**8566. How does a taxpayer determine whether income is derived from the taxpayer’s trade or business and, if so, excluded from net investment income?**

The test for determining whether interest, dividends, annuities, royalties and rents otherwise included as net investment income pursuant to IRC Section 1411(c)(1)(A)(i) are excluded from net investment income is different from the test to determine whether net investment income otherwise included pursuant to IRC Sections 1411(c)(1)(A)(ii) and (iii) are similarly excluded.

As to IRC Section 1411(c)(1)(A)(i) net investment income, i.e., the traditional types of investment income, the exclusion applies if such income is derived in the “ordinary course” of a trade or business within the meaning of Treasury Regulation Section 1.469–2T(c)(3)(ii). This means the income is the type the trade or business is designed to generate. The following are examples of such income:

1. Interest income on loans and investments made in the ordinary course of a trade or business of lending money;
2. 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;
3. 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;
4. 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;
5. Royalties derived by the taxpayer in the ordinary course of a trade or business of licensing intangible property.[[1]](#footnote-1)

The common denominator in these examples is the nexus between the trade or business and the income generated. For example, interest income on loans is the type of income a bank is designed to generate. Conversely, interest or dividend income derived from invested working capital for future use in the taxpayer’s trade or business is not that type of income; and, thus is treated as net investment income.[[2]](#footnote-2) Moreover, under no circumstances is any income derived from trading in financial instruments or commodities ever be excluded from net investment income.[[3]](#footnote-3)

As to income derived in a trade or business that is not treated as net investment income pursuant to IRC Sections 1411(c)(1)(A)(ii) and (iii), there is a much looser test for the application of the exclusion. That test is the same for both sections. As discussed in Q 8560, IRC Section 1411(c)(1)(A)(ii) deals with the regular gross income of a trade or business. Conversely, IRC Section 1411(c)(1)(A)(iii) deals with net gain attributable to the sale or exchange of property.

Unlike the IRC Section 1411(c)(1)(A)(i) exclusion, there is no requirement that the income must be of the type that the trade or business is designed to generate. Instead, to qualify for the exception, the income must be derived from a trade or business in which the taxpayer materially participates (non-passive) and under no circumstances is the income derived from trading in financial instruments or commodities.[[4]](#footnote-4) Stated differently, pursuant to IRC Section 1411(c)(1)(A)(ii), net investment income includes all income derived from a trade or business that is passive with respect to the taxpayer. However, if the trade or business is non-passive with respect to the taxpayer, the income is excluded from net investment income. For a discussion regarding determining whether an activity is passive or non-passive, see Q 8567.

As mentioned above, the same test is used to determine whether net gain attributable to disposition of property (sale or exchange) otherwise included in net investment income pursuant to IRC Section 1411(c)(1)(A)(iii) is excluded from net investment income. In applying this test, the net gain is excluded only if the disposed of property is held in a trade or business which is non-passive with respect to the taxpayer and is not derived from a business trading in financial instruments or commodities. Thus, the net gain from the disposition of property held by a trade or business that is passive with respect to the taxpayer would be included in net investment income.

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| **Net Investment Income Exclusion for Income Derived in the Taxpayer’s Trade or Business** | | |
|  | **Included as Net Investment Income** | **Excluded from Net Investment Income** |
| **IRC Section 1411(c)(1)(A)(i) Interest, Dividends, Annuities, Rents and Royalties** | **Traditional Investment Income** | **The type of income the business was designed to generate, i.e., interest income earned by a bank.** |
| **IRC Section 1411(c)(1)(A)(ii)**  **Gross Income from a Trade or Business** | **Income derived from a trade or business that is passive with respect to the taxpayer or derived from a business trading in financial instruments or commodities. Also includes income from an activity that does not arise to the level of a trade or business.** | **Income derived from a trade or business that is non-passive with respect to the taxpayer other than income derived from a business trading in financial instruments or commodities.** |
| **IRC Section 1411(c)(1)(A)(iii)**  **Net Gain from the Disposition of Property Held in a Trade or Business** | **The underlying trade or business is passive with respect to the taxpayer or is a business trading in financial instruments or commodities.** | **The underlying trade or business is non-passive with respect to the taxpayer and is not a business trading in financial instruments or commodities.** |

1. Treas. Regs. §1.469-2T(c)(3)(ii); 1.1411-6. [↑](#footnote-ref-1)
2. IRC Section 1411(c)(3). [↑](#footnote-ref-2)
3. . IRC Sec. 1411(c)(2). [↑](#footnote-ref-3)
4. . IRC Sec. 1411(c)(2). [↑](#footnote-ref-4)