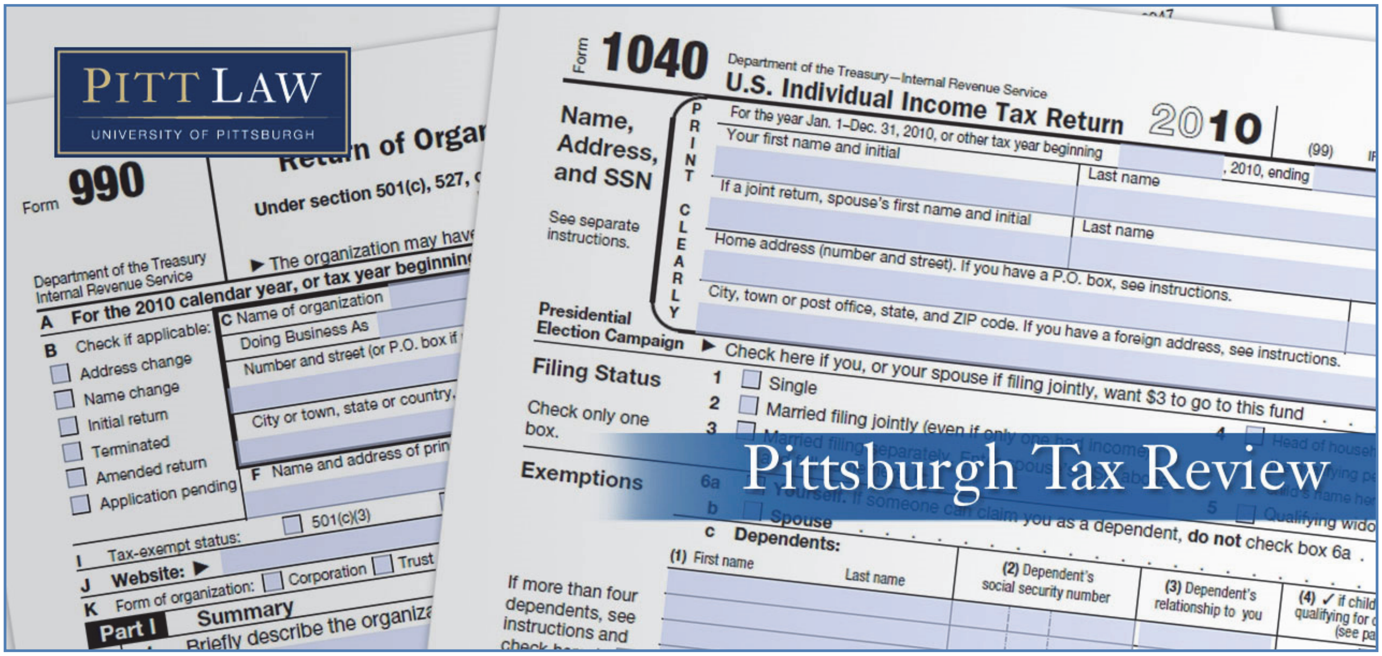

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CROSS-DEDUCTIONS IN THE NET INVESTMENT INCOME TAX IMPOSED ON A TRUST OR ESTATE WITH SEPARATE SHARES

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*Michael T. Yu**

INTRODUCTION

The Health Care and Education Reconciliation Act of 2010 imposed, through new Code § 1411, a tax of 3.8% on certain net investment income (NII) of certain individuals, estates, and trusts for taxable years beginning after December 31, 2012 (the Net Investment Income Tax, or NIIT).[1] Final regulations under § 1411 were published on December 16, 2013, which are effective for taxable years beginning after December 31, 2013.[2] Section 1411 and the regulations thereunder, despite imposing the NIIT on certain trusts and estates, contain no reference to § 663 or the regulations thereunder (the separate share rule).[3] Neither § 663(c) nor the regulations thereunder have been amended to reflect new § 1411 or the regulations thereunder. Treasury Regulation § 1.1411-1(a) ostensibly incorporates § 663(c) (and all other Chapter 1 Code provisions that determine taxable income under § 63(a), sometimes referred to in this article as the regular income tax) into

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[1] Health Care and Education Reconciliation Act of 2010, Pub. L. No. 111-152, § 1411, 124 Stat. 1029, 1061–63 (2010).

[2] For taxable years beginning on or before December 31, 2013, "taxpayers may rely on either the proposed regulations or these final regulations for purposes of compliance with section 1411." T.D. 9644, 2013-51 I.R.B. 676.

[3] The term "separate share rule" does not appear in § 663(c). The Treasury Regulations, however, refer to the "separate share rule" and "the separate share rule provided by section 663(c)." *E.g.*, Treas. Reg. § 1.663(c)-1–4 (as amended in 1999). In previous articles of mine, the term "separate share rule" referred to § 663(c), and the term "separate share regulations" referred to Treasury Regulation section 1.663(c)-1–5. In this article, I sometimes refrain from referring to the separate share "rule" or "regulation" in order to parallel references to § 663(c) to references to § 1411.

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determining the NIIT, but I argue that the regulation uses imprecise language and should be amended along the lines of my proposed language.

Additionally, § 1411 currently allows for certain cross-deductions between and among the separate shares of a trust or estate, which I have previously criticized as to the regular income tax imposed on trusts and estates imposed under § 641.[4] By allowing such cross-deductions, § 1411 contravenes the separate share regulation providing that deductions and losses applicable solely to one separate share of a trust or estate are "not available to any other share of the same trust or estate."[5] Consequently, I propose a calculation and allocation of distributable net income (DNI)[6] for purposes of the NIIT that allows for tracing of the separate economic interests of the separate shares of a trust or estate.[7]

Part I of this article first provides a general overview of §§ 1411 and 663(c) and the interaction between them and the respective regulations thereunder and then proposes a revised regulation to clarify the relationship between and among the two sections and their regulations. Part II discusses the possibility of certain cross-deductions under § 1411, in conjunction with §§ 661, 662, and 663(c).[8] Finally, Part III presents and discusses a proposed calculation and allocation, to the separate shares of a trust or estate, of income and deduction items entering into the computation of NII and DNI of the trust or estate.

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[4] Michael T. Yu, *Deductions in a Proposed Allocation of Distributable Net Income to the Separate Shares of a Trust or Estate*, 5 PITT. TAX REV. 123, 134–44 (2008).

[5] Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999).

[6] Distributable net income (DNI), which will be discussed more fully later in the article, is, for any taxable year, the taxable income of the trust or estate with certain modifications. I.R.C. § 643(a).

[7] I have previously proposed a calculation and allocation of DNI for purposes of the regular income tax. *See* Yu, *supra* note 4, at 145–53.

[8] For an overview of the income taxation of trusts and estates with separate shares and of the separate share rule and the separate share regulations, see Michael T. Yu, *A Proposed Allocation of Distributable Net Income to the Separate Shares of a Trust or Estate*, 3 PITT. TAX REV. 121, 123–27 (2006).

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I. Overview of Interaction Between §§ 1411 and 663(c)

Section 1411 provides a 3.8% tax on certain NII of certain individuals, estates, and trusts for the taxable years beginning after December 31, 2012.[9] The NIIT applies in addition to "any other tax imposed by this subtitle,"[10] which includes the regular income tax applicable to trusts and estates under § 641. The NIIT, as to a trust or estate, applies to the lesser of the following two amounts: (1) the "undistributed net investment income" for such taxable year or (2) the excess (if any) of the "adjusted gross income" for such taxable year over "the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year."[11]

NII is, in general terms, the excess (if any) of (1) certain gross income and net gain over (2) those allowed deductions that are properly allocable to such gross income or net gain.[12] More specifically, included in such gross income or net gain are the following three amounts: (1) certain gross income from interest, dividends, annuities, royalties, and rents;[13] (2) certain gross income derived from a passive activity or a financial instruments or commodities trading business;[14] and (3) certain net gain attributable to the disposition of certain property.[15] NII, therefore, is calculated under the NIIT at the entity level of the trust or estate (similar to the calculation of taxable income under the regular income tax).

Section 663(c) provides the separate share rule, the general purpose of which is to prevent one independent separate share of a trust or estate from

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[9] I.R.C. § 1411.

[10] *Id.* § 1411(a)(1).

[11] *Id.* § 1411(a)(2).

[12] *Id.* § 1411(c)(1).

[13] *Id.* § 1411(c)(1)(A)(i) (but such gross income must be other than such income that is derived from certain trades or businesses that are not, under § 1411(c)(2), a passive activity (within the meaning of § 469) with respect to the taxpayer or a trade or business of trading in financial instruments or commodities (as defined in § 475(e)(2))).

[14] I.R.C. § 1411(c)(1)(A)(ii).

[15] *Id.* § 1411(c)(1)(A)(iii) (but such net gain must be attributable to property other than property held in a trade or business that is not, under § 1411(c)(2), a passive activity or financial instruments or commodities trading business).

being subjected to income tax attributable to income being accumulated for another independent separate share.[16] The separate share rule and the separate share regulations seek to ensure that the separate shares of a trust or estate have independent economic interests by attempting to separate and to allocate items of income and deduction to the proper separate shares of a trust or estate.

Certain trusts and estates have no separate shares; those trusts and estates, consequently, would not be subject to § 663(c) and the regulations thereunder. For any trust or estate with separate shares, however, the NIIT, in order to be consistent with the separate share rule, should attempt to separate and to allocate the items of net investment income and deduction (as defined in § 1411) to the proper separate shares of the trust or estate. Section 1411 and the regulations thereunder contain no express reference to § 663(c) or the regulations thereunder. Although § 1411 and the regulations thereunder should incorporate and, indeed, ostensibly incorporate § 663(c) and the regulations thereunder, I submit that the § 1411 regulation's incorporation language is imprecise for the following reasons, and, consequently, I propose new incorporation language.

Although § 1411 and the regulations thereunder never expressly refer to § 663(c) and the regulations thereunder, they do twice implicitly refer to § 663(c) and the regulations thereunder. The first reference appears in the preamble to the final § 1411 regulations—and, technically, the reference is to § 663, not § 663(c) specifically.[17] In the preamble, the Treasury Department indicates that the final regulations retained the adoption by the proposed regulations of "the class system of income categorization, generally embodied in sections 651 through 663 and the regulations thereunder, to arrive at the trust's net investment reduction in the case of distributions that are comprised of both net investment income and net excluded income items."[18] Without specifically referring to § 663(c) and the regulations thereunder, the Treasury Department notes that § 663 (as part of "sections 651 through 663") and the regulations thereunder—to the extent that they assist in establishing "the class system of income categorization"—are

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[16] *See* Yu, *supra* note 8, at 127–32 for a discussion of the general operation of the separate share rule.

[17] T.D. 9644, 2013-51 I.R.B. 676.

[18] *Id.*

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implicitly incorporated into the final § 1411 regulations. The preamble, however, provides no governing authority, absent any reference of § 1411 and the regulations thereunder incorporating § 663(c) and the regulations thereunder.

The second instance in which § 1411 and the regulations thereunder implicitly refer to § 663(c) and the regulations thereunder is Treasury Regulation § 1.1411-1(a). That regulation provides the general rule that "[e]xcept as otherwise provided, all Internal Revenue Code (Code) provisions that apply for chapter 1 purposes in determining taxable income (as defined in section 63(a)) of a taxpayer also apply in determining the tax imposed by section 1411."[19] I concede that the intent behind Treasury Regulation § 1.1411-1(a) is to incorporate § 663(c) and the regulations thereunder into § 1411's NIIT, but I submit that the regulation is imprecise for the following reasons.

First, the Treasury Regulation attempts to incorporate § 663(c) into § 1411 by providing that "all Internal Revenue Code (Code) provisions" that apply in determining the taxable income of "a taxpayer" also apply in determining the tax imposed by § 1411.[20] Section 663(c) refers to "a single trust having more than one beneficiary" in which the trust has "substantially separate and independent shares of beneficiaries in the trust."[21] Accordingly, the "taxpayer" to which § 663(c) refers is the single trust (or estate) itself, not the beneficiaries thereof that may be linked to separate shares of the trust (or estate). Additionally, the separate shares of a trust or estate are not always each "a taxpayer"; under the § 663(c) regulations, a separate share can be, among other things, certain spouse's elective shares and certain pecuniary formula bequests.[22] Accordingly, Treasury Regulation § 1.1411-1(a)'s reference to Code provisions determining the taxable income of "a taxpayer" is imprecise in incorporating § 663(c) into § 1411.

A second imprecision in the Treasury Regulation is its reference to Code provisions that determine the "taxable income (as defined in section 63(a))"

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[19] Treas. Reg. § 1.1411-1(a) (2013).

[20] *Id.*

[21] I.R.C. § 663(c).

[22] Treas. Reg. § 1.663(c)-4(b) (1999).

of a taxpayer.[23] Section 662, which applies to beneficiaries of trusts or estates accumulating income or distributing corpus, refers to the inclusion of certain items in the "gross income" of a beneficiary.[24] Accordingly, in a very strict reading of the Treasury Regulation, it incorporates into § 1411 only those provisions that determine "taxable income," but not § 662, which addresses "gross income." Under that very strict reading, the Treasury Regulation is imprecise in its incorporation of § 662 into § 1411.

A final imprecision in the Treasury Regulation is its reference to Code provisions that apply in "determining" the taxable income of a taxpayer. Section 663(c) provides that it applies to treat "substantially separate and independent shares of different beneficiaries in the trust" as separate trusts "[f]or the sole purpose of determining the amount of distributable net income in the application of sections 661 and 662."[25] In another very strict reading of the Treasury Regulation, it incorporates into § 1411 only those provisions that determine "taxable income" of a taxpayer, but not § 663(c), which by its own terms only determines the "distributable net income" attributable to separate shares of a trust or estate. Under that very strict reading, the Treasury Regulation is imprecise in its incorporation of § 663(c) into § 1411.

Given the foregoing instances of imprecise language, I propose the following Treasury Regulation. The revised regulation should provide that "[e]xcept as otherwise provided, all Internal Revenue Code (Code) provisions that apply for Chapter 1 purposes in determining the tax liability of a taxpayer or attributable to a taxpayer also apply in determining the tax imposed by section 1411." The foregoing proposed regulation resolves the concerns I discuss above as follows: (1) it does not refer to "taxable income" but instead the more general "tax liability," and (2) it refers not only to the tax liability "of a taxpayer" but also to the tax liability "attributable to a taxpayer."

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[23] Treas. Reg. § 1.1411-1(a) (2013).

[24] I.R.C. § 662(a).

[25] *Id.* § 663(c).

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II. Possibility of Cross-Deductions Allowed Under §§ 1411, 661, 662, and 663(c)

In previous articles,[26] I criticized the § 663(c) regulations[27] for potentially producing certain inequitable or anomalous results under the regular income tax. One of those anomalous results was that the calculation of DNI (pursuant to § 663(c) and the regulations thereunder) at the entity level of the trust or estate allows for cross-deductions of passive income and passive losses between or among different separate shares, which contravenes the separate share regulation providing that deductions and losses applicable solely to one separate share of a trust or estate are "not available to any other share of the same trust or estate."[28] This part of the article discusses the possibility of cross-deductions under the NIIT.

A. Discussion of the Issue of Cross-deductions Allowed Under § 1411

This Part II.A discusses the general issue of certain cross-deductions that are allowed under § 1411; later, Part II.B summarizes the provisions of §§ 1411, 661, 662, and 663(c) that allow for the possibility of certain cross-deductions. As stated in Part I above, the Treasury Department indicated that the NIIT final regulations adopted (among other regulations) the § 663(c) regulations for the purpose of using "the class system of income categorization, generally embodied in sections 651 through 663 and the regulations thereunder" to calculate "the trust's *net investment reduction* in the case of distributions that are comprised of both net investment income and net excluded income items."[29] In the preamble to the NIIT final regulations, the Treasury Department did not indicate how the calculation of the NIIT (as opposed to the "net investment reduction," noted above) would be affected by the § 663(c) regulations, including the one providing that deductions and losses applicable solely to one separate share of a trust or estate are "not available to any other share of the same trust or estate."[30] The

[26] *See* Yu, *supra* note 4; Yu, *supra* note 8.

[27] Treas. Reg. § 1.663(c)-1–5 (as amended in 1999).

[28] *Id.* § 1.663(c)-2(b)(5).

[29] T.D. 9644, 2013-51 I.R.B. 676 (emphasis added).

[30] Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999).

calculation of NII and DNI under the NIIT is similar to the calculation of taxable income and DNI under the regular income tax because both require an initial calculation of such amount (whether (1) NII and DNI or (2) taxable income and DNI) first at the entity level. Because of the similarity between the two calculations, my concern about possible cross-deductions of passive income and passive losses between and among separate shares of a trust or estate under the regular income tax applies also to the NIIT.

The general issue of possible cross-deductions under § 1411 appears in the preamble to the final § 1411 regulations, but the Treasury Department addresses such cross-deductions in the context of electing small business trusts (ESBTs)[31] and not in the context of separate shares of a trust or estate. In the preamble, the Treasury Department noted that certain commentators' criticism that the proposed § 1411 regulations, as to an ESBT with an S portion and a non-S portion, prevented the offset of "the net investment income losses (capital, ordinary, and/or passive) from one portion of the ESBT with net investment income from the other portion."[32] Those commentators recommended that, as to an ESBT with an S portion and a non-S portion, "if one portion has income or a net capital gain and other has a net capital loss, the ESBT should be able to offset one against the other in the same manner as a non-ESBT grantor trust."[33]

In response to those commentators, the Treasury Department indicated: (1) the treatment of an ESBT's S and non-S portions (which disallows cross-deductions between the two portions) results from "the tax imposed under chapter 1" and not § 1411 and (2) allowing "a full integration of the S portion and non-S portion into a single trust for purposes of section 1411 is administratively burdensome to both taxpayers and the IRS because it would cause the section 1411 calculations to deviate significantly from the calculations for purposes of chapter 1."[34] The Treasury Department noted, as an example, that allowing cross deductions (under the NIIT but not under the

[31] An electing small business trust is, generally, a trust that holds S corporation stock that the trust did not purchase; the trust's beneficiaries are only individuals, estates, or charitable organizations; and the trust is not a Qualified Subchapter S Trust or a tax-exempt trust. I.R.C. § 1361(e).

[32] T.D. 9644, 2013-51 I.R.B. 676.

[33] *Id.*

[34] *Id.*

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regular income tax) between an ESBT's S and non-S portions "would result in different loss carryforwards for regular tax and section 1411 purposes."[35] The Treasury Department indicated that the rules in the proposed § 1411 regulations would be retained,[36] including the prohibition of cross-deductions between the S and non-S portions of an ESBT.

Although the Treasury Department addresses cross-deductions as to ESBTs, the Treasury Department does not address cross-deductions as to a trust or estate with separate shares. As discussed more fully in the next section of this article, the interplay of the NIIT, the separate share rule, and the calculation of NII and DNI leads to the possibility of certain cross-deductions[37] in the application of the NIIT to a trust or estate with separate shares. The possibility of such cross-deductions contravenes: (1) the Treasury Department's concern about cross-deducting passive income and losses (expressed explicitly only as to the S and non-S portions of an ESBT), and (2) the separate share regulation providing that deductions and losses applicable solely to one separate share of a trust or estate are "not available to any other share of the same trust or estate."[38]

B. Summary of §§ 1411, 661, 662, and 663(c) that Allow for Certain Cross-Deductions

This Part II.B summarizes the relevant portions of §§ 1411, 661, 662, and 663(c) that, when applied together, allow for certain cross-deductions. As noted above, § 1411 provides a NIIT on certain NII of certain individuals, estates, and trusts for taxable years beginning after December 31, 2012.[39] The

[35] *Id.*

[36] *Id.*

[37] This article focuses on the deductions related to ordinary portfolio income and passive income because certain other deductions (such as deductions for charitable contributions and deductions for capital losses) are beyond the scope of the calculation and allocation of net investment income proposed in this article. Additionally, this article does not address deductions in the year of termination of the trust or estate.

[38] Treas. Reg. § 1.663(c)-2(b)(5) (as amended in 1999).

[39] I.R.C. § 1411.

NIIT applies in addition to the regular income tax.[40] The NIIT, as to a trust or estate, applies to

> the lesser of—(A) the undistributed net investment income for such taxable year, or (B) the excess (if any) of—(i) the adjusted gross income (as defined in section 67(e)) for such taxable year, over (ii) the dollar amount at which the highest tax bracket in section 1(e) begins for such taxable year.[41]

"Net investment income" (NII) is, in general terms, the excess (if any) of (1) certain gross income and net gain over (2) those allowed deductions that are properly allocable to such gross income or net gain.[42] More specifically, included in such gross income or net gain are the following three amounts: (1) certain gross income from interest, dividends, annuities, royalties, and rents;[43] (2) certain gross income derived from a passive activity or a financial instruments or commodities trading business;[44] and (3) certain net gain attributable to the disposition of certain property.[45] Similar to the regular income tax, the NIIT applies first at the entity level, reducing certain gross income of the trust or estate by certain allowable deductions to obtain "net investment income."[46]

Under § 1411, "undistributed net investment income" is the trust's or estate's net investment income minus a deduction for net investment income distributions made to beneficiaries (and minus certain deductions for a charitable purpose under § 642(c), which are beyond the scope of this

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[40] *Id.* § 1411(a)(1).

[41] *Id.* § 1411(a)(2). For the proposed calculation and allocation of net investment income and DNI discussed later, this article presumes that the NIIT will be imposed on "undistributed net investment income."

[42] *Id.* § 1411(c)(1).

[43] *Id.* § 1411(c)(1)(A)(i) (but such gross income must be other than such income that is derived from certain trades or businesses that are not, under § 1411(c)(2), a passive activity (within the meaning of § 469) with respect to the taxpayer or a trade or business of trading in financial instruments or commodities (as defined in § 475(e)(2))).

[44] *Id.* § 1411(c)(1)(A)(ii).

[45] *Id.* § 1411(c)(1)(A)(iii) (but such net gain must be attributable to property other than property held in a trade or business that is not, under § 1411(c)(2), a passive activity or financial instruments or commodities trading business).

[46] *Id.*

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article).[47] The foregoing deduction allowed to a trust or estate is "limited to the lesser of the amount deductible to the estate or trust under section 651 or section 661, as applicable, or the net investment income of the estate or trust."[48] If a deduction to a trust or estate is attributable to a distribution of both net investment income and excluded income (as defined in Treasury Regulation § 1.1411-1(d)(4)), then the distribution must be allocated between net investment income and excluded income in a manner similar to Treasury Regulation § 1.661(b)-1 (which allocates gross income and amounts not includible in gross income).[49] Also, as to the item or items comprising a distribution for which a deduction is allowed to a trust or estate, such item or items retain their character as net investment income (under § 652(b) or § 662(b), as applicable) for purposes of computing the NII of the recipient of the distribution.[50] Although § 1411 does not mention §§ 661 and 662, the § 1411 regulations, as noted above, incorporate §§ 661 and 662 and the regulations thereunder.

Section 661[51] provides that a trust or estate making distributions to its beneficiaries in the same taxable year that it receives items of income may claim an income tax deduction for all such distributions.[52] The deduction for such distributions, however, cannot exceed the DNI of the trust or estate.[53] DNI is, for any taxable year, the taxable income of the trust or estate with

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[47] Treas. Reg. § 1.1411-3(e)(2) (as amended in 2014).

[48] *Id.* § 1.1411-3(e)(3)(i). Sections 651 and 652 govern the income taxation of distributions from a trust that provides that "all of its income is required to be distributed currently," I.R.C. § 651(a)(1), and that does not provide that "any amounts are to be paid, permanently set aside, or used" for a charitable purpose. *Id.*; *see id.* § 651(a)(2). Sections 661 and 662 govern the income taxation of distributions from estates and from trusts that during the relevant taxable year do not meet the requirements of § 651(a)(1) and (2). Section 663(c) addresses the income taxation of trusts that hold income and, therefore, expressly applies only to trusts and estates that are governed by §§ 661 and 662. *See id.* § 663(c); Treas. Reg. § 1.663(c)-1(a) (as amended in 1999).

[49] Treas. Reg. § 1.1411-3(e)(3)(i).

[50] *Id.* § 1.1411-3(e)(3)(ii). Section 663(c) applies only to trusts and estates that are governed not by §§ 651 and 652 but rather §§ 661 and 662. *See supra* note 48.

[51] The following summary of § 661 is excerpted from a more detailed summary of § 661 in a previous article. *See* Yu, *supra* note 4, at 127–30.

[52] I.R.C. § 661(a).

[53] *Id.*

certain modifications.[54] Additionally, under § 661, the deduction for such distributions from a trust or estate excludes any amount attributable to net tax-exempt income of the trust or estate because such amount is not subject to income tax and therefore should not be included in the deduction for distributions.[55]

Under § 661(b), absent a specific provision in the governing instrument allocating different classes of income to different beneficiaries, the deduction for distributions allowed to the trust or estate is deemed to consist proportionally of each class of items that enters (as a net amount) into the computation of DNI of the trust or estate.[56] As to the deduction for distributions by a trust or estate, in the determination of the proportion by which classes of income (as net amounts) enter into the computation of the DNI of a trust or estate, the items of deduction entering into such computation of DNI (including the deduction allowed under § 642(c) regarding amounts paid or permanently set aside for a charitable purpose, which is beyond the scope of this article) are allocated, absent an allocation of different classes of income under the specific terms of the governing instrument, among the items of "distributable net income"[57] entering into such computation of DNI in accordance with Treasury Regulations.[58] The relevant Treasury

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[54] *Id.* § 643(a). See Yu, *supra* note 4, at 125–27 for a more detailed discussion of the calculation of DNI.

[55] I.R.C. § 661(c); Treas. Reg. § 1.661(c)-1 (as amended in 1964).

[56] I.R.C. § 661(b).

[57] Section 661(b) refers to "items of distributable net income," but Treasury Regulation § 1.661(b)-2 (1960) refers to "items of income." The author believes that the Code is imprecise to refer to "items of distributable net income" when apparently it refers to "items of income that enter into the computation of distributable net income," or, as the regulations provide, "items of income." Additionally, the author notes that DNI, as discussed in Part II.A of this article, is a single amount (calculated from the taxpayer's taxable income with certain modifications) and therefore cannot properly be apportioned into "items of distributable net income."

[58] I.R.C. § 661(b).

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Regulations[59] provide the following principles governing the allocation of items of deduction.[60]

The regulations provide rules for two categories of expenses: those that are "directly attributable to one class of income"[61] (direct expenses) and those that are "not directly attributable to a specific class of income"[62] (indirect expenses). All direct expenses are allocated to the class of income to which they relate.[63] If the total of direct expenses exceeds the class of income to which the direct expenses relate, the excess of direct expenses may be allocated (in part or in whole) to "any other class of income" (including capital gains) included in the DNI of the trust or estate.[64] Excess direct expenses attributable to tax-exempt income, however, may not be allocated to any class of taxable income.[65] Although passive losses are not specifically addressed in the regulations under § 652, several commentators have noted that passive losses should not reduce nonpassive income.[66] Indirect expenses may be allocated (in part or in whole) to "any item of income" (including capital gains) included in computing DNI, "but a portion must be allocated to nontaxable income."[67]

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[59] Treasury Regulation § 1.661(b)-2 provides that the items of deduction entering into the computation of DNI are allocated among the items of income entering into the computation of DNI in accordance with the rules set forth in Treasury Regulation § 1.652(b)-3 (1960).

[60] *Id.* § 1.652(b)-3.

[61] *Id.* § 1.652(b)-3(a).

[62] *Id.* § 1.652(b)-3(b).

[63] *Id.* § 1.652(b)-3(a).

[64] *Id.* § 1.652(b)-3(a), (d).

[65] *Id.* § 1.652(b)-3(d).

[66] Alan S. Acker, *Income Taxation of Trusts and Estates*, 852-4th TAX MGMT. PORTFOLIO (BNA) ("Generally, a taxpayer may deduct losses from passive activities only against income from passive activities."); Leo L. Schmolka, *Passive Activity Losses, Trusts, and Estates: The Regulations (If I Were King)*, 58 TAX L. REV. 191, 200 (2005) (citing I.R.C. § 469(e)(1), which excludes portfolio income in the determination of income or loss from a passive activity and noting that "Congress specifically intended that portfolio income not be subject to offset by passive losses").

[67] Treas. Reg. § 1.652(b)-3(b) (1960).

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Section 662[68] addresses the income taxation of a beneficiary receiving a distribution from a trust or estate. Each beneficiary receiving a distribution from a trust or estate must include the distribution in the beneficiary's gross income, but the amount of the distribution to be included[69] in the beneficiary's gross income cannot exceed the beneficiary's share of the DNI of the trust or estate.[70] A beneficiary's share of the DNI of a trust or estate is determined by a two-tiered distribution system.[71]

Generally, the first tier consists of amounts that are required to be distributed in the current taxable year to beneficiaries, and the second tier consists of all other amounts properly distributed to beneficiaries during the current taxable year.[72] Initially, amounts in the first tier are allocated DNI proportionally to the extent that DNI is available.[73] If, however, amounts in the first tier are greater than DNI, then the DNI is allocated proportionally among those amounts in the first tier.[74] After the allocation of DNI to first-tier distributions, if any DNI remains, then it is allocated proportionally among second-tier distributions in the same manner as first-tier distributions.[75] If, however, no DNI remains after allocations have been made to first-tier distributions, then the second-tier distributions are allocated no DNI.[76] Absent a specific allocation in the governing instrument of different classes of income to different beneficiaries, the amount to be included in the

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[68] The following summary of § 662 is excerpted from a more detailed summary of § 662 in a previous article. *See* Yu, *supra* note 4, at 131–33.

[69] The term, "the amount to be included in the beneficiary's gross income," refers to the maximum amount that, as to a distribution received by the beneficiary from a trust or estate, the beneficiary must include in the beneficiary's gross income. Such "amount to be included in the beneficiary's gross income" may include tax-exempt interest income, which is excluded from the beneficiary's gross income under I.R.C. § 103(a). Section 662 and the regulations thereunder nonetheless indicate that the distribution initially is "to be included in gross income."

[70] I.R.C. § 662(a)(1).

[71] *Id.* § 662(a)(1)–(2).

[72] *Id.* § 662.

[73] *Id.* § 662(a)(1).

[74] *Id.*

[75] *Id.* § 662(a)(2).

[76] *Id.*

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beneficiary's gross income will have the same proportional character in the hands of the beneficiary as it had in the hands of the trust or estate.[77]

Section 663(c) governs the calculation and allocation of DNI as used in the income taxation of a trust or estate with separate shares and the beneficiaries of such a trust or estate.[78] The application of § 663(c) is not elective to a trustee of a trust or to a personal representative of an estate.[79] If a trust or estate is ever treated as having separate shares, then the application of § 663(c) continues until different treatment is required by the terms of the trust or estate instrument or under proper administration.[80] Accordingly, a trust or estate with separate shares that is subject to § 1411, which, as discussed above, incorporates §§ 661 and 662, also is subject to § 663(c).

Under the § 663(c) regulations, just as the income items of one separate share should not be allocated to another separate share, the deductions and losses that are applicable solely to one separate share of a trust or estate are "not available to any other share of the same trust or estate."[81] Because the separate shares of a trust or estate are viewed as having independent economic interests, the separate share regulations attempt to ensure that the items of income and deduction are properly separated among the separate shares of a trust or estate.

The § 663(c) regulations[82] provide two methods for calculating and allocating DNI to the separate shares of a trust or estate. A summary of the first method is as follows: First, calculate the DNI of the trust or estate under § 643; second, allocate such DNI to the separate shares of the trust or estate. This method presupposes that the DNI of the trust or estate consists of only positive net amounts that can be divided and allocated to the separate shares generating such positive net amounts. In contrast, a summary of the second method implementing the separate share rule is as follows. First, calculate

[77] *Id.* § 662(b).

[78] *Id.* § 663(c).

[79] Treas. Reg. § 1.663(c)-1(d) (as amended in 1999).

[80] *Id.*

[81] *Id.* § 1.663(c)-2(b)(5) (as amended in 1999).

[82] The following summary of the § 663(c) regulations is excerpted from a more detailed discussion in a previous article. *See* Yu, *supra* note 4, at 135–38.

the DNI of each separate share of the trust or estate individually under § 643, allocating to each such separate share its appropriate items of income and deduction; second, sum the DNI amounts of all separate shares, which should equal the DNI of the trust or estate.

I have previously addressed how, under the regular income tax, the foregoing first method of calculating and allocating DNI creates the possibility of cross-deductions between and among separate shares of a trust or estate (and how the foregoing second method of calculating and allocating DNI produces anomalous results).[83] Similar to the regular income tax, the NIIT, when applied to the separate shares of a trust or estate, can also produce cross-deductions, thereby effectively achieving a "full integration" of those separate shares that the Treasury Department notes is prohibited under the § 1411 regulations as to the S and non-S portions of an ESBT (but not expressly prohibited as to separate shares).[84] Cross-deductions under the NIIT, also, of course, contravene the Treasury Regulation providing that the deductions and losses that are applicable solely to one separate share of a trust or estate are "not available to any other share of the same trust or estate."[85]

The following example shows the possibility of cross-deductions under the NIIT.[86] Assume that a trust has two separate shares. If the separate shares are examined independently, the first separate share has NII of $25 (attributable to $50 of taxable interest income and $25 of direct expenses), and the second separate share has zero NII (attributable to $10 of taxable interest income and $25 of direct expenses, but NII cannot be less than zero[87]).

If the first method of calculating and allocating DNI is applied, then the trust's NII is $10 (attributable to the two separate shares' combined $60 of taxable interest minus $50 of direct expenses and assuming that there are no modifications to the trust's NII). If there are no distributions from the trust,

[83] *Id.* at 139–44.

[84] T.D. 9644, 2013-51 I.R.B. 676.

[85] Treas. Reg. § 1.663(c)-2(b)(5).

[86] This example is based on my discussion of cross-deductions under the regular income tax. *See* Yu, *supra* note 4, at 139–44. For simplicity, in all examples in this article, there are no distributions from the trust or estate, and the NIIT applies to the undistributed NII of the trust or estate.

[87] I.R.C. § 1411(c)(1).

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then the trust's DNI is $10, and the NIIT is imposed on $10 of undistributed net investment income. If, however, there are distributions from the trust, the ceiling of $10 of DNI applies both for purposes of characterizing any distribution deduction for the trust under § 661 and of characterizing the distribution in the hands of the beneficiary under § 662.

The foregoing interplay of the NIIT, the separate share rule, and the calculation of DNI leads to a cross-deduction between the two separate shares of the trust. As discussed above, if the separate shares are examined independently, the first separate share has NII of $25. Because, however, the NIIT calculates NII and DNI first at the entity level, the excess direct expenses of the second separate share reduce the net investment income of the first separate share. If no distributions are made from the trust, the NIIT imposed on the trust's NII of $10 is less than the NIIT that would theoretically be imposed solely on the first separate share's NII of $25 (with no NIIT imposed on the second separate share's NII of zero).

If the second method of calculating and allocating DNI is applied, the NII and DNI of each separate share are first independently calculated. The first separate share's NII is calculated as $25 (attributable to $50 of taxable interest income and $25 of direct expenses allowed as a deduction); with no modifications, the first separate share's DNI is also $25. The second separate share's NII is calculated as zero (attributable to $10 of taxable interest income and $25 direct expenses, but NII cannot be less than zero); with no modifications, the second separate share's DNI is also zero. The foregoing calculations are anomalous because there are only $10 of NII and DNI at the level of trust or estate; the anomalous results arise, of course, because the second method presumes that the sum of all NII and DNI amounts of the separate shares (as calculated independently) equals the NII and DNI of the trust or estate (as calculated at the entity level).

The possibility of cross-deductions under the NIIT between and among the separate shares of a trust or estate cannot, I believe, be completely eliminated. As to a trust or estate with separate shares, the taxpayer who is subject to the NIIT is the trust or estate as an entity; the separate shares of a trust or estate are not each a taxpayer subject to the NIIT (indeed, certain separate shares such as a spouse's elective share or certain pecuniary formula bequests are not a "taxpayer"). Accordingly, pursuant to § 1411 and the regulations thereunder (and other relevant Code sections), NII and DNI are initially calculated at the level of the trust or estate as an entity; NII and DNI are not initially calculated individually as to each separate share. A theoretical prohibition against cross-deductions between and among the separate shares of a trust or estate would, essentially, require using only the foregoing second method of calculating and allocating DNI (in which NII and DNI are calculated individually as to each separate share). As discussed above, the second method can produce anomalous results in which the total NII and total DNI of the separate shares when calculated individually exceed the total NII and total DNI of the trust or estate when calculated at the entity level. Any theoretical prohibition against cross-deductions would, nevertheless, still require NII and DNI to be calculated at the entity level to serve as the maximum NII and DNI that would possibly be attributed to the relevant separate shares.

Because the possibility of cross-deductions between and among the separate shares of a trust or estate cannot be completely eliminated, I propose a more limited and directed calculation and allocation of DNI that allow the independent economic interests of each separate share to be traced. Accordingly, even if a cross-deduction occurs at the level of the trust or estate, a beneficiary of a separate share can, under my proposal, calculate the independent economic interest of such separate share and seek, if appropriate and allowed, an equitable adjustment. Consequently, the next part of this article includes, for purposes of the NIIT, a proposed calculation and allocation of DNI to the separate shares of a trust or estate that combine the features of the § 663(c) regulations' two methods.

III. Proposed Calculation of DNI Under the NIIT Imposed on a Trust or Estate with Separate Shares

My previous proposed treatment of the deductions as to a trust or estate applied to the calculation of DNI of a trust or estate under the regular income tax.[88] For the NIIT, my proposed calculation of DNI is similar except for new references to NII and a new treatment of indirect expenses allocated to NII from expenses allocable under the § 1411 regulations between NII and income excluded from the NIIT. Before I present my proposal, I address a few preliminary matters.

[88] *See* Yu, *supra* note 4, at 145–53.

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The NIIT might not appear initially to address income in respect of a decedent (IRD),[89] but it does. IRD, in general terms, is an item of gross income earned by a decedent while living that the decedent did not receive while living.[90] Although neither § 1411 nor the regulations thereunder expressly provide that IRD is included in "gross income" for purposes of the NIIT, the preamble to the final § 1411 regulations provides that "[n]et investment income may include items of IRD (such as annuities and outstanding installment sale payments)."[91] Accordingly, a trust or estate with separate shares that receives IRD must apply not only § 1411 (with §§ 661 and 662) but also § 663(c) and its special rule regarding IRD.

The § 663(c) regulations provide a special rule regarding IRD, which is that, when a trust or estate with separate shares receives IRD, the IRD is "allocated among the separate shares that could potentially be funded with these amounts irrespective of whether the share is entitled to receive any income under terms of the governing instrument or applicable law."[92] The amount of IRD allocated to each share "is based on the relative value of each share that could potentially be funded with such amounts."[93] In accordance with the § 663(c) special rule regarding IRD, the proposed calculation of DNI separately traces it.

Under the NIIT, certain expenses may be allocated between NII and income excluded from the NIIT; these expenses must be separately traced under the proposed calculation and allocation of DNI for purposes of the NIIT as follows. First, certain items of income are excluded from NII under the § 1411 regulations. The term "excluded income" means: (1) "[i]tems of income excluded from gross income in chapter 1," such as "interest on state

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[89] The following summary of income in respect of a decedent (IRD) and its treatment under the separate share rule is excerpted from a more detailed discussion in a previous article. *See* Yu, *supra* note 8, at 142–46.

[90] *See* I.R.C. § 691(a).

[91] T.D. 9644, 2013-51 I.R.B. 676. *But see* Treas. Reg. § 1.1411-4(d)(4), ex. 2 (as amended in 2014) (addressing an example in which an estate receives a distributive share of gain from a partnership that constitutes IRD "under section 691(a)(4) and subchapter K" but is excluded from net investment income as gain from the disposition of property used in a certain specified trade or business).

[92] Treas. Reg. § 1.663(c)-2(b)(3) (as amended in 1999).

[93] *Id.*

and local bonds excluded from gross income under section 103 and gain from the sale of a principal residence excluded from gross income under section 121"; (2) "[i]tems of income not included in net investment income, as determined under §§ 1.1411-4 and 1.1411-10," such as wages and unemployment compensation; and (iii) "[i]tems of gross income and net gain specifically excluded by section 1411, the regulations thereunder, or other guidance published in the Internal Revenue Bulletin."[94] Although all of the foregoing items are "excluded income" under § 1411, they are not all excluded from "distributable net income" under § 643. Any "tax-exempt interest to which section 103 applies" is included in DNI of a trust or estate.[95] For purposes of the proposed calculation and allocation of DNI to the separate shares of a trust of estate for purposes of the NIIT, the foregoing two different types of "excluded income" require different treatment.

The first type of "excluded income" includes tax-exempt interest to which § 103 applies; such tax-exempt interest is excluded from NII but is included in DNI. The treatment of tax-exempt interest, under the proposed calculation and allocation of DNI to the separate shares of a trust or estate for purposes of the NIIT, is the same as in the proposed calculation and allocation for regular income tax; tax-exempt interest receives its own basket and can, therefore, be independently traced. The second type of "excluded income," all "excluded income" other than tax-exempt interest to which § 103 applies, is excluded from NII and excluded from DNI and is not traced under the proposal. Accordingly, the proposed calculation and allocation of DNI treat direct expenses as to each of the foregoing two types of "excluded income" as follows: (1) direct expenses as to tax-exempt interest are directly allocated to such tax-exempt interest, and (2) direct expenses as to "excluded income" other than such tax-exempt interest have no effect on NII and, accordingly, do not enter into the calculation of DNI.

There may exist, however, indirect expenses that are allocable between "excluded income" and NII. The general rule under § 1411 is that the

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[94] Treas. Reg. § 1.1411-1(d)(4) (2013).

[95] I.R.C. § 643(a)(5). It should perhaps be emphasized that the term "excluded income" in this article refers to income that is excluded from the NIIT under § 1411 (but which may be subject to the regular income tax), and the term "tax-exempt interest" in this article refers to interest income that is: (1) excluded from regular income tax under § 103, (2) excluded from NIIT under Treasury Regulation § 1.1411-1(d)(4)(i), and (3) included in DNI under § 643(a)(5).

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deductions that reduce gross income to result in "net investment income" are the "deductions allowed by subtitle A that are properly allocable to such gross income or net gain" included in gross income.[96] As to any properly allocable deduction under § 1411 "that is allocable to both net investment income and excluded income, the portion of the deduction that is properly allocable to net investment income may be determined by taxpayers using any reasonable method."[97] The regulations provide two examples of a "reasonable method" of a trust or estate: (1) "an allocation of the deduction based on the ratio of the amount of a taxpayer's gross income (including net gain) described in § 1.1411-4(a)(1) to the amount of the taxpayer's adjusted gross income" and (2) "an allocation of a deduction pursuant to rules described in § 1.652(b)-3(b) (and § 1.641(c)-1(h) in the case of an ESBT)."[98]

The proposed calculation and allocation of DNI to the separate shares of a trust or estate for NIIT purposes address the foregoing rules as follows. First, the proposal allocates direct expenses to tax-exempt interest. Second, the proposal notes that, in calculating the NII and DNI of a trust or estate, a fiduciary must allocate certain indirect expenses at least in part to tax-exempt interest (if any), as required under Treasury Regulation § 1.652(b)-3(b).

A. Proposed Calculation and Allocation of DNI to the Separate Shares of a Trust or Estate

In this Part, the article presents the proposed calculation and allocation of DNI to the separate shares of a trust or estate, focusing on the items of income and deduction entering into the computation of DNI of the trust or

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[96] Treas. Reg. § 1.1411-4(a)(2).

[97] *Id.* § 1.1411-4(g)(1). The 2014 Instructions for Form 8960 enumerate "3 items that may be allocated between net investment income and excluded income": (1) "[s]tate, local, and foreign income taxes if properly deducted on your return when calculating your US regular income tax"; (2) "[a]ll ordinary and necessary expenses paid or incurred during the tax year to determine, collect, or obtain a refund of any tax owed if properly deducted on your return when calculating your US regular income tax"; and (3) "[a]mounts paid or incurred by the fiduciary of an estate or trust on account of administration expenses, including fiduciaries' fees and expenses of litigation, which are ordinary and necessary in connection with the performance of the duties of administration if properly deducted on your return when calculating your US regular income tax." I.R.S. Form 8960, Net Investment Income Tax—Individuals, Estates and Trusts 12 (2014).

[98] Treas. Reg. § 1.1411-4(g)(1).

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estate for purposes of the NIIT.[99] In the next section, the article applies the proposed calculation and allocation to an example to show the treatment of a possible cross-deduction and indirect expenses allocated to NII.

An overview of the proposed calculation and allocation is as follows. First, the proposal provides two calculations of NII and DNI, the first at the trust or estate level, and a second for each separate share. Second, the proposal provides baskets so that each separate share can trace different types of income and deductions. Third, and finally, the proposal provides a final reconciliation between the DNI of the trust or estate and the sum of the DNI amounts calculated for each separate share.

The proposed calculation and allocation consist of the following steps:

Step 1. Calculation of DNI of a trust or estate with separate shares

This Step ensures that, during the relevant taxable year, the trust or estate has separate shares. Additionally, this Step calculates the NII and the DNI of the trust or estate; if there is DNI, this Step identifies for later use the net investment income items entering into the computation of such DNI. This Step is consistent with the separate share regulations' first method for calculating and allocating DNI; accordingly, this Step provides a calculation for Entity DNI (or EDNI) that serves as the maximum DNI of the trust or estate for purposes of the NIIT.

a. Ensure that the trust or estate has separate shares, as defined in Treasury Regulation § 1.663(c)-1.

b. Calculate, for purposes of the NIIT, the trust's or estate's NII (under § 1411 and the regulations thereunder) and DNI (under § 643 and the regulations thereunder) (Entity DNI or EDNI), ensuring: (1) to deduct any amounts allocated to NII by the fiduciary from those expenses that can be allocated between NII and excluded income and (2) to apply all limitations on deductions for passive losses and expenses related to tax-exempt income. Proceed with this calculation if there is undistributed NII for purposes of the NIIT.

[99] The seven steps in this proposed calculation and allocation expand upon and replace the first three steps in the allocation proposed in my first article. *See* Yu, *supra* note 8, at 155–62.

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i. If EDNI equals zero, stop because there is no DNI to allocate to the separate shares of the trust or estate.

ii. If EDNI is greater than zero, note the NII items entering into the computation of EDNI because the proportions of those items will be retained if EDNI is greater than the sum of the DNI amounts of the separate shares of the trust or estate, as calculated in Step 7.

Step 2. Allocation to principal and income baskets of the items of income entering into the computation of EDNI

This Step allocates the items of investment income of the trust or estate to four baskets: principal—IRD, principal—non-IRD, income—passive, and income—nonpassive. The allocation to the four baskets identifies and traces the different types of income.

a. Sum all items of investment income entering into the computation of EDNI of the trust or estate (Entity (Items of Investment Income)).

b. Allocate to one basket (Entity (principal)) the portion of Entity (Items of Investment Income), if any, attributable to items of investment income that are not income within the meaning of § 643(b).

i. Allocate to one subbasket (Entity (principal—IRD)) the portion of Entity (principal), if any, attributable to items that are IRD.

ii. Allocate to a second subbasket (Entity (principal—non-IRD)) the portion of Entity (principal), if any, attributable to items that are not IRD.

c. Allocate to a second basket (Entity (income)) the portion of Entity (Items of Investment Income), if any, attributable to items of investment income that either: (1) are income within the meaning of § 643(b) or (2) are not cash received by the trust or estate (for example, a distributable share of partnership tax items).

i. Allocate to one subbasket (Entity (income—passive)) the portion of Entity (income), if any, attributable to passive investment income items, and, as necessary, divide Entity

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(income—passive) into relevant classes of income (such as "Entity (income—passive rents)").

ii. Allocate to a second subbasket (Entity (income—nonpassive)) the portion of Entity (income), if any, attributable to nonpassive investment income items.

A. Allocate to one sub-subbasket (Entity (income—nonpassive tax-exempt) the portion of Entity (income—nonpassive), if any, attributable to tax-exempt income items, and, as necessary, divide such amount into relevant classes of investment income (such as "Entity (income—nonpassive tax-exempt interest)").

B. Allocate to a second sub-subbasket (Entity (income—nonpassive taxable) the portion of Entity (income—nonpassive), if any, attributable to taxable income items, and, as necessary, divide such amount into relevant classes of investment income (such as "Entity (income—nonpassive taxable interest)" and "Entity (income—nonpassive taxable dividends)").

Step 3. Allocation to principal and income baskets of the items of deduction entering into the computation of EDNI

This Step allocates the items of deduction of the trust or estate to four baskets: principal—IRD, principal—non-IRD, income—passive, and income—nonpassive. The allocation to the four baskets identifies and traces the deductions relating to the different types of investment income received by the trust or estate.

a. Sum all items of deduction entering into the computation of EDNI of the trust or estate (Entity (Items of Deduction)).

b. Divide, under Treasury Regulation § 1.652(b)-3, Entity (Items of Deduction) into direct expenses (Entity (Direct Items of Deduction)) and indirect expenses (Entity (Indirect Items of Deduction)) (these indirect expenses include any deductible amounts allocated to NII by the fiduciary from those deductions that can be allocated between NII and excluded income).

c. Allocate Entity (Direct Items of Deduction) as follows:

i. Allocate to one basket (Entity (principal deductions)) the portion of Entity (Direct Items of Deduction), if any, directly

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related to the items of investment income that are not income within the meaning of § 643(b).

A. Allocate to one subbasket (Entity (principal—IRD deductions)) the portion of Entity (principal deductions), if any, directly related to IRD.

B. Allocate to a second subbasket (Entity (principal—non-IRD deductions)) the portion of Entity (principal deductions), if any, directly related to non-IRD items.

ii. Allocate to a second basket (Entity (income deductions)) the portion of Entity (Direct Items of Deduction), if any, directly related to items of investment income that either: (1) are income within the meaning of § 643(b) or (2) are not cash received by the estate or trust (for example, a distributable share of partnership tax items).

A. Allocate to one subbasket (Entity (income—passive deductions)) the portion of Entity (income deductions), if any, directly related to passive investment income items.

B. Allocate to a second subbasket (Entity (income—nonpassive deductions)) the portion of Entity (income deductions), if any, directly related to nonpassive investment income items.

I. Allocate to one sub-subbasket (Entity (income—nonpassive tax-exempt deductions) the portion of Entity (income—nonpassive deductions), if any, directly related to tax-exempt income items, and, as necessary, divide such amount into relevant classes of deduction (such as "Entity (income—nonpassive tax-exempt interest deductions)").

II. Allocate to a second sub-subbasket (Entity (income—nonpassive taxable deductions) the portion of Entity (income—nonpassive deductions), if any, directly related to taxable income items, and, as necessary, divide such amount into relevant classes of deduction (such as "Entity (income—nonpassive taxable interest deductions)" and "Entity

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(income—nonpassive taxable dividends deductions)").

d. Hold the Entity (Indirect Items of Deduction) basket, which will be allocated later.

Step 4. Tentative allocation to the separate shares of a trust or estate of the items of income entering into the computation of EDNI

This Step allocates to the separate shares of a trust or estate the items of investment income entering into the computation of EDNI based on whether EDNI is attributable to principal items or to income items received by the trust or estate. This allocation identifies and traces the different types of income.

a. Tentatively allocate all items of investment income in the Entity (principal—IRD) and Entity (principal—non-IRD) baskets, if any, to the separate shares of the trust or estate in accordance with the amount of principal of the trust or estate that each separate share is entitled to under the terms of the governing instrument or applicable law (each separate share's tentative allocation respectively called its "Tentative investment income (principal—IRD)" and "Tentative investment income (principal—non-IRD)").

b. Tentatively allocate all items of investment income in the Entity (income—passive), Entity (income—nonpassive tax-exempt), Entity (income—nonpassive taxable) baskets, if any, to the separate shares of the trust or estate in accordance with the amount of income of the trust or estate that each separate share is entitled to under the terms of the governing instrument or applicable law (each separate share's tentative allocation respectively called its "Tentative investment income (income—passive)," "Tentative investment income (income—nonpassive tax-exempt)," and "Tentative investment income (income—nonpassive taxable)").

Step 5. Allocation to the separate shares of a trust or estate of the items of deduction attributable to direct expenses entering into the computation of EDNI and reduction of tentatively allocated investment income by such deductions

This Step allocates to the separate shares of a trust or estate the items of deduction attributable to direct expenses entering into the computation of EDNI and then reduces the tentative allocation of investment income by such expenses. This Step ensures that no deduction is allowed for excess direct

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tax-exempt income or passive expenses but allows a further deduction, as to the other three baskets of investment income, for any excess direct expenses (but disallows a deduction for any net loss).

a. Allocate the direct expenses (if any) in the following five baskets, Entity (principal—IRD deductions), Entity (principal—non-IRD deductions), Entity (income—passive deductions), Entity (income—nonpassive tax-exempt deductions), and Entity (income—nonpassive taxable deductions) to the appropriate separate shares in accordance with the terms of the governing instrument or applicable law.

b. As to each separate share's five baskets of tentatively allocated investment income (Tentative investment income (principal—IRD), Tentative investment income (principal—non-IRD), Tentative investment income (income—passive), Tentative investment income (income—nonpassive tax-exempt), and Tentative investment income (income—nonpassive taxable)), calculate each such basket's tentative net investment income (or tentative net loss), after direct expenses only, by reducing each such basket by any direct expenses allocated to the separate shares under Step 5.a above.

    i. Any tentative net loss as to the two baskets of investment income, Tentative investment income (income—passive) and Tentative investment income (income—nonpassive tax-exempt), gives rise to no further deduction.

    ii. Any tentative net loss as to the three baskets of investment income, Tentative investment income (principal—IRD), Tentative investment income (principal—non-IRD), and Tentative investment income (income—nonpassive taxable), gives rise to a further deduction for excess direct expenses, which may be allocated under Treasury Regulation § 1.652(b)-3(d) as the fiduciary may elect.[100] Recalculate each separate share's tentative net investment income (or tentative net loss) as to the foregoing three baskets, after any direct

[100] Generally, each basket of income should, if possible, be greater than or equal to zero (and not less than zero) because the fiduciary should attempt to maximize the deductibility of indirect expenses by ensuring their allocation to baskets of income that could be reduced by them.

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expenses and excess direct expenses; any tentative net loss gives rise to no further deduction.

Step 6. Allocation to the separate shares of a trust or estate of the items of deduction attributable to indirect expenses entering into the computation of EDNI and reduction of tentatively allocated investment income (after any direct expenses and excess direct expenses) by such deductions

This Step allocates to the separate shares of a trust or estate the items of deduction attributable to indirect expenses entering into the computation of EDNI and then reduces the tentative allocation of investment income (after any direct expenses and excess direct expenses) by indirect expenses and ensures that no deduction is allowed for any excess expenses (both direct and indirect). The allocation in Step 6.a of indirect expenses is based on the relative gross amounts of tax-exempt income and taxable investment income before direct expenses have been taken into account.

a. If Entity (Indirect Items of Deduction) is greater than zero, as to each separate share with Tentative investment income (income—nonpassive tax-exempt) greater than zero (before being reduced by direct expenses), allocate to each such separate share an amount of Entity (Indirect Items of Deduction) that bears the same ratio to Entity (Indirect Items of Deduction) as each such separate share's Entity (income—nonpassive tax-exempt) bears to Entity (Items of Income).

b. After Step 6.a above (and after Step 5 regarding direct expenses), as to each separate share's Tentative investment income (income—nonpassive tax-exempt) basket, calculate net tax-exempt income (or net tax-exempt loss), and disallow a deduction for net losses attributable to excess direct and indirect expenses over tax-exempt income.

c. After Step 6.a above, allocate the remaining indirect expenses, if any, to the separate shares of the trust or estate under Treasury Regulation § 1.652(b)-3(b) as the fiduciary may elect.

d. After Step 6.b and 6.c above (and after Step 5 regarding direct expenses), as to each separate share's five baskets of investment income (Tentative investment income (principal—IRD), Tentative investment income (principal—non-IRD), Tentative investment income (income—passive), Tentative investment income

(income—nonpassive tax-exempt), and Tentative investment income (income—nonpassive taxable)), calculate each such basket's final net investment income (or final net loss).

i. Any net loss as to the two baskets of investment income, Tentative investment income (income—passive) and Tentative investment income (income—nonpassive tax-exempt), gives rise to no further deduction.

ii. Any net loss as to the three baskets of investment income, Tentative investment income (principal—IRD), Tentative investment income (principal—non-IRD), and Tentative investment income (income—nonpassive taxable), may give rise to a reallocation by the fiduciary of the indirect expenses, which may be allocated under Treasury Regulation § 1.652(b)-3(b) as the fiduciary may elect. Any net loss after any such reallocation gives rise to no further deduction.

Step 7. Calculation of the DNI of each separate share of a trust or estate and reconciliation with Entity DNI

This Step is consistent with the separate share regulations' second method for calculating and allocating DNI; accordingly, this Step provides a calculation for the NII and DNI of each separate share of the trust or estate, thus ensuring that each separate share is treated as having an independent, economic interest and, consequently, its own items of income and deduction. However, as discussed in Part II of this article, cross-deduction between and among separate shares may be impossible to prevent because both NII (under § 1411) and DNI (under § 643) are each calculated at the level of the trust or estate.

Consequently, this Step compares the DNI of the trust or estate (as calculated in Step 1 above) and the sum of the DNI amounts of the separate shares (as calculated in this Step). If the DNI of the trust or estate is less than the sum of the individual DNI amounts, this Step adjusts the individual DNI amounts to equal the DNI of the trust or estate. Any adjustment to the DNI of a separate share is transparent so that a beneficiary of such separate share can seek possible equitable adjustment from the fiduciary.

a. Calculate, for purposes of the NIIT, the NII (under § 1411 and the regulations thereunder) and an initial DNI (under § 643 and the regulations thereunder) (Tentative DNI) individually of each such separate share, ensuring: (1) to deduct any amounts allocated to net

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investment income by the fiduciary from those expenses that can be allocated between net investment income and excluded income and (2) to apply all limitations on deductions for passive losses and expenses related to tax-exempt income.

b. Sum the Tentative DNI amounts of all separate shares of the trust or estate.

   i. If the sum of Tentative DNI amounts equals Entity DNI, each separate share's Tentative DNI amount equals its Final DNI amount.

   ii. If the sum of Tentative DNI amounts is greater than Entity DNI:

      A. Confirm the NII items entering into the computation of Entity DNI in Step 1.

      B. As to each separate share with a Tentative DNI greater than zero, adjust each such separate share's Tentative DNI so that each such Tentative DNI amount includes only the same class of NII items that entered into the computation of Entity DNI in Step 1.

      C. After Step 7.b.ii.B. above, as to each separate share with NII items that entered into the computation of Entity DNI in Step 1, allocate to each such separate share a portion of Entity DNI that bears the same ratio to Entity DNI as each such separate share's Tentative DNI amount (as adjusted in Step 7.b.ii.B. above) bears to the total Tentative DNI amounts (as adjusted in Step 7.b.ii.B. above) of all such separate shares. The portion of Entity DNI allocated to each such separate share is the separate share's Final DNI, and the character of the Final DNI in the hands of each such separate share consists of a proportionate share of the NII items entering into the computation of Entity DNI in Step 1.

B. Application of the Proposed Calculation and Allocation and Discussion

A trust has two equal separate shares. The two separate shares have (1) nonpassive income and deductions, (2) passive income and deductions, and (3) tax-exempt interest and deductions as follows. One separate share

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has: (1) net interest income of $25 (attributable to $50 of taxable interest income and $25 of direct interest expenses), (2) net passive rental income of $25 (attributable to $50 of passive rents and $25 of direct passive rent expenses), and (3) net tax-exempt interest of $25 (attributable to $50 of tax-exempt interest and $25 of direct tax-exempt interest expenses). Another separate share has: (1) net interest income of $25 (attributable to $50 of taxable interest income and $25 of direct interest expenses), (2) a net passive rental loss of $30 (attributable to $50 of passive rents and $80 of direct passive rental expenses), and (3) net tax-exempt interest of $25 (attributable to $50 of tax-exempt interest and $25 of direct tax-exempt interest expenses). Additionally, the trust has $30 of indirect expenses (from certain total indirect expenses that are allocable by the fiduciary between NII and excluded income). As to the foregoing facts, this article first summarizes the application of the proposed calculation and allocation and then provides a detailed analysis of each Step of the proposed calculation and allocation.

Step 1 of the proposed calculation and allocation calculates the trust's NII as $30 and its DNI as $70. Before indirect expenses are deducted, there is $50 of NII, calculated from the sum of: (1) $50 of net taxable interest income ($100 gross taxable interest income less $50 of direct expenses allowed as a deduction) and (2) $0 of net passive rents ($100 passive rents less $105 direct passive rental expenses, but not less than zero), and excluding tax-exempt interest and its direct expenses. Initially, there are $30 of indirect expenses to be allocated by the fiduciary. Twenty dollars (from the total of $30) of indirect expenses are allocated to net taxable interest income (the only net positive type of income) because $10 (from the total of $30) of indirect expenses must be allocated to tax-exempt interest, which is one-third ($10/$30) of such indirect expenses, the same ratio gross tax-exempt interest of $100 bears to total gross income of $300 (from $100 of each of taxable interest, passive rents, and tax-exempt interest). The final NII is $30 ($50 of net taxable interest income less $20 indirect expenses allocated above to net taxable interest income). NII of $30 is modified to include net tax-exempt interest of $40 for final DNI for the entire trust of $70. The net tax-exempt interest is $40 (from $50 net tax-exempt interest less the foregoing $10 of indirect expenses allocated to tax-exempt interest).

Next, Steps 2 through 5 allocate the trust's items of income and deduction (including direct expenses but not indirect expenses) between the two separate shares and then calculate each separate share's net income (or net loss) as follows. Before deducting the $30 of indirect expenses, the first separate share has: (1) $25 of net interest income, (2) $25 of net passive rents,

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and (3) $25 of net tax-exempt interest; and the second separate share has: (1) $25 of net interest income, (2) a $30 net passive rental loss, and (3) $25 of net tax-exempt interest. The $30 of indirect expenses must be allocated in part to tax-exempt interest. Because there is $300 of total gross income (from $100 of each of the three types of income, taxable interest, passive rents, and tax-exempt interest), the $30 of indirect expenses is allocated one-third, or $10, to tax-exempt interest (and then divided between the two separate shares). The remaining $20 of indirect expenses should, under these facts, be used by the fiduciary to reduce taxable interest (divided between the two separate shares) because allocating any of these expenses to passive rents may not be effectively deducted. Consequently, after deducting the $30 of indirect expenses, the first separate share has: (1) $15 of net interest income, (2) $25 of net passive rents, and (3) $20 of net tax-exempt interest; and the second separate share has: (1) $15 of net interest income, (2) a $30 net passive rental loss, and (3) $20 of net tax-exempt interest.

Step 7 calculates the taxable income and a Tentative DNI amount individually for each separate share as follows. From the foregoing amounts, the first separate share's NII is $40 (from $15 of net interest income and $25 of net passive rents) and a Tentative DNI of $60 (from NII of $40 modified to include $20 of net tax-exempt interest). Also from the foregoing amounts, the second separate share's NII is $15 (from $15 of net interest income and $0 of passive rents (because the passive loss cannot reduce nonpassive income)) and a Tentative DNI of $35 (from NII of $15 modified to include $20 of net tax-exempt interest). Additionally, Step 7 provides a final reconciliation of the trust's $70 of DNI with the amount of $95 of DNI, which is the sum of the Tentative DNI amounts calculated individually for the two separate shares ($60 from the first separate share and $35 from the second separate share). First, Step 7 adjusts the Tentative DNI amount of each separate share so that it includes only the classes of income included in the trust's DNI, which here are net interest income and net tax-exempt interest; accordingly, as adjusted, the first separate share's Tentative DNI is $35, and the second separate share's Tentative DNI is $35. Next, because the trust's $70 of DNI sets the maximum of DNI for the two separate shares, Step 7 allocates the $70 of DNI based on the separate shares' Tentative DNI amounts (after the adjustment to the Tentative DNI amounts to include only net interest income), so that the first separate share has $35 of Final DNI and the second separate share has $35 of Final DNI.

Under the proposed calculation and allocation, each separate share calculates its NII and DNI amount by taking into account its own items of

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passive and nonpassive items of income and deduction. Steps 5 and 6 highlight the independent economic interests of the two separate shares; after $30 of indirect expenses are allocated and then deducted, the first separate share has $15 of net interest income, $25 of net passive rents, and $20 of net tax-exempt income, and the second separate share has $15 of net interest income, a $30 net passive rental loss, and $20 of net tax-exempt income. The proposed calculation and allocation cannot prevent the cross-deduction between the two separate shares as to passive rents, which occurs in Step 1 at the trust level; the proposal, however, does prevent the trust's overall $5 passive rental loss from reducing nonpassive income. Additionally, although the trust's $70 of DNI is allocated equally between the two separate shares based upon their equal amounts of net interest income and net tax-exempt interest, the tracing of all items of income and deduction nonetheless may assist the second separate share in seeking from the fiduciary equitable adjustments or reimbursements resulting from the first separate share benefiting from the excess passive rental deductions of such second separate share.

The Steps of the proposed calculation and allocation of DNI apply as follows.

Step 1.a. The trust has separate shares.

Step 1.b. The trust's NII is $30 (attributable to $50 of net investment income less $20 of indirect expenses); the $50 of net investment income is the sum of: (1) $50 net interest income, resulting from $100 interest income less $50 direct interest expenses, and (2) $0 net passive rents, resulting from $100 passive rents less $105 direct passive rental expenses (but not less than zero). The NII of $30 is modified to include $40 net tax-exempt interest (resulting from $100 tax-exempt interest less $50 direct tax-exempt interest expense and less $10 indirect expenses), so EDNI is $70. There are no distributions from the trust, so there is undistributed NII for purposes of the NIIT.

Step 1.b.i. This Step does not apply because EDNI does not equal zero.

Step 1.b.ii. EDNI is $70, which is greater than zero. Because there is $0 of net passive rents, the only net income items

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entering into the computation of EDNI are net interest income of $30 and net tax-exempt interest of $40.

Step 2.a.	Entity (Items of Income) is $300 ($100 of total interest income, $100 of total passive rents, and $100 of total tax-exempt interest).
Step 2.b.	This Step does not apply because there is no portion of Entity (Items of Income) that is Entity (principal).
Step 2.c.	Entity (income) is $300 (attributable to $100 of total interest income, $100 of total passive rents, and $100 of total tax-exempt interest, which are each income within the meaning of § 643(b)).
Step 2.c.i.	Entity (income—passive) is $100 (attributable to $100 of passive rents).
Step 2.c.ii.	Entity (income—nonpassive) is $200 (attributable to $100 of nonpassive interest income and $100 of nonpassive tax-exempt interest).
Step 2.c.ii.A.	Entity (income—nonpassive tax-exempt) is $100 (attributable to $100 of nonpassive tax-exempt interest).
Step 2.c.ii.B.	Entity (income—nonpassive taxable) is $100 (attributable to $100 of nonpassive taxable interest income).
Step 3.a.	Entity (Items of Deduction) is $235 (attributable to $50 of total direct interest expenses, $105 of total direct passive rental expenses, and $50 direct tax-exempt interest expenses, as well as $30 indirect expenses).
Step 3.b.	Entity (Direct Items of Deduction) is $205 (attributable to $50 of direct interest expenses, $105 of direct passive rental expenses, and $50 direct tax-exempt interest expenses), and Entity (Indirect Items of Deduction) is $30.
Step 3.c.i.	This Step does not apply because no portion of Entity (Direct Items of Deduction) is Entity (principal deductions).
Step 3.c.ii.	Entity (income deductions) is $205 (attributable to $50 of direct interest expenses, $105 of direct passive rental

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expenses, and $50 of direct tax-exempt interest expenses).

Step 3.c.ii.A. Entity (income—passive deductions) is $105 (attributable to $105 of direct passive rental expenses).

Step 3.c.ii.B. Entity (income—nonpassive deductions) is $100 (attributable to $50 of direct nonpassive taxable interest expenses and $50 of direct nonpassive tax-exempt interest expenses).

Step 3.c.ii.B.I. Entity (income—nonpassive tax-exempt deductions) is $50 (attributable to $50 of direct nonpassive tax-exempt interest expenses).

Step 3.c.ii.B.II. Entity (income—nonpassive taxable deductions) is $50 (attributable to $50 of direct nonpassive taxable interest expenses).

Step 3.d. Entity (Indirect Items of Deduction) is $30, which is held for later allocation.

Step 4.a. This Step does not apply because there is no Entity (principal).

Step 4.b. There are three baskets of income, $100 of Entity (income—passive), $100 of Entity (income—nonpassive tax-exempt income), and $100 of Entity (income—nonpassive taxable income), each of which must be allocated to the two separate shares. Under the terms of the governing instrument and the facts of this example, each of the two separate shares has Tentative income (income—passive) of $50, Tentative Income (income—nonpassive tax-exempt interest) of $50, and Tentative income (income—nonpassive taxable income) of $50.

Step 5.a. The $105 of Entity (income—passive deductions) are allocated to the appropriate separate shares as follows. The $25 of expenses directly attributable to the first separate share are allocated to such separate share, and the $80 of expenses directly attributable to the second separate share are allocated to such separate share.

The $50 of Entity (income—nonpassive tax-exempt deductions) are allocated to the appropriate separate shares as follows. The $25 of expenses directly attributable to the first separate share are allocated to such separate share, and the $25 of expenses directly attributable to the second separate share are allocated to such separate share.

The $50 of Entity (income—nonpassive taxable deductions) are allocated to the appropriate separate shares as follows. The $25 of expenses directly attributable to the first separate share are allocated to such separate share, and the $25 of expenses directly attributable to the second separate share are allocated to such separate share.

Step 5.b. Each of the two separate shares has three baskets of income, and each separate share must calculate the net income (or net loss) of each basket of income (after direct expenses only). The first separate share's calculations are as follows: Tentative income (income—passive) of $50 is reduced by $25 of direct expenses, resulting in net income of $25 (after direct expenses only), Tentative income (income—nonpassive tax-exempt) of $50 is reduced by $25 of direct expenses, resulting in net income of $25 (after direct expenses only), and Tentative income (income—nonpassive taxable) of $50 is reduced by $25 of direct expenses, resulting in net income of $25 (after direct expenses only).

The second separate share's calculations are as follows: Tentative income (income—passive) of $50 is reduced by $80 of direct expenses, resulting in net loss of $30 (after direct expenses only), Tentative income (income—nonpassive tax-exempt) of $50 is reduced by $25 of direct expenses, resulting in net income of $25 (after direct expenses only), and Tentative income (income—nonpassive taxable) of $50 is reduced by $25 of direct expenses, resulting in net income of $25 (after direct expenses only).

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Step 5.b.i. The second separate share's net loss as to Tentative income (income—passive) gives rise to no further deduction.

Step 5.b.ii. This Step does not apply because there is no net loss as to the baskets of income relevant to this Step.

Step 6.a. Entity (Indirect Items of Deduction) is $30. Each separate share has, before direct expenses, Tentative income (income—nonpassive tax-exempt) of $50, which is greater than zero. From Entity (Indirect Items of Deduction) of $30, each separate share will be allocated $5 of those indirect expenses. Five dollars bears the same ratio to $30, $5/$30 or 1/6, that each such separate share's Tentative income (income—nonpassive tax-exempt) of $50 bears to Entity (Items of Income) of $300.

Step 6.b. Each separate share's Tentative income (income—nonpassive tax-exempt) of $50 is reduced by that separate share's $25 of direct expenses (from Step 5.b above) and $5 of indirect expenses (from Step 6.a above) so that each separate share's net income from this basket of nonpassive tax-exempt interest is $20.

Step 6.c. The remaining indirect expenses are $20 (attributable to $30 of original indirect expenses reduced by $10 of such expenses allocated to the foregoing separate shares' nonpassive tax-exempt income baskets). Under Treasury Regulation § 1.652(b)-3(b), a fiduciary should, under these facts, allocate the $20 of indirect expenses to reduce Tentative income (income—nonpassive taxable), $10 to each of the two separate shares, because allocating expenses to Tentative income (income—passive) may lead to no deduction.

Step 6.d. Each separate share's final net income (or final net loss) is calculated as follows. The first separate share has: Tentative income (income—passive) of $25, Tentative income (income—nonpassive tax-exempt) of $20, and Tentative income (income—nonpassive taxable) of $15. The second separate share has: a Tentative income (income—passive) loss of $30, Tentative income

(income—nonpassive tax-exempt) of $20, and Tentative income (income—nonpassive taxable) of $15.

Step 6.d.i. The second separate share's Tentative income (income—passive) loss of $30 gives rise to no further deduction.

Step 6.d.ii. This Step does not apply because no separate share has a net loss as to the baskets of income relevant to this Step.

Step 7.a. The Tentative DNI of each of the two separate shares is calculated independently as follows. The first separate share's NII (without indirect expenses) is $50, the sum of: (1) $25 (Tentative income (income—nonpassive taxable) of $50 less $25 direct expenses (but no indirect expenses)), and (2) $25 (Tentative income (income—passive) of $50 less $25 direct expenses (but no indirect expenses)). From $15 of indirect expenses (the first separate share's one-half portion of $30 total indirect expenses), this separate share's Tentative income (income—nonpassive tax-exempt) will be allocated $5 of indirect expenses. Five dollars bears the same ratio to $15 of total indirect expenses that this separate share's Tentative income (income—nonpassive tax-exempt) of $50 bears to this separate share's total Tentative income of $150 (from $50 of each of passive rents, taxable interest, and tax-exempt interest). The remaining $10 of indirect expenses should, under the foregoing facts, be allocated by a fiduciary solely to taxable income because an allocation to passive rents may lead to no deduction. Accordingly, the first separate share's NII is $40 ($100 income less $50 direct expenses and less $10 indirect expenses).

The first separate share's taxable income of $40 is modified to include $20 of net tax-exempt interest for a Tentative DNI of $60. The $20 of net tax-exempt interest results from $50 tax-exempt interest less $25 direct expenses and less $5 indirect expenses.

The second separate share's NII (without indirect expenses) is $25, the sum of: (1) $25 (Tentative income (income—nonpassive taxable) of $50 less $25 direct expenses (but no indirect expenses), and (2) $0

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(Tentative income (income—passive) of $50 less $80 direct expenses (but no indirect expenses), but this cannot be less than zero). From $15 of indirect expenses (the second separate share's one-half portion of $30 total indirect expenses), this separate share's Tentative income (income—nonpassive tax-exempt) will be allocated $5 of indirect expenses. Five dollars bears the same ratio to $15 of total indirect expenses that this separate share's Tentative income (income—nonpassive tax-exempt) of $50 bears to this separate share's total Tentative income of $150 (from $50 of each of passive rents, taxable interest, and tax-exempt interest). The remaining $10 of indirect expenses should, under the foregoing facts, be allocated by a fiduciary solely to taxable income because an allocation to passive rents may lead to no deduction. Accordingly, the second separate share's NII is $15 ($50 taxable interest income less $25 direct expenses and less $10 indirect expenses, and disregarding passive rents because they lead to a loss).

The second separate share's taxable income of $15 is modified to include $20 of net tax-exempt interest for a Tentative DNI of $35. The $20 of net tax-exempt interest results from $50 tax-exempt interest less $25 direct expenses and less $5 indirect expenses.

Step 7.b. The sum of the Tentative DNI amounts of all separate shares is $95 (attributable to the first separate share's Tentative DNI of $60 and the second separate share's Tentative DNI of $35).

Step 7.b.i. This Step does not apply because the sum of the separate shares' Tentative DNI amounts of $95 does not equal Entity DNI of $70.

Step 7.b.ii. The sum of the separate shares' Tentative DNI amounts of $95 is greater than Entity DNI of $70, so this Step applies.

Step 7.b.ii.A. The net income items entering into the computation of Entity DNI in Step 1 are interest income and tax-exempt interest items.

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Step 7.b.ii.B. The first separate share's Tentative DNI of $60 consists of $15 of net interest income items, $20 of net tax-exempt interest, and $25 of net passive rents, so the first separate share's Tentative DNI is adjusted to be $35, so that such separate share's Tentative DNI amount includes only the same classes of net income items ($15 of net interest income and $20 of tax-exempt interest) that entered into the computation of Entity DNI in Step 1.

The second separate share's Tentative DNI of $35 consists of $15 of net interest income items, $20 of net tax-exempt interest, and $0 of net passive rents, so there is no adjustment because the second separate share's Tentative DNI includes only the same classes of net income items ($15 of net taxable interest income and $20 of net tax-exempt interest) that entered into the computation of Entity DNI in Step 1.

Step 7.b.ii.C. The first and second separate shares each receive $35 of Final DNI under the same calculation as follows. Each separate share is allocated $35 of Entity DNI, which is the portion of $70 of Entity DNI that bears the same ratio (50%) to $70 of Entity DNI as each such separate share's Tentative DNI amount of $35 (as adjusted in Step 7.B.ii.B. above) bears to $70, the total Tentative DNI amounts (as adjusted in Step 7.B.ii.B. above) of all such separate shares.

Each of the first and second separate shares has $35 of Final DNI. The character of the Final DNI in the hands of each separate share consists of $15 of interest income and $20 of tax-exempt interest, which are the same proportions as the net interest income items and net tax-exempt interest entering into the computation of Entity DNI. Each separate share's Final DNI consists of: (1) $15 of interest income, which is $15/$35 or 3/7, the same proportion as the net interest income of $30 bears to Entity DNI of $70, and (2) $20 of tax-exempt interest, which is $20/$35 or 4/7, the same proportion as the net tax-exempt interest of $40 bears to Entity DNI of $70.

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IV. CONCLUSION

The calculation of the NIIT, similar to the one for the regular income tax, allows for cross-deductions of passive income and losses as to a trust or estate with separate shares. The NIIT regulations prevent such a cross-deduction between the S and non-S portions of an ESBT, but they cannot do so as to a trust or estate with separate shares because the trust or estate must first calculate the NII and DNI at the entity level before allocating such DNI to its separate shares. Under the NIIT, the calculation of NII and DNI at the level of the trust or estate means that the proposed calculation and allocation cannot ensure that, for example, a passive loss of one separate share is "not available" to another separate share of the trust or estate. The proposed calculation and allocation for the NIIT, however, trace passive and nonpassive income and deductions so that the independent economic interests of each separate share may be identified, which may help a beneficiary of a separate share with a net loss to seek an equitable adjustment because another separate share benefitted from the loss. Accordingly, the separate share regulations as applied to the NIIT should provide a calculation and allocation of DNI to the separate shares of a trust or estate such as those proposed in this article.

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