

**Office of Chief Counsel
Internal Revenue Service
Memorandum**

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subject: Application of § 1411 to dividend income

This Chief Counsel Advice responds to your request for assistance. This advice may not be used or cited as precedent.

ISSUES

- 1) Whether dividend income received by an individual shareholder from a C corporation, in which the shareholder is an employee, is subject to the Net Investment Income Tax (NIIT) under § 1411.
- 2) Whether the conclusion is affected if the C corporation is a closely-held corporation within the meaning of § 469(j)(1) as described in § 465(a)(1)(B).

CONCLUSIONS

- 1) Dividend income received by an individual shareholder from a C corporation in which the shareholder is an employee is subject to tax under § 1411.
- 2) This conclusion is the same even if the C corporation is a closely-held corporation within the meaning of § 469(h)(1) as described in § 465(a)(1)(B).

FACTS

The Taxpayer is a shareholder in a C corporation. It was determined under examination that the corporation paid Taxpayer's personal expenses from corporate accounts, and the payments were reclassified as dividend income paid to the Taxpayer by the corporation. The Taxpayer is also an employee of the corporation and is involved in the day-to-day operations of the corporation's manufacturing trade or business. The facts further indicate that the corporation may be a closely-held corporation within the meaning of § 469(h)(1) as described in § 465(a)(1)(B) (the Taxpayer appears to own a majority of the shares of the corporation). The Taxpayer contends that because the Taxpayer materially participates in the manufacturing trade or business of the corporation as an employee, the dividend income that the Taxpayer received from the corporation is not subject to tax under § 1411, because the dividend income is derived in the ordinary course of a trade or business that is not a passive activity of the Taxpayer within the meaning of § 469.

LAW AND ANALYSIS

Section 1411(a)(1) provides that in the case of an individual, there is a 3.8 percent tax imposed on the lesser of (A) net investment income, or (B) the excess of modified adjusted gross income for the taxable year, over the threshold amount.

Section 1411(c)(1) provides that "net investment income" means: (i) gross income from interest, dividends, annuities, royalties, and rents, other than such income which is derived in the ordinary course of a trade or business not described in § 1411(c)(2), (ii) other gross income derived from a trade or business described in § 1411(c)(2), and (iii) net gain attributable to the disposition of property other than property held in a trade or business not described in § 1411(c)(2).

Section 1411(c)(2) provides that § 1411 applies to income derived in the ordinary course of a trade or business if such trade or business is: (A) a passive activity (within the meaning of § 469) with respect to the taxpayer, or (B) a trade or business of trading in financial instruments or commodities (as defined in § 475(e)(2)).

Treas. Reg. § 1.1411-1(d)(3) provides, in part, that the term gross income from dividends includes amounts treated as dividends pursuant to subchapter C that are included in gross income (including constructive dividends).

Treas. Reg. § 1.1411-4(a) provides that net investment income means the excess any of--

(1) The sum of --

- (i) Gross income from interest, dividends, annuities, royalties, and rents, except to the extent excluded by the ordinary course of a trade or business exception described in § 1.1411-4(b);

- (ii) Other gross income derived from a trade or business described in § 1.1411-5 (which describes trades or businesses to which § 1411 applies); and
- (iii) Net gain (to the extent taken into account in computing taxable income) attributable to the disposition of property, except to the extent excluded by the exception described in § 1.1411-4(d)(4)(i)(A) for gain or loss attributable to property held in a trade or business not described in § 1.1411-5; over

(2) The deductions allowed by subtitle A that are properly allocable to such gross income or net gain (as determined in § 1.1411-4(f)).

Treas. Reg. § 1.1411-4(b) provides, in part, that gross income described in § 1.1411-4(a) is excluded from net investment income if it is derived in the ordinary course of a trade or business that is not a passive activity of the taxpayer (within the meaning of § 469)¹ To determine whether gross income is derived in the ordinary course of a trade or business, the following rules apply.

- (1) In the case of an individual, estate, or trust that owns or engages in a trade or business directly (or indirectly through ownership of a disregarded entity within the meaning of § 301.7701-3), the determination is made at the individual, estate, or trust level.
- (2) In the case of an individual, estate, or trust that owns an interest in a passthrough entity (for example, a partnership or S corporation), and that entity is engaged in a trade or business, the determination of whether gross income is derived from a passive activity is made at the owner level.

Section 469(c)(1) defines a passive activity, in part, as any activity which involves the conduct of any trade or business, and in which the taxpayer does not materially participate.

Section 469(e)(1)(A)(i)(I) provides that, for purposes of § 469, 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.

Treas. Reg. § 1.469-2T(c)(3)(i)(A) provides that passive activity gross income does not include portfolio income. For purposes of the preceding sentence, portfolio income includes all gross income, other than income derived in the ordinary course of a trade or business (within the meaning of § 1.469-2T(c)(3)(ii)) that is attributable to interest (including amounts treated as interest under § 1.469-2T(e)(2)(ii)), relating to certain

¹ The rules for determining whether gross income is derived in the ordinary course of a trade or business under § 1.1411-4(b) also apply to the trade or business of trading in financial instruments or commodities. See 1.1411-5. This memo only focuses on the passive activity rules.

payments to partners for the use of capital); annuities; royalties (including fees and other payments for the use of intangible property); dividends on C corporation stock; and income (including dividends) from a real estate investment trust (within the meaning of § 856), regulated investment company (within the meaning of § 851), real estate mortgage investment conduit (within the meaning of § 860D), common trust fund (within the meaning of § 854), controlled foreign corporation (within the meaning of § 957), qualified electing fund (within the meaning of § 1295(a)), or cooperative (within the meaning of § 1381(a)).

Treas. Reg. § 1.469-2T(c)(3)(ii) provides for seven limited scenarios where certain types of portfolio income described in § 1.469-2T(c)(3)(i) will be treated as derived in the ordinary course of a trade or business. Only under two of these scenarios would dividend income be treated as derived in the ordinary course of a trade or business. Section 1.469-2T(c)(3)(ii)(C) provides that 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. Section 1.469-2T(c)(3)(ii)(D) provides that 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.

Treas. Reg. § 1.469-4(d)(5)(i) provides, generally, that a C corporation subject to § 469, an S corporation, or a partnership (a § 469 entity) must group its activities under the rules of § 1.469-4. Once a § 469 entity groups its activities, a shareholder or partner may group those activities with each other, with activities conducted directly by the shareholder or partner, and with activities conducted through other § 469 entities, in accordance with the rules of § 1.469-4. A shareholder or partner may not treat activities grouped together by a § 469 entity as separate activities.

Treas. Reg. § 1.469-4(d)(5)(ii) provides that an activity that a taxpayer conducts through a C corporation subject to § 469 may be grouped with another activity of the taxpayer, but only for purposes of determining whether the taxpayer materially or significantly participates in the other activity. See § 1.469-2T(c)(3)(i)(A) and (c)(4)(i) for the rules regarding dividends on C corporation stock and compensation paid for personal services.

A. Section 1411 applies to dividends received by a shareholder of a C Corporation.

Section 1411(c)(1) generally provides that dividend income received by an individual taxpayer from a C corporation is net investment income unless such income is derived in the ordinary course of a trade or business. To qualify for the “ordinary course of a trade or business” exception, § 1.1411-4(b) provides that the dividend income must be derived in a trade or business conducted (1) directly by the taxpayer (or through a disregarded entity owned by the taxpayer), or (2) through a passthrough entity (partnership or S corporation). Since a C corporation is not a passthrough entity and is also not a disregarded entity, dividend income received by a C corporation

shareholder generally cannot satisfy the “ordinary course of trade or business” exception in § 1.1411-4(b).

C corporation stock generally produces dividend income to its shareholders and the stock is generally treated as property held for investment for purposes of § 469(e)(1)(A) and § 1.469-2T(c)(3), unless the dividends are derived in the ordinary course of a trade or business. Under these rules, any dividend income paid by a C corporation would not be derived by a shareholder in the ordinary course of a trade or business unless the shareholder is a dealer or a trader in stock or securities. Being a shareholder in a C corporation in and of itself is not a trade or business that would cause the dividend income received by the shareholder from the C corporation to be properly treated as derived in the ordinary course of a trade or business.

To further illustrate this point, it should be noted that a shareholder generally cannot offset dividend income from a C corporation with any deductions for expenses the C corporation incurred in carrying on its business, because such expenses would not be properly allocable deductions within the meaning and for purposes of § 1411(c)(1)(B). If, for argument’s sake, dividend income could be properly treated as derived in the ordinary course of the trade or business conducted by the C corporation, it would seem that, for purposes of calculating the net investment income of the shareholder under § 1411(c)(1)(B), such deductible expenses of the C corporation would be properly allocable deductions against such income (because the income and deductible expenses would have been derived in the ordinary course of the same trade or business). This clearly is not the proper result under § 1411 or under the tax law generally.

In this case, Taxpayer holds C corporation stock and has not shown that the dividends were received in the ordinary course of the Taxpayer’s trade or business. Rather, Taxpayer argues that participating in the C corporation’s business as an employee is sufficient to meet the exception in § 1411(c)(1)(A)(i). Taxpayer’s involvement in the C corporation’s trade or business is not relevant. Further, § 1.469-2T(c)(3)(ii) contain two exceptions that treat dividend income from C corporations as income from a trade or business. See § 1.469-2T(c)(3)(ii)(D) and (E). Those exceptions are for insurance businesses, and for the business of trading or dealing in property. Neither of these two exceptions apply in this case. The dividends paid to Taxpayer are net investment income under § 1411(c)(1)(A)(i).

B. The conclusion is not affected if the C corporation is a closely-held corporation within the meaning of § 469(h)(1) as described in § 465(a)(1)(B).

C corporations generally are not subject to the passive loss rules under § 469. Section 469 does, however, apply to closely held C corporations. See 469(a)(2)(B). Special rules under § 469 apply to closely-held C corporations such that a closely held C corporation generally can only offset its passive losses against its active income. Closely held C corporations are subject to § 469 because Congress feared that individuals would use these entities to incorporate their portfolio investments to avoid

§ 469. S. Rep. No. 313, 99th Cong. 2d Sess. 722 (1986). The passive loss rules to the entity and limit the closely held C corporation's use of passive losses.

Section 1.469-4 provides rules for grouping a taxpayer's activities for purposes of applying § 469. Section 1.469-4(d)(5)(ii) provides an activity that a taxpayer conducts through a closely held C corporation subject to section 469 may be grouped with another activity of the taxpayer, but only for purposes of determining whether the taxpayer materially or significantly participates in the other activity. See, Gregg v. U.S., 186 F. Supp.2d 1123 (D. OR 2000), Senra v. CIR, T.C. Memo 2009-79.

As discussed above, § 1.1411-4(b) does not provide any rules for determining whether gross income derived by a shareholder of a C corporation (including a closely held C corporation) may be properly treated as derived in the ordinary course of a trade or business. C Corporations, including closely held C corporations, are not passthrough entities. This analysis and conclusion do not change simply because a shareholder may be treated as materially participating, for purposes of § 469, in a trade or business activity conducted through a closely held C corporation. Accordingly, any dividend income received by a shareholder from a C corporation will be subject to tax under § 1411, irrespective of whether the C corporation is a closely held C corporation within the meaning of § 469(h)(1) or whether the shareholder is treated as materially participating in the trade or business activity of the C corporation.

Please call (312) 777-5279 if you have any further questions.