurred regularly and arising from transactions that commonly or frequently occur in the type of business involved are "ordinary") and Treas. Reg. § 1.469-2T(c)(3)(ii) (providing rules for determining whether certain portfolio income is excluded from the definition of passive activity gross income).
[48] *See* Prop. Reg. §§ 1.1411-4(a)(2) and -(4)(f).
[49] Prop. Reg. § 1.1411-4(f).
[50] Prop. Reg. § 1.1411-4(f)(3)(ii).
[51] Prop. Reg. § 1.1411-4(f)(4).
[52] *Id.*

Chapter 1, and (ii) in no event will a net operating loss deduction allowed under section 172 be taken into account in determining NII for any taxable year.[53]

e. Proposed Regulation § 1.1411-5: Trades or Businesses to Which Tax Applies

As noted above, the trades or businesses to which section 1411 applies are Section 1411 469 Businesses and Section 1411 Trading Businesses. Under the Proposed Regulations, an activity will constitute a Section 1411 Business only if the activity rises to the level of a trade or business within the meaning of section 162 (which allows deductions for ordinary and necessary expenses paid while carrying on a trade or business).[54] Well-established body of case law and administrative guidance exist on the interpretation of section 162's meaning of trade or business.[55]

1. Section 1411 469 Business

Under the Proposed Regulations, in order for a trade or business to constitute a Section 1411 469 Business, the trade or business must be a "passive activity" within the meaning of section 469 as to the individual taxpayer.[56] Section 469 is a rule that limits an individual's ability to deduct losses derived from a "passive activity." Consistent with the intent of section 469, "passive activity" is defined generally as a trade or business activity in which the individual does not "materially participate." Section 469(h)(1) provides that a taxpayer "materially participates" in an activity only if his involvement is regular, continuous and substantial. Additional guidance, including bright line rules, is provided under the section 469 regulations.

The definition of passive activity under Prop. Reg. § 1.1411-5(b) is a more restrictive definition than that under section 469. Under section 469, a trade or business includes "any activity conducted in anticipation of the commencement of a trade or business and any activity involving research or experimentation."[57] Section 469 also specifies that all rental activity is included within the definition of passive activity.[58] For purposes of section 1411, the requirement that the passive activity be a trade or business within the meaning of section 162 limits the definition of passive activity to exclude certain activity that would be treated as a passive activity under section 469. In particular, certain rental activity that would be treated as a passive activity under section 469 may not qualify as such for purposes of computing NII because the activity does not rise to the level of a trade or business. In general, rent derived in a non-trade or business activity would be treated as Category 1 Income for purposes of computing NII.[59]

---

[53] Prop. Reg. § 1.1411-4(f)(1)(ii).
[54] Prop. Reg. § 1.1411-5(a).
[55] *See* Preamble at 72625 (citing Higgins v Comm'r, 312 U.S. 212 (1941); Estate of Yaeger v Comm'r, 889 F.2d 29 (2d Cir. 1989); Groetzinger v Comm'r, 771 F.2d 269 (7th Cir. 1985); Moller v US, 721 F.2d 810 (Fed. Cir. 1983); Boatner v Comm'r, 74 T.C. Memo 1997-379, *aff'd* in unpublished opinion 164 F.3d 629 (9th Cir. 1998).
[56] Prop. Reg. § 1.1411-5(b).
[57] Treas. Reg. § 1.469-4(b)(1).
[58] Section 469(c)(2).
[59] *See* Prop. Reg. § 1.1411-5(b)(2) *Example 1*.

This distinction is particularly relevant to real estate professionals. If a real estate professional engages in a rental real estate activity which qualifies as a trade or business under section 162 and the real estate professional meets the material participation standard of section 469 with respect to such activity, then the rental income from such activity may be excluded from NII under the ordinary course of a trade or business exception. However, if the rental real estate activity does not rise to the level of a trade or business under section 162, then the rental income from that activity would not qualify for the ordinary course of a trade or business exception (even if not treated as passive income under section 469) and would be included in NII as Category 1 Income.

Note, finally, that under section 469 temporary regulations, the trade or business of trading in personal property, within the meaning of section 1092(d) (but without regard to paragraph 3 thereof), for the account of owners of interests in the activity, is not a passive activity business.[60]

2. Regrouping under Section 1411

Treas. Reg. § 1.469-4 provides rules that allow the grouping of certain passive activities for purposes of applying the passive activity rules of section 469. Treas. Reg. § 1.469-4(e)(1) provides that once a taxpayer has grouped activities, the taxpayer is not allowed to regroup activities in subsequent taxable years. The Proposed Regulations would provide a one-time exception to this rule. Under Prop. Reg. § 1.469-11(b)(3)(iv), an individual[61] would be entitled to regroup his activities for any taxable year that begins during 2013 if section 1411 "appl[ies] to such [individual] for such year."[62] In addition, an individual may regroup his activities in the first taxable year beginning after December 31, 2013 in which section 1411 first applies to that individual. For this purpose, the determination of whether section 1411 would apply is made without regard to the effect of the regrouping. A taxpayer may regroup only once pursuant to this Proposed Regulation, and any regrouping will apply to the taxable year in which regrouping takes place and all subsequent years.

3. Section 1411 Trading Business

Category 2 Income includes income and gains from trading in financial instruments or commodities. Prop. Reg. § 1.1411-5 defines financial instruments to include stocks and other equity interests, evidences of indebtedness, options, forward or futures contracts, notional principal contracts, any other derivatives or any evidence of interests in the prior mentioned items, which includes but is not limited to short positions or partial units. This definition mirrors the definition of financial instruments from section 731(c)(2)(C).[63] The statute and Proposed Regulations define commodities as items described in section 475(e)(2). The Preamble states

[60] Treas. Reg. § 1.469-1T(e)(6). Personal property is defined in section 1092(d) as any personal property of a type that is actively traded. Actively traded property includes any personal property for which there is an established financial market. Treas. Reg. § 1.1092(d)-1(a).
[61] Under the Proposed Regulations, these regrouping rules also apply to estates and trusts.
[62] The Proposed Regulations relating to years beginning after December 31, 2013 state that regrouping for an individual is only permitted for a year where the individual has NII and has MAGI above the threshold. This requirement is not expressly stated for taxable years beginning in 2013, but may be subsumed within the meaning of "section 1411 applies."
[63] Preamble at 72625.

that whether trading in the above-defined financial instruments or commodities rises to the level of a trade or business under section 162 is fact-specific inquiry..

f. Proposed Regulation § 1.1411-6: Income From Investment of Working Capital

Under section 1441(c)(3) and Prop. Reg. § 1.1411-6, all gross income and gains derived from the investment of working capital is included in computing NII, regardless of whether such gross income is derived in a trade or business or such net gains are derived from property held in a trade or business. The Proposed Regulations provide that in determining whether gross income or gain is attributable to working capital, principles similar to those described in Treas. Reg. § 1.469-2T(c)(3)(ii) apply. The Preamble states that generally, working capital refers to "the capital set aside for use in and the future needs of a trade or business."[64]

g. Proposed Regulation § 1.1411-7: Dispositions of Interests in Partnerships and S Corporations

The Proposed Regulations state that interests in partnerships or S corporations are generally not property held in a trade or business and that, accordingly, gain (or loss) from the disposition of such interests or stock will generally be taken into account in computing Category 3 Net Gain.[65] However, as noted above, section 1411(c)(4) provides that gain or loss from the sale or other disposition of an interest in a partnership or S corporation is taken into account under clause (iii) of the definition of net investment income (*i.e.*, as components of Category 3 Net Gain), only to the extent of the net gain or loss that "would be taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest."[66] The Proposed Regulations implement section 1411(c)(4) by adjusting the net gain from the disposition of the interest (determined without regard to the adjustment) (the net gain or loss from the disposition of the interest prior to the adjustment is referred to herein as the "Unadjusted Gain or Loss") in the manner provided in Prop. Reg. § 1.1411-7.[67] Under the Proposed Regulations, no adjustment is made unless the partnership or S corporation is engaged in at least one trade or business that is neither a Section 1411 Trading Business nor a Section 1411 469 Business with respect to the transferor.[68] Prop.

---

[64] *Id.*

[65] Prop. Reg. § 1.1411-4(d)(3)(ii)(B)(1).

[66] Section 1411(c)(4)(A). The Preamble states that Congress's intent for section 1411(c)(4) was to put the transferor of the interest in a similar position as if the partnership or the S corporation had sold all of its assets and the gain or loss from such sale was passed through to the owners. However, this does not quite match up with the statute, and it is recognized that the transferor's basis in the interest or stock may differ from the entity's basis in the underlying properties which are deemed to be sold. Preamble at 72626.

[67] The Unadjusted Gain or Loss is the net gain or loss recognized on disposition of the interest as determined under Chapter 1. Prop. Reg. § 1.1411-4(d)(3)(i). Special rules are included in the Proposed Regulations for gain recognized on or after the effective date of section 1411 from installment sales (including installment sales entered into prior to the effective date). Prop. Reg. § 1.1411-7(b). Note that the calculation of Category 3 Net Gain will take into account gain or loss treated as ordinary income under section 751(c). *See* discussion *infra* Part IV.j.1.

[68] Prop. Reg. § 1.1411-7(a)(2).

Reg. § 1.1411-7 does not apply to gain or loss recognized on disposition of the stock of an S corporation if a section 338(h)(10) election is made.[69]

The Proposed Regulations adopt a four-step deemed sale ("Deemed Sale") approach to determine the amount of the adjustment (if any) to the Unadjusted Gain or Loss.[70]

First, all of the entity's properties, including goodwill, are deemed to be sold in a fully taxable transaction for cash equal to the fair market value of the entity's properties immediately before the disposition of the transferor's interest.[71] Second, the gain or loss on each of the properties is computed by comparing the fair market value of each property with the entity's adjusted basis in such property.[72] Third, the amount of gain or loss for each property that is allocable to the transferor is determined.[73] Lastly, the gains and or losses deemed allocated to the transferor from assets held in all Non-Section 1411 Businesses of the entity are aggregated to create a net gain (tentative negative adjustment) or a net loss (tentative positive adjustment), and these amounts (subject to the limitations described below) are then applied as adjustments in computing the amount of gain or loss included in the calculation of Category 3 Net Gain.[74]

The Proposed Regulations impose certain limitations on the tentative adjustments. Under the Proposed Regulations, if the Unadjusted Gain or Loss is a net gain, the Unadjusted Gain or Loss will be reduced by any tentative negative adjustment, but not below zero.[75] Likewise, if the Unadjusted Gain or Loss is a net loss, the Unadjusted Gain or Loss will be increased by any tentative positive adjustment, but not above zero.[76] No adjustments are made if (i) the Unadjusted Gain or Loss is a net gain and there is a tentative positive adjustment[77] or (ii) the Unadjusted Gain or Loss is a net loss and there is a tentative negative adjustment.[78] The effect of these limitations is that the adjustment cannot cause a net gain on the sale of an interest to become a loss for section 1411 purposes or cause a net loss on the sale of an interest to become a gain for section 1411 purposes. The basic operation of the Deemed Sale approach is illustrated by the following examples:

---

[69] Prop. Reg. § 1.1411-7(a)(2)(ii).

[70] The Preamble explains that in developing the Deemed Sale approach, Treasury and the IRS considered existing hypothetical transactions to determine a transferee's basis adjustment under section 743(b) and that the Deemed Sale approach applies, in part, rules similar to those in Treas. Reg. § 1.743-1(d)(2). The Preamble also notes that the approach may impose an administrative burden on owners of partnerships and S corporations and requests comments on other methods to implement the provisions of section 1411(c)(4) without imposing an undue burden. Preamble at 72626.

[71] Prop. Reg. § 1.1411-7(c)(2).

[72] Prop. Reg. § 1.1411-7(c)(3).

[73] Prop. Reg. § 1.1411-7(c)(4). In the case of a disposition of an interest in a partnership, this determination must comply with the requirements of section 704(b) and take into account any applicable adjustments under sections 704(c) and 743(b). In the case of a disposition of an interest in an S corporation, this determination is made pursuant to section 1366(a), and no adjustment shall be made to take into account any reduction of the transferor's distributive share pursuant to section 1366(f)(2).

[74] Prop. Reg. § 1.1411-7(c)(5).

[75] Prop. Reg. § 1.1411-7(c)(5)(iii).

[76] Prop. Reg. § 1.1411-7(c)(5)(iv).

[77] Prop. Reg. § 1.1411-7(c)(5)(iv)(B).

[78] Prop. Reg. § 1.1411-7(c)(5)(iii)(B).

Example 1. X, an individual, is the sole shareholder of S, an S corporation. X sells all of his stock in S, recognizing a gain of $100. S has two businesses: Business A, which is a Section 1411 Business with respect to X, and Business B, which is a Non-Section 1411 Business. S has no assets other than the assets associated with Businesses A and B. If S were to sell all of its assets, it would recognize a net gain of $60 with respect to the assets of Business A, and a gain of $50 with respect to the assets of Business B, in each case none of which would be attributable to working capital. Under the Deemed Sale approach, there would be a negative adjustment of $50, equal to the net gain with respect to the assets of Business B. Accordingly, the amount of gain includible in X's NII from the sale of the stock of S would be $50 (*i.e.*, $100 of gain recognized on the sale less the negative adjustment of $50).

Example 2. The facts are the same as Example 1, except that if S were to sell all of its assets, it would recognize a net gain of $110 with respect the assets of Business A and a net loss of $10 with respect to the assets of Business B. Under the Deemed Sale approach, there would be no adjustment due to the limitations on tentative adjustments, as there is an Unadjusted Gain of $100 and a tentative positive adjustment of $10.

The Proposed Regulations provide a special rule with respect to the treatment of goodwill in applying the Deemed Sale approach where the entity is engaged in more than one trade or business. Under this rule, the gain or loss from goodwill allocated to the transferor, pursuant to the Deemed Sale steps above, will be considered attributable to the entity's trades or businesses based on the relative fair market value of the property (excluding cash and goodwill) held for use in each trade or business.[79] The application of this rule is illustrated by the following example:

Example 3. S is an S corporation wholly owned by individual X. X sells all of his stock in S and recognizes a gain of $100. S has two businesses: Business A, which is a Section 1411 Business with respect to X, and Business B, which is a Non-Section 1411 Business. S has no assets other than the assets associated with Businesses A and B. S has goodwill associated with Businesses A and B with a fair market value of $30 and a tax basis of $10 (reflecting a built-in gain of $20). The fair market value of S's assets (other than goodwill and cash) associated with Business A is $15, and the fair market value of those associated with Business B is $45. For purposes of determining X's adjustment under the Deemed Sale approach, $5 of the gain attributable to the goodwill would be treated as arising from the deemed sale of assets in Business A[80] and $15 of the gain attributable to

---

[79] Prop. Reg. § 1.1411-7(c)(5)(ii)(B). *See* also Prop. Reg. § 1.1411-7(e) *Example 8*. Rules are also provided for property that is held for use in more than one trade or business. Prop. Reg. § 1.1411-7(c)(ii)(A).

[80] $5 (gain attributable to the deemed sale of goodwill of business A) = $20 (total gain in goodwill) times $15 (the fair market value of all assets of Business A, other than cash and goodwill) divided by $60 (the total fair market value of all assets of Businesses A and B, other than cash and goodwill).

the goodwill would be treated as arising from the deemed sale of the assets in Business B.[81]

A transferor making an adjustment under Prop. Reg. § 1.1411-7 must attach a statement to the transferor's return for the year of disposition.[82] The statement must include a description of the disposed interest; the name and TIN of the entity in which the transferor disposed interest; the fair market value of each property; the entity's adjusted basis of each property; the transferor's allocable share of gain or loss for each property; information of whether the property was held in a Non-Section 1411 Business; the amount of gain on the disposition of the interest; and the computation of the adjustment.

h. Proposed Regulation § 1.1411-9: Exception for Income Subject to Section 1401 Tax

Section 1411(c)(6) and the Proposed Regulations exclude from NII any item taken into account in determining self-employment income that is subject to tax under section 1401(b).[83] Amounts that are not included in determining earnings from self-employment under sections 1402(a)(1)-(17) are not considered subject to tax under section 1401(b) for this purpose and may be included in NII (if these amounts fit within the definition of Category 1, Category 2 or Category 3).

In regards to wages, the Preamble states that "[f]or purposes of section 1411, an employee is treated as engaged in the trade or business of being an employee."[84] Thus, any amounts treated as wages for purposes of section 3401 that are paid by an employer to an employee are considered derived in the ordinary course of business and not NII. The Preamble further states that amounts paid to an employee under a nonqualified deferred compensation plan are not NII.[85]

III. Summary of Recommendations

A summary of the recommendations made in this report and discussed in Part IV are presented below:

- Many important aspects of how the Proposed Regulations work are explained only in the Preamble. We recommend that the substantive portions of the Preamble (with whatever modifications are made) be reflected in the text of the Final Regulations. (Section IV.a.)

- We recommend that the Final Regulations clarify the manner in which NII is computed by explaining (i) that "properly allocable deductions" do not need to be

[81] $15 (gain attributable to the deemed sale of goodwill of Business B) = $20 (total gain in goodwill) times $45 (the fair market value of all assets of Business A, other than cash and goodwill) divided by $60 (the total fair market value of all assets of Businesses A and B, other than cash and goodwill).
[82] Prop. Reg. § 1.1411-7(d).
[83] Prop. Reg. § 1.1411-9(a).
[84] Preamble at 72619.
[85] Such amounts are not treated as NII regardless of whether they are subject to Federal Insurance Contributions Act tax under section 3121(v)(2).

assigned among the three categories of income and that properly allocated deductions are aggregated and deducted from the sum of the amounts in the three categories, including Category 3; (ii) that notwithstanding the separation of the computation of NII into three categories, in the case of items that could be in Category 1 or Category 2, there is no consequence to which category they are placed in (although the proper category would be Category 1), and that in the case of income that could be in Category 2 or Category 3, the proper category would be Category 3 and that this is important because it may impact the amount of total NII; (iii) all Category 1-Type Income, including income derived from a Section 1411 Business, is in Category 1, unless excluded because derived in the ordinary course of a Non-Section 1411 Business. (Section IV.b.)

- We recommend that the Final Regulations clarify how the ordinary course of trade or business exception for Category 1-Type Income applies by explicitly identifying what rules govern the determination of whether income is "derived in the ordinary course" of a business (and selecting common law rules rather than the Treas. Reg. § 1.469-2T rules (which under section 469 treat certain types of income as being income from a passive activity)). (Section IV.c.1.)

- We recommend that the Final Regulations clarify which (if any) of the section 469 regulations' special recharacterization rules apply in determining what is a Section 1411 469 Business and what income is treated as derived from that business (for purposes of computing NII). While we recognize that the section 1411 statute defines passive activity by reference to section 469's definition of a passive activity, we believe that given the differing purposes of section 469 and section 1411, strict adherence to the recharacterization regulations under section 469 is not required in applying section 1411, and that strict adherence could potentially result in unwarranted exclusions of income from the scope of NII. (Section IV.c.2.)

- We recommend that the Final Regulations clarify the extent to which the so-called "self-charged interest rule" in the section 469 regulations applies for section 1411 purposes and the consequences of it applying. (Section IV.c.3.)

- We recommend that the Final Regulations address how guaranteed payments by a partnership for the use of capital, within the meaning of section 707(c), are treated in the section 1411 context. (Section IV.c.4.)

- We recommend removing or modifying the rule that puts all of a Section 1411 Trading Business' trading gains in Category 2 Income (while all of its trading losses are included in Category 3 Net Gain). We believe that such gains should be in Category 3 Net Gain. (Section IV.d.)

- We recommend that the Final Regulations clarify how Category 3 Net Gain is computed by describing the rules in more detail. The Final Regulations also should address ordering rules for how capital losses and capital loss carryforwards are used or absorbed and rules for how taxpayers should "track" the amount of capital loss

carryforwards that are available to be used in computing Category 3 Net Gains. (Section IV.e.1.)

- The Preamble requested comments on the Proposed Regulations' approach of not permitting an NOL deduction in determining NII. We believe that it would be more appropriate to permit an NOL deduction in this context than to deny it, and we also believe it would be possible to establish administrable rules which would be no more complex that those otherwise encountered in other carryover contexts. (Section IV.e.2.)

- We recommend that the Final Regulations expressly state that for a deduction to be properly allocable to income included in NII, the deduction need not be recognized in the same taxable year as the gross income or net gain is recognized. We also recommend that the Final Regulations confirm that negative adjustments pursuant to Treas. Reg. § 1.1275-4(b)(6), treated as ordinary loss pursuant to that regulation, will be treated as properly allocable deductions and not items taken into account in computing Category 3 Net Gain. (Section IV.e.3.)

- We recommend that suspended passive losses triggered under section 469(g)(1) be treated as properly allocable deductions, except that any portion of a suspended loss that is a section 165 loss should be taken into account as a component of Category 3 Net Gains. (Section IV.e.4.)

- We agree with the Proposed Regulations that a taxpayer who claims a foreign tax credit under Chapter 1 is not, under the words of the Code, permitted to claim a deduction for foreign income taxes in computing NII or a credit for foreign income taxes in computing the tax due under section 1411. We believe, however, that there is a strong argument that taking the section 1411 tax into account under sections 901 and 904 may be required under certain U.S. tax treaties in computing the credit allowable for taxes paid to those treaty partners. On the other hand, we also believe that Congress has the power to enact a statute that overrides treaty obligations but we think it is unclear if Congress intended to do that here. We also think it is unclear whether Treasury and the IRS have the authority to issue regulations that would follow the treaties but contradict the terms of sections 901, 904 and section 1411. (Section IV.f.)

- We recommend that the Treasury and IRS consider expanding the definition of Category 1 Income to pick up NPC periodic income, securities lending fee income and other similar items, through a specific or "similar items" rule. In the event that Treasury and the IRS do not believe that they can expand the definition of Category 1 Income by regulation to cover these items, we recommend that the Final Regulations include a specific anti-abuse rule to protect against attempts to exploit these exclusions. (Section IV.g.1.)

- We recommend including in the text of the Final Regulations the statement in the Preamble explaining that Category 1-Type Income includes amounts treated as

dividends under Chapter 1, including amounts treated as dividends under subchapter C, section 1248, section 1368(c)(2) and Treas. Reg. § 1.367(b)-2(e)(2). (Section IV.g.2.)

- The Final Regulations should include an explicit statement that whether an activity is a trade or business is to be determined, in all cases, at the entity level (as is currently illustrated in examples in the Proposed Regulations). (Section IV.h.)

- We recommend that the Final Regulations extend the one-time regrouping right to section 469 entities. (Section IV.i.)

- In computing the amount of NII resulting from the sale of an interest in a partnership or S corporation, we recommend that the Final Regulations follow more closely the approach set out in section 1411(c)(4), and that the special rule for valuing goodwill be replaced with a rule that any goodwill in the entity be treated as attributable to the business(es) it is actually attributable to and that it be valued using commonly accepted valuation methods. (Section IV.j.1. and 2.)

- With respect to the statement (relating to the computation of NII) that must be included in the tax return filed by the transferor of a partnership interest or S corporation stock, we recommend that the Final Regulations contain an unambiguous rule requiring an entity to provide the information necessary for the statement if (i) the transferor requests such information in writing and (ii) the transferor advises the entity of its passive or active status with respect to each trade or business of the entity. We also recommend that a transferor be permitted to group and net assets for purposes of this statement. Finally, if our recommendation regarding the method of computing NII under section 1411(c)(4) is not adopted, we recommend that the statement be required to include only information regarding the deemed sale of Non-Section 1411 Business assets rather than all of the entity's asset. (Section IV.j.3.)

- The legislative history to section 1411 makes it clear that the section 1411 Medicare contribution tax was intended by Congress to parallel the other two existing hospital insurance taxes imposed on income of individuals (*i.e.*, the 3.8% tax imposed on wages by sections 3101 and 3111 (the "FICA HI tax") and the 3.8% tax imposed on self-employment income by section 1401 (the "NESE HI tax")). There is no statement in the legislative history or elsewhere that indicates that all income recognized by U.S. individuals is intended to be subject to one of these three Medicare contribution taxes. Nevertheless, it is clear that Congress intended the section 1411 tax to apply only to income that was not subject to the other two Medicare taxes. In the Report, we discuss classes of income recognized by individuals that historically have not been subject to the FICA HI tax or the NESE HI tax, and also may not be subject to the section 1411 tax; we then provide some commentary on whether we think this was intentional. (Section IV.k.)

- With respect to retirement payments to partners and income received by an individual for a covenant not to compete, we recommend that the Treasury and the IRS carefully

consider whether the exclusion of these payments from NII is an omission that can be corrected by regulation. If so, in the case of retirement payments to partners, we recommend that the Treasury consider limiting the available material participation tests under Treas. Reg. 1.469-5T for purposes of computing NII. (Section IV.k)

- In the final section of the Report, we address the application of section 1411 to one type of income: income derived by managers of collective investment vehicles that are classified as partnerships for U.S. tax purposes (namely, investment funds and hedge funds). The managers of the investment funds and hedge funds often receive fee income (separate and apart from their carried interest) for providing management services to the fund. This fee income may, in some cases, be excluded from NESE under the exception for income derived as a limited partner (*i.e.*, section 1402(a)(13)) or an S corporation shareholder. Under the Proposed Regulations, this fee income may also not be included in NII. There are many different views as to whether this is appropriate, and those who view it as inappropriate have differing views as to what possible responses are available to Treasury and the IRS under the current statutory provisions. In this section of the Report, we try to set out those views in the hope that this will assist Treasury and the IRS in deciding what, if any, action to take. (Section IV.1.)

- As closing comments, we express our concerns that the implementing of section 1411 has proven to be far more complicated than we think Congress intended or expected. We urge the tax writing committees to consider whether statutory amendments to section 1411 might be appropriate in order to remove what we believe are unintended complexities and in order to simplify the computation of NII. We would be pleased to assist in any way that we can. (Section V.)

IV. Discussion of Issues and Recommendations

a. The Preamble

Understanding how section 1411 works and applying it to a taxpayer's actual items in a given year is complex. The ways in which the computations under section 1411 rely upon, but also differ from, the taxpayer's Chapter 1 computations, add tremendously to this complexity. Many important aspects of how the Proposed Regulations work are explained only in the Preamble. As a general matter, we think it is important and valuable for all of the operative rules to be contained in the text of the regulations. In this context, we think it is especially important because the rules are so complex and affect such a broad range of taxpayers. It will be particularly important that tax return preparers have a full understanding of how the rules work. Accordingly, we recommend that the substantive portions of the Preamble (with whatever modifications are made) be reflected in the text of the Final Regulations. We mention in this

Report some portions of the Preamble that seem to state operative rules that we believe should be included in the Final Regulations, but we do not mention all of them.[86]

b. General Approach to Definition of NII

The Proposed Regulations define NII by reference to three categories of income. Two of the categories include only items of gross income, and the third, by contrast, includes both income and loss items. Both the statute and the Proposed Regulations provide that NII is equal to (1) the sum of the amounts in the three categories, minus (2) the deductions that "are properly allocable to such gross income or net gain." The Proposed Regulations and the Preamble are explicit that Category 3 can never be a negative amount, meaning that a net loss in Category 3 cannot be used to offset net positive amounts in Category 1 and Category 2. Given this emphasis, it would be helpful if the Final Regulations would also explicitly state that "properly allocable deductions" do not need to be assigned among the three categories of income and that properly allocated deductions are aggregated and deducted from the sum of the amounts in the three categories, including Category 3. We also think an example illustrating the principles could be added to make this clear.

We also think it would be very helpful if the Final Regulations would explain that (i) notwithstanding the separation of the computation of NII into three categories, in the case of items that could be in Category 1 or Category 2, there is no consequence to which category they are placed in (although the proper category would be Category 1); and (ii) in the case of income that could be in Category 2 or Category 3, the proper category would be Category 3 and that this is important because it may impact the amount of total NII. In other words, Category 2 is intended to include "all other gross income" not included in Category 1 or Category 3.[87] We think that it would be very helpful if the Final Regulations would address these points because they are easily misunderstood and a significant amount of confusion can arise from this misunderstanding.

Another element of confusion relating to the three categories is whether Category 1-Type Income (interest, dividends, etc.) that is derived from a Section 1411 Business is in Category 1 or Category 2. Although a careful reading of the Proposed Regulations confirms that this income is Category 1, the double negatives used in the definitions may lead many practitioners to a contrary result. While this should not matter, for the reasons just discussed above, we have found that this creates confusion in trying to understand how section 1411 and the Proposed Regulations work. Thus, it would be helpful if the Final Regulations could clarify that *all* Category 1-Type Income, including income derived from a Section 1411 Business, is in Category 1, unless excluded because derived in the ordinary course of a Non-Section 1411 Business.

One reason why these rules may be particularly confusing is that embedded within this 3-category approach is a restriction permitting the use of losses from property dispositions

[86] Another source of confusion is that some of the examples in the Proposed Regulations appear to contain facts that are not necessary to the analysis, but their inclusion in the facts suggests that they might be. *See*, *e.g.*, the discussion below of *Example 5* in Prop. Reg. § 1.1411-5(b)(2).

[87] Preamble part 5.B, at 72620. This is, of course, subject to the special rule that treats gain from property dispositions in the course of a Section 1411 Trading Business as Category 2 Income.

(including ordinary losses) to offset only income and gains from property dispositions. This restriction includes an unusual separation of ordinary deductions into (i) those permitted only against Category 3 Net Gains and (ii) those permitted against all three categories of income. While these rules are clearly mandated by the statute, they can produce results that seem arbitrary and unrelated to the actual economic performance of the taxpayer's activities. For example, in many common contexts, this paradigm will artificially separate income and loss items that are functionally and economically connected. This is illustrated by the following example:

> Example 4. Individual A owns a partnership interest in "P". P's business is a Section 1411 469 Business as to A, so all the income and loss items from the business are taken into account in computing A's NII. P sells cellular phones (held as inventory) and provides cell phone services. P's business model is to sell the phones at a loss and then derive profits from providing the cell phone services.
>
> In 2013, P has a net loss of $1 million from sales of phones and $3 million of gross income from sales of services and no other income or loss for the year. For section 1411 purposes, under the Proposed Regulations, the $3 million of service income will be Category 2 Income and the $1 million inventory loss will be in Category 3. Because Category 3 Net Gain cannot be less than zero, the computation of NII will include the $3 million of income and not the $1 million of loss.

This problem arises from the statute, and we are not suggesting that we think it could be changed by regulations.

c. Scope of the Incorporation of the Section 469 Regulations

1. The Ordinary Course of a Trade or Business Exception for Category 1-Type Income

As noted above, Category 1-Type Income is included in Category 1 Income unless it is "derived in the ordinary course of a [Non-Section 1411 Business]."[88] The Preamble explains that determining whether this ordinary course of a trade or business exception applies involves two separate inquiries: (i) whether the item of income was "derived from" the Non-Section 1411 Business,[89] and (ii) whether the item of income was derived "in the ordinary course" of that business. The Proposed Regulations set out some rules for making the first inquiry,[90] but the Proposed Regulations do not address the second inquiry at all, other than through two examples. In one example, the facts given are that an S corporation in the banking business "earns… interest in the ordinary course of its trade or business";[91] and in the second example, the facts

[88] Section 1411(c)(1)(A)(i); Prop. Reg. § 1.1411-4(a)(1)(i). The Proposed Regulations refer to this as the "ordinary course of trade or business exception" and Prop. Reg. § 1.1411-4(b) sets out the only guidance as to how to apply this exception. This exception does not apply to income derived from the investment of working capital. Prop. Reg. § 1.1411-6(a).

[89] Prop. Reg. § 1.1411-4(b); discussed in Preamble part 5.A.vi.(a).

[90] See Prop. Reg. §§ 1.1411-4(b) and (d)(3)(ii).

[91] See Prop. Reg. § 1.1411-4(b)(3) *Example 3*. In this example, the business is a Non-Section 1411 Business so the ordinary course of trade or business exception applies. This example is also discussed in the Preamble which

given are that the "dividends and interest… is not derived in the ordinary course of the trade or business."[92] Thus, neither example gives any guidance as to how to determine whether income is derived "in the ordinary course" of a trade or business.

The Preamble, by contrast, provides the following in the way of guidance:

> Section 1411 does not define ordinary course of a trade or business, and the proposed regulations do not provide guidance on the meaning of ordinary course. However, other regulation sections and case law provide guidance on whether an item of gross income is derived in the ordinary course of a trade or business. *See,* for example, *Lilly* v. *Comm'r*, 343 U.S. 90, 93 (1953), *rev'g* 188 F.2d 269 (4th Cir. 1951), *aff'g* 14 T.C. 1066 (1950) (holding that expenses incurred regularly and arising from transactions that commonly or frequently occur in the type of business involved are "ordinary"); §1.469-2T(c)(3)(ii) (providing rules for determining whether certain portfolio income is excluded from the definition of passive activity gross income).[93]
>
> . . .
>
> Coordination with portfolio income rules in section 469
>
> Because section 469 treats portfolio income (which includes, for example, gross income from interest and dividends) as not derived in the ordinary course of a trade or business, the ordinary course of a trade or business exception in section 1411(c)(1)(A)(i) does not apply to such income, and such income will be net investment income under proposed § 1.1411-4(a)(1)(i). The section 469 portfolio income rules are discussed in detail in part 6.B.i.(c).(1).(I) of this preamble.[94]

We believe that inclusion of these statements in the Preamble serves to create confusion and leaves taxpayers and practitioner with insufficient guidance.

Focusing on the first segment of quoted text first: it is unclear whether this is saying that, in determining what is "ordinary course", the specific rules in Treas. Reg. § 1.469-2T(c)(3)(ii) will apply or that common law will apply. The two are different and may lead to different results.

Moreover, it is not clear that either is the right standard. First, the *Lilly* case addresses when expenses are derived in the ordinary course of business and therefore meet the requirements of section 162 to be currently deductible. The considerations that apply in

---

elaborates on the results if the business *is* a passive activity with respect to the taxpayer (*i.e.*, a Section 1411 469 Business). In that case, the ordinary course of trade or business exception does not apply and the interest income is included in Category 1 Income. (There appears to be an error in the Preamble because it concludes the interest income is in Category 2. *Compare* Prop. Reg. § 1.1411-5(b)(2) *Example 4*.)

[92] Prop. Reg. § 1.1441-5(b)(2) *Example 5*. In this example, the Section 1411 ordinary course of business exception would never be available because the dividends and interest are from a Section 1411 469 Business, so the inclusion of this fact is confusing.

[93] Preamble, part 5.A.vi.(b), at 72619.

[94] Preamble, part 5.A.viii., at 72620.

determining whether expenses are derived in the ordinary course of business may differ from those involved in determining if income is derived in the ordinary course of a business. Second, the section 469 regulations referred to (Treas. Reg. § 1.469-2T(c)(3)(ii)) are a special set of rules crafted for the section 469 context. These regulations provide very specific and narrow rules defining when certain items of "portfolio type" income will be treated as derived from a business that is a "passive activity" (and thus treated as passive activity gross income that is available to be offset by passive activity losses).[95] These special rules may not be appropriate in this section 1411 context. Moreover, these rules do not address all the types of Category 1-Type Income, so that if these rules did apply, it might mean that some types of Category 1-Type Income (rents and annuities) would *never* be eligible for the ordinary course of trade or business exception.

Further, the reference to the section 469 regulations' rule is confusing here, because, in the section 1411 context, the section 469 rules are used to determine when a business is a Section 1411 469 Business and when income is considered to be derived from such a business. If a business is a Section 1411 469 Business, then *all income* from that business is included in NII (*i.e.*, the ordinary course of trade or business exception is irrelevant). The section 469 regulations are being referred in the above-quoted text to determine when Category 1-Type Income is from the "ordinary course" of a *Non-Section 1411 Business* (in other words, a business that is a not a section 469 passive activity with respect to the taxpayer).

This leads us to the second segment quoted above from the Preamble. We believe this statement is incorrect; the statute specifically says that Category 1-Type Income *can be* within the ordinary course of business exception. In fact, that exception applies, if at all, *only to Category 1-Type Income*. We request that the Final Regulations not include a similar statement.

We recommend that (1) the Final Regulations explicitly provide what rules govern the determination of whether income is "derived in the ordinary course" of a trade or business and

---

[95] Treas. Reg. § 1.469-2T(c)(3)(ii) reads as follows:

> Gross income derived in the ordinary course of a trade or business. Solely for purposes of paragraph (c)(3)(i) of this section, gross income derived in the ordinary course of a trade or business includes only--
>
> (A) Interest income on loans and investments made in the ordinary course of a trade or business of lending money;
> (B) Interest on accounts receivable arising from the performance of services or the sale of property in the ordinary course of a trade or business of performing such services or selling such property, but only if credit is customarily offered to customers of the business;
> (C) Income from investments made in the ordinary course of a trade or business of furnishing insurance or annuity contracts or reinsuring risks underwritten by insurance companies;
> (D) Income or gain derived in the ordinary course of an activity of trading or dealing in any property if such activity constitutes a trade or business (but see paragraph (c)(3)(iii)(A) of this section);
> (E) Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property (within the meaning of paragraph (c)(3)(iii)(B) of this section);
> (F) Amount included in the gross income of a patron of a cooperative (within the meaning of section 1381(a), without regard to paragraph (2)(A) or (C) thereof) by reason of any payment or allocation to the patron based on patronage occurring with respect to a trade or business of the patron; and
> (G) Other income identified by the Commissioner as income derived by the taxpayer in the ordinary course of a trade or business.

(2) that the governing rules be common law, not the Treas. Reg. § 1.469-2T rules. If the section 469 rules are used, it should be set out clearly in the Final Regulations that these section 469 regulations (which under section 469 treat certain types of income as being income from a passive activity) are being used to determine whether Category 1-Type Income is from the ordinary course of non-passive activity (*i.e.*, a Non-Section 1411 Business).

2. Determining Whether an Activity is a Section 1411 469 Business As To the Taxpayer and Determining the Income From That Business

The statute provides that a trade or business is a Section 1411 469 Business if "such trade or business is – (A) a passive activity (within the meaning of section 469) with respect to the taxpayer."[96] The Proposed Regulations follow the statute in providing that a trade or business is a Section 1411 469 Business if "such trade or business is a passive activity within the meaning of section 469 and the regulations thereunder."[97]

Section 469 and the regulations under section 469 contain a significant number of complex special rules that (i) take income that would otherwise be treated as derived from a section 469 passive activity and recharacterize that income as income that is *not derived from a passive activity*, and (ii) recharacterize what would otherwise be a section 469 passive activity as not a section 469 passive activity. The Preamble discusses some of these rules and in doing so assumes that all of these special rules will apply in determining both what is a Section 1411 469 Business and also what income is treated as derived from that business (for purposes of determining if the income is included in NII).

> Application of Existing Section 469 Rules
>
> Section 469 and the regulations thereunder provide rules for determining whether trade or business activities and certain rental activities are passive activities with respect to a taxpayer. Generally, these rules will also apply in determining whether a section 162 trade or business is a passive activity for purposes of section 1411(c)(2)(A). Examples of this principle are discussed in this preamble, but these examples are not meant to be an exhaustive list of the rules that apply.[98]
>
> . . .
>
> Special Rules for Certain Income From Passive Activities
>
> Section 469 and the regulations thereunder provide several rules that restrict the ability of taxpayers to artificially generate passive income from certain types of passive activities. Some rules specifically recharacterize income from a passive activity as income not from a passive activity (income recharacterization rules).

[96] Section 1411(c)(2)(A).
[97] Prop. Reg. § 1.1411-5(b)(1)(ii).
[98] Preamble, part 6.B.i.(b), at 72623.

Other rules recharacterize the activity itself as being a non-passive activity (activity recharacterization rules).[99]

The Preamble goes on to discuss some of these special rules, and the Proposed Regulations illustrate a few of them in examples.[100] In our view, there is nothing in the text of section 1411 or its legislative history that indicates that these rules must or even should apply. We recognize that there are benefits from having consistency for purposes of Chapter 1 and section 1411 in the characterization of income as being derived from a passive activity. We also think it is a reasonable interpretation of section 1411 to provide that these existing section 469 rules apply. We do, however, think that this interaction between section 1411 and section 469 is confusing and that the Final Regulations should explicitly address whether and how the rules of section 469 and the regulations thereunder apply in determining both whether a trade or business is a Section 1411 469 Business and whether income is derived from that business for section 1411 purposes.

We also think consideration should be given to whether any of these special section 469 rules should not be imported into section 1411. These income recharacterization rules take income that was technically derived from a passive activity and, in order to preserve the integrity of the section 469 loss limitation rules, treat it as non-passive activity income.[101] While we recognize that the section 1411 statute defines passive activity by reference to section 469's definition of a passive activity, we believe that given the differing purposes of section 469 and section 1411, strict adherence to the recharacterization regulations under section 469 is not required in applying section 1411, and that strict adherence could potentially result in unwarranted exclusions of income from the scope of NII.[102]

Indeed, the statute already creates a distinct divergence between the scope of section 469 and the scope of a Section 1411 469 Business. The Preamble stresses that the scope of businesses that are Section 1411 469 Businesses *will not* be the same as the scope of activities that are section 469 passive activities because Section 1411 469 Businesses must be section 162 trade or businesses and section 469 passive activities are not limited in this way.

Accordingly, we believe that consideration should be given to specifying, in the Final Regulations, which aspects of the section 469 regulations' recharacterization rules apply (if any)

---

[99] Preamble, part 6.B.i.(c), at 72624.

[100] The specific text used in these two segments of the Preamble is confusing: the use of the word "generally" in the first segment above creates confusion as to whether there are some unstated exceptions, and the second segment refers to some special rules buts lacks an affirmative statement that those special rules apply and that all of them apply.

[101] For section 469 purposes, it does not matter if this income is recharacterized as income from investments or income from an active (non-section 469) business.

[102] Particular focus should be given to any of these rules which might potentially have the effect of exempting income that is not subject to section 1402 taxation from the section 1411 tax. For example, rental income from a rental business that is otherwise passive (and hence treated as Category 1 Income), may be recharacterized under the principles of Treas. Reg. § 1.469-2T(f)(6) into active rental income (which is not Category 1 Income because it is derived in the ordinary course of a business). This income may also be excepted from the section 1402 tax under section 1402(a)(13) if earned by a limited partner. So the effect of the recharacterization would be to shift the income from income subject to tax under section 1411 to income not subject to tax under either section 1411 or section 1402.

and which do not for purposes of determining what is a Section 1411 469 Business and what income is derived from that business and thus included in NII.

Finally, the Preamble's discussion of these special rules includes a particularly confusing statement that we think should be clarified:

> (1) Income recharacterization rules
>
> (I) Portfolio income
>
> Section 469(e)(1)(A)(i)(I) provides that in determining the income or loss from any activity there shall not be taken into account any gross income from interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business (portfolio income). Thus, items of net investment income in section 1411(c)(1)(A)(i) and proposed § 1.1411-4(a)(1)(i) that are portfolio income will, by definition, be included in section 1411 because these portfolio items are not derived in the ordinary course of a trade or business.[103]

If this passage is addressing whether Category 1-Type Income could be treated as being "from the ordinary course" of a trade or business that is a Section 1411 469 Trade or Business, then we submit that the discussion is unnecessary. It is unnecessary because *all Category 1-Type Income* from a Section 1411 469 Business is in Category 1; it is irrelevant whether it is "derived in the ordinary course" of that business or not, because it is in Category 1 regardless.[104] If this passage is repeating what was said earlier in the Preamble (which does in fact reference this section of the Preamble), then we submit that this is incorrect for the reasons discussed above.

3. Self-Charged Interest

One of the section 469 regulations' recharacterization rules, the rule for so-called "self-charged interest,"[105] serves a different purpose. Under this rule, if a taxpayer, who owns an interest in a pass-through entity that is engaged in a passive activity with respect to such taxpayer, lends money to such pass-through entity, a portion of the interest income received by the taxpayer (based upon the amount of passive activity interest deductions of the entity allocated to the taxpayer (so-called "self-charged interest")) will be recharacterized as passive activity income to the taxpayer rather than as income that is not from a passive activity. In the section 469 context, this rule provides a basic element of fairness by allowing the taxpayer to use the interest deductions allocated to him by the pass-through entity against the taxpayer's corresponding interest income from the entity.[106] The Preamble acknowledges this rule and indicates that it applies for section 1411 purposes, and that the recharacterized interest will still

---

[103] Preamble, part 6.B.i.c.(1)(I), at 72624.

[104] We also believe that is incorrect to say that Category 1-Type Income can never be from the "ordinary course" of a trade or business *just because that business is a section 469 passive activity with respect to* a specific individual. Section 469 may treat that income as not "passive activity income" for section 469 purposes, but that income would indeed be within the ordinary course exception of Category 1 as to another owner for whom the business was not a Section 1411 469 Business.

[105] Treas. Reg. § 1.469-7.

[106] In fact, Treas. Reg. § 1.469-7(g) permits a taxpayer to elect *out* of applying these rules.

be interest and thus included in Category 1. This discussion creates some ambiguity as to the intended scope and effect of this self-charged rule in the section 1411 context.[107]

We think that the intention was for the self-charged interest rule to apply in the section 1411 context only where it actually applies for section 469 purposes. Thus, interest income that is in fact recharacterized as passive activity income for section 469 purposes pursuant to Treas. Reg. § 1.469-7 will also be recharacterized as passive activity income for section 1411 purposes; and interest income paid to an individual partner by a partnership that is engaged in a business that is not a section 469 passive activity with respect to that partner would be unaffected by the Treas. Reg. § 1.469-7 rule, and it would retain its characterization as interest derived from a loan for all purposes, including section 1411, as interest. We request that the Final Regulations clarify the extent to which the self-charged interest rule applies for section 1411 purposes and the consequences of it applying.

4. Section 707(c) Guaranteed Payments for the Use of Capital

The section 469 regulations also include a rule under which guaranteed payments by a partnership for the use of capital, within the meaning of section 707(c), are treated as interest income rather than a distributive share of partnership income.[108] This interest income is then subject to being recharacterized as passive activity income under the self-charged interest rule, which was promulgated many years after the guaranteed payment rule.[109] Neither the Preamble nor the Proposed Regulations discuss guaranteed payments for the use of capital, and it is not clear if this rule applies in the section 1411 context and if so, what its scope is.

We think the better answer is for this guaranteed payment rule to apply in the section 1411 context only where it actually applies for section 469 purposes. Thus, it would apply only when the partnership is engaged in a section 469 passive activity with respect to the recipient of the section 707(c) guaranteed payment.[110] We note, however, that in that case, it will have little or no impact because if not for this rule, the guaranteed payment would also be included in NII, as it would presumably be treated as being a distributive share of income from a Section 1411 469 Business engaged in by the partnership.

---

[107] This ambiguity is due in large part to the fact that the application of the self-charged interest rule has no real impact under section 1411 because the interest income is in Category 1 both before and after the application of the self-charged interest rule. The discussion of it in the Preamble suggests there is an actual consequence of it applying for section 1411 purposes. Assuming our understanding is correct, we believe it is not necessary for the Final Regulations to address whether an election out of the rule pursuant to Treas. Reg. § 1.469-7(g) would apply for section 1411 purposes.

[108] Treas. Reg. § 1.469-2(e)(2)(ii) ("Except as provided in paragraph (e)(2)(iii)(B) of this section, any payment to a partner for services or the use of capital that is described in section 707(c), including any payment described in section 736(a)(2) (relating to guaranteed payments made in liquidation of the interest of a retiring or deceased partner), is characterized as a payment for services or as the payment of interest, respectively, and not as a distributive share of partnership income.").

[109] See Treas. Reg. § 1.469-7 and its preamble, 67 Fed. Reg. 162,54087-93 (Aug. 21, 2002).

[110] Note that if guaranteed payments from an active business were generally treated as interest and if application of the self-charged interest rule were limited to passive businesses as discussed above, an active taxpayer could generally avoid the NII tax by restructuring the guaranteed payment as a preferred partnership distribution covered by a gross income allocation.

In the case of an individual who is a partner in a partnership engaged in a business that is not a passive activity with respect to that taxpayer, applying this rule would seem inappropriate. First, there is no statutory basis for applying a section 469 rule to a non-469 activity (even for purposes of section 1411). Second, it is unnecessary because a section 707(c) guaranteed payment for the use of capital from the partnership is generally taxed to the individual partner under section 1402.[111] The only exception is in the case of a limited partner qualifying for the exception in section 1402(a)(13). We recommend that whatever course is chosen, the treatment of guaranteed payments for the use of capital be addressed and clarified in the Final Regulations.

d. Treatment of Trading Gains and Losses of a Section 1411 Trading Business

As discussed above, the Preamble explains that, in the case of Section 1411 469 Business, if any item of gross income is described in Category 1 or Category 3 and also in Category 2, the item is included in Category 1 or Category 3, as the case may be, treating Category 2 as including "all other gross income" not included in Category 1 or Category 3.[112] In the case of a Section 1411 Trading Business, the Preamble and the Proposed Regulations provide a different approach: any item of gross income from the business that is not Category 1-Type Income is treated as Category 2 Income.[113] Accordingly, all gains from the disposition of property of a Section 1411 Trading Business (including securities and commodities) are Category 2 Income,[114] whereas losses from the disposition of property of that business (including securities and commodities) would be in Category 3.[115] This means that those losses cannot be used to offset those gains in computing the NII generated by that business. By contrast, both gains and losses from the disposition of property of a Section 1411 469 Business are taken into account in computing Category 3 Net Gain.[116] We agree that gains from the disposition of property of a Section 1411 Trading Business could be assigned to either Category 2 or Category 3, but we do not understand the reason for the different approach to the two types of Section 1411 Businesses.

We believe that in the case of a Section 1411 Trading Business putting gains from the sale or disposition (or deemed sale or disposition) of securities and commodities in Category 2 and losses from the same types of dispositions into Category 3 Net Gains creates an odd result which might not have been intended.

It is clear that NII is intended to be a net income concept. The statute permits the deduction of "properly allocable deductions."[117] The only departure from the full netting of loss items against income items is in the case of disposition of property, where the losses can only offset those gains (and not other income). In the case of a Section 1411 Trading Business,

---

[111] See Treas. Reg. § 1.1402(a)-1(b).
[112] Preamble part 5.B., at 72620.
[113] Prop. Reg. § 1.1411-4(c)(2).
[114] *Id.* This includes gains recognized from marking to market under section 475(f) or section 1256, as well as gains from actual dispositions of property.
[115] Under Prop. Reg. 1.1411-4(f)(4), "properly allocable deductions" do not include any losses deductible under section 165 from the disposition of property.
[116] Prop. Reg. § 1.1411-4(c)(1).
[117] Section 1411(c)(1)(B).

income from property dispositions and losses from property dispositions all result from the same core activity of the business (*i.e.*, buying and selling property). This artificial separation (whereby the losses from the ordinary course of business are quarantined in Category 3 where they can never be used to offset the gains from the ordinary course of business) seems contrary to the statutory intent.

To address this issue, we recommend that Prop. Reg. § 1.1411-4(c)(2) be removed (or modified to provide that all gains from the disposition of property of a Section 1411 Trading Business are taken into account in computing Category 3 Net Gain).

An alternative means of allowing netting of gains and losses from a Section 1411 Trading Business would be to modify the Proposed Regulations so that section 165 losses of a Section 1411 Trading Business are treated as properly allocable deductions rather than being taken into account in computing Category 3 Net Gain. This approach would go too far, though, because it would permit disposition losses to offset Category 1 Income and Category 2 Income that is not from dispositions of property. Our recommended approach also adopts a uniform rule that where an item is potentially in both Category 2 and Category 3, the item should be allocated to Category 3 and treats gains and losses from property dispositions the same under section 1411 for all taxpayers.[118]

e. Section 1411 Treatment of Certain Losses and Deductions

1. The Computation of Category 3 Net Gains: Capital Loss Carryforwards and Limitations on the Use of Capital Losses

The manner in which Category 3 Net Gains are computed is very complex and it would be valuable if the Final Regulations could describe the rules governing this computation in more detail. Much of the complexity emanates from how the rules in Chapter 1 and the rules in section 1411 interact. For example, Category 3 Net Gains can include items that are capital and items that are ordinary Chapter 1's capital loss carryforward rules and limitations on the use of capital losses apply in respect of Category 3; however, items may be used in computing NII only if those same items are actually used in that same year under Chapter 1. The examples under Prop. Reg. § 1.1441-4(h) illustrate some (but not all) of these complexities.

Example 2 tells us that Chapter 1's rule limiting the use of capital losses to offset capital gains applies in computing Category 3 Net Gains, meaning that a section 165 capital loss may be used only to offset gain from the disposition of a capital asset (*i.e.*, capital gain) and that disposition gain that is characterized as ordinary pursuant to section 1250 is still in Category 3 but it may be offset only by losses otherwise allowed as deductions against such income under

[118] One effect of our recommended approach, when compared to the alternative, is that if a taxpayer's Section 1411 Trading Business has a net loss for the year from dispositions (or deemed dispositions) of property, that loss under the recommended approach will only be available as an offset against available Category 3 Net Gains of the taxpayer for that year. This is in contrast to the alternative, where such loss would have been a properly allocable deduction available against income of the taxpayer in any of the categories for such year, in each case subject to applicable Chapter 1 limitations. Adopting the recommended approach will increase the likelihood that such loss will never be deductible in computing NII and will increase the importance of permitting NOL deductions to be taken into account in computing NII in contexts where the Section 1411 Trading Business has a section 475(f) election in effect.

Chapter 1, including in the case of this example, $3,000 of capital loss that was used under Chapter 1 to offset ordinary income.

Example 4 tells us that a capital loss carryforward under Chapter 1 from a year that preceded the enactment of section 1411 may, when it is used under Chapter 1, also be used in computing NII. This is also stated in the Preamble.

Example 1 involves a case where a taxpayer has a capital loss carryforward of $27,000 for Chapter 1 purposes from year 1 to year 2 (all of which was derived from losses that would have been in year 1's Category 3 Net Gains but for the rule that Category 3 Net Gains can never be less than zero). In Year 3, the taxpayer uses that capital loss carryforward in computing his taxable income for Chapter 1 purposes. The example illustrates that, because that capital loss carryforward was available and used under Chapter 1 in year 2, the taxpayer may also use that capital loss carryforward in computing his Category 3 Net Gains for year 2.

This example illustrates how a divergence can occur between what happens under Chapter 1 and what happens under section 1411 with respect to NII. In the example, in year 1, capital losses ($40,000) exceed capital gains ($10,000) by $30,000. For Chapter 1 purposes, $3,000 of that net capital loss was used to offset ordinary income consisting of wages and interest, so that the total capital loss carryforward from year 1 for Chapter 1 purposes was $27,000. For purposes of section 1411, the example makes clear that the $3,000 of capital loss permitted to be used against ordinary income for Chapter 1 purposes is not permitted to be used for section 1411 purposes as a deduction against ordinary income in Category 1 or Category 2 in year 1 or in any other year (*i.e.*, it never reduces NII).[119]

These examples are very helpful, but we think it would be better if the rules illustrated by these examples were set out in the Final Regulations and then illustrated by these examples. Additional issues that we believe should be addressed are ordering rules for how capital losses and capital loss carryforwards are used or absorbed and rules for how taxpayers should "track" the amount of capital loss carryforwards that are available to be used in computing Category 3 Net Gains. These issues are illustrated by the following hypotheticals:

Hypothetical #1: In year 1, the taxpayer has $30,000 of capital gain from a Non-Section 1411 Business and $40,000 of capital loss, $20,000 of which is described in Category 3 and $20,000 of which is from the Non-Section 1411 Business. For Chapter 1 purposes, the taxpayer will carry into year 2 a capital loss carryforward of $10,000. The section 1411 question is how much of that $10,000 in year 2, if any, considered a Category 3 loss? We believe that the correct answer is that the capital loss from the Non-Section 1411 Business offsets the capital gain from the Non-Section 1411 Business first, meaning that the entire $10,000 of capital loss carryforward is available in year 2 to offset Category 3 capital gain.

[119] This result is not necessarily mandated by the statute, and the Proposed Regulations could have taken the approach that Category 3 capital losses are separately accounted for and are available as capital loss carryforwards, if not utilized for NII purposes, even if absorbed by gains from a Non-Section 1411 Business for Chapter 1 purposes. Such an approach would desynchronize the Chapter 1 computations from those under chapter 2A in a manner that we believe would result in excessive complexity. Accordingly, while this alternative approach has merit, we are not recommending that it be adopted.

Hypothetical #2: Same facts as Hypothetical #1 but it is now year 2 and the taxpayer has $10,000 of capital gain from a Non-Section 1411 Business and $10,000 of ordinary income that is Category 3 Net Gain (*e.g.*, from dispositions of inventory from a Section 1411 469 Business). Let's also assume that our recommendation is followed and the $10,000 capital loss carryforward from year 1 is available to offset Category 3 Net Gain in year 2. Under Chapter 1, the $10,000 of capital loss carryforward is used in year 2 (to offset the $10,000 of capital gain from the Non-Section 1411 Business), so it is potentially also available to be used in computing NII. But, it cannot be used to offset the Category 3 ordinary income because capital losses cannot be used to offset ordinary income. The result is that none of the $20,000 of Category 3-type capital loss generated in year 1 is never able to be used in computing NII.

One possible approach to ordering and tracking losses is for a taxpayer to assign capital losses to either Category 3 or the "non-NII" category of income and loss in the year the loss is recognized, match (i) non-NII losses to non-NII gains and (ii) Category 3 losses to Category 3 gains first, in each case to the extent permitted by Chapter 1 rules, and then keep track of how much of the taxpayer's total capital loss carryforward (after taking into account utilization of the net Category 3 capital losses for the year against non-NII income) is non-NII and how much is Category 3. Also needed is an ordering rule to address "which" losses are used when capital losses are used, pursuant to section 1211(b), to offset ordinary income and the taxpayer's total capital losses included both "NII" losses and "non-NII" losses.

2. Comments On the Proposed Disallowance of NOL Deductions in Determining NII

The Preamble requested comments on the Proposed Regulations' approach of not permitting an NOL deduction in determining NII.[120] The Preamble explains that some of the deductions included in the computation of an NOL may be "properly allocable deductions" but that the character of each deduction-item that comprises an NOL is generally not tracked after the item becomes part of an NOL.[121] The Preamble further states that "rules to determine the portion of a net operating loss deduction properly allocable to items of gross income or net gain subject to section 1411 would be unduly complex and not administrable."[122] The Preamble also notes that this is similar to the computation of NESE (net income from self-employment), where the statute (section 1402(a)(4)) specifies that there is no NOL deduction.

We believe that it would be more appropriate to permit an NOL deduction in this context than to deny it, and we also believe it would be possible to establish administrable rules which would be no more complex that those otherwise encountered in other carryover contexts.

We think that permitting an NOL deduction is appropriate in the section 1411 context for the same reason that it is appropriate in the Chapter 1 context: the 12-month tax year is an arbitrary system that can produce year-to-year results which are not an accurate reflection of the taxpayer's economic returns; and a deductible expense incurred to produce income should not be

[120] Preamble at 72621.
[121] *Id*.
[122] *Id.*

deductible only if the income generated is recognized in the same 12-month period as the expense is recognized. These reasons are just as relevant and true in the section 1411 context.[123]

The analogy to the self-employment tax context does not support denying the NOL deduction because in the self-employment context the statute addresses the issues directly, and here there is nothing in the statute (or the legislative history) to suggest a departure from the Chapter 1 rules permitting an NOL deduction. The Proposed Regulations state, as is appropriate, that in determining the tax imposed by section 1411, all the Chapter 1 rules apply, except as specifically provided otherwise. Here, we believe there is no specific reason to depart.

The tracing issues introduced by an NOL present many of the same tracing issues that occur for other section 1411 purposes and would not necessarily be materially more complex to implement. The other section 1411 purposes include section 704(d) carryovers, where losses are only allowed to the extent of adjusted basis of the partnership interest, section 1366(d)(2) carryovers, losses suspended under the at-risk rules of section 465 and capital loss carryforwards, all of which are permitted in computing NII.

One approach to NOL tracing would be to follow the basic approach we suggest above for ordering and tracking capital loss carryforwards in computing Category 3 Net Gains. Each year in which an NOL is generated, the taxpayer would determine how much of that NOL consists of section 1411 "properly allocable deductions" and the remainder would be non-NII NOL. The taxpayer would maintain two pools: an NII NOL pool and a non-NII NOL pool. In future years, as portions of the aggregate NOL are used for Chapter 1 purposes, the corresponding portion of the unused NII NOL pool would be available for the purpose of computing NII (but, like capital loss carryforwards, the NOL could be used in computing NII only in the same year it is actually used under Chapter 1). The application of this approach is illustrated in the examples below.

> Example 5. In year 1, individual A has $1 million of "properly allocable deductions" from a Section 1411 Trading Business and $600,000 of wages. The wages are not included in NII and at the end of year the taxpayer has a $400,000 NOL carryforward, all of which is a section 1411 "properly allocable deduction" (*i.e.*, it is all in the NII NOL pool).
>
> In year 2, A has $300,000 of wage income and no other income or deductions. For Chapter 1 purposes, $300,000 of the $400,000 NOL in year 2 would be absorbed, and A would have a $100,000 remaining in the NII NOL pool to carry into year 3.

Any portion of an NOL that is a section 165 deduction (but is ordinary in character) and would be in Category 3 in the year recognized would be carried forward in the NII NOL pool, but available in future years only against Category 3 Net Gain (and of course only in the same year actually used under Chapter 1). We would expect the ordering rules to require that any

[123] Also consider an individual that makes a section 475 election and has a significant ordinary loss from a trading business for the taxable year (which loss is not suspended as a passive activity loss) and that loss represents all or the bulk of the taxpayer's NOL. It would be unfair to deny the taxpayer the use of that NOL in computing NII in subsequent years.

Category 3 NOL carryforward be taken into account (in computing Category 3 Net Gain) prior to aggregating of the 3 categories of income and the deduction therefrom of available properly allocable deductions (which would include any NII NOL that consists of properly allocable deductions). Rules explaining how the section 1231 rules interact with the section 1411 computations will also be necessary.

3. Deductions Recognized in Different Years than the Related Income

We interpret the definition of properly allocable deductions to include a deduction that is otherwise described in Prop. Reg. § 1.1411-4(f) where the deduction is recognized and allowed for Chapter 1 purposes in a later taxable year than the gross income to which it relates. A simple example would be where a cash basis individual has investment income in year 1 and a related investment expense deduction in year 2. The related investment expense deduction can only be claimed in year 2 because such expense is not paid until year 2. As another example, consider Treas. Reg. § 1.1275-4(b), relating to original issue discount accruals on contingent payment debt obligations accounted for under the non-contingent bond method, which provides for positive and negative adjustments when contingent payments differ from the projected amount of such payment established at the time that the debt obligation was issued. In some circumstances, these negative adjustments are treated as ordinary loss. In general, such loss should qualify as "investment expense" (as defined in section 163(d)(4)(C)) that is deductible in computing NII under Prop. Reg. § 1.1411-4(f)(3)(B), even though it is potentially recognized many taxable years after the relating gross income is recognized in NII.

We recommend that the Final Regulations expressly state that for a deduction to be properly allocable to income included in NII, the deduction need not be recognized in the same taxable year as the gross income or net gain is recognized. We also recommend that the Final Regulations confirm that negative adjustments pursuant to Treas. Reg. § 1.1275-4(b)(6), treated as ordinary loss pursuant to that regulation, will be treated as properly allocable deductions and not items taken into account in computing Category 3 Net Gain. Such treatment is appropriate for the same reasons that the negative adjustment is treated as an ordinary loss for Chapter 1 purposes, *i.e.*, the negative adjustment should be permitted to reverse (subject to timing differences) the prior inclusion of interest under the non-contingent bond method.

4. Comments Regarding Losses Triggered under Section 469(g)(1)

The Treasury has requested comments on whether passive activity losses that are triggered pursuant to section 469(g)(1) when the taxpayer disposes of his interest in a passive activity (*i.e.*, a Section 1411 469 Business) should be taken into account only in computing Category 3 Net Gain or instead should be included in "properly allocable deductions."[124] Under section 469(g)(1), a special rule applies to a taxpayer who disposes of his entire interest in any passive activity in a fully taxable transaction to an unrelated party. The taxpayer's aggregate passive losses that were previously suspended under section 469 with respect to that activity plus any passive losses from that activity recognized in the year of disposition are first used to offset passive activity income from that activity for the year, then used to offset income from other

[124] The Preamble could be read to suggest that the first alternative was to allow the losses only to offset the gain recognized from that disposition, but we do not believe that is what was intended.

passive activities for the year, and then any excess may be used against income that is not passive activity income, in each case subject to any non-section 469 limitations that may be applicable to such losses at that time.

If previously suspended losses triggered under section 469(g)(1) on disposition of a passive activity are allowed to offset only Category 3 Net Gains recognized in the year of the disposition, and those losses exceed the amount of other Category 3 Net Gains for that year, then those excess losses will never be taken into account in computing NII.[125] We believe this result is inappropriate and unfair since some or all of the losses subject to section 469(g)(1) (that is, some of the losses generated by the passive activity in prior years and in the year of the disposition) would have been, but for their suspension under section 469, "properly allocable deductions" available to offset all three categories of NII in the year generated. However, some of the losses subject to section 469(g)(1) may have been section 165 losses that would belong in Category 3 (and not in properly allocable deductions). We believe that losses triggered under section 469(g)(1) should be treated as properly allocable deductions, except that any portion of those losses which are section 165 losses should be taken into account as a component of Category 3 Net Gains.

We note that under section 469(g)(1), suspended losses may, once triggered, potentially be used against non-passive income. We do not believe that this should prevent those losses from being used in computing NII (once the losses are triggered). We believe that their origin as passive activity losses should govern whether they may be used in computing NII because they were losses incurred for the purpose of generated income that was (or would have been) included in NII. We also do not believe that the statute in any way precludes treating such losses as properly allocable deductions.

Accordingly, we recommend that suspended passive losses triggered under section 469(g)(1) be treated as properly allocable deductions, except that any portion that is section 165 losses should be taken into account as a component of Category 3 Net Gains. We believe that the application of such rule would be administrable and not overly complex. Taxpayers already generally track the character of the losses suspended under section 469 so they should be able to track which portions are section 165 losses.

f. Foreign Income Taxes and the Chapter 1 Foreign Tax Credit

The Proposed Regulations provide that "properly allocable deductions" include taxes described in section 164(a)(3) that are imposed on the gross income and net gain that is taken into account in computing NII.[126] Taxes described in section 164(a)(3) include foreign income taxes. Under Chapter 1, in any year in which a taxpayer elects to claim a credit under section

---

[125] Prop. Reg. § 1.1411-4(d)(2). That is, except to the extent that they are carried forward as capital losses under Chapter 1 or, if a NOL carryforward is permitted under section 1411, that they are carried forward as part of an NOL under Chapter 1.

[126] Prop. Reg. § 1.1441-4(f)(3)(i)(C).

901 for foreign income taxes, section 275(a)(4) provides that those taxes may not be deducted under section 164(a)(3) in computing the taxpayer's taxable income.[127]

Under the general rule of the Proposed Regulations, provisions of the Code that apply for purposes of computing taxable income under Chapter 1 generally also apply for purposes of computing NII. Applying that principle to this context, if a taxpayer claimed a foreign tax credit under Chapter 1, the foreign taxes would not be deductible in computing the taxpayer's NII.

We considered whether, given that the section 1411 tax is a separate tax from the tax imposed under Chapter 1, it might be appropriate to allow a deduction for a foreign tax in computing NII even if the taxpayer had claimed a credit for those taxes for purposes of Chapter 1. We conclude that it would not be appropriate and believe our rationale is best illustrated with two examples.

> Example 6. United States individual A recognizes $100 of foreign source income, all of which is included in taxable income under Chapter 1 and in NII under section 1411, and A pays $30 in foreign income tax. A has no other items of income or loss and A's effective rate of U.S. income tax under Chapter 1 is 35%.
>
> If A elects to claim a foreign tax credit under Chapter 1, then A's U.S. income tax on the $100, after taking into account the foreign tax credit, is $5 (*i.e.*, $35-$30). A's tax under section 1411 (assuming A's MAGI is above the threshold) will be $3.80. Thus, A's combined Chapter 1, Chapter 2A and foreign tax is $38.80.
>
> If the foreign tax of $30 were deductible in computing NII, the section 1411 tax would be $2.66 (*i.e.*, 3.8% times $70 of NII), and A's combined Chapter 1, Chapter 2A and foreign tax would be $37.66.
>
> Example 7. Contrast Example 6 to a case where United States individual B recognizes $100 of NII that is all U.S source and not subject to foreign tax, but the facts are otherwise the same as in the case of individual A in Example 6.
>
> Individual B will have a combined Chapter 1 and Chapter 2A tax of $38.80. This is the same amount of combined Chapter 1, Chapter 2A and foreign tax that individual A would owe *if* the foreign tax is not deductible in computing NII.

We believe that A should not have a lower Section 1411 liability (or a lower total U.S. tax liability) than B just because A's $100 of income was foreign-sourced and A paid foreign tax on that income. Thus, we believe that Examples 6 and 7 illustrate that allowing a deduction for the foreign tax in computing NII is not appropriate if the individual has claimed a foreign tax credit.

Another approach would be to take the section 1411 tax into account, as a U.S. income tax, in computing the foreign tax credit limitation under section 904 (*i.e.*, total U.S. taxes times a

[127] Importantly, this rule applies even if the taxpayer is limited from using the foreign tax credit as a result of the foreign tax credit limitation provided in section 904.

fraction where the numerator is foreign source income and the denominator is total taxable income). In connection with this idea, consider the following example:

> Example 8. The facts are the same as Example 6, except that the foreign tax paid by individual A is $40 and, because of the section 904 limitation, A is able to utilize in the current year only $35 of the foreign tax credit against his Chapter 1 tax liability. So, A has $5 of excess (unused) credits and zero U.S. income tax liability.
>
> Prior to the enactment of section 1411, A would have had a combined Chapter 1 tax and foreign tax of $40. This can be contrasted to our individual B, who did not have any foreign income and would have had a total tax bill (pre-section 1411) of $35.
>
> After the effective date of section 1411, A's total combined U.S. and foreign taxes would be $40 plus $3.80, for a total of $43.80. B's total combined U.S. taxes would be $35 plus $3.80, for a total of $38.80. Thus, both A and B would have paid an additional $3.80 in U.S. taxes because of the enactment of section 1411. Note that A would still have excess foreign tax credits of $5.

The question being posed is whether the section 1411 tax should be treated as a U.S. tax against which a foreign tax credit can be claimed. Essentially, should A be able to use foreign tax credits to offset the section 1411 tax liability (by taking the section 1411 tax into account under sections 901 and 904)? The statutory text of section 1411 does not provide for a foreign tax credit, but it also does not preclude the section 1411 tax from being considered a U.S. income tax for purposes of computing the section 904 credit limitation. The argument would be that, in computing A's foreign tax credit limitation under section 904, the computation should be

$$\text{U.S. income taxes of \$38.80} \times \frac{\text{foreign income of \$100}}{\text{total income of \$100}} = \text{\$38.80 of 904 limitation}$$

The next step would be that A would claim an additional $3.80 of foreign tax credits and pay a total U.S. and foreign tax of $40.00. A would be offsetting his entire section 1411 liability with the foreign tax credit.

This position is difficult to square with the text of section 901(a) and 904(a) which provide that the section 901 credit may be used only against taxes imposed under Chapter 1, and that the computation of the allowable credit may take into account only those taxes. The pertinent parts of sections 901(a) and 904(a) read as follow (emphasis added):

> 901(a) Allowance of credit
>
> If the taxpayer chooses to have the benefits of this subpart, the tax imposed *by this chapter* shall, subject to the limitation of section 904, be credited with the amounts provided in the applicable paragraph of subsection (b) plus, in the case of a corporation, the taxes deemed to have been paid under sections 902 and 960.
>
> 904(a) Limitation

> The total amount of the credit taken under section 901(a) shall not exceed the same proportion of *the tax against which such credit* is taken which the taxpayer's taxable income from sources without the United States (but not in excess of the taxpayer's entire taxable income) bears to his entire taxable income for the same taxable year.

It appears well-accepted that other taxes imposed by the Code, but not by provisions within Chapter 1, are not taken into account under sections 901 and 904. These include the section 1401 tax (Chapter 2) and the FICA taxes in section 3101.

Nevertheless, we believe that there may be a strong argument that taking the section 1411 tax into account under sections 901 and 904 might be required under certain U.S. income tax treaties when determining the allowable foreign tax credit for taxes imposed by the treaty partner. To assess this argument, we looked at the United States Model Income Tax Convention of November 15, 2006 (the "Model Treaty"), which provides as follows (in pertinent part, with emphasis added):[128]

> Article 23 Relief From Double Taxation
>
> 2. In accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof), the United States shall allow to a resident or citizen of the United States as a credit against *the United States tax on income* applicable to residents and citizens:
>
> a) the income tax paid or accrued to _____ by or on behalf of such resident or citizen …
>
> Article 2 Taxes Covered
>
> 1. This Convention shall apply to taxes on income imposed on behalf of a Contracting State irrespective of the manner in which they are levied.
>
> 2. There shall be regarded as taxes on income all taxes imposed on total income, or on elements of income, including taxes on gains from the alienation of property.
>
> 3. The existing taxes to which this Convention shall apply are:
> a) in the case of _____:
> b) in the case of the United States: *the Federal income taxes imposed by the Internal Revenue Code (but excluding social security and unemployment taxes),* and the Federal excise taxes imposed with respect to private foundations.

---

[128] The U.S. Model Income Tax Convention of November 15, 2006, together with model technical explanation, is available at http://www.irs.gov/Individuals/International-Taxpayers/The-U.S.-Model-Income-Tax-Convention-and-Model-Technical-Explanation.

4. *This Convention shall apply also to any identical or substantially similar taxes that are imposed after the date of signature of the Convention in addition to, or in place of, the existing taxes. The competent authorities of the Contracting States shall notify each other of any changes that have been made in their respective taxation or other laws that significantly affect their obligations under this Convention.*

These provisions would seem to promise the treaty partner that all U.S. taxes on income, other than social security and unemployment taxes, will be taken into account as U.S. taxes against which a credit for the foreign tax can be claimed.[129] The section 1411 tax is an income tax imposed by the Code (*i.e.*, a tax described in Article 2(3)(b)). Although it is designed to match the wages and self-employment Medicare taxes (which are arguable social security taxes), the collected revenues are not paid into any trust fund[130] and this would suggest that it is not a social security tax. The Model Treaty provides that the U.S. foreign tax credit will be allowed "[i]n accordance with the provisions and subject to the limitations of the law of the United States (as it may be amended from time to time without changing the general principle hereof)." This appears to mean that the Model Treaty permits the U.S. to apply its section 901 and section 904 limitations, and that the U.S. reserves the right to amend those rules, but only "without changing the general principle" of the treaty's promise of the foreign tax credit being allowed subject to only those limitations. Thus, under a treaty with the same wording as the Model Treaty, the section 1411 tax would appear to be an income tax that we may have promised our treaty partner would be credited with foreign income taxes subject to the various limitations under U.S. law, including under sections 901 and 904.[131] Of course, all treaties have their own unique wording, but the point is that, depending upon what that wording is, a treaty partner might,

[129] The Technical Explanation to the Model Treaty provides the following explanation:

> The United States agrees, in paragraph 2, to allow to its citizens and residents a credit against U.S. tax for income taxes paid or accrued to the other Contracting State.
> . . . .
> The credits allowed under paragraph 2 are allowed in accordance with the provisions and subject to the limitations of U.S. law, as that law may be amended over time, so long as the general principle of the Article, that is, the allowance of a credit, is retained. Thus, although the Convention provides for a foreign tax credit, the terms of the credit are determined by the provisions, at the time a credit is given, of the U.S. statutory credit.
>
> Therefore, the U.S. credit under the Convention is subject to the various limitations of U.S. law (see, *e.g.*, Code sections 901-908). For example, the credit against U.S. tax generally is limited to the amount of U.S. tax due with respect to net foreign source income within the relevant foreign tax credit limitation category (see Code section 904(a) and (d)), and the dollar amount of the credit is determined in accordance with U.S. currency translation rules (see, *e.g.*, Code section 986). Similarly, U.S. law applies to determine carryover periods for excess credits and other inter-year adjustments.

[130] Staff of the Joint Committee on Taxation, *General Explanation of Tax Legislation Enacted in the 111th Congress,* JCS-2-11, at 260-72; 363-65 (March 23, 2011); Staff of the Joint Committee on Taxation, *Description of the Social Security Tax Base*, JCX-36-11 (June 21, 2011).

[131] The so-called "savings clause" in the Model Treaty excludes the article on preventing double taxation. See Model Treaty, Article 1(5)(a).

understandably, view a denial of the foreign tax credit against the section 1411 tax to be a violation of the treaty.

Consider the following example.

> Example 9. U.S. citizen residing in Country X earns $100 every year. Every year, the U.S. citizen pays foreign income tax to Country X of $39 and receives a full credit in the U.S. resulting in no additional U.S. Federal income tax. The U.S. and X have a treaty that is identical to the Model Treaty.
>
> Beginning in 2013, the U.S. citizen is obligated to pay to the U.S. an additional $3.80 in tax each year and may not reduce that liability with the Country X tax.
>
> In this example, would the U.S. resident have a claim that the U.S. is violating the X-U.S. treaty and would Country X be aggrieved?

Congress does have the power to enact a statute that overrides prior treaty commitments, but it is not at all clear that a treaty override was intended by Congress when it enacted new section 1411 under Chapter 2A (instead of Chapter 1). There is no indication in the legislative history that Congress intended to override prior promises, made to our treaty partners, that all U.S. income taxes would be subject to the credit.

We believe that this raises a number of issues as to which there is no definitive answer: If it is correct that Congress did not intend a treaty override (that is, Congress did not intend to prevent the section 1411 tax from being taken into account under the section 901 and 904 credit computations when the creditable foreign taxes were imposed by a treaty partner whose treaty had provisions in it that are analogous to the Model Treaty provisions), can Treasury and the IRS issue regulations that treat the section 1411 tax as if it were a Chapter 1 income tax in this limited context? Or, does the text of section 901 simply prevent the Treasury and the IRS from reaching this result, such that the only possible fix would be legislative?

We note that if the interpretation is permitted or required only in the case of foreign taxes imposed by treaty partners whose treaties have these provisions, then another complicated question would be how the section 901 and 904 computations should be made when the taxpayer has foreign source income from both a treaty country that follows the Model Treaty and a country that has different treaty provisions with the U.S. or no treaty.

g. Section 1411 Treatment of Certain Income Items

1. Notional Principal Contract Income and Securities Lending Fee Income

Notional principal contract ("NPC") periodic income does not fit within Category 1-Type Income as defined in the Proposed Regulations, and the Preamble seems to confirm this.[132] If the NPC periodic income is derived in a Section 1411 Business, then the NPC periodic income

[132] Preamble at 72617-18.

would be included in NII as Category 2 Income. In addition, gain on a disposition of an NPC will be included in NII as either Category 2 Income (if from a Section 1411 Trading Business) or Category 3 Net Gain. But, NPC periodic income that is earned by an investor would not be included in NII. The Preamble discusses NPCs and, by omitting a discussion of the case of the investor, appears to acknowledge this result.

This omission of NPC periodic income may seem unusual in light of how the Proposed Regulations and the Preamble handle substitute interest and substitute dividends. The Preamble explains that the Proposed Regulations include substitute interest and substitute dividends in Category 1 Income (even though the statute does not refer to them) because Treasury and the IRS do not believe it was Congress's intention for the section 1411 tax to be avoided by easily manipulable formalities. The terms substitute interest and substitute dividends are not defined in the Proposed Regulations, but the Preamble implies that the terms are limited to their traditional (Chapter 1) meaning as substitute payments made to the transferor of a security in a securities lending transaction or a sale repurchase transaction.[133] There is no indication that the reference to substitute dividends is intended to extend to "dividend equivalent payments" within the meaning of section 871(m)(2)(B) (*i.e.*, certain payments made pursuant to NPCs). It appears that such amounts would be treated under the Proposed Regulations in the same manner as other NPC periodic income.

Other types of financial income earned by investors may also not be included in NII. One example, among others, is a "borrow fee" paid or deemed to be paid to an investor in securities lending transaction.[134]

We note that the Preamble cautions that the IRS will closely review and, in appropriate circumstances challenge, using existing judicial doctrines and statutes, transactions that manipulate a taxpayer's NII to reduce or eliminate the tax imposed by section 1411.[135] However, transactions that generate these types of income may not be entered into or structured so as to reduce NII. They may be entered into for business reasons. Yet, the exclusion of these types of investment income from NII, without any explanation as to why these items are excluded, seems arbitrary.

We recommend that the Treasury and IRS consider expanding the definition of Category 1 Income to pick up NPC periodic income, securities lending fee income and other similar items, through a specific or "similar items" rule. However, we recognize that Treasury and the IRS may be concerned about the lack of authority to affect this expansion. In the event that Treasury and the IRS do not believe that they can expand the definition of Category 1 Income by regulation to cover these items, we recommend that the Final Regulations include a specific anti-abuse rule to protect against attempts to exploit these exclusions.

---

[133] Preamble at 72618.

[134] In a securities lending transaction, the lender of the security typically receives substitute dividend or substitute interest payments equal to the dividends or interest paid on the security plus a borrow fee for allowing the borrowing to borrow the security. *See* Shapiro, 188 T.M., *Taxation of Equity Derivatives*, part II.D.4.

[135] Preamble at 72614.

2. Amounts Treated as Dividends Under Chapter 1

The Preamble states that Category 1 Type Income includes amounts treated as dividends under Chapter 1, including amounts treated as dividends under subchapter C, section 1248, section 1368(c)(2) and Treas. Reg. § 1.367(b)-2(e)(2). In order to ensure that practitioners and tax return preparers are aware that these amounts are included in NII, we recommend that the statement provided in the Preamble relating to these amounts be included in the text of the Final Regulations.

h. Determining Whether An Activity Conducted Through an Entity is a Trade or Business

The Proposed Regulations provide rules for determining whether gross income is derived in a Section 1411 Business and whether Category 3 Net Gain is derived from property held in a Section 1411 Business. Under Prop. Regs. §§ 1.1411-4(b)(2)(i) and -4(d)(3)(ii)(B)(3)(i), the determination of whether a trade or business is a Section 1411 469 Business is made at the partner or shareholder level, and under Prop. Regs. §§ 1.1411-4(b)(2)(ii) and -4(d)(3)(ii)(B)(3)(ii), the determination of whether a trade or business is a Section 1411 Trading Business is made at the entity level.[136] However, in each case, an initial determination must be made as to whether the activity itself is a trade or business.

The Proposed Regulations do not clearly state that the determination of whether an activity is a trade or business is made at the entity level, although the examples assume that this is the case.[137] The Final Regulations should include an explicit statement that whether an activity is a trade or business is determined, in all cases, at the entity level.

i. Regrouping under Section 1411

Treas. Reg. § 1.469-4 permits a taxpayer to group its trade or business activities and rental activities, subject to certain limitations, for purposes of applying section 469. Treas. Reg. § 1.469-4(d)(5) provides that a "section 469 entity" must group its activities under the rules of Treas. Reg. § 1.469-4. Once the entity groups its activities, a shareholder or partner of that entity may group those activities with each other, with activities conducted directly by the shareholder or partner, and/or with activities conducted through other "section 469 entities." Under Treas. Reg. § 1.469-4, a shareholder or partner may not treat activities grouped by a section 469 entity as separate activities. As discussed above, the Proposed Regulations permit regroupings of activities for individuals, estates and trusts that are or become subject to section 1411 taxation.[138] While the Proposed Regulations permit individuals, estates and trusts to regroup, they do not permit section 469 entities to regroup. The enactment of section 1411 may cause section 469 entities to reconsider their prior grouping decisions for the same reasons that their shareholders

---

[136] This is illustrated in *Example 2* of Prop. Reg. § 1.1411-4(b)(3), in which individual B owns an interest in a partnership engaged in the Section 1411 Trading Business. Note, however, the statement in that example that "B" is not directly engaged in the business of trading financial instruments. It is unclear what the purpose of the statement is, and whether its inclusion in the example could raise a question of whether B's individual level activities could be relevant to whether the partnership in that example was engaged in a Section 1411 Trading Business (which we believe not to be the intent).

[137] See *Examples 1, 2* and *3* of Prop. Reg. § 1.1411-4(b)(3).

[138] Prop. Reg. § 1.469-11(b)(3)(iv).

or partners would want to regroup. If section 469 entities are not permitted to regroup, many individuals, estates and trusts may not be able to obtain the benefit of the one-time regrouping election.

We recommend that the Final Regulations extend the one-time regrouping right to section 469 entities.[139]

We note that the Proposed Regulations impose limitations as to when taxpayers can regroup. Under Prop. Reg. § 1.469-11(b)(3)(iv), an individual may regroup one's activities for any taxable year that begins during 2013 if section 1411 would "apply to such individual" for such taxable year. In addition, an individual may regroup one's activities in its first taxable year beginning after December 31, 2013 in which section 1411 applies to the individual. If the Proposed Regulations are extended to cover regrouping by entities, the regulations could provide that the regrouping would have to be effected at the first time any of its partners or shareholders was eligible to regroup. A more administrable rule may be to allow the entity to choose to regroup in 2013 or 2014 but not otherwise, without regard to knowing whether its partners or shareholders are eligible to regroup.

j. Gain on Disposition of Interests in Partnerships and S Corporations

1. Computation of Amount Included in Category 3 Net Gains

Section 1411(c)(4)(A) provides that gain from the disposition of an interest in a partnership or S corporation:

> shall be [included in Category 3 Net Gain] only to the extent of the net gain which would be so taken into account by the transferor if all property of the partnership or S corporation were sold for fair market value immediately before the disposition of such interest.

Subsection (B) states that a "similar" rule shall apply to losses from such a disposition.

The Proposed Regulations implement section 1411(c)(4) by first defining when it is relevant: if a partnership or S corporation has no assets from a Non-Section 1411 Business, then all of the income or gain from a disposition of an interest in that partnership or S corporation is included in the computation of NII (in Category 3 Net Gains). Therefore, section 1411(c)(4) applies only if a partnership has both (i) assets used in a Non-Section 1411 Business, and (ii) other assets (whether used in a Section 1411 Business or non-business assets).

The Proposed Regulations then explain that when section 1411(c)(4) does apply to the sale of a partnership interest or S corporation stock, the calculation of the amount of gain or loss taken into account in computing NII occurs as follows: first, the *entire* gain or loss recognized by the transferor from the disposition of the interest (the "outside gain") is potentially Category 3 Net Gain; that total gain (or loss) is then reduced (but not below zero) by the amount of net gain

[139] There have been a number of prior times when regrouping has been permitted. In these cases, the provisions of Treas. Reg. § 1.469-11 allowed "taxpayers" to regroup. These regulations do not include a definition of taxpayer, but in practice it has been assumed that these provisions permitted section 469 entities to regroup.

(or net loss) that would have been allocated to the transferor and would have constituted non-NII income (or loss) to the transferor if the entity had sold all of its assets for fair market value. In other words, the amount of "inside gain" (or loss) on the assets of the Non-Section 1411 Business will be backed-out of the total outside gain (or loss).[140] This approach means that the amount of inside gain or loss from a deemed sale on the entity's Non-Section 1411 Business assets is the primary determinant of how much of the "outside gain" is treated as Category 3 Net Gain. This approach is analogous to how section 751(a) and Treas. Reg. § 1.751-1 recharacterize a portion of the outside capital gain from the disposition of a partnership interest as ordinary income because of the partnership's inside "hot assets,"[141] with the Non-Section 1411 Business assets being analogous to hot assets (and resulting in that portion of the outside gain (otherwise entirely NII) not being treated as NII). Examples 1 and 2 above illustrate the Proposed Regulations' approach.

One possible alternative way to implement section 1411(c)(4) would be to treat the outside gain (or loss) on the sale of an interest in an S corporation or partnership as Category 3 Net Gain to the extent of the lesser of

> (i) the transferor's gain (or loss) on sale of the interest, and
>
> (ii) the amount of Category 3 Net Gain that would be allocated to the transferor if the entity had sold all its assets the disposition of which would give rise to NII.

Under this approach, the amount of inside gain or loss from a deemed sale of the entity's Section 1411 Business assets is the primary determinant of how much of the "outside gain" is treated as Category 3 Net Gain. This approach is again analogous to the approach under section 751 and Treas. Reg. § 1.751-1, except that here the entity's Section 1411 Business assets are the "hot assets." We believe that this approach matches the statutory language more closely than the Proposed Regulations' approach (thus, we will refer to it herein as the "Statutory Approach"). Example 10 illustrates the difference in the mechanics of the two approaches.

> Example 10. Individual X is the sole owner of S, an S corporation, that has two businesses: Business A, which is a Section 1411 Business for X and has a fair market value of $60 and basis of $0, and Business B, which is a Non-Section 1411 Business for X and has a fair market value of $40 and basis of $0. Thus, Business A has $60 of inside gain and Business B has $40 of inside gain. S has no other assets and no working capital. X sells all of his S stock, which has a basis of $0, for $100 and recognizes a $100 gain.

---

140 To be more precise, the Proposed Regulations posit a hypothetical sale of *all* of the entity's properties, but the amount of the reduction is equal to the net gain or net loss that would have allocated to the transferor from the hypothetical sale of the entity's Non-Section 1411 Business properties. The Proposed Regulations do not also posit a hypothetical liquidation of the entity (which might generate additional gain or loss to the transferor). We are not commenting on the asset-by-asset approach of the Proposed Regulations, but we do not mean for that to be interpreted as our agreeing with it or endorsing it.

141 Hot assets refers to unrealized receivables and inventory items within the meaning of section 751(c). Note that the analog is not complete as Treas. Reg. § 1.751-1 does not impose on outside gain/loss limitation on the amount of hot asset gain or loss recognized on disposition of a partnership interest.

Under the Proposed Regulations, X's Category 3 Net Gain is computed as (i) $100 of outside gain *minus* (ii) inside gain on Non-Section 1411 Business of $40, for a total of $60.

Under the Statutory Approach, X's Category 3 Net Gain would be computed as the lesser of (i) total outside gain of $100, and (iii) inside gain on Section 1411 Business assets of $60, for a total of $60.

The Proposed Regulations and the Statutory Approach will always reach the same result if the transferor's outside gain (or loss) is equal to the inside gain (or loss) that he would be allocated if the entity sold all of its assets. Thus, in Example 10, the two approaches produce the same result.[142] The results of the two approaches will differ in cases where outside gain or loss is not equal to inside gain or loss.[143] Examples 11 and 12 illustrate this.

Example 11 (sale at a discount to liquidation value). The facts are the same as Example 10 except that X owns only one third of the stock of S, which he sells for $30. Thus, X's outside gain is $30 and his share of total inside gain is $33.33. Under the Proposed Regulations, X's Category 3 Net Gain would be $16.67 (*i.e.*, (i) $30 of outside gain minus (ii) X's share of the inside gain on Non-Section 1411 Business of $13.33).

Under the Statutory Approach, X's Category 3 Net Gain would be $20 (*i.e.*, the lesser of (i) outside gain of $30 and (ii) inside gain on the Section 1411 Business assets of $20).[144]

Example 12 (inside-outside basis difference). The facts are the same as Example 11 except that X sells his stock for 33.33 (*i.e.*, at its liquidation value) and X has a basis of $3.33 for its one third of the stock of S. Thus, X's outside gain is $30 and his share of total inside gain is $33.33. Under the Proposed Regulations, X's Category 3 Net Gain would be $16.67 (*i.e.*, (i) $30 of outside gain minus (ii) X's share of the inside gain on Non-Section 1411 Business of $13.33).

Under the Statutory Approach, X's Category 3 Net Gain would be $20 (*i.e.*, the lesser of (i) outside gain of $30 and (ii) inside gain on the Section 1411 Business assets of $20).[145]

---

[142] Under the approach of the Proposed Regulations, the gain of 100 on sale of the interest in the entity would be reduced by 40 of deemed sale gain with respect to Business B, resulting in 60 of Category 3 Net Gain.

[143] A difference between inside gain or loss and outside gain or loss can result from either differences (i) between the transferor's basis in interest in the entity and his share of the entity's basis in its assets or (ii) a difference between the sales price of the transferor's interest in the entity and the transferor's share of the deemed proceeds of a Deemed Sale by the entity (*e.g.*, a discount or a premium when the sale is of one partner's interest).

[144] Similar to the case of premium, the Proposed Regulations, in effect, treat the discount as reducing the Category 3 Net Gain, and the Statutory Approach focuses on the inside gain from the Section 1411 Business. This essentially treats the discount as attributable to the entity's other assets.

[145] The Proposed Regulations, in effect, treat the discount as reducing the Category 3 Net Gain, and the Statutory Approach focuses on the inside gain from the Section 1411 Business. This essentially treats the discount as attributable to the entity's other assets.

Examples 11 and 12 illustrate how the Proposed Regulations let the inside net gain (or loss) on the Non-Section 1411 Business control how much of the outside gain is NII, and how the Statutory Approach lets the inside net gain or loss on the Section 1411 Business assets control.

Another possible approach would be a pro-rata method. Under that approach, the portion of outside gain (or loss) treated as Category 3 Net Gain would be determined by multiplying the entire outside gain or loss by a fraction (not exceeding one) where the numerator is the inside gain (or loss) on the Section 1411 Business assets and the denominator is the total inside gain (or loss). Under this approach, any premium or discount or inside-outside basis difference would effectively be allocated between the Section 1411 Business assets and the Non-Section 1411 Business assets pro rata.

In evaluating the respective merits (and disadvantages) of each of these approaches, we considered this statement from the Preamble:

> Congress intended section 1411(c)(4) to put a transferor of an interest in a partnership or S corporation in a similar position as if the partnership or S corporation had disposed of all of its properties and the accompanying gain or loss from the disposition of such properties passed through to its owners (including the transferor).[146]

The Preamble continues by pointing out that inside gain (or loss) might not always match outside gain (or loss) so that an approach must be adopted to determine the amount of outside gain or loss that is Category 3 Net Gain. The Preamble explains that "[i]n most cases" the interest in the entity will not be held by the individual in a trade or business, and that therefore the disposition of the interest would be the disposition of an asset described in Category 3 (and thus would give rise to entirely Category 3 Net Gain).[147] The Preamble then focuses on the fact that section 1411(c)(4) applies *only if* the entity has assets used in a Non-Section 1411 Business.[148] It is from here that we believe the drafters determined that the proper approach was to treat the entire outside gain as Category 3 Net Gain initially but then to back-out the inside gain (or loss) from the Non-Section 1411 Business assets (if there were any).

While we understand the Preamble's reasoning and approach, we believe that the statutory language requires the use of the Statutory Approach. We do not believe that any of the three possible approaches is clearly more consistent with the overall intent of section 1411, or leads to clearly more reasonable or fair results. The Statutory Approach, which treats Section 1411 Business assets in a similar manner to section 751 "hot assets" (but with a cap on the amount of section 1411 asset gain or loss recognized) is probably conceptually easier to understand because of its similarity to the existing section 751 rules and, in that way, less complex. With respect to administrability and the burden imposed on taxpayers, we believe the approaches are roughly the same. Accordingly, we recommend that the Final Regulations adopt the Statutory Approach rather than the approach of the Proposed Regulations.

---

[146] Preamble at 72626.
[147] *Id*.
[148] *Id*.

2. Valuing Goodwill For Purposes of the Deemed Asset Sale

The Proposed Regulations provide a special rule for valuing goodwill (the "Goodwill Rule") in performing the deemed asset sale computations described in the prior section. This special rule applies only if section 1411(c)(4) applies, the entity is engaged in more than one business, *and* the deemed asset sale results in any gain or loss attributable to goodwill. Under this Goodwill Rule, the value of the entity's total goodwill is treated as though it is attributable to the entity's trades or businesses based on the relative fair market value of the property (excluding cash and goodwill) held for use in each trade or business.[149]

We recommend, for the reasons discussed below, that the Goodwill Rule not be included in the Final Regulations. Instead, we recommend that any goodwill in the entity be treated as attributable to the business(es) it is actually attributable to and that it be valued using commonly accepted valuation methods. Our reasons for this recommendation are as follows:

First, the Goodwill Rule potentially resurrects many of the troublesome and time-consuming issues which led to the enactment of section 197 (enacted as part of the Omnibus Budget Reconciliation Act of 1993). Under section 197, all "amortizable section 197 intangibles" are amortizable and all are assigned the same amortization period; and, subject to certain limited anti-churning rules, goodwill is an amortizable section 197 intangible. Section 197 eliminated most of the controversy relating to the distinction of goodwill (which was not amortizable prior to the enactment of section 197) from other intangibles, such as workplace in force, customer lists and supplier relationships, that were amortizable under pre-section 197 law. The controversies involved significant amounts of money (in taxes) and taxpayers took the controversies to the courts (including, in one notable case, to the United States Supreme Court). The Goodwill Rule resurrects the importance of the distinction of goodwill from other section 197 intangibles for tax purposes. These distinctions can be hazy and complicated, with no definitive answers. If the Goodwill Rule is included in the Final Regulations, it will in some cases give taxpayers and the IRS incentives to try to characterize intangibles as goodwill or as something other than goodwill (*i.e.*, in cases where the distinction would change the total amount of section 1411 tax due from the taxpayer).[150] Even if the amounts at issue do not merit litigating the issue, they could cause significant controversies which would consume resources and attention.

---

[149] Prop. Reg. § 1.1411-7(c)(5)(ii)(A). See also Prop. Reg. § 1.1411-7 (e) *Example 8*. If the entity is engaged in one trade or business, the entire gain or loss on the hypothetical sale of goodwill will be treated as gain or loss from the disposition of property held for use in that trade or business. Rules are also provided for property that is held for use in more than one trade or business. The Goodwill Rule actually should not be relevant unless the entity is engaged in at least one Section 1411 Business and at least one Non-Section 1411 Business, but the Proposed Regulations express the rule as applying whenever the entity has more than one business.

[150] We are sympathetic to the difficulty of the issue presented when a partnership interest or S corporation stock is sold at a premium to the value of the identified assets. In such a circumstance, under the typical valuation, such excess would be allocated to section 197 intangibles for purposes of the regular income tax. Where one business is subject to tax under section 1411 and another is not, there is a legitimate concern about allocating that premium between the two businesses. In essence, the premium reflects the value of some intangible assets and most likely goodwill. In such a case, allocating the residual premium or goodwill will raise issues. Nevertheless, we do not believe that an arbitrary rule is preferable over a rule that requires that the businesses be valued separately.

Second, this Goodwill Rule (when it applies) will create a distinct difference in the section 1411 tax results of a sale of an interest in the entity as contrasted to a sale of the assets of the entity. Such a difference would be contrary to the goal articulated in the Preamble and would provide taxpayers with some amount of electivity as to which results they would prefer (provided they can alter the form of the sale to bring about the results they desire). For example, the Goodwill Rule will apply if the members of a partnership sell all of their partnership interests to a single buyer, but the rule will not apply if the partnership sells all of its assets to that buyer. In the example below, the individual partners would have better NII consequences if the partnership sold its asset (rather than the individual partners selling their partnership interests), but in other cases the converse would be true.

> Example 13. Partnership P is owned 40% by individual A, who has a tax basis of \$108 for his interest. P has two businesses, (i) Business X which is a Non-Section 1411 Business with respect to A, has a fair market value of \$100, and the sole asset of that business is goodwill with a value of \$100 with a tax basis of \$70, and (ii) Business Y that is a Section 1411 469 Business with respect to A and has a fair market value and tax basis of \$200 and no goodwill. Neither business has any cash.
>
> Assume that all partners sell their partnership interests to a single buyer for \$300. A will have \$12 of gain on the sale. If the Goodwill Rule applies, all of that gain will be attributed to the Section 1411 469 Business, and accordingly all of the A's gain will be NII (even though economically all of the gain is attributable to the Non-Section 1411 Business). If instead, P sold all of its assets for \$300, A's distributive share of the gain would again be \$12, but the Goodwill Rule would not apply and none of A's gain would be NII. Thus, from an NII perspective, A will prefer an asset sale.

If under the facts of the example, X was the Section 1411 469 Business and Y was the Non-Section 1411 Business, the consequences would be reversed, and A's gain would be NII on the asset sale but not on the partnership interest sale. In that case, A would prefer a partnership interest sale.[151]

In addition, as this example shows, the rule may produce results that do not match the economic reality. For example, under the facts of Example 13 above, allocating all of the goodwill to Business Y contradicts the actual fact that the goodwill belongs to Business X.

For the foregoing reasons, we recommend that the Goodwill Rule be eliminated.

3. Reporting Requirements for a Disposition of an Interest in a Partnership or S Corporation

Pursuant to Prop. Reg. § 1.1411-7(d), the transferor must attach a statement to the transferor's return for the year of disposition (the "Adjustment Statement"). The statement must include (i) a description of the disposed of interest, (ii) the name and taxpayer identification

---

[151] We believe that there may be a variety of other ways that taxpayers could try to structure out of or into the Goodwill Rule.

number of the entity disposed of, (iii) the fair market value of each property of the entity, (iv) the entity's adjusted basis in each property, (v) the transferor's allocable share of gain or loss with respect to each of the entity's properties, (vi) information regarding whether the property is a Non-Section 1411 Business asset, (vii) the amount of Category 3 Net Gain with respect to the disposition of the interest in the entity, and (viii) the computation of the adjustment under section 1411(c)(4).

Treasury and the IRS recognize that this requirement may impose an administrative burden on owners of interests in partnerships or S corporations and have requested comments for other methods that may be less burdensome. While a partnership that has a section 754 election in effect will generally have the information required by the Adjustment Statement, the partnership would generally not be expected, or required, to provide it with the level of detail contemplated by the Proposed Regulations. Instead, the partnership would generally just provide the transferee partner with the amount of its section 743 adjustment. Technical compliance with the Adjustment Statement requires information about hundreds, or potentially thousands of assets. Moreover, S corporations do not make such adjustments and would not be likely to have even the information available to partners in a partnership that has made a section 754 election.

A transferor does not generally have access to the fair market value and adjusted basis of each property held by the entity and, therefore, does not have the information necessary for the Adjustment Statement. However, the Proposed Regulations require the transferor, and not the entity, to file the Adjustment Statement. The Proposed Regulations seem to imply that the entity should provide this information to the transferor and yet, the Proposed Regulations do not provide a clear mechanism for the transferor to obtain such information.

Regardless whether the Final Regulations maintain the Proposed Regulations' current approach, adopt the Statutory Approach, or adopt another approach, we have the following recommendations with respect to the Adjustment Statement:

We recommend that the Final Regulations contain an unambiguous rule requiring an entity to provide the information necessary for the Adjustment Statement, but only if (i) the transferor requests such information in writing and (ii) the transferor advises the entity of its passive or active status with respect to each trade or business of the entity.

We also recommend that a transferor be permitted to group and net assets for purposes of the Adjustment Statement. The entity would report to the transferor the net gain or net loss from each category of the trade or business, rather than sending the transferor a potentially lengthy asset-by-asset list. The property-by-property analysis can become even more complicated when multi-tier entities are involved and when a lower-tiered entity owns thousands of assets (which may all be treated as Non-Section 1411 Business assets with respect to the transferor).

Treasury and the IRS should also consider whether to apply a disclosure requirement in the context of a multi-tiered entity. Multi-tiered entities present especially problematic informational issues as an entity may have access to information of certain entities but not others. In addition, the transferor may own a small percentage of certain entities within a multi-tiered

entity structure and it may prove too burdensome for the transferor to submit an Adjustment Statement that incorporates the required information with respect to such entities.[152]

Finally, if our recommendation regarding adoption of the Statutory Approach is not adopted, we recommend that the Adjustment Statement be required to include only information regarding the deemed sale of Non-Section 1411 Business assets. The information required under the Proposed Regulations with respect to Non-Section 1411 Business assets is not used in the calculation of Category 3 Net Gain. Requiring the inclusion of such information in the Adjustment Statement, while perhaps useful in an audit context, imposes a substantial burden that we believe is not justified when weighed against the benefit of having the information regarding Non-Section 1411 Business assets on the statement.

k. How The Code's Three 3.8% Medicare Hospital Insurance Taxes Apply to Different Types of Income and Types of Income That Are Not Subject to Any of These Taxes

The legislative history to section 1411 makes it clear that the section 1411 Medicare contribution tax was intended by Congress to parallel the other two existing hospital insurance taxes imposed on income of individuals, and that it was not a coincidence that for taxable years beginning in 2012 all three taxes are imposed at the same rate on income over a specified threshold (which is the same in the case of all three taxes).[153] These three taxes are:

> *The "FICA HI" Tax:* The Medicare hospital insurance taxes imposed on "wages", which consists (for 2012 and later years) of a 1.45% tax on all wages payable by the employer, a 1.45% tax on all wages payable by the employee, and a .9% tax payable by the employee on wages above the threshold amount (meaning all wages above the threshold are subject to a combined 3.8% tax).[154]
>
> *The "NESE HI" Tax:* The Medicare hospital insurance tax imposed on "net income from self employment" which consists (for 2012 and later years) of a 2.9% tax on all NESE and a .9% tax on NESE in excess of the threshold amount (meaning that all NESE above the threshold is subject to a 3.8% tax).[155]
>
> The Medicare contribution tax on "net investment income" (titled the "Medicare contribution tax on *unearned income*" (emphasis added), which consists of a 3.8% tax on NII.

There is no statement in the legislative history or elsewhere that indicates that all income of U.S. individuals is intended to be subject to one of these three Medicare contribution taxes. Nevertheless, it is clear that Congress intended the section 1411 tax to apply only to income that

[152] We believe that the appropriate rule in the case of multi-tiered entities is a look through rule to the underlying trades or businesses. This rule should apply both for determining whether a trade or business is a Section 1411 Business as well as for purposes of computing the amount of gain or loss that should be included in NII.

[153] This is the case, even though section 1411 also applies to estates and trusts, while the FICA HI tax and NESE HI tax do not.

[154] Section 3111(b)(6)(employer's 1.45% tax), 3101(b)(1)(employee's 1.45% tax), and 3101(b)(2)(employee's 0.9% tax). These three taxes are part of FICA.

[155] Section 1401.

was not subject to the other two Medicare taxes. In this section of the Report, we consider classes of income recognized by individuals that historically have not been subject to the FICA HI tax or the NESE HI tax and also may not be subject to the section 1411 tax.

1. Income From Ownership of S Corporation Shares

An individual who owns S corporation shares will be subject to the FICA HI tax on any amount paid to the individual by the S corporation as wages (and any additional amount recharacterized as wages); the individual's share of S corporation profits, as a shareholder, are not subject to the FICA HI tax or the NESE HI tax. This has been the state of the law for many years and we and others have commented on it in the past.[156] The question we ask here is whether that share of S corporation profits is subject to the NII HI tax?

The share of S corporation profits that will be subject to the NII HI tax consists of income that is:

(i) derived by the S corporation through a Section 1411 Trading Business,

(ii) derived by the S corporation from a business that is a Section 1411 469 Business as to the shareholder (*i.e.*, an active business as to which the shareholder is not a material participant),

(iii) Category 1-Type Income (not derived in the ordinary course of a Non-Section 1411 Business by the S corporation), and

(iv) gains from the dispositions of property that is not used by the S corporation in a Non-Section 1411 Business.

The share of the S corporation profits that will not be subject to the NII HI tax (and also not subject to the FICA HI tax or the NESE HI tax) consists of income that is:

(i) derived by the S corporation through a business as to which the individual shareholder is a material participant for section 469 purposes (provided the business is not a Section 1411 Trading Business).

Similarly, the shareholder will not be subject to any of these three taxes with respect to gain on the sale of the stock of the S corporation, to the extent that such gain is attributable to Non-Section 1411 Businesses of the S corporation.[157]

---

[156] New York State Bar Association Tax Section, *Report on Legislative Proposal Regarding Employment Taxes and Professional Service Businesses,* Report No. 1218 (Sept. 21, 2010) ("**2010 Report**"); New York State Bar Association Tax Section, *Comments on JCT Recommendation Relating to Employment and Self-Employment Taxes of Partners, LLC Members and S Corporation Shareholders* Report No. 1097 (Sept. 23, 2005) ("**2005 Report**"); New York State Bar Association Tax Section, *Report on the Self-Employment Tax As Applied to Owners of Interests in Pass-Through Entities* (Dec. 9, 1994) ("**1994 Report**").

[157] Gain on sale of the stock is excluded under section 1402. As to section 1411, see Prop. Reg. § 1.1411-7.

Whether it is inappropriate for this type of business income or gains to be subject to none of these three taxes is obviously a question for Congress because the design of the three statutory provisions leaves no room for doubt as to the treatment of this type of income.

2. Income From Owning a General Partner Interest

An individual who owns an interest in a partnership as a general partner will be subject to the NESE HI Tax on:

> the partner's distributive share of partnership income[158] other than income that consists of dividends, interest, capital gains and gains from the disposition of property that is neither inventory nor property held for sale in the ordinary course of a trade or business.

These items that are excluded from NESE will generally be included in NII, except that gains from the disposition of property that is excluded from NESE will also be excluded from NII if the property is held by the partnership for use in a trade or business that the individual partner materially participates in (for section 469 purpose) (and which business is not a Section 1411 Trading Business).[159]

In addition, a general partner will not be subject to either section 1401 or 1411 tax with respect to gain on the sale of an interest in the partnership, to the extent that such gain is attributable to a trade or business of the partnership that the individual materially participates in (and that is not a Section 1411 Trading Businesses).[160]

Whether it is inappropriate for this type of business income or gains to be subject to none of these three taxes is obviously a question for Congress, because the design of the three statutory provisions leaves no room for doubt as to the treatment of this type of income.

3. Income of Limited Partners under Section 1402(a)(13)

Another case of income that is not subject to any of the three taxes is income of a limited partnership, passed through to a limited partner (as defined for section 1402(a)(13) purposes), that is (i) not Category 1 Income or gain from the sale of assets held for investment, (ii) not passive activity income of the limited partner (because the partner materially participates in the activity), (iii) not derived in a Section 1411 Trading Business and (iv) not a guaranteed payment within the meaning of section 707(c) for services to the partnership. This income is not wages, does not fall within the definition of NII and, under section 1402(a)(13), is not included in NESE. In addition, the limited partner will not be subject to any of the three 3.8% taxes with respect to gain on the sale of an interest in the limited partnership, to the extent that such gain is attributable to Non-Section 1411 Business assets of the limited partnership.

This outcome, with respect to a limited partner's distributive share of income (but not gains exempt from both taxes), results from an individual potentially being able to qualify as a

---

[158] Treas. Reg. § 1.1402(a)-2(d).
[159] Assuming they are not derived in a Section 1411 Trading Business.
[160] Gain on sale of the partnership interest is excluded under section 1402. As to section 1411, see Prop. Reg. § 1.1411-7.

limited partner for purposes of section 1402,[161] but nevertheless being able to participate sufficiently in the activities of the partnership to meet the material participation standard of section 469,[162] and thereby, avoiding classification of the partner's income from the partnership as passive activity income. Past NYSBA reports have recommended that revised regulations should be issued under section 1402 with respect to the definition of a limited partner for purposes of section 1402(a)(13), and that such regulations should give little or no weight to state law classifications, including (i) whether a person that is a member of an entity that is a partnership for federal income tax purposes is a state law partner (in comparison to, *e.g.*, a member of an LLC) and (ii) whether the partner or member of the entity is a limited partner or managing member for state law purposes.[163] Instead, we have recommended that the distinction between a limited partner and a person (treated as a partner for federal income tax purposes) that is not a limited partner for purposes of section 1402(a)(13) be based on that person's level of participation in the activities of the partnership determined under guidelines similar to those contained in the material participation rules of Treas. Reg. § 1.469-5T(a). Under our recommendation, a partner or member that materially participates in the partnership's activities would be treated as a general partner for purposes of applying section 1402(a)(13).[164] Our prior reports concluded that the Treasury had the authority to issue such regulations. In our most recent prior report,[165] we also noted that amending the section 1402(a)(13) regulations has developed an increasing importance and urgency in light of the adoption of section 1411, and absent an amendment, significant potential for tax avoidance will develop to take advantage of any gap between the definitions of "income and loss of a limited partner" for purposes of section 1402(a)(13) and income that is treated as passive income under section 469 (and hence Category 2 Income).[166] The potential avoidance opportunity is illustrated by the following example.

---

[161] The definition of limited partner for purposes of section 1402(a)(13) has been narrowly interpreted by the courts under current law. The statutory definition would include any limited partner in a state law partnership, regardless of level of activity. Note also that the treatment of members of an LLC as limited partner under both sections 469 and 1402 is unclear, and it has been argued that a member of an LLC (taxed as a partnership for federal income tax purposes) is not a partner for purposes of either statute. *See, e.g.*, Renkemeyer, Campbell & Weaver, LLP, *et al.* v. Comm'r, 136 T.C. No. 7 (2011).

[162] The regulations under section 469(h)(2) provide that in the case of a limited partner, only a subset of the provision that generally allow a partner to establish material participation is available; but a limited partner can avoid passive treatment if it meets at least one of the tests in this subset. Treas. Reg. § 1.1469-5T(e)(2). For example, limited partners can meet the material participation standards for a taxable year by participating in the activity for more than 500 hours during the taxable year.

[163] New York State Bar Association Tax Section, *Comments on the Application of Employment Taxes to Partners and the Interaction of the Section 1401 Tax With the New Section 1411 Tax*, Report No. 1247 (Nov. 14, 2011) ("**2011** Report"); New York State Bar Association Tax Section Report, *Comments on Proposed Regulations Relating to Definition of Limited Partner For Self-Employment Tax Purposes* (March 11, 1997); New York State Bar Association Tax Section Report, *Comments on Proposed Regulations Relating to Self-Employment Tax Treatment of LLC Members* (Nov. 16, 1995); 1994 Report; *see also* 2010 Report and 2005 Report.

[164] Note that amending the regulations under section 1402 to conform with the definition of a limited partner interest proposed in Prop. Reg. § 1.469-5(e) would not be sufficient to close the gap. This is because (i) the proposed regulations under section 469 define limited partner interest by reference to the partner's rights to manage the entity rather than level of participation and (ii) a partner that is classified as a limited partner for purposes of section 469(h)(2) may nevertheless still be considered to materially participate in the activities of the partnership for purposes of section 469. *Id.*

[165] 2011 Report.

[166] Some members of the working group have suggested that even if Treasury cannot modify the section 1402 regulations to achieve that result, it might instead be possible to include a provision in the section 1411 regulations

Example 14. P is a state law limited partnership that engages in the business of manufacturing widgets. Individual A is a state law limited partner of P, who works full time in the business, and as a result, meets the material participation standards of Treas. Reg. § 1.469-5T(a). A's distributive share of P's income from operations for 2013 (excluding income from working capital and other items that would be considered Category 1 Income) is $100,000. P also receives guaranteed payments for services of $60,000 for 2013. Under section 1402(a)(13), P's $100,000 of distributive share will be exempt from tax under section 1401, and it will not be subject to tax under section 1411, as it is not passive income or otherwise includible in NII.

As discussed below, the result with respect to gains recognized by a partner, either passed through as distributive share or upon disposition of its limited partnership interest, is more of an inherent feature of the section 1411 statute and does not depend on his classification of a limited partner under section 1402(a)(13) or the regulations thereunder.

4. Retirement Payments to Partners

In the case of both general and limited partners, retirement payments paid by the partnership are included in NESE, unless they qualify for a specific exception set out in section 1402(a)(10).[167]

Retirement payments that are excluded from NESE under this exception would generally be included in NII because the payments would be considered "other income" from a Section 1411 Business. Specifically, the retirement payments would be treated as allocation of profits from a partnership and included in NII either (i) as Category 2 Income (income from a trade or business conducted by the partnership which is a passive activity under section 469 as to the retired partner) or (ii) as Category 1 Income and Category 3 Net Gains (investment income derived by the partnership). However, the retirement payments that are excluded from NESE under the NESE exception might also be excluded from NII if considered derived in the conduct of a trade or business activity which is not a Section 1411 469 Business as to the retired partner.[168] Specifically, the retired partner might meet the second requirement of the NESE exception and also meet the material participation test under Treas. Reg. § 1.469-5T (by having materially participated in any three taxable years before the current one and the activity is a

that would treat the income of any person from a federal tax partnership as passive income, if that person claimed limited partner status for purposes of section 1402(a)(13), regardless of whether that person otherwise met the material participation standards of section 469. Most members of the working group believe that this would be problematic given the explicit statutory reference in section 1411 to using section 469 standards for purposes of determining whether income is passive.

[167] The exception applies only if four requirements are met: (1) the payments are paid on a periodic basis upon retirement to a partner pursuant to a written plan and which continue at least until the partner's death, (2) the retired partner receiving the payments rendered no services with respect to any trade or business carried on by the partnership *during the taxable year of the partnership that ends within or with the taxable year of the partner and in which the payment is received*, (3) there is no obligation on the part of the other partners to the retired partner except with respect to retirement payments under the plan, and (4) the retired partner's share of the capital of the partnership has been paid to him in full before the close of the partnership's taxable year in which the payment is received. (emphasis added)

[168] Prop. Reg. § 1.1411-4(c).

personal service activity or materially participated in any five taxable years during the ten preceding taxable years).

It is unclear whether the exclusion of these retirement payments from both NESE and NII should be viewed as a statutory feature of section 1411 or as an omission that can be corrected by regulation. If the latter, the Treasury could consider limiting the available material participation tests under Treas. Reg. § 1.469-5T for purposes of computing NII.

5. Covenant Not to Compete Income

Income received by an individual for a covenant not to compete ("CNC") is ordinary income.[169] In some contexts, CNC income will be included in NESE,[170] but in other contexts, it will not be included in NESE[171] or treated as "wages." For example, if a founder of a company, who is not an employee, enters into a CNC in connection with a sale of his stock in the company, the CNC income would be neither "wages" nor NESE. The CNC income would also not be Category 1 Income or a component of Category 3 Net Gain, nor would it appear to be "other income" from a trade or business. Accordingly, it would appear that under some circumstances CNC income would not be subject to any of the three Medicare HI taxes.

I. Application of Section 1411 to Funds

The application of section 1411 to income derived by managers of investment vehicles that are classified as partnerships for U.S. tax purposes (namely, investment funds and hedge funds) is complex and raises issues that should be carefully considered. One reason that we focus on this type of income is that section 1411 explicitly includes in NII income "derived from … a trade or business of trading in financial instruments or commodities," and yet income derived by the managers of these businesses (and other similar businesses) may not be included in NII.[172]

1. Private Equity and Hedge Funds

We focus on two common types of investment vehicles. We use the term "private equity fund" to refer to an entity that is a partnership for U.S. tax purposes, is an investor (not a trader)

---

[169] See Baker v Comm'r, 118 T.C. 452 (2002). This assumes that CNC payments, if made in the context of a sale of a business, are not viewed as payments for goodwill.

[170] *See, e.g.*, Rev. Rul. 82-210 (providing that a consulting agreement with a former employer that prohibited the former employee from performing work for any other business or individual does not preclude liability of the former employee for self-employment tax); *see also, e.g.*, *Norman D. Erickson*, TC Memo 1992-585 (providing that where amounts received for past services in conjunction with a noncompete covenant, such amounts are subject to self-employment tax). CNCs entered into as part of a consulting agreement are particularly vulnerable as consulting is generally considered a trade or business. See RIA Federal Tax Coordinator 2nd paragraph A-6094.

[171] *See*, *e.g.*, *Herbert R. Barrett*, 58 TC 284 (providing that amounts received by a former executive under an agreement that provided for both consulting and a covenant not to compete were not subject to self-employment tax); *Milligan* v. *Comm'r*, 74 AFTR 2d 94-6714 (providing that certain termination payments to a former insurance agent were not subject to self-employment tax). The case for exclusion from self-employment tax will be strongest if the CNC is not coupled with a consulting agreement and is not part of an agreement to compensate for past services. *See* RIA Federal Tax Coordinator 2nd at par. A-6094.

[172] The issues are not limited to managers of funds, but in the case of managers of funds, there are some unique issues due to the fact that section 1411 explicitly includes in NII income derived from a trading business.

for U.S. tax purposes, and invests primarily in equity interests and debt interests issued by "portfolio companies." We use the term "hedge fund" to refer to an entity that is a partnership for U.S. tax purposes, is a trader for U.S. tax purposes, and trades in stock, securities, derivatives or commodities.

The investors who contribute capital to these funds usually invest as limited partners and receive allocations of the fund's profits, losses, income, deductions and credits in proportion to the capital they have invested. The managers of these funds usually receive compensation composed of two elements.

First, there is a fixed management fee paid periodically. The management fee is usually a fixed percentage (often 2%) multiplied by the amount invested in (or the value of) assets held by the fund plus, in certain cases, uninvested capital commitments. This management fee is typically paid by the fund to a management company (the "Management Company"). The Management Company is typically an entity classified for U.S. tax purposes as a partnership (a state law partnership or limited liability company) or an S corporation and owned (directly or indirectly) by the individuals who provide the management services. The management company may or may not be an owner of an equity interest in the fund. The Management Company may receive management fees from more than one fund (and may engage in other activities as well).

Second, there is what is referred to as a "carried interest." Funds typically have one partner (usually the general partner or the managing member) that is a partnership for U.S. tax purposes and is owned (directly or indirectly) by the individuals who provide the management services (the "GP Entity"). The GP Entity receives an allocation of a percentage of the fund's profits (typically 20%, and usually only after a specified hurdle rate of return has been received by the other investors). This profit share is proportionately greater than the portion of the total capital contributed by the GP Entity (which may be a *de minimis* amount) and therefore is referred to as a "carried interest." Because the fund is a partnership for U.S. tax purposes, the profits and losses allocated to the investors and to the GP Entity have the same character as they have for the fund. In some cases, the Management Company and the GP Entity are the same entity or one is owned by the other.

2. Applying Section 1411 to Managers of Private Equity Funds and Hedge Funds

As explained above, individuals who provide the management services to a private equity fund or hedge fund will usually be allocated (i) as owners of the Management Company, a portion of the management fee paid by the fund to the Management Company, and (ii) as owners of the GP Entity, a portion of the carried interest allocated by the fund to the GP Entity.

For section 1411 purposes, the management fee income would not be included in Category 1 Income (interest, dividends, annuities, royalties, and rents) or Category 3 Net Gains, so it would be included in NII only if it falls in Category 2 as other income from a Section 1411 Business. The Management Company is not in the business of trading in securities or commodities, so under the Proposed Regulations the fee would not be income from a Section 1411 Trading Business. The Management Company is usually in the business of providing management services to the fund, and the individual managers are likely to take the position that

that business is not, as to them, a "passive activity" within the meaning of section 469 (and thus the fee is not, as to them, income from a Section 1411 469 Business). Accordingly, the managers will likely take the position that the fee income is income from a Non-Section 1411 Business and thus not included in NII.

The analysis of the carried interest is different. The types of profits and losses recognized by a private equity fund or hedge fund will usually include dividends, interest, long and short term capital gains and losses from disposing of stock, debt, and certain other securities and derivatives, and ordinary income and expenses from derivatives. The carried interest allocated to the GP Entity will therefore be composed of some or all of these types of income. The income will retain that character for section 1411 purposes when recognized by the individual managers who are owners of the GP Entity.

The portion of the carried interest consisting of dividends and interest will be included in those individual's NII as Category 1 Income and the portion consisting of long and short term capital gains and losses will be included in Category 3 Net Gains unless it was derived in the ordinary course of a Non-Section 1411 Business (for the Category 1 Income) or attributable to property held in a Non-Section 1411 Business (for the Category 3 Net Gains). The Proposed Regulations provide that the determination of whether these Non-Section 1411 Business exceptions are met is made at the lowest level at which the items of income are recognized,[173] which in this context means the fund. In order for a fund to be engaged in a Non-Section 1411 Business, the business would need to be both (i) an active trade or business to which Section 162 applies and (ii) not the business of trading in securities or commodities.

A private equity fund is unlikely to meet those requirements. Accordingly, the carried interest when recognized by the individual managers will generally be included in their NII.[174]

In the case of a hedge fund, the fund is likely to be, for U.S. tax purposes, engaged in the business of trading in securities or commodities (*i.e.*, a "Section 1411 Trading Business") and, accordingly, in the hands of the managers, the carried interest will be income from a Section

---

[173] Prop. Regs. §§ 1.1411-4(b)(2) and (d)(3)(ii)(B)(3); see also § 1.1411-4(b)(3) *Example 1*.

[174] We have not discussed the section 1411 treatment of the managers' carried interest when the private equity fund invests in a portfolio company that is a pass-through for U.S. tax purposes (*e.g.*, a Delaware limited liability company engaged in an active business in the U.S.). In that case, the income, gain, loss and deductions derived by the portfolio company will be allocated to the fund and by the fund to its partners (and may be included in the carried interest allocated to the GP Entity). The character of this income for section 1411 purposes in the hands of the managers will depend upon a number of factors. One possibility is that the portfolio company is engaged in business that is not a Section 1411 Trading Business. In that case, the income from that business will retain its character in the hands of the managers and the determinative question will be whether the portfolio company's activities are "passive activities" within the meaning of section 469 as to each manager. The individual managers of a private equity fund often become involved in the business of the portfolio companies, ranging from serving as director to active day to day involvement in management; whether that involvement would make the portfolio company's business not a passive activity (within the meaning of section 469) as to any individual manager would depend upon all the facts. If the portfolio company's activity is a passive activity as to an individual manager, then the portion of the carried interest attributable to that portfolio company's income would be included in that individual's NII as income from a Section 1411 469 Business. If the manager were active (within the meaning of section 469) in the portfolio company's business, all or some of the carried interest attributable to profits from that company would likely be excluded from NII as income derived in a Non-Section 1411 Business.

1411 Trading Business. In this context, it will be irrelevant whether the managers actively participate in the fund's trading business, because income from a Section 1411 Trading Business is always included in NII. Thus, the carried interest of the managers of a hedge fund will be generally included in NII.

3. Interaction of Sections 1411 and 1401 in the Case of Fund Managers

How section 1411 and section 1401 interact in the case of fund managers is also complex. Section 1411(c)(6) provides that:

> Net investment income shall not include any item taken into account in determining self-employment income for such taxable year on which a tax is imposed by section 1401(b).

The Proposed Regulations follow this by providing (in Prop. Reg. § 1.1411-9(a)) that:

> Except as provided in paragraph (b) of this section, net investment income (as defined in § 1.1411-4) does not include any item taken into account in determining self-employment income that is subject to tax under section 1401(b) for such taxable year.

The section 1401 tax is imposed on an individual's "net income from self-employment " ("NESE") as defined in section 1402.

4. The Management Fee Paid to the Management Company

For the reasons explained above, the management fee would not be included in the individual managers' NII under the Proposed Regulations. The management fee might also not be included in those managers' NESE. Even though fee income is the type of income that is normally included in NESE, in cases where the Management Company is a partnership for U.S. tax purposes, the individual managers may take the position that, except to the extent of any Section 707(c) guaranteed payments, their share of the Management Company's profit is excluded from NESE because it is derived by them as limited partners in the Management Company and thus excluded from NESE pursuant to the exception in section 1402(a)(13).[175] Alternatively, the management company may be an S corporation and the individual shareholders' share of the S corporation profits would not be includible in NESE (although any amount paid to them as wages by the S corporation (or recharacterized as wages) would be subject to the FICA HI tax. Other structures are also possible, including that the Management Company is a general partnership or a limited liability company and the managers own their interests through limited partnerships (in which they are limited partners) or through S corporations.

---

[175] See section 1402(a)(13) ("there shall be excluded the distributive share of any item of income or loss of a limited partner, as such, other than guaranteed payments described in section 707(c) to that partner for services actually rendered to or on behalf of the partnership to the extent that those payments are established to be in the nature of remuneration for those services").

Whether it is appropriate for the management fee income allocated to the managers not to be included in NESE pursuant to Section 1402(a)(13) or because it is received as profits from an S corporation are historic issues that pre-date section 1411. We have separately addressed these NESE issues in other reports. Our focus here is on section 1411, and that the management fee income (which historically has not been subject to the section 1401 tax) is likely also not to be subject to the new section 1411 tax.

5. The Carried Interest Allocated to the GP Entity

For the reasons explained above, the carried interest of both private equity fund managers and hedge fund managers will generally be included in their NII. Historically, this income has usually not been included in NESE because it consists of income, dividends, capital gains and other investment income that is not included in NESE (see section 1402(a)(2) and (3)) or because the managers claim the section 1402(a)(13) exception. Thus, the carried interest generally will be subject to this new additional 3.8% tax while the management fee will not be.

This raises the question of whether fund managers may have an incentive to restructure their compensation so that they no longer receive a carried interest, and instead receive an equivalent amount of income as additional management fee income (which could be paid to the Management Company that is already receiving the management fee). The managers would then take the position that this additional management fee would not be includible in either their NESE or their NII.

If the carried interest were so restructured, the character of the income would change (from passed-through dividends, interest, long and short term capital gains and losses, etc.) to ordinary fee income. In the case of a hedge fund where the carried interest does not include long-term capital gains and therefore is already subject to tax at ordinary income rates, the managers are not likely to care about the change from pass-through income to fee income.

In the case of equity fund managers, because their carried interest will usually consist primarily of long-term capital gains and qualifying dividend income, which are taxed at rates significantly below ordinary income, they would not be willing to change the character to ordinary or in order to save a 3.8% tax. However, if long-term capital gains rates cease to be lower than ordinary income rates, or through legislation or otherwise carried interest is no longer taxed at capital gains rates, then private equity fund managers may also have a reason to restructure their compensation structure along the same lines.[176]

6. Possible Options Available to Treasury and the IRS

As outlined above, some individual fund managers have historically taken the position that their management fee income is excluded from NESE to the extent received by them as a limited partner or as an S corporation shareholder.[177] Under the Proposed Regulations, the management fee income would also not be included in those individuals' NII (assuming the

---

[176] Private equity funds would need to address section 457A concerns.

[177] We do not in our analysis mean to imply that tiered structures intended to change the tax treatment of income for NESE purposes is not subject to question under present law. *See Renkemeyer, Campbell & Weaver, LLP* v. *Comm'r*, 136 T.C. 137, (2011); *Robucci* v. *Comm'r*,101 T.C.M. (CCH) 1060 (2011).

individual manager materially participates in the Management Company's business activities). Thus, the fee income that has historically not been included in NESE may also not be included in NII.

There are many different views as to whether this is appropriate, and those who view it as inappropriate have differing views as to what possible responses are available to Treasury and the IRS under the current statute. In this section, we try to set out those views in the hope that this will assist Treasury and the IRS in deciding what action, if any, to take. Some members of our committee are of the view that an individual should not be able to take the position (i) that he or she is a "limited partner" under section 1402(a)(13) as to a stream of income and (ii) at the same time that the same income is derived from a section 162 trade or business as to which he or she is a material participant (and thus it is not a section 469 passive activity as to the individual). In other words, an individual should not be able to be both a "limited partner" for section 1402 purposes and a "material participant" for section 1411 purposes as to a stream of income since, these members believe, this would be contrary to the apparent purpose of the statute.

One way for Treasury and the IRS to address this concern would be to issue regulations under section 1411 providing that a taxpayer who takes the position he or she is a limited partner as to certain income under section 1402 cannot take the position that, for section 1411 purposes, this same income is from a trade or business as to which he or she actively participates (*i.e.*, a Non-1411 Business). This would be a regulation under section 1411 and would not address whether the position taken under section 1402 was correct or supportable.[178] This would also address taxpayers in all types of industries, not just fund managers.

There may be a concern that such regulations would contradict section 1411, which provides that the existing section 469 rules should determine whether an individual is a "material participant." One possible way to address that concern would be to issue regulations under both section 469 and section 1411.[179]

Others believe that the regulations should be targeted to fee income of fund managers. These members focus on the fact that section 1411 explicitly includes in NII *all income* from any business that is the business of trading in securities or commodities. Their view is that the inclusion of all income from a securities or commodities trading business reflects clear Congressional intent to include in NII all income derived by those individuals who manage those trading businesses and that this outweighs the section 1411 reference to section 469 in the case of hedge fund managers.

Others point out that the statutory inclusion of income from a Section 1411 Trading Business may not support including in NII the fee income of managers who are not managing Section 1411 Trading Businesses. In other words, should managers of private equity funds have their fee income included in NII even though they are section 469 material participants and even

[178] Such a regulation would not do anything about S corporation shareholders whose profits are included in neither NESE nor NII.

[179] Alternatively, regulations could be issued under section 469 which provide that no individual may take the position that he is a limited partner for section 1402 purposes and a material participant for section 469 purposes. That idea is beyond the scope of this Report, but we note that it could have collateral consequences that may be undesirable for other reasons.

though their fee income is not from managing a Section 1411 Trading Business? Whether managers of hedge funds should be treated differently from or the same as managers of equity funds with respect the section 1411 treatment of their management fees is an important question.

Another important question is whether regulations should be issued that prevent S corporation shareholders from excluding their share of the S corporation's fee income from both NESE and NII, or whether such regulations would be beyond Treasury and the IRS's authority under current law. [180] These questions are particularly difficult because the legislative history is so sparse.

Another consideration is how to address the possibility of hedge fund managers converting what was previously a carried interest (which would be included in NII) into a component of the management fee which presumably would not be included in NII (or in the NESE HI tax base). One view is that the very reason Congress included any income from a Section 1411 Trading Business in NII is that Congress intended to have hedge fund managers' carried interests included in NII (not their fee income). If Treasury and the IRS want to prevent hedge fund managers from converting what was carried interest into management fee in an attempt to avoid section 1411, we see a few options available to Treasury and the IRS.[181]

One possibility would be to provide in regulations under section 1411 that NII includes any income where the amount is determined (in whole or in substantial part) by the profits of a business of trading on securities and/or commodities. This would capture a management fee of a hedge fund manager that is computed in the same manner as carried interest is now computed.

Another possibility would be to provide in regulations under section 1411 that any compensation derived from managing a trading business is included in NII, unless it is included in wages or NESE. Another possibility would be an anti-abuse rule that is narrowly targeted to situations where structures were modified or adopted with principal or significant purposes of avoiding section 1411. We believe, however, that a targeted anti-abuse rule would be difficult to write and difficult to apply without being overinclusive, easy to avoid, or so difficult to apply in practice as to create unacceptable uncertainty.

Finally, some members of our group find these issues troubling but believe that these issues cannot be resolved through regulations and that what is needed is legislative action.

---

[180] Some members view the issues raised by limited partners who claim the section 1402(a)(13) exception as different from the issues raised by S corporation shareholders who share of profits is not included in NESE.

Other members do not differentiate between the two. These members focus on the fact that the Code now includes three 3.8% Medicare taxes applicable to income of individuals: one applicably to wages, one applicable to earned income that is not wages (section 1401), and one applicable to unearned income (section 1411). These members have expressed the view that Congress's intent was that all income of individuals be subject to one of these three taxes.

[181] We focus here on hedge fund managers because they have an incentive to do such restructuring under current law, whereas equity fund managers do not (for the reasons explained in the text). An additional consideration in the case of each option is whether the same rule should apply to managers of equity funds.

V. Closing Comments

As illustrated by this Report (and other commentaries on the Proposed Regulations), the statutory text of section 1411, together with its placement in a new Chapter 2A, has resulted in the computation of NII being exceedingly complex. In fact, we believe that section 1411 (together with the Proposed Regulations) is now one of the most complex provisions in the Code, even though the complexities may be relevant only to certain taxpayers. The amount of resources that have been and will, we anticipate, continue to be spent on interpreting, applying, and auditing compliance with section 1411 is daunting when one considers it in the context of the Code and the U.S. Federal income tax as a whole. We doubt that Congress intended this. We urge the tax writing committees to consider whether statutory amendments to section 1411 might be appropriate in order to remove what we believe are unintended complexities and in order to simplify the computation of NII. We would be pleased to assist in any way that we can.