**8564. What is “net gain” with respect to the disposition of property and net investment income?**

Pursuant to IRC Section 1411(c)(1)(A)(iii), “net gain” attributable to the disposition of property is included in net investment income. Significantly, the term “net gain” means that dispositions of property that trigger gain that are netted against “losses” generated in those same types of dispositions. Similar to regular income taxation, only taxable gains and non-deductible losses are considered. Thus, because the gain must be “recognized” for income tax purposes, dispositions of property that are income tax-free are also net investment income tax-free. Examples of such tax-free gains include but are not limited to like-kind exchanges under IRC 1031 (See Q 8574 - Q 8594) and involuntary conversions (See Q 8574 – Q 8582).[[1]](#footnote-1)

Although the term “net gain” means that the gains and losses described above have been netted, as discussed in Q 8567, gain attributable to the disposition of property held by a trade or business in which the taxpayer materially participates, i.e., non-passive (other than a trade or business trading in financial instruments and commodities) is excluded from net investment income. In other words,

* Net gain recognized from the disposition of property held in a trade or business in which the taxpayer materially participates -- not included in net investment income
* Net gain recognized from the disposition of property held in a trade or business in which the taxpayer does not materially participate -- included in net investment income.
* Net gain recognized from the disposition of investment property (no trade or business involved) – always included in net investment income.
* Net gain recognized from the disposition of any property held by business of trading financial instruments or commodities (regardless of the taxpayer’s participation in the business) -- always included in net investment income.

See Q 8569.02 for a discussion of how net investment income gains are netted against net investment income losses.

**8564.02. How are gains from the disposition of property netted against losses in determining “net gain” included in net investment income?**

As discussed in Q 8564, above, for purposes of IRC Section 1411(c)(1)(A)(iii) “net gain” means that gains are netted against “losses.” For example, a disposition of property held by a trade or business in which the taxpayer does not materially participate (passive) that results in a recognized gain would be offset by a similar disposition of property that results in an allowed deductible loss. Examples of losses include those allowed under IRC Section 165, i.e., casualty losses (see Q 8617), theft losses (see Q 8620), and losses realized as a result of worthless securities (see Q 8667) involving property held by a trade or business in which the taxpayer does not materially participate.

Additionally, the same rules for the deductibility of regular income tax losses also apply to the netting of net investment income losses against gains. So, similar to regular income tax, net investment income ordinary losses are netted against net investment income capital gain and net investment ordinary gain.

Also, the final regulations provide for the offset of capital losses and capital gains in arriving at “net gain” included in net investment income in the same way as they offset each other for regular income tax purposes. For regular income tax purposes, capital losses are deductible to the extent of capital gains plus $3,000 of any excess being deductible against other income. The unused excess loss is carried over to subsequent tax years subject to being netted against capital gains generated in such years.[[2]](#footnote-2) Similarly, for net investment income purposes, a taxpayer may use the same netting rules to reduce “net gain” to zero, with $3,000 of any excess reducing other investment income. Any unused excess capital loss is carried over to subsequent years to be netted against capital gain in the same manner.[[3]](#footnote-3)

**Planning Point:** Significantly, in the aggregate net investment income losses are only deductible to the extent of net investment income gains meaning that net gain cannot be reduced below zero.[[4]](#footnote-4) In other words, there can never be a “net loss.” However, as discussed in Q 8564.03, the final regulations do allow excess investment income losses to be used to reduce other net investment income.[[5]](#footnote-5)

 **8564.03. Can excess net investment income losses be used to reduce other net investment income?**

Yes. As discussed in Q 8564.02, the offsetting of net investment income losses against net investment income gains can never result in a “net loss.” However, pursuant to the final regulations, excess losses may be used to reduce other net investment income provided those losses were deducted in the computation of regular income tax. In other words, the loss must be deductible for regular income tax purposes for it to be deducible in this context.[[6]](#footnote-6)

*Example:* Iris, a single taxpayer has $125,000 of interest and dividends, $60,000 of ordinary losses from a trade or business in which Iris does not materially participate and long-term capital gain from the sale of undeveloped land. For purposes of IRC Section 1411(c)(1)(A)(iii), the net long-term capital gain is net investment income gain because the property was held for investment and there is no trade or business involved. The $60,000 ordinary losses are net investment income losses because the underlying property was held by a trade or business in which Iris did not materially participate. As a result of netting the $60,000 of ordinary losses against the $50,000 of long-term capital gain, there is an excess loss of $10,000. Assuming the excess loss is deducted for regular income tax purposes, the final regulations allow that amount to be deducted against the Iris’ other net investment income, i.e., $125,000 of interest and dividend net investment income (includible under IRC Section 1411(c)(1)(A)(i)).[[7]](#footnote-7)

So in the end, the entire amount of $60,000 of net investment income loss was fully deductible against some type of net investment income. First, $50,000 of the loss offset $50,000 of long-term capital gain. Second, the excess loss, $10,000 was deductible against the $125,000 of interest and dividends, resulting in $115,000 of net investment income.

1. . Treas. Regs. §§1.1411-4(a)(1)(iii), 1.1411(d) (see examples). [↑](#footnote-ref-1)
2. . IRC Sec. 1211(b).. [↑](#footnote-ref-2)
3. Treas. Reg. §1.1411-4(d)(2). [↑](#footnote-ref-3)
4. Treas. Reg. §1.1411-4(d)(2). [↑](#footnote-ref-4)
5. Treas. Reg. §1.1411-4(f)(1). [↑](#footnote-ref-5)
6. Treas. Reg. §1.1411-4(f)(1). [↑](#footnote-ref-6)
7. Treas. Reg. §1.1411-4(h). [↑](#footnote-ref-7)