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# Investment Income and Expenses

**(Including Capital  
Gains and Losses)**

For use in preparing

**2001** Returns



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## Important Changes

**8% capital gain rate.** Beginning in 2001, the 10% capital gain rate is lowered to 8% for qualified 5-year gain. For more information, see *Capital Gain Tax Rates* in chapter 4.

**18% capital gain rate.** Beginning in 2006, the 20% capital gain rate will be lowered to 18% for qualified 5-year gain from property with a holding period that begins after 2000.

You can give a new holding period to certain assets you already held on January 1, 2001, by treating them as sold and then reacquired on the same date. You must pay tax for 2001 on any resulting gain. For more information, see *Capital Gain Tax Rates* in chapter 4.

**Securities futures contracts.** A securities futures contract is a new financial product that is a contract of sale for future delivery of a single security or of a narrow-based security index. Gain or loss from the sale or exchange of the contract will generally have the same character as gain or loss from transactions in the property to which the contract relates. Any capital gain or loss on a sale or exchange of the contract will be considered short-term, regardless of how long you hold the contract. For more information, see chapter 4.

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## Important Reminders

**Sale of DC Zone assets.** Beginning in 2003, investments in District of Columbia Enterprise Zone (DC Zone) assets held more than 5 years will qualify for a special tax benefit. If you sell or trade a DC Zone asset at a gain, you will not have to include any qualified capital gain in your gross income. This exclusion applies to an interest in, or property of, certain businesses operating in the District of Columbia. For more information, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities*.

**U.S. property acquired from a foreign person.** If you acquire a U.S. real property interest from a foreign person or firm, you may have to withhold income tax on the amount you pay for the property (including cash, the fair market value of other property, and any assumed liability). Domestic or foreign corporations, partnerships, trusts, and estates may also have to withhold on certain distributions and other transactions involving U.S. real property interests. If you fail to withhold, you may be held liable for the tax, penalties that apply, and interest. For more information, see Publication 515, *Withholding of Tax on Nonresident Aliens and Foreign Entities*.

**Foreign income.** If you are a U.S. citizen with investment income from sources outside the United States (foreign income), you must report that income on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the foreign payer.

**Alien's individual taxpayer identification number (ITIN).** The IRS will issue an ITIN to a nonresident or resident alien who does not have and is not eligible to get a social security number (SSN). To apply for an ITIN, file Form W-7, *Application for IRS Individual Taxpayer Identification Number*, with the IRS. Enter your ITIN wherever an SSN is requested on a tax return. If you must include another person's SSN on your return and that person does not have and cannot get an SSN, enter that person's ITIN.

An ITIN is for tax use only. It does not entitle you to social security benefits or change your employment or immigration status under U.S. law.

**Photographs of missing children.** The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on

pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1-800-THE-LOST (1-800-843-5678)** if you recognize a child.

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## Introduction

This publication provides information on the tax treatment of investment income and expenses. It explains what investment income is taxable and what investment expenses are deductible. It explains when and how to show these items on your tax return. It also explains how to determine and report gains and losses on the disposition of investment property and provides information on property trades and tax shelters.

There is a glossary at the end of this publication that defines many of the terms used.

**Investment income.** This generally includes interest, dividends, capital gains, and other types of distributions.

**Investment expenses.** These include interest paid or incurred to acquire investment property and expenses to manage or collect income from investment property.

**Comments and suggestions.** We welcome your comments about this publication and your suggestions for future editions.

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# 1.

## Investment Income

### Topics

This chapter discusses:

- Interest income,
- Dividends and other corporate distributions,
- Real estate mortgage investment conduits (REMICs), financial asset securitization investment trusts (FASITs), and other collateralized debt obligations (CDOs),
- S corporations, and
- Investment clubs.

### Useful Items

You may want to see:

#### Publication

- 525** Taxable and Nontaxable Income
- 537** Installment Sales
- 564** Mutual Fund Distributions
- 590** Individual Retirement Arrangements (IRAs)
- 925** Passive Activity and At-Risk Rules
- 1212** List of Original Issue Discount Instruments

#### Form (and Instructions)

- Schedule B (Form 1040)** Interest and Ordinary Dividends
- Schedule 1 (Form 1040A)** Interest and Ordinary Dividends for Form 1040 Filers
- 1099** General Instructions for Forms 1099, 1098, 5498, and W-2G
- 3115** Application for Change in Accounting Method
- 6251** Alternative Minimum Tax—Individuals
- 8582** Passive Activity Loss Limitations
- 8615** Tax for Children Under Age 14 Who Have Investment Income of More Than \$1,500
- 8814** Parents' Election To Report Child's Interest and Dividends
- 8815** Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989
- 8818** Optional Form To Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989

See chapter 5 for information about getting these publications and forms.

## General Information

A few items of general interest are covered here.



**Recordkeeping.** You should keep a list showing sources and amounts of investment income that you receive during the year. Also, keep the forms you receive that show your investment income (Forms 1099-INT, *Interest Income*, and 1099-DIV, *Dividends and Distributions*, for example) as an important part of your records.

**Tax on investment income of a child under age 14.** Part of a child's 2001 investment income may be taxed at the parent's tax rate. This may happen if all of the following are true.

- 1) The child was under age 14 on January 1, 2002.
- 2) The child had more than \$1,500 of investment income (such as taxable interest and dividends) and has to file a tax return.
- 3) Either parent was alive at the end of 2001.

If all of these statements are true, **Form 8615** must be completed and attached to the child's tax return. If any of these statements is not true, Form 8615 is not required and the child's income is taxed at his or her own tax rate.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. Use **Form 8814** for this purpose.

For more information about the tax on investment income of children and the parents' election, see Publication 929, *Tax Rules for Children and Dependents*.

**Beneficiary of an estate or trust.** Interest, dividends, and other investment income you receive as a beneficiary of an estate or trust is generally taxable income. You should receive a Schedule K-1 (Form 1041), *Beneficiary's Share of Income, Deductions, Credits, etc.*, from the fiduciary. Your copy of Schedule K-1 and its instructions will tell you where to report the income on your Form 1040.

**Social security number (SSN).** You must give your name and SSN to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of interest and dividends.

**SSN for joint account.** If the funds in a joint account belong to one person, list that person's name first on the account and give that person's SSN to the payer. (For information on who owns the funds in a joint account, see *Joint accounts*, later.) If the joint account contains combined funds, give the SSN of the person whose name is listed first on the account.

These rules apply both to joint ownership by a married couple and to joint ownership by other individuals. For example, if you open a joint savings account with your child using funds belonging to the child, list the child's name first on the account and give the child's SSN.

**Custodian account for your child.** If your child is the actual owner of an account that is

recorded in your name as custodian for the child, give the child's SSN to the payer. For example, you must give your child's SSN to the payer of dividends on stock owned by your child, even though the dividends are paid to you as custodian.

**Penalty for failure to supply SSN.** You will be subject to a penalty if, when required, you fail to:

- 1) Include your SSN on any return, statement, or other document,
- 2) Give your SSN to another person who has to include it on any return, statement, or other document, or
- 3) Include the SSN of another person on any return, statement, or other document.

The penalty is \$50 for each failure up to a maximum penalty of \$100,000 for any calendar year.

You will not be subject to this penalty if you can show that your failure to provide the SSN was due to a reasonable cause and not to willful neglect.

If you fail to supply an SSN, you may also be subject to backup withholding.

**Backup withholding.** Your investment income is generally not subject to regular withholding. However, it may be subject to backup withholding to ensure that income tax is collected on the income. Under backup withholding, the bank, broker, or other payer of interest, original issue discount (OID), dividends, cash patronage dividends, or royalties must withhold, as income tax, a percentage of the amount you are paid. For 2002, the percentage is 30%.

Backup withholding applies if:

- 1) You do not give the payer your identification number (either a social security number or an employer identification number) in the required manner,
- 2) The Internal Revenue Service (IRS) notifies the payer that you gave an incorrect identification number,
- 3) The IRS notifies the payer that you are subject to backup withholding on interest or dividends because you have underreported interest or dividends on your income tax return, or
- 4) You are required, but fail, to certify that you are not subject to backup withholding for the reason described in (3).

**Certification.** For new accounts paying interest or dividends, you must certify under penalties of perjury that your social security number (SSN) is correct and that you are not subject to backup withholding. Your payer will give you a **Form W-9, Request for Taxpayer Identification Number and Certification**, or similar form, to make this certification. If you fail to make this certification, backup withholding may begin immediately on your new account or investment.

**Underreported interest and dividends.** You will be considered to have underreported your interest and dividends if the IRS has determined for a tax year that:

- 1) You failed to include any part of a reportable interest or dividend payment required to be shown on your return, or

**Table 1–1. Where To Report Common Types of Investment Income**

(For detailed information about reporting investment income, see the rest of this publication, especially *How To Report Interest Income* and *How To Report Dividend Income* in chapter 1.)

Income	If you file Form 1040	If you can file Form 1040A	If you can file Form 1040EZ
Taxable interest that totals \$400 or less	Line 8a (You may need to file Schedule B as well.)	Line 8a (You may need to file Schedule 1 as well.)	Line 2
Ordinary dividends that total \$400 or less	Line 9 (You may need to file Schedule B as well.)	Line 9 (You may need to file Schedule 1 as well.)	You cannot use Form 1040EZ.
Taxable interest that totals more than \$400	Line 8a; also use Schedule B	Line 8a; also use Schedule 1	
Ordinary dividends that total more than \$400	Line 9; also use Schedule B	Line 9; also use Schedule 1	
Savings bond interest you will exclude because of higher education expenses	Schedule B; also use Form 8815	Schedule 1; also use Form 8815	
Capital gain distributions (if you do not have to file Schedule D)	Line 13	Line 10	
Capital gain distributions (if you have to file Schedule D)	Schedule D, line 13	You cannot use Form 1040A.	
Gain or loss from sale of stocks and bonds	Line 13; also use Schedule D		
Gain or loss from exchanges of like investment property	Line 13; also use Schedule D and Form 8824		

- 2) You were required to file a return and to include a reportable interest or dividend payment on that return, but you failed to file the return.

**How to stop backup withholding due to underreporting.** If you have been notified that you underreported interest or dividends, you can request a determination from the IRS to prevent backup withholding from starting or to stop backup withholding once it has begun. You must show that at least one of the following situations applies.

- 1) No underreporting occurred.
- 2) You have a bona fide dispute with the IRS about whether underreporting occurred.
- 3) Backup withholding will cause or is causing an undue hardship, and it is unlikely that you will underreport interest and dividends in the future.
- 4) You have corrected the underreporting by filing a return if you did not previously file one and by paying all taxes, penalties, and interest due for any underreported interest or dividend payments.

If the IRS determines that backup withholding should stop, it will provide you with a certification and will notify the payers who were sent notices earlier.

**How to stop backup withholding due to an incorrect identification number.** If you have been notified by a payer that you are subject to backup withholding because you have provided an incorrect SSN or employer identification number, you can stop it by following the instructions the payer gives you.

**Reporting backup withholding.** If backup withholding is deducted from your interest or dividend income or other reportable payment, the bank or other business must give you an

information return for the year (for example, a Form 1099–INT) that indicates the amount withheld. The information return will show any backup withholding as “Federal income tax withheld.”

**Nonresident aliens.** Generally, payments made to nonresident aliens are not subject to backup withholding. You can use **Form W–8BEN, Certificate of Foreign Status of Beneficial Owner for United States Tax Withholding**, to certify exempt status. However, this does not exempt you from the 30% (or lower treaty) withholding rate that may apply to your investment income. For information on the 30% rate, see Publication 519, *U.S. Tax Guide for Aliens*.

**Penalties.** There are civil and criminal penalties for giving false information to avoid backup withholding. The civil penalty is \$500. The criminal penalty, upon conviction, is a fine of up to \$1,000, or imprisonment of up to 1 year, or both.

**Where to report investment income.** *Table 1–1* gives an overview of the forms and schedules to use to report some common types of investment income. But, see the rest of this publication for detailed information about reporting investment income.

**Joint accounts.** If two or more persons hold property (such as a savings account, bond, or stock) as joint tenants, tenants by the entirety, or tenants in common, each person’s share of any interest or dividends from the property is determined by local law.

**Example.** You and your husband have a joint money market account. Under state law, half the income from the account belongs to you, and half belongs to your husband. If you file separate returns, you each report half of the income.

**Income from property given to a child.** Property you give as a parent to your child under the Model Gifts of Securities to Minors Act, the Uniform Gifts to Minors Act, or any similar law, becomes the child’s property.

Income from the property is taxable to the child, except that any part used to satisfy a legal obligation to support the child is taxable to the parent or guardian having that legal obligation.

**Savings account with parent as trustee.** Interest income from a savings account opened for a child who is a minor, but placed in the name and subject to the order of the parents as trustees, is taxable to the child if, under the law of the state in which the child resides, both of the following are true.

- 1) The savings account legally belongs to the child.
- 2) The parents are not legally permitted to use any of the funds to support the child.

**Accuracy-related penalty.** An accuracy-related penalty of 20% can be charged for underpayments of tax due to negligence or disregard of rules or regulations or substantial understatement of tax. For information on the penalty and any interest that applies, see *Penalties* in chapter 2.

## Interest Income

### Terms you may need to know (see Glossary):

- Accrual method
- Below-market loan
- Cash method
- Demand loan

Forgone interest  
Gift loan  
Interest  
Nominee  
Original issue discount  
Private activity bond  
Term loan

This section discusses the tax treatment of different types of interest income.

In general, any interest that you receive or that is credited to your account and can be withdrawn is taxable income. (It does not have to be entered in your passbook.) Exceptions to this rule are discussed later.

**Form 1099–INT.** Interest income is generally reported to you on Form 1099–INT, or a similar statement, by banks, savings and loans, and other payers of interest. This form shows you the interest you received during the year. Keep this form for your records. You do not have to attach it to your tax return.

Report on your tax return the total amount of interest income that you receive for the tax year. This includes amounts reported to you on Form 1099–INT and amounts for which you did not receive a Form 1099–INT.

**Nominees.** Generally, if someone receives interest as a nominee for you, that person will give you a Form 1099–INT showing the interest received on your behalf.

If you receive a Form 1099–INT that includes amounts belonging to another person, see the discussion on nominee distributions, later, under *How To Report Interest Income*.

**Incorrect amount.** If you receive a Form 1099–INT that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099–INT you receive will be marked “Corrected.”

**Form 1099–OID.** Reportable interest income may also be shown on Form 1099–OID, *Original Issue Discount*. For more information about amounts shown on this form, see *Original Issue Discount (OID)*, later in this chapter.

**Exempt-interest dividends.** Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. (However, see *Information-reporting requirement*, next.) You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends that you received. Exempt-interest dividends are not shown on Form 1099–DIV or Form 1099–INT.

**Information-reporting requirement.** Although exempt-interest dividends are not taxable, you must show them on your tax return if you have to file. This is an information-reporting requirement and does not change the exempt-interest dividends to taxable income. See *How To Report Interest Income*, later.

**Note.** Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax. See Form 6251 and its instructions for more information about

this tax. (Private activity bonds are discussed later under *State or Local Government Obligations*.)

**Interest on VA dividends.** Interest on insurance dividends that you leave on deposit with the Department of Veterans Affairs (VA) is not taxable. This includes interest paid on dividends on converted United States Government Life Insurance policies and on National Service Life Insurance policies.

**Individual retirement arrangements (IRAs).** Interest on a Roth IRA generally is not taxable. Interest on a traditional IRA is tax deferred. You generally do not include it in your income until you make withdrawals from the IRA. See Publication 590 for more information.

## Taxable Interest — General

Taxable interest includes interest you receive from bank accounts, loans you make to others, and other sources. The following are some sources of taxable interest.

**Dividends that are actually interest.** Certain distributions commonly called dividends are actually interest. You must report as interest so-called “dividends” on deposits or on share accounts in:

- Cooperative banks,
- Credit unions,
- Domestic building and loan associations,
- Domestic savings and loan associations,
- Federal savings and loan associations, and
- Mutual savings banks.

**Money market funds.** Generally, amounts you receive from money market funds should be reported as dividends, not as interest.

**Money market certificates, savings certificates, and other deferred interest accounts.** If you open any of these accounts, interest may be paid at fixed intervals of 1 year or less during the term of the account. You generally must include this interest in your income when you actually receive it or are entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in 1 year or less and pay interest in a single payment at maturity. If interest is deferred for more than 1 year, see *Original Issue Discount (OID)*, later.

**Interest subject to penalty for early withdrawal.** If you withdraw funds from a deferred interest account before maturity, you may have to pay a penalty. You must report the total amount of interest paid or credited to your account during the year, without subtracting the penalty. See *Penalty on early withdrawal of savings* under *How To Report Interest Income*, later, for more information on how to report the interest and deduct the penalty.

**Money borrowed to invest in money market certificate.** The interest you pay on money borrowed from a bank or savings institution to meet the minimum deposit required for a money market certificate from the institution and the interest you earn on the certificate are two separate items. You must report the total interest you

earn on the certificate in your income. If you itemize deductions, you can deduct the interest you pay as investment interest, up to the amount of your net investment income. See *Interest Expenses* in chapter 3.

**Example.** You deposited \$5,000 with a bank and borrowed \$5,000 from the bank to make up the \$10,000 minimum deposit required to buy a 6-month money market certificate. The certificate earned \$575 at maturity in 2001, but you received only \$265, which represented the \$575 you earned minus \$310 interest charged on your \$5,000 loan. The bank gives you a Form 1099–INT for 2001 showing the \$575 interest you earned. The bank also gives you a statement showing that you paid \$310 interest for 2001. You must include the \$575 in your income. If you itemize your deductions on Schedule A (Form 1040), you can deduct \$310, subject to the net investment income limit.

**Gift for opening account.** If you receive non-cash gifts or services for making deposits or for opening an account in a savings institution, you may have to report the value as interest.

For deposits of less than \$5,000, gifts or services valued at more than \$10 must be reported as interest. For deposits of \$5,000 or more, gifts or services valued at more than \$20 must be reported as interest. The value is determined by the cost to the financial institution.

**Example.** You open a savings account at your local bank and deposit \$800. The account earns \$20 interest. You also receive a \$15 calculator. If no other interest is credited to your account during the year, the Form 1099–INT you receive will show \$35 interest for the year. You must report \$35 interest income on your tax return.

**Interest on insurance dividends.** Interest on insurance dividends left on deposit with an insurance company that can be withdrawn annually is taxable to you in the year it is credited to your account. However, if you can withdraw it only on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.

**Prepaid insurance premiums.** Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for you to withdraw.

**U.S. obligations.** Interest on U.S. obligations, such as U.S. Treasury bills, notes and bonds, issued by any agency or instrumentality of the United States is taxable for federal income tax purposes.

**Interest on tax refunds.** Interest you receive on tax refunds is taxable income.

**Interest on condemnation award.** If the condemning authority pays you interest to compensate you for a delay in payment of an award, the interest is taxable.

**Installment sale payments.** If a contract for the sale or exchange of property provides for deferred payments, it also usually provides for interest payable with the deferred payments. That interest is taxable when you receive it. If little or no interest is provided for in a deferred

payment contract, part of each payment may be treated as interest. See *Unstated Interest* in Publication 537.

**Interest on annuity contract.** Accumulated interest on an annuity contract you sell before its maturity date is taxable.

**Usurious interest.** Usurious interest is interest charged at an illegal rate. This is taxable as interest unless state law automatically changes it to a payment on the principal.

**Interest income on frozen deposits.** Exclude from your gross income interest on frozen deposits. A deposit is frozen if, at the end of the year, you cannot withdraw any part of the deposit because:

- 1) The financial institution is bankrupt or insolvent, or
- 2) The state in which the institution is located has placed limits on withdrawals because other financial institutions in the state are bankrupt or insolvent.

The amount of interest you must exclude is the interest that was credited on the frozen deposits minus the sum of:

- 1) The net amount you withdrew from these deposits during the year, and
- 2) The amount you could have withdrawn as of the end of the year (not reduced by any penalty for premature withdrawals of a time deposit).

If you receive a Form 1099-INT for interest income on deposits that were frozen at the end of 2001, see *Frozen deposits* under *How To Report Interest Income* for information about reporting this interest income exclusion on your tax return.

The interest you exclude is treated as credited to your account in the following year. You must include it in income in the year you can withdraw it.

**Example.** \$100 of interest was credited on your frozen deposit during the year. You withdrew \$80 but could not withdraw any more as of the end of the year. You must include \$80 in your income for the year. You must exclude \$20.

**Bonds traded flat.** If you buy a bond when interest has been defaulted or when the interest has accrued but has not been paid, that interest is not income and is not taxable as interest if paid later. When you receive a payment of that interest, it is a return of capital that reduces the remaining cost basis. Interest that accrues after the date of purchase, however, is taxable interest income for the year received or accrued. See *Bonds Sold Between Interest Dates*, later in this chapter.

## Below-Market Loans

If you make a below-market gift or demand loan, you must report as interest income any forgone interest (defined later) from that loan. The below-market loan rules and exceptions are described in this section. For more information, see section 7872 of the Internal Revenue Code and its regulations.

If you receive a below-market loan, you may be able to deduct the forgone interest, as well as

any interest that you actually paid, but not if it is personal interest.

**Loans subject to the rules.** The rules for below-market loans apply to:

- Gift loans,
- Pay-related loans,
- Corporation-shareholder loans,
- Tax avoidance loans, and
- Loans to qualified continuing care facilities (made after October 11, 1985) under a continuing care contract.

A pay-related loan is any below-market loan between an employer and an employee or between an independent contractor and a person for whom the contractor provides services.

A tax avoidance loan is any below-market loan where the avoidance of federal tax is one of the main purposes of the interest arrangement.

**Forgone interest.** For any period, forgone interest is:

- 1) The amount of interest that would be payable for that period if interest accrued on the loan at the applicable federal rate and was payable annually on December 31, minus
- 2) Any interest actually payable on the loan for the period.

**Applicable federal rate.** Applicable federal rates are published by the IRS each month in the *Internal Revenue Bulletin*. You can also contact the IRS to get these rates. See chapter 5 for the telephone number to call.

**Rules for below-market loans.** The rules that apply to a below-market loan depend on whether the loan is a gift loan, demand loan, or term loan.

**Gift and demand loans.** A gift loan is any below-market loan where the forgone interest is in the nature of a gift.

A demand loan is a loan payable in full at any time upon demand by the lender. A demand loan is a below-market loan if no interest is charged or if interest is charged at a rate below the applicable federal rate.

A demand loan or gift loan that is a below-market loan is generally treated as an arm's-length transaction in which the lender is treated as having made:

- 1) A loan to the borrower in exchange for a note that requires the payment of interest at the applicable federal rate, and
- 2) An additional payment to the borrower in an amount equal to the forgone interest.

The borrower is generally treated as transferring the additional payment back to the lender as interest. The lender must report that amount as interest income.

The lender's additional payment to the borrower is treated as a gift, dividend, contribution to capital, pay for services, or other payment, depending on the substance of the transaction. The borrower may have to report this payment as taxable income, depending on its classification.

These transfers are considered to occur annually, generally on December 31.

**Term loans.** A term loan is any loan that is not a demand loan. A term loan is a below-market loan if the amount of the loan is more than the present value of all payments due under the loan.

A lender who makes a below-market term loan other than a gift loan is treated as transferring an additional lump-sum cash payment to the borrower (as a dividend, contribution to capital, etc.) on the date the loan is made. The amount of this payment is the amount of the loan minus the present value, at the applicable federal rate, of all payments due under the loan. An equal amount is treated as original issue discount (OID). The lender must report the annual part of the OID as interest income. The borrower may be able to deduct the OID as interest expense. See *Original Issue Discount (OID)*, later.

**Exceptions to the below-market loan rules.** Exceptions to the below-market loan rules are discussed here.

### **Exception for loans of \$10,000 or less.**

The rules for below-market loans do not apply to any day on which the total outstanding amount of loans between the borrower and lender is \$10,000 or less. This exception applies only to:

- 1) Gift loans between individuals if the gift loan is not directly used to buy or carry income-producing assets, and
- 2) Pay-related loans or corporation-shareholder loans if the avoidance of federal tax is not a principal purpose of the interest arrangement.

This exception does not apply to a term loan described in (2) above that previously has been subject to the below-market loan rules. Those rules will continue to apply even if the outstanding balance is reduced to \$10,000 or less.

### **Exception for loans to continuing care facilities.**

Loans to qualified continuing care facilities under continuing care contracts are not subject to the rules for below-market loans for the calendar year if the lender or the lender's spouse is 65 or older at the end of the year. For 2001, this exception applies only to the part of the total outstanding loan balance that is \$144,100 or less.

### **Exception for loans without significant tax effect.**

Loans are excluded from the below-market loan rules if their interest arrangements do not have a significant effect on the federal tax liability of the borrower or the lender. These loans include:

- 1) Loans made available by the lender to the general public on the same terms and conditions that are consistent with the lender's customary business practice,
- 2) Loans subsidized by a federal, state, or municipal government that are made available under a program of general application to the public,
- 3) Certain employee-relocation loans,
- 4) Certain loans from a foreign person, unless the interest income would be effectively connected with the conduct of a U.S. trade or business and would not be ex-

empt from U.S. tax under an income tax treaty,

- 5) Gift loans to a charitable organization, contributions to which are deductible, if the total outstanding amount of loans between the organization and lender is \$250,000 or less at all times during the tax year, and
- 6) Other loans on which the interest arrangement can be shown to have no significant effect on the federal tax liability of the lender or the borrower.

For a loan described in (6) above, all the factors and circumstances are used to determine if the interest arrangement has a significant effect on the federal tax liability of the lender or borrower. Some factors to be considered are:

- Whether items of income and deduction generated by the loan offset each other,
- The amount of these items,
- The cost to you of complying with the below-market loan rules, if they were to apply, and
- Any reasons other than taxes for structuring the transaction as a below-market loan.

If you structure a transaction to meet this exception, and one of the principal purposes of structuring the transaction in that way is the avoidance of federal tax, the loan will be considered a tax-avoidance loan and this exception will not apply.

**Limit on forgone interest for gift loans of \$100,000 or less.** For gift loans between individuals, if the outstanding loans between the lender and borrower total \$100,000 or less, the forgone interest to be included in income by the lender and deducted by the borrower is limited to the amount of the borrower's net investment income for the year. If the borrower's net investment income is \$1,000 or less, it is treated as zero. This limit does not apply to a loan if the avoidance of federal tax is one of the main purposes of the interest arrangement.

**Effective dates.** These rules apply to term loans made after June 6, 1984, and to demand loans outstanding after that date.

## U.S. Savings Bonds

This section provides tax information on U.S. savings bonds. It explains how to report the interest income on these bonds and how to treat transfers of these bonds.



For other information on U.S. savings bonds, write to:

Bureau of the Public Debt  
Savings Bond Operations Office  
Parkersburg, WV 26106-1328.



Or, on the Internet, visit:  
[www.savingsbonds.gov](http://www.savingsbonds.gov)

**Accrual method taxpayers.** If you use an accrual method of accounting, you must report interest on U.S. savings bonds each year as it

accrues. You cannot postpone reporting interest until you receive it or until the bonds mature.

**Cash method taxpayers.** If you use the cash method of accounting, as most individual taxpayers do, you generally report the interest on U.S. savings bonds when you receive it. But see the discussion of *Series EE and series I bonds*, below.

**Series HH bonds.** These bonds are issued at face value. Interest is paid twice a year by direct deposit to your bank account. If you are a cash method taxpayer, you must report interest on these bonds as income in the year you receive it.

Series HH bonds were first offered in 1980. Before 1980, *series H bonds* were issued. Series H bonds are treated the same as series HH bonds. If you are a cash method taxpayer, you must report the interest when you receive it.

Series H bonds have a maturity period of 30 years. Series HH bonds mature in 20 years.

**Series EE and series I bonds.** Interest on these bonds is payable when you redeem the bonds. The difference between the purchase price and the redemption value is taxable interest.

Series EE bonds were first offered in July 1980. They have a maturity period of 30 years. Before July 1980, *series E bonds* were issued. The original 10-year maturity period of series E bonds has been extended to 40 years for bonds issued before December 1965 and 30 years for bonds issued after November 1965. Series EE and series E bonds are issued at a discount. The face value is payable to you at maturity.

Series I bonds were first offered in 1998. These are inflation-indexed bonds issued at their face amount with a maturity period of 30 years. The face value plus accrued interest is payable to you at maturity.

If you use the cash method of reporting income, you can report the interest on series EE, series E, and series I bonds in either of the following ways.

- 1) **Method 1.** Postpone reporting the interest until the earlier of the year you cash or dispose of the bonds or the year in which they mature. (However, see *Savings bonds traded*, later.) **Note.** Series E bonds issued in 1961 and 1971 matured in 2001. If you have used method 1, you generally must report the interest on these bonds on your 2001 return.
- 2) **Method 2.** Choose to report the increase in redemption value as interest each year.

You must use the same method for all series EE, series E, and series I bonds you own. If you do not choose method 2 by reporting the increase in redemption value as interest each year, you must use method 1.



**TIP** If you plan to cash your bonds in the same year that you will pay for higher educational expenses, you may want to use method 1 because you may be able to exclude the interest from your income. To learn how, see Education Savings Bond Program, later.

**Change from method 1.** If you want to change your method of reporting the interest from method 1 to method 2, you can do so without permission from the IRS. In the year of

change you must report all interest accrued to date and not previously reported for all your bonds.

Once you choose to report the interest each year, you must continue to do so for all series EE, series E, and series I bonds you own and for any you get later, unless you request permission to change, as explained next.

**Change from method 2.** To change from method 2 to method 1, you must request permission from the IRS. Permission for the change is automatically granted if you send the IRS a statement that meets all the following requirements.

- 1) You have typed or printed at the top, "Change in Method of Accounting Under Section 6.01 of the Appendix of Rev. Proc. 99-49" (or later update).
- 2) It includes your name and social security number under the label in (1).
- 3) It identifies the savings bonds for which you are requesting this change.
- 4) It includes your agreement to:
  - a) Report all interest on any bonds acquired during or after the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, and
  - b) Report all interest on the bonds acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of the interest reported in prior tax years.
- 5) It includes your signature.

You must attach this statement to your tax return for the year of change, which you must file by the due date (including extensions).

You can have an automatic extension of 6 months from the due date of your return (including extensions) to file the statement with an amended return. To get this extension, you must have filed your original return by the due date (including extensions). At the top of the statement, print "Filed pursuant to section 301.9100-2."



By the date you file the original statement, you must also send a copy to the address below.

Internal Revenue Service  
Attention: CC:PA:T  
P.O. Box 7604  
Benjamin Franklin Station  
Washington, DC 20044.

If you use a private delivery service, send the copy to Internal Revenue, Attention: CC:PA:T, Room 6561, 1111 Constitution Avenue, NW, Washington, DC 20224.

Instead of filing this statement, you can request permission to change from method 2 to method 1 by filing **Form 3115**. In that case, follow the form instructions for an automatic change. No user fee is required.

**Co-owners.** If a U.S. savings bond is issued in the names of co-owners, such as you and your child or you and your spouse, interest on the bond is generally taxable to the co-owner who bought the bond.

Table 1–2. Who Pays the Tax on U.S. Savings Bond Interest

IF . . .	THEN the tax on the bond interest must be paid by . . .
You buy a bond in your name and the name of another person as co-owners, using only your own funds	You.
You buy a bond in the name of another person, who is the sole owner of the bond	The person for whom you bought the bond.
You and another person buy a bond as co-owners, each contributing part of the purchase price	Both you and the other co-owner, in proportion to the amount each paid for the bond.
You and your spouse, who live in a community property state, buy a bond that is community property	You and your spouse. If you file separate returns, both you and your spouse generally pay tax on one-half of the interest.

has to report at that time the interest earned before the bonds were reissued.

**Example 1.** You and your spouse each spent an equal amount to buy a \$1,000 series EE savings bond. The bond was issued to you and your spouse as co-owners. You both postpone reporting interest on the bond. You later have the bond reissued as two \$500 bonds, one in your name and one in your spouse's name. At that time neither you nor your spouse has to report the interest earned to the date of reissue.

**Example 2.** You bought a \$1,000 series EE savings bond entirely with your own funds. The bond was issued to you and your spouse as co-owners. You both postponed reporting interest on the bond. You later have the bond reissued as two \$500 bonds, one in your name and one in your spouse's name. You must report half the interest earned to the date of reissue.

**Transfer to a trust.** If you own series E, series EE, or series I bonds and transfer them to a trust, giving up all rights of ownership, you must include in your income for that year the interest earned to the date of transfer if you have not already reported it. However, if you are considered the owner of the trust and if the increase in value both before and after the transfer continues to be taxable to you, you can continue to defer reporting the interest earned each year. You must include the total interest in your income in the year you cash or dispose of the bonds or the year the bonds finally mature, whichever is earlier.

The same rules apply to previously unreported interest on series EE or series E bonds if the transfer to a trust consisted of series HH or series H bonds you acquired in a trade for the series EE or series E bonds. See *Savings bonds traded*, later.

**Decedents.** The manner of reporting interest income on series E, series EE, or series I bonds, after the death of the owner, depends on the accounting and income-reporting method previously used by the decedent.

**Decedent who reported interest each year.** If the bonds transferred because of death were owned by a person who used an accrual method, or who used the cash method and had chosen to report the interest each year, the interest earned in the year of death up to the date of death must be reported on that person's final return. The person who acquires the bonds includes in income only interest earned after the date of death.

**Decedent who postponed reporting interest.** If the transferred bonds were owned by a decedent who had used the cash method and had not chosen to report the interest each year, and who had bought the bonds entirely with his or her own funds, all interest earned before death must be reported in one of the following ways.

- 1) The surviving spouse or personal representative (executor, administrator, etc.) who files the final income tax return of the decedent can choose to include on that return all of the interest earned on the bonds before the decedent's death. The person who acquires the bonds then in-

**One co-owner's funds used.** If you used your funds to buy the bond, you must pay the tax on the interest. This is true even if you let the other co-owner redeem the bond and keep all the proceeds. Under these circumstances, since the other co-owner will receive a Form 1099–INT at the time of redemption, the other co-owner must provide you with another Form 1099–INT showing the amount of interest from the bond that is taxable to you. The co-owner who redeemed the bond is a "nominee." See *Nominee distributions under How To Report Interest Income*, later, for more information about how a person who is a nominee reports interest income belonging to another person.

**Both co-owners' funds used.** If you and the other co-owner each contribute part of the bond's purchase price, the interest is generally taxable to each of you, in proportion to the amount each of you paid.

**Community property.** If you and your spouse live in a community property state and hold bonds as community property, one-half of the interest is considered received by each of you. If you file separate returns, each of you generally must report one-half of the bond interest. For more information about community property, see Publication 555, *Community Property*.

**Table 1–2.** These rules are also shown in Table 1–2.

**Child as only owner.** Interest on U.S. savings bonds bought for and registered only in the name of your child is income to your child, even if you paid for the bonds and are named as beneficiary. If the bonds are series EE, series E, or series I bonds, the interest on the bonds is income to your child in the earlier of the year the bonds are cashed or disposed of or the year the bonds mature, unless your child chooses to report the interest income each year.

**Choice to report interest each year.** The choice to report the accrued interest each year can be made either by your child or by you for your child. This choice is made by filing an income tax return that shows all the interest earned to date, and by stating on the return that your child chooses to report the interest each year. Either you or your child should keep a copy of this return.

Unless your child is otherwise required to file a tax return for any year after making this choice, your child does not have to file a return only to report the annual accrual of U.S. savings bond

interest under this choice. However, see *Tax on investment income of a child under age 14*, earlier, under *General Information*. Neither you nor your child can change the way you report the interest unless you request permission from the IRS, as discussed earlier under *Change from method 2*.

**Ownership transferred.** If you bought series E, series EE, or series I bonds **entirely with your own funds** and had them reissued in your co-owner's name or beneficiary's name alone, you must include in your gross income for the year of reissue all interest that you earned on these bonds and have not previously reported. But, if the bonds were reissued in your name alone, you do not have to report the interest accrued at that time.

This same rule applies when bonds (other than bonds held as community property) are transferred between spouses or incident to divorce.

**Example.** You bought series EE bonds entirely with your own funds. You did not choose to report the accrued interest each year. Later, you transfer the bonds to your former spouse under a divorce agreement. You must include the deferred accrued interest, from the date of the original issue of the bonds to the date of transfer, in your income in the year of transfer. Your former spouse includes in income the interest on the bonds from the date of transfer to the date of redemption.

**Purchased jointly.** If you and a co-owner each contributed funds to buy series E, series EE, or series I bonds **jointly** and later have the bonds reissued in the co-owner's name alone, you must include in your gross income for the year of reissue your share of all the interest earned on the bonds that you have not previously reported. At the time of reissue, the former co-owner does not have to include in gross income his or her share of the interest earned that was not reported before the transfer. This interest, however, as well as all interest earned after the reissue, is income to the former co-owner.

This income-reporting rule also applies when the bonds are reissued in the name of your former co-owner and a new co-owner. But the new co-owner will report only his or her share of the interest earned after the transfer.

If bonds that you and a co-owner bought **jointly** are reissued to each of you separately in the same proportion as your contribution to the purchase price, neither you nor your co-owner



cludes in income only interest earned after the date of death.

- 2) If the choice in (1) is not made, the interest earned up to the date of death is income in respect of the decedent. It should not be included in the decedent's final return. All of the interest earned both before and after the decedent's death (except any part reported by the estate on its income tax return) is income to the person who acquires the bonds. If that person uses the cash method and does not choose to report the interest each year, he or she can postpone reporting it until the year the bonds are cashed or disposed of or the year they mature, whichever is earlier. In the year that person reports the interest, he or she can claim a deduction for any federal estate tax that was paid on the part of the interest included in the decedent's estate.

For more information on income in respect of a decedent, see Publication 559, *Survivors, Executors, and Administrators*.

**Example 1.** Your uncle, a cash method taxpayer, died and left you a \$1,000 series EE bond. He had bought the bond for \$500 and had not chosen to report the interest each year. At the date of death, interest of \$200 had accrued on the bond and its value of \$700 was included in your uncle's estate. Your uncle's executor chose not to include the \$200 accrued interest in your uncle's final income tax return. The \$200 is income in respect of the decedent.

You are a cash method taxpayer and do not choose to report the interest each year as it is earned. If you cash the bond when it reaches maturity value of \$1,000, you report \$500 interest income—the difference between maturity value of \$1,000 and the original cost of \$500. For that year, you can deduct (as a miscellaneous itemized deduction not subject to the 2%-of-adjusted-gross-income limit) any federal estate tax paid because the \$200 interest was included in your uncle's estate.

**Example 2.** If, in *Example 1*, the executor had chosen to include the \$200 accrued interest in your uncle's final return, you would report only \$300 as interest when you cashed the bond at maturity. \$300 is the interest earned after your uncle's death.

**Example 3.** If, in *Example 1*, you make or have made the choice to report the increase in redemption value as interest each year, you include in gross income for the year you acquire the bond all of the unreported increase in value of all series E, series EE, and series I bonds you hold, including the \$200 on the bond you inherited from your uncle.

**Example 4.** When your aunt died, she owned series H bonds that she had acquired in a trade for series E bonds. You were the beneficiary of these bonds. Your aunt used the cash method and did not choose to report the interest on the series E bonds each year as it accrued. Your aunt's executor chose not to include any interest earned before your aunt's death on her final return.

The income in respect of the decedent is the sum of the unreported interest on the series E bonds and the interest, if any, payable on the

series H bonds but not received as of the date of your aunt's death. You must report any interest received during the year as income on your return. The part of the interest that was payable but not received before your aunt's death is income in respect of the decedent and may qualify for the estate tax deduction. For information on when to report the interest on the series E bonds traded, see *Savings bonds traded*, later.

**Savings bonds distributed from a retirement or profit-sharing plan.** If you acquire a U.S. savings bond in a taxable distribution from a retirement or profit-sharing plan, your income for the year of distribution includes the bond's redemption value (its cost plus the interest accrued before the distribution). When you redeem the bond (whether in the year of distribution or later), your interest income includes only the interest accrued after the bond was distributed. To figure the interest reported as a taxable distribution and your interest income when you redeem the bond, see *Worksheet for savings bonds distributed from a retirement or profit-sharing plan* under *How To Report Interest Income*, later.

**Savings bonds traded.** If you postponed reporting the interest on your series EE or series E bonds, you did not recognize taxable income when you traded the bonds for series HH or series H bonds, unless you received cash in the trade. (You cannot trade series I bonds for series HH bonds.) Any cash you received is income up to the amount of the interest earned on the bonds traded. When your series HH or series H bonds mature, or if you dispose of them before maturity, you report as interest the difference between their redemption value and your cost. Your cost is the sum of the amount you paid for the traded series EE or series E bonds plus any amount you had to pay at the time of the trade.

**Example 1.** You own series E bonds with accrued interest of \$523 and a redemption value of \$2,723 and have postponed reporting the interest. You trade the bonds for \$2,500 in series HH bonds and \$223 in cash. You must report the \$223 as taxable income in the year of the trade.

**Example 2.** The facts are the same as in *Example 1*. You hold the series HH bonds until maturity, when you receive \$2,500. You must report \$300 as interest income in the year of maturity. This is the difference between their redemption value, \$2,500, and your cost, \$2,200 (the amount you paid for the series E bonds). (It is also the difference between the accrued interest of \$523 on the series E bonds and the \$223 cash received on the trade.)

**Choice to report interest in year of trade.** You can choose to treat all of the previously unreported accrued interest on series EE or series E bonds traded for series HH bonds as income in the year of the trade. If you make this choice, it is treated as a change from method 1. See *Change from method 1* under *Series EE and series I bonds*, earlier.

**Form 1099–INT for U.S. savings bond interest.** When you cash a bond, the bank or other payer that redeems it must give you a Form 1099–INT if the interest part of the payment you receive is \$10 or more. Box 3 of your

Form 1099–INT should show the interest as the difference between the amount you received and the amount paid for the bond. However, your Form 1099–INT may show more interest than you have to include on your income tax return. For example, this may happen if any of the following are true.

- 1) You chose to report the increase in the redemption value of the bond each year. The interest shown on your Form 1099–INT will not be reduced by amounts previously included in income.
- 2) You received the bond from a decedent. The interest shown on your Form 1099–INT will not be reduced by any interest reported by the decedent before death, or on the decedent's final return, or by the estate on the estate's income tax return.
- 3) Ownership of the bond was transferred. The interest shown on your Form 1099–INT will not be reduced by interest that accrued before the transfer.
- 4) You were named as a co-owner and the other co-owner contributed funds to buy the bond. The interest shown on your Form 1099–INT will not be reduced by the amount you received as nominee for the other co-owner. (See *Co-owners*, earlier in this chapter, for more information about the reporting requirements.)
- 5) You received the bond in a taxable distribution from a retirement or profit-sharing plan. The interest shown on your Form 1099–INT will not be reduced by the interest portion of the amount taxable as a distribution from the plan and not taxable as interest. (This amount is generally shown on Form 1099–R, *Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.*, for the year of distribution.)

For more information on including the correct amount of interest on your return, see *U.S. savings bond interest previously reported* or *Nominee distributions* under *How To Report Interest Income*, later.

**TIP** Interest on U.S. savings bonds is exempt from state and local taxes. The Form 1099–INT you receive will indicate the amount that is for U.S. savings bonds interest in box 3. Do not include this income on your state or local income tax return.

## Education Savings Bond Program

You may be able to exclude from income all or part of the interest you receive on the redemption of qualified U.S. savings bonds during the year if you pay qualified higher educational expenses during the same year. This exclusion is known as the *Education Savings Bond Program*.

If you are married, you can qualify for this exclusion only if you file a joint return with your spouse.

**Form 8815.** Use Form 8815, *Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989*, to figure your exclusion. Attach the form to your Form 1040 or Form 1040A.

**Qualified U.S. savings bonds.** A qualified U.S. savings bond is a series EE bond **issued after 1989** or a series I bond. The bond must be issued either in your name (sole owner) or in you and your spouse's names (co-owners). You must be at least 24 years old before the bond's issue date.



*The date a bond is issued may be earlier than the date the bond is purchased because bonds are issued as of the first day of the month in which they are purchased.*

**Beneficiary.** You can designate any individual (including a child) as a beneficiary of the bond.

**Verification by IRS.** If you claim the exclusion, the IRS will check it by using bond redemption information from the Department of Treasury.

**Qualified expenses.** Qualified higher educational expenses are tuition and fees required for you, your spouse, or your dependent (for whom you claim an exemption) to attend an eligible educational institution.

Qualified expenses include any contribution you make to a qualified state tuition program or to a Coverdell education savings account. For information about these programs, see Publication 970, *Tax Benefits for Higher Education*.

Qualified expenses do not include expenses for room and board or for courses involving sports, games, or hobbies that are not part of a degree program.

**Eligible educational institutions.** These institutions include most public, private, and nonprofit universities, colleges, and vocational schools that are accredited and are eligible to participate in student aid programs run by the Department of Education.

**Reduction for certain benefits.** You must reduce your qualified higher educational expenses by certain benefits the student may have received. These benefits include:

- 1) Qualified scholarships that are exempt from tax (see Publication 520, *Scholarships and Fellowships*, for information on qualified scholarships), and
- 2) Any other nontaxable payments (other than gifts, bequests, or inheritances) received for educational expenses, such as:
  - a) Veterans' educational assistance benefits,
  - b) Benefits under a qualified state tuition program, or
  - c) Certain employer-provided educational assistance benefits.

**Effect of other tax benefits.** Do not include in your qualified expenses any expense used to:

- 1) Figure an education credit on Form 8863, or
- 2) Figure how much of a distribution from an education IRA you can exclude from your income.

For information about education credits or education IRAs, see Publication 970.

**Amount excludable.** If the total proceeds (interest and principal) from the qualified U.S. savings bonds you redeem during the year are not more than your qualified higher educational expenses for the year, you can exclude all of the interest. If the proceeds are more than the expenses, you can exclude only part of the interest.

To determine the excludable amount, multiply the interest part of the proceeds by a fraction. The numerator (top part) of the fraction is the qualified higher educational expenses you paid during the year. The denominator (bottom part) of the fraction is the total proceeds you received during the year.

**Example.** In February 2001, Mark and Joan, a married couple, cashed a qualified series EE U.S. savings bond they bought in April 1993. They received proceeds of \$7,256, representing principal of \$5,000 and interest of \$2,256. In 2001, they paid \$4,000 of their daughter's college tuition. They are not claiming an education credit for that amount, and they do not have an education IRA. They can exclude \$1,244 ( $\$2,256 \times (\$4,000 \div \$7,256)$ ) of interest in 2001. They must pay tax on the remaining \$1,012 ( $\$2,256 - \$1,244$ ) interest.

**Figuring the interest part of the proceeds (Form 8815, line 6).** To figure the amount of interest to report on Form 8815, line 6, use the *Line 6 Worksheet* in the Form 8815 instructions.



If you previously reported any interest from savings bonds cashed during 2001, use the *Alternate Line 6 Worksheet* below instead.

#### Alternate Line 6 Worksheet

1. Enter the amount from Form 8815, line 5 \_\_\_\_\_
2. Enter the face value of all post-1989 series EE bonds cashed in 2001 . . . . . \_\_\_\_\_
3. Multiply line 2 above by 50% (.50) . . . . . \_\_\_\_\_
4. Enter the face value of all series I bonds cashed in 2001. . . . . \_\_\_\_\_
5. Add lines 3 and 4 . . . . . \_\_\_\_\_
6. Subtract line 5 from line 1 . . . . . \_\_\_\_\_
7. Enter the amount of interest reported as income in previous years . . . . . \_\_\_\_\_
8. Subtract line 7 from line 6. Enter the result here and on Form 8815, line 6 . . . . . \_\_\_\_\_

#### Modified adjusted gross income limit.

The interest exclusion is limited if your modified adjusted gross income (modified AGI) is:

- \$55,750 to \$70,750 for taxpayers filing single or head of household, and
- \$83,650 to \$113,650 for married taxpayers filing jointly, or for a qualifying widow(er) with dependent child.

You do not qualify for the interest exclusion if your modified AGI is equal to or more than the upper limit for your filing status.

**Modified AGI.** Modified AGI, for purposes of this exclusion, is adjusted gross income (line 20 of Form 1040A or line 34 of Form 1040) figured before the interest exclusion, and modified by adding back any:

- 1) Foreign earned income exclusion,
- 2) Foreign housing exclusion or deduction,
- 3) Exclusion of income for bona fide residents of American Samoa,

- 4) Exclusion for income from Puerto Rico,
- 5) Exclusion for adoption benefits received under an employer's adoption assistance program, and
- 6) Deduction for student loan interest.

Use the worksheet in the instructions for line 9, Form 8815, to figure your modified AGI. If you claim any of the exclusion or deduction items listed above (except item 6), add the amount of the exclusion or deduction (except any deduction for student loan interest) to the amount on line 5 of the worksheet, and enter the total on Form 8815, line 9, as your modified AGI.

**Royalties included in modified AGI.** Because the deduction for interest expenses attributable to royalties and other investments is limited to your net investment income (see *Investment Interest* in chapter 3), you cannot figure the deduction until you have figured this interest exclusion. Therefore, if you had interest expenses attributable to royalties and deductible on Schedule E (Form 1040), you must make a special computation of your deductible interest without regard to this exclusion to figure the net royalty income included in your modified AGI.

You can use a "dummy" Form 4952, *Investment Interest Expense Deduction*, to make the special computation. On this form, include in your net investment income your total interest income for the year from series EE and I U.S. savings bonds. Use the deductible interest amount from this form only to figure your modified AGI. Do not attach this form to your tax return.

After you figure this interest exclusion, use a separate Form 4952 to figure your actual deduction for investment interest expenses, and attach that form to your return.



**Recordkeeping.** If you claim the interest exclusion, you must keep a written record of the qualified U.S. savings bonds you redeem. Your record must include the serial number, issue date, face value, and total redemption proceeds (principal and interest) of each bond. You can use **Form 8818, Optional Form To Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989**, to record this information. You should also keep bills, receipts, canceled checks, or other documentation that shows you paid qualified higher educational expenses during the year.

## U.S. Treasury Bills, Notes, and Bonds

Treasury bills, notes, and bonds are direct debts (obligations) of the U.S. Government.

Interest income from Treasury bills, notes, and bonds is subject to federal income tax, but is exempt from all state and local income taxes. You should receive Form 1099-INT showing the amount of interest (in box 3) that was paid to you for the year.

Payments of principal and interest generally will be credited to your designated checking or savings account by direct deposit through the TREASURY DIRECT system.

**Treasury bills.** These bills generally have a 13-week, 26-week, or 52-week maturity period. They are issued at a discount in the amount of \$1,000 and multiples of \$1,000. The difference

between the discounted price you pay for the bills and the face value you receive at maturity is interest income. Generally, you report this interest income when the bill is paid at maturity. See *Discount on Short-Term Obligations* under *Discount on Debt Instruments*, later.

If you reinvest your Treasury bill at its maturity in a new Treasury bill, note, or bond, you will receive payment for the difference between the proceeds of the maturing bill (par amount less any tax withheld) and the purchase price of the new Treasury security. However, you must report the full amount of the interest income on each of your Treasury bills at the time it reaches maturity.

**Treasury notes and bonds.** Treasury notes have maturity periods of more than 1 year, ranging up to 10 years. Maturity periods for Treasury bonds are longer than 10 years. Both of these Treasury issues generally are issued in denominations of \$1,000 to \$1 million. Both notes and bonds generally pay interest every 6 months. Generally, you report this interest for the year paid. When the notes or bonds mature, you can redeem these securities for face value.

Treasury notes and bonds are usually sold by auction with competitive bidding. If, after compiling the competitive bids, a determination is made that the purchase price is less than the face value, you will receive a refund for the difference between the purchase price and the face value. This amount is considered original issue discount. However, the original issue discount rules (discussed later) do not apply if the discount is less than one-fourth of 1% (.0025) of the face amount multiplied by the number of full years from the date of original issue to maturity. See *De minimis OID* under *Original Issue Discount (OID)*, later. If the purchase price is determined to be more than the face amount, the difference is a premium. (See *Bond Premium Amortization* in chapter 3.)



For other information on these notes or bonds, write to:

Bureau of the Public Debt  
Customer Information and  
Current Income Branch  
Parkersburg, WV 26106-2186.



Or, on the Internet, visit:  
[www.publicdebt.treas.gov](http://www.publicdebt.treas.gov)

**Treasury inflation-indexed securities.** These securities pay interest twice a year at a fixed rate, based on a principal amount that is adjusted to take into account inflation and deflation. For the tax treatment of these securities, see *Inflation-Indexed Debt Instruments* under *Original Issue Discount (OID)*, later.

**Retirement, sale, or redemption.** For information on the retirement, sale, or redemption of U.S. government obligations, see *Capital or Ordinary Gain or Loss* in chapter 4. Also see *Non-taxable Trades* in chapter 4 for information about trading U.S. Treasury obligations for certain other designated issues.

## Bonds Sold Between Interest Dates

If you sell a bond between interest payment dates, part of the sales price represents interest accrued to the date of sale. You must report that part of the sales price as interest income for the year of sale.

If you buy a bond between interest payment dates, part of the purchase price represents interest accrued before the date of purchase. When that interest is paid to you, treat it as a return of your capital investment, rather than interest income, by reducing your basis in the bond. See *Accrued interest on bonds* under *How To Report Interest Income*, later in this chapter, for information on reporting the payment.

## Insurance

Life insurance proceeds paid to you as beneficiary of the insured person are usually not taxable. But if you receive the proceeds in installments, you must usually report part of each installment payment as interest income.

For more information about insurance proceeds received in installments, see Publication 525.

**Interest option on insurance.** If you leave life insurance proceeds on deposit with an insurance company under an agreement to pay interest only, the interest paid to you is taxable.

**Annuity.** If you buy an annuity with life insurance proceeds, the annuity payments you receive are taxed as pension and annuity income, not as interest income. See Publication 939, *General Rule for Pensions and Annuities*, for information on taxation of pension and annuity income.

## State or Local Government Obligations

Interest you receive on an obligation issued by a state or local government is generally not taxable. The issuer should be able to tell you whether the interest is taxable. The issuer should also give you a periodic (or year-end) statement showing the tax treatment of the obligation. If you invested in the obligation through a trust, a fund, or other organization, that organization should give you this information.



*Even if interest on the obligation is not subject to income tax, you may have to report capital gain or loss when you sell it. Estate, gift, or generation-skipping tax may apply to other dispositions of the obligation.*

## Tax-Exempt Interest

Interest on a bond used to finance government operations generally is not taxable if the bond is issued by a state, the District of Columbia, a U.S. possession, or any of their political subdivisions. Political subdivisions include:

- Port authorities,
- Toll road commissions,
- Utility services authorities,

- Community redevelopment agencies, and
- Qualified volunteer fire departments (for certain obligations issued after 1980).

There are other requirements for tax-exempt bonds. Contact the issuing state or local government agency or see sections 103 and 141 through 150 of the Internal Revenue Code and the related regulations.



**Obligations that are not bonds.** *Interest on a state or local government obligation may be tax exempt even if the obligation is not a bond. For example, interest on a debt evidenced only by an ordinary written agreement of purchase and sale may be tax exempt. Also, interest paid by an insurer on default by the state or political subdivision may be tax exempt.*

**Registration requirement.** A bond issued after June 30, 1983, generally must be in registered form for the interest to be tax exempt.

**Indian tribal government.** Bonds issued after 1982 by an Indian tribal government are treated as issued by a state. Interest on these bonds is generally tax exempt if the bonds are part of an issue of which substantially all of the proceeds are to be used in the exercise of any essential government function. However, interest on private activity bonds (other than certain bonds for tribal manufacturing facilities) is taxable.

**Original issue discount.** Original issue discount (OID) on tax-exempt state or local government bonds is treated as tax-exempt interest.

For information on the treatment of OID when you dispose of a tax-exempt bond, see *Tax-exempt state and local government bonds* under *Discounted Debt Instruments* in chapter 4.

**Stripped bonds or coupons.** For special rules that apply to stripped tax-exempt obligations, see *Stripped Bonds and Coupons* under *Original Issue Discount (OID)*, later.

**Information reporting requirement.** If you must file a tax return, you are required to show any tax-exempt interest you received on your return. This is an information-reporting requirement only. It does not change tax-exempt interest to taxable interest. See *Reporting tax-exempt interest* under *How To Report Interest Income*, later in this chapter. That discussion also explains what to do if you receive a Form 1099-INT for tax-exempt interest.

## Taxable Interest

Interest on some state or local obligations is taxable.

**Federally guaranteed bonds.** Interest on federally guaranteed state or local obligations issued after 1983 is generally taxable. This rule does **not** apply to interest on obligations guaranteed by the following U.S. Government agencies.

- Bonneville Power Authority (if the guarantee was under the Northwest Power Act as in effect on July 18, 1984).
- Department of Veterans Affairs.

- Federal Home Loan Mortgage Corporation.
- Federal Housing Administration.
- Federal National Mortgage Association.
- Government National Mortgage Corporation.
- Resolution Funding Corporation.
- Student Loan Marketing Association.

**Mortgage revenue bonds.** The proceeds of these bonds are used to finance mortgage loans for homebuyers. Generally, interest on state or local government home mortgage bonds issued after April 24, 1979, is taxable unless the bonds are qualified mortgage bonds or qualified veterans' mortgage bonds.

**Arbitrage bonds.** Interest on arbitrage bonds issued by state or local governments after October 9, 1969, is taxable. An arbitrage bond is a bond any portion of the proceeds of which is expected to be used to buy (or to replace funds used to buy) higher yielding investments. A bond is treated as an arbitrage bond if the issuer intentionally uses any part of the proceeds of the issue in this manner.

**Private activity bonds.** Interest on a private activity bond that is not a qualified bond (defined below) is taxable. Generally, a private activity bond is part of a state or local government bond issue that meets both of the following requirements.

- 1) More than 10% of the proceeds of the issue is to be used for a private business use.
- 2) More than 10% of the payment of the principal or interest is:
  - a) Secured by an interest in property to be used for a private business use (or payments for this property), or
  - b) Derived from payments for property (or borrowed money) used for a private business use.

Also, a bond is generally considered a private activity bond if the amount of the proceeds to be used to make or finance loans to persons other than government units is more than 5% of the proceeds or \$5 million (whichever is less).

**Qualified bond.** Interest on a private activity bond that is a qualified bond is tax exempt. A qualified bond is an exempt-facility bond (including an enterprise zone facility bond), qualified student loan bond, qualified small issue bond (including a tribal manufacturing facility bond), qualified redevelopment bond, qualified mortgage bond, qualified veterans' mortgage bond, or qualified 501(c)(3) bond (a bond issued for the benefit of certain tax-exempt organizations).

Interest that you receive on these tax-exempt bonds (except qualified 501(c)(3) bonds), if issued after August 7, 1986, generally is a "tax preference item" and may be subject to the alternative minimum tax. See Form 6251 and its instructions for more information.

**Enterprise zone facility bonds.** Interest on certain private activity bonds issued by a state or

local government to finance a facility used in an empowerment zone or enterprise community is tax exempt. For information on these bonds, see Publication 954.

**Market discount.** Market discount on a tax-exempt bond is not tax-exempt. If you bought the bond after April 30, 1993, you can choose to accrue the market discount over the period you own the bond and include it in your income currently, as taxable interest. See *Market Discount Bonds* under *Discount on Debt Instruments*, later. If you do not make that choice, or if you bought the bond before May 1, 1993, any gain from market discount is taxable when you dispose of the bond.

For more information on the treatment of market discount when you dispose of a tax-exempt bond, see *Discounted Debt Instruments* under *Capital or Ordinary Gain or Loss* in chapter 4.

## Discount on Debt Instruments

### Terms you may need to know (see Glossary):

- Market discount
- Market discount bond
- Original issue discount (OID)
- Premium

In general, a debt instrument, such as a bond, note, debenture, or other evidence of indebtedness, that bears no interest or bears interest at a lower than current market rate will usually be issued at less than its face amount. This discount is, in effect, additional interest income. The following are some of the types of discounted debt instruments.

- Corporate bonds.
- Municipal bonds.
- Certificates of deposit.
- Notes between individuals.
- Stripped bonds and coupons.
- Collateralized debt obligations (CDOs).

The discount on these instruments (except municipal bonds) is taxable in most instances. The discount on municipal bonds generally is not taxable (but see *State or Local Government Obligations*, earlier, for exceptions). See also *REMICs, FASITs, and Other CDOs*, later, for information about applying the rules discussed in this section to the regular interest holder of a real estate mortgage investment conduit, a financial asset securitization investment trust, or other CDO.

### Original Issue Discount (OID)

OID is a form of interest. You generally include OID in your income as it accrues over the term of the debt instrument, whether or not you receive any payments from the issuer.

A debt instrument generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity. OID is the difference between the stated redemption price at maturity and the issue price.

All instruments that pay no interest before maturity are presumed to be issued at a discount. Zero coupon bonds are one example of these instruments.

The OID accrual rules generally do not apply to short-term obligations (those with a fixed maturity date of 1 year or less from date of issue). See *Discount on Short-Term Obligations*, later.

For information about the sale of a debt instrument with OID, see chapter 4.

**De minimis OID.** You can treat the discount as zero if it is less than one-fourth of 1% (.0025) of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity. This small discount is known as "de minimis" OID.

**Example 1.** You bought a 10-year bond with a stated redemption price at maturity of \$1,000, issued at \$980 with OID of \$20. One-fourth of 1% of \$1,000 (stated redemption price) times 10 (the number of full years from the date of original issue to maturity) equals \$25. Because the \$20 discount is less than \$25, the OID is treated as zero. (If you hold the bond at maturity, you will recognize \$20 (\$1,000 – \$980) of capital gain.)

**Example 2.** The facts are the same as in *Example 1*, except that the bond was issued at \$950. The OID is \$50. Because the \$50 discount is more than the \$25 figured in *Example 1*, you must include the OID in income as it accrues over the term of the bond.

**Debt instrument bought after original issue.** If you buy a debt instrument with de minimis OID at a premium, the discount is not includable in income. If you buy a debt instrument with de minimis OID at a discount, the discount is reported under the market discount rules. See *Market Discount Bonds*, later in this chapter.

**Exceptions to reporting OID.** The OID rules discussed here do not apply to the following debt instruments.

- 1) Tax-exempt obligations. (However, see *Stripped tax-exempt obligations*, later.)
- 2) U.S. savings bonds.
- 3) Short-term debt instruments (those with a fixed maturity date of not more than 1 year from the date of issue).
- 4) Obligations issued by an individual before March 2, 1984.
- 5) Loans between individuals, if all the following are true.
  - a) The lender is not in the business of lending money.
  - b) The amount of the loan, plus the amount of any outstanding prior loans between the same individuals, is \$10,000 or less.
  - c) Avoiding any federal tax is not one of the principal purposes of the loan.

## Form 1099–OID

The issuer of the debt instrument (or your broker, if you held the instrument through a broker) should give you Form 1099–OID, *Original Issue Discount*, or a similar statement, if the total OID for the calendar year is \$10 or more. Form 1099–OID will show, in box 1, the amount of OID for the part of the year that you held the bond. It also will show, in box 2, the stated interest that you must include in your income. A copy of Form 1099–OID will be sent to the IRS. Do not file your copy with your return. Keep it for your records.

In most cases, you must report the entire amount in boxes 1 and 2 of Form 1099–OID as interest income. But see *Refiguring OID shown on Form 1099–OID*, later in this discussion, and also *Original issue discount (OID) adjustment under How To Report Interest Income*, later in this chapter, for more information.

### Form 1099–OID not received.

If you had OID for the year but did not receive a Form 1099–OID, see Publication 1212, which lists total OID on certain debt instruments and has information that will help you figure OID. If your debt instrument is not listed in Publication 1212, consult the issuer for further information about the accrued OID for the year.

**Nominee.** If someone else is the holder of record (the registered owner) of an OID instrument that belongs to you and receives a Form 1099–OID on your behalf, that person must give you a Form 1099–OID.

If you receive a Form 1099–OID that includes amounts belonging to another person, see *Nominee distributions under How To Report Interest Income*, later.

**Refiguring OID shown on Form 1099–OID.** You must refigure the OID shown in box 1 of Form 1099–OID if either of the following apply.

- 1) You bought the debt instrument after its original issue and paid a premium or an acquisition premium.
- 2) The debt instrument is a stripped bond or a stripped coupon (including certain zero coupon instruments). See *Figuring OID under Stripped Bonds and Coupons*, later in this chapter.

See *Original issue discount (OID) adjustment under How To Report Interest Income*, later in this chapter, for information about reporting the correct amount of OID.

**Premium.** You bought a debt instrument at a premium if its adjusted basis immediately after purchase was greater than the total of all amounts payable on the instrument after the purchase date, other than qualified stated interest.

If you bought an OID debt instrument at a premium, you generally do not have to report any OID as ordinary income.

**Qualified stated interest.** In general, this is stated interest that is unconditionally payable in cash or property (other than debt instruments of the issuer) at least annually at a fixed rate.

**Acquisition premium.** You bought a debt instrument at an acquisition premium if both of the following are true.

- 1) You did not pay a premium.
- 2) The instrument's adjusted basis immediately after purchase (including purchase at original issue) was greater than its adjusted issue price. This is the issue price plus the OID previously accrued, minus any payment previously made on the instrument other than qualified stated interest.

Acquisition premium reduces the amount of OID includible in your income. For information about figuring the correct amount of OID to include in your income, see *Figuring OID on Long-Term Debt Instruments* in Publication 1212.

**Refiguring periodic interest shown on Form 1099–OID.** If you disposed of a debt instrument or acquired it from another holder during the year, see *Bonds Sold Between Interest Dates*, earlier, for information about the treatment of periodic interest that may be shown in box 2 of Form 1099–OID for that instrument.

## Applying the OID Rules

The rules for reporting OID depend on the date the long-term debt instrument was issued.

**Debt instruments issued after 1954 and before May 28, 1969 (before July 2, 1982, if a government instrument).** For these instruments, you do not report the OID until the year you sell, exchange, or redeem the instrument. If a gain results and the instrument is a capital asset, the amount of the gain equal to the OID is ordinary interest income. The rest of the gain is capital gain. If there is a loss on the sale of the instrument, the entire loss is a capital loss and no reporting of OID is required.

In general, the amount of gain that is ordinary interest income equals the following amount:

$$\frac{\text{Number of full months you held the instrument}}{\text{Number of full months from date of original issue to date of maturity}} \times \text{Original Issue Discount}$$

**Debt instruments issued after May 27, 1969 (after July 1, 1982, if a government instrument), and before 1985.** If you hold these debt instruments as capital assets, you must include a part of the discount in your gross income each year that you own the instruments.

**Effect on basis.** Your basis in the instrument is increased by the amount of OID that you include in your gross income.

**Debt instruments issued after 1984.** For these debt instruments, you report the total OID that applies each year regardless of whether you hold that debt instrument as a capital asset.

**Effect on basis.** Your basis in the instrument is increased by the amount of OID that you include in your gross income.

## Certificates of Deposit (CDs)

If you buy a CD with a maturity of more than 1 year, you must include in income each year a

part of the total interest due and report it in the same manner as other OID.

This also applies to similar deposit arrangements with banks, building and loan associations, etc., including:

- Time deposits,
- Bonus plans,
- Savings certificates,
- Deferred income certificates,
- Bonus savings certificates, and
- Growth savings certificates.

**Bearer CDs.** CDs issued after 1982 generally must be in registered form. (For details, see *Obligations required to be in registered form under Capital Gains and Losses* in chapter 4.) Bearer CDs are CDs that are not in registered form. They are not issued in the depositor's name and are transferable from one individual to another.

Banks must provide the IRS and the person redeeming a bearer CD with a Form 1099–INT.

### Time deposit open account arrangement.

This is an arrangement with a fixed maturity date in which you make deposits on a schedule arranged between you and your bank. But there is no actual or constructive receipt of interest until the fixed maturity date is reached. For instance, you and your bank enter into an arrangement under which you agree to deposit \$100 each month for a period of 5 years. Interest will be compounded twice a year at 7½%, but payable only at the end of the 5-year period. You must include a part of the interest in your income as OID each year. Each year the bank must give you a Form 1099–OID to show you the amount you must include in your income for the year.

**Redemption before maturity.** If, before the maturity date, you redeem a deferred interest account for less than its stated redemption price at maturity, you can deduct the amount of OID that you previously included in income but did not receive.

**Renewable certificates.** If you renew a CD at maturity, it is treated as a redemption and a purchase of a new certificate. This is true regardless of the terms of renewal.

## Face-Amount Certificates

These certificates are subject to the OID rules. They are a form of endowment contracts issued by insurance or investment companies for either a lump-sum payment or periodic payments, with the face amount becoming payable on the maturity date of the certificate.

In general, the difference between the face amount and the amount you paid for the contract is OID. You must include a part of the OID in your income over the term of the certificate.

The issuer must give you a statement on Form 1099–OID indicating the amount you must include in your income each year.

## Inflation-Indexed Debt Instruments

If you hold an inflation-indexed debt instrument (other than a series I U.S. savings bond), you must report as OID any increase in the inflation-adjusted principal amount of the instrument that occurs while you held the instrument during the year. In general, an inflation-indexed debt instrument is a debt instrument on which the payments are adjusted for inflation and deflation (such as Treasury Inflation-Indexed Securities). You should receive Form 1099–OID from the payer showing the amount you must report as OID and any qualified stated interest paid to you during the year. For more information, see Publication 1212.

## Stripped Bonds and Coupons

If you strip one or more coupons from a bond and sell the bond or the coupons, the bond and coupons are treated as separate debt instruments issued with OID.

The holder of a stripped bond has the right to receive the principal (redemption price) payment. The holder of a stripped coupon has the right to receive interest on the bond.

Stripped bonds and stripped coupons include:

- 1) Zero coupon instruments available through the Department of the Treasury's Separate Trading of Registered Interest and Principal of Securities (STRIPS) program and government-sponsored enterprises such as the Resolution Funding Corporation and the Financing Corporation, and
- 2) Instruments backed by U.S. Treasury securities that represent ownership interests in those securities, such as obligations backed by U.S. Treasury bonds that are offered primarily by brokerage firms.

**Seller.** If you strip coupons from a bond and sell the bond or coupons, include in income the interest that accrued while you held the bond before the date of sale to the extent you did not previously include this interest in your income. For an obligation acquired after October 22, 1986, you must also include the market discount that accrued before the date of sale of the stripped bond (or coupon) to the extent you did not previously include this discount in your income.

Add the interest and market discount that you include in income to the basis of the bond and coupons. Allocate this adjusted basis between the items you keep and the items you sell, based on the fair market value of the items. The difference between the sale price of the bond (or coupon) and the allocated basis of the bond (or coupon) is your gain or loss from the sale.

Treat any item you keep as an OID bond originally issued and bought by you on the sale date of the other items. If you keep the bond, treat the amount of the redemption price of the bond that is more than the basis of the bond as the OID. If you keep the coupons, treat the amount payable on the coupons that is more than the basis of the coupons as the OID.

**Buyer.** If you buy a stripped bond or stripped coupon, treat it as if it were originally issued on

the date you buy it. If you buy a stripped bond, treat as OID any excess of the stated redemption price at maturity over your purchase price. If you buy a stripped coupon, treat as OID any excess of the amount payable on the due date of the coupon over your purchase price.

**Figuring OID.** The rules for figuring OID on stripped bonds and stripped coupons depend on the date the debt instruments were purchased, not the date issued.

You must refigure the OID shown on the Form 1099–OID you receive for a stripped bond or coupon. For information about figuring the correct amount of OID on these instruments to include in your income, see *Figuring OID on Stripped Bonds and Coupons* in Publication 1212. However, owners of stripped bonds and coupons should not rely on the OID shown in Section II of Publication 1212, because the amounts listed in Section II for stripped bonds or coupons are figured without reference to the date or price at which you acquired them.

**Stripped inflation-indexed debt instruments.** OID on stripped inflation-indexed debt instruments is figured under the **discount bond method**. This method is described in section 1.1275–7(e) of the regulations.

**Stripped tax-exempt obligations.** You do not have to pay tax on OID on any stripped tax-exempt bond or coupon that you bought before June 11, 1987. However, if you acquired it after October 22, 1986, you must accrue OID on it to determine its basis when you dispose of it. See *Original issue discount (OID) on debt instruments* under *Stocks and Bonds* in chapter 4.

You may have to pay tax on part of the OID on stripped tax-exempt bonds or coupons that you bought after June 10, 1987. For information on figuring the taxable part, see *Tax-Exempt Bonds and Coupons* under *Figuring OID on Stripped Bonds and Coupons* in Publication 1212.

## Market Discount Bonds

A market discount bond is any bond having market discount except:

- 1) Short-term obligations (those with fixed maturity dates of up to 1 year from the date of issue),
- 2) Tax-exempt obligations that you bought before May 1, 1993,
- 3) U.S. savings bonds, and
- 4) Certain installment obligations.

Market discount arises when the value of a debt obligation decreases after its issue date, generally because of an increase in interest rates. If you buy a bond on the secondary market, it may have market discount.

When you buy a market discount bond, you can choose to accrue the market discount over the period you own the bond and include it in your income currently as interest income. If you do not make this choice, the following rules generally apply.

- 1) You must treat any gain when you dispose of the bond as ordinary interest income, up to the amount of the accrued market discount. See *Discounted Debt Instruments*

under *Capital Gains and Losses* in chapter 4.

- 2) You must treat any partial payment of principal on the bond as ordinary interest income, up to the amount of the accrued market discount. See *Partial principal payments*, later in this discussion.
- 3) If you borrow money to buy or carry the bond, your deduction for interest paid on the debt is limited. See *Deferral of interest deduction for market discount bonds* under *When To Deduct Investment Interest* in chapter 3.

**Market discount.** Market discount is the amount of the stated redemption price of a bond at maturity that is more than your basis in the bond immediately after you acquire it. You treat market discount as zero if it is less than one-fourth of 1% (.0025) of the stated redemption price of the bond multiplied by the number of full years to maturity (after you acquire the bond).

If a market discount bond also has OID, the market discount is the sum of the bond's issue price and the total OID includible in the gross income of all holders (for a tax-exempt bond, the total OID that accrued) before you acquired the bond, reduced by your basis in the bond immediately after you acquired it.

**Bonds acquired at original issue.** Generally, a bond that you acquired at original issue is not a market discount bond. If your adjusted basis in a bond is determined by reference to the adjusted basis of another person who acquired the bond at original issue, you are also considered to have acquired it at original issue.

**Exceptions.** A bond you acquired at original issue can be a market discount bond if either of the following is true.

- 1) Your cost basis in the bond is less than the bond's issue price.
- 2) The bond is issued in exchange for a market discount bond under a plan of reorganization. (This does not apply if the bond is issued in exchange for a market discount bond issued before July 19, 1984, and the terms and interest rates of both bonds are the same.)

**Accrued market discount.** The accrued market discount is figured in one of two ways.

**Ratable accrual method.** Treat the market discount as accruing in equal daily installments during the period you hold the bond. Figure the daily installments by dividing the market discount by the number of days after the date you acquired the bond, up to and including its maturity date. Multiply the daily installments by the number of days you held the bond to figure your accrued market discount.

**Constant yield method.** Instead of using the ratable accrual method, you can choose to figure the accrued discount using a constant interest rate (the constant yield method). Make this choice by attaching to your timely filed return a statement identifying the bond and stating that you are making a constant interest rate election. The choice takes effect on the date you acquired the bond. If you choose to use this method for

any bond, you cannot change your choice for that bond.

For information about using the constant yield method, see *Figuring OID using the constant yield method* under *Debt Instruments Issued After 1984* in Publication 1212. To use this method to figure market discount (instead of OID), treat the bond as having been issued on the date you acquired it. Treat the amount of your basis (immediately after you acquired the bond) as the issue price. Then apply the formula shown in Publication 1212.

**Choosing to include market discount in income currently.** You can make this choice if you have not revoked a prior choice to include market discount in income currently within the last 5 calendar years. Make the choice by attaching to your timely filed return a statement in which you:

- 1) State that you have included market discount in your gross income for the year under section 1278(b) of the Internal Revenue Code, and
- 2) Describe the method you used to figure the accrued market discount for the year.

Once you make this choice, it will apply to all market discount bonds that you acquire during the tax year and in later tax years. You cannot revoke your choice without the consent of the IRS.

Also see *Election To Report All Interest as OID*, later. If you make that election, you must use the constant yield method.

**Effect on basis.** You increase the basis of your bonds by the amount of market discount you include in your income.

**Partial principal payments.** If you receive a partial payment of principal on a market discount bond that you acquired after October 22, 1986, and you did not choose to include the discount in income currently, you must treat the payment as ordinary interest income up to the amount of the bond's accrued market discount. Reduce the amount of accrued market discount reportable as interest at disposition by that amount.

You can choose to figure accrued market discount for this purpose:

- 1) On the basis of the constant yield method, described earlier,
- 2) In proportion to the accrual of OID for any accrual period, if the debt instrument has OID, or
- 3) In proportion to the amount of stated interest paid in the accrual period, if the debt instrument has no OID.

Under method (2) above, figure accrued market discount for a period by multiplying the total remaining market discount by a fraction. The numerator (top part) of the fraction is the OID for the period, and the denominator (bottom part) is the total remaining OID at the beginning of the period.

Under method (3) above, figure accrued market discount for a period by multiplying the total remaining market discount by a fraction. The numerator is the stated interest paid in the accrual period, and the denominator is the total stated interest remaining to be paid at the beginning of the accrual period.

## Discount on Short-Term Obligations

When you buy a short-term obligation (one with a fixed maturity date of 1 year or less from the date of issue), other than a tax-exempt obligation, you can generally choose to accrue any discount and interest payable on the obligation and include it in income currently. If you do **not** make this choice, the following rules generally apply.

- 1) You must treat any gain when you sell, exchange, or redeem the obligation as ordinary income, up to the amount of the ratable share of the discount. See *Discounted Debt Instruments* under *Capital Gains and Losses* in chapter 4.
- 2) If you borrow money to buy or carry the obligation, your deduction for interest paid on the debt is limited. See *Deferral of interest deduction for short-term obligations* under *When To Deduct Investment Interest* in chapter 3.

**Short-term obligations for which no choice is available.** You must include any discount or interest in current income as it accrues for any short-term obligation (other than a tax-exempt obligation) that is:

- 1) Held by an accrual-basis taxpayer,
- 2) Held primarily for sale to customers in the ordinary course of your trade or business,
- 3) Held by a bank, regulated investment company, or common trust fund,
- 4) Held by certain pass-through entities,
- 5) Identified as part of a hedging transaction, or
- 6) A stripped bond or stripped coupon held by the person who stripped the bond or coupon (or by any other person whose basis in the obligation is determined by reference to the basis in the hands of that person).

**Effect on basis.** Increase the basis of your obligation by the amount of discount you include in income currently.

**Accrual methods.** Figure the accrued discount by using either the **ratable accrual method** or the **constant yield method** discussed previously in *Accrued market discount* under *Market Discount Bonds*, earlier.

**Government obligations.** For an obligation described above that is a short-term government obligation, the amount you include in your income for the current year is the accrued acquisition discount, if any, plus any other accrued interest payable on the obligation. The **acquisition discount** is the stated redemption price at maturity minus your basis.

If you choose to use the constant yield method to figure accrued acquisition discount, treat the cost of acquiring the obligation as the issue price. If you choose to use this method, you cannot change your choice.

**Nongovernment obligations.** For an obligation listed above that is not a government obligation, the amount you include in your income for

the current year is the accrued OID, if any, plus any other accrued interest payable. If you choose the constant yield method to figure accrued OID, apply it by using the obligation's issue price.

**Choosing to include accrued acquisition discount instead of OID.** You can choose to report accrued acquisition discount (defined earlier under *Government obligations*) rather than accrued OID on these short-term obligations. Your choice will apply to the year for which it is made and to all later years and cannot be changed without the consent of the IRS.

You must make your choice by the due date of your return, including extensions, for the first year for which you are making the choice. Attach a statement to your return or amended return indicating:

- 1) Your name, address, and social security number,
- 2) The choice you are making and that it is being made under section 1283(c)(2) of the Internal Revenue Code,
- 3) The period for which the choice is being made and the obligation to which it applies, and
- 4) Any other information necessary to show you are entitled to make this choice.

**Choosing to include accrued discount and other interest in current income.** If you acquire short-term discount obligations that are not subject to the rules for current inclusion in income of the accrued discount or other interest, you can choose to have those rules apply. This choice applies to all short-term obligations you acquire during the year and in all later years. You cannot change this choice without the consent of the IRS.

The procedures to use in making this choice are the same as those described for choosing to include acquisition discount instead of OID on nongovernment obligations in current income. However, you should indicate that you are making the choice under section 1282(b)(2) of the Internal Revenue Code.

Also see the following discussion. If you make the election to report all interest currently as OID, you must use the constant yield method.

## Election To Report All Interest as OID

Generally, you can elect to treat all interest on a debt instrument acquired during the tax year as OID and include it in income currently. For purposes of this election, interest includes stated interest, acquisition discount, OID, de minimis OID, market discount, de minimis market discount, and unstated interest as adjusted by any amortizable bond premium or acquisition premium. See Treasury Regulation 1.1272-3.

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## When To Report Interest Income

**Terms you may need to know (see Glossary):**

Accrual method

Cash method

When to report your interest income depends on whether you use the cash method or an accrual method to report income.

**Cash method.** Most individual taxpayers use the cash method. If you use this method, you generally report your interest income in the year in which you actually or constructively receive it. However, there are special rules for reporting the discount on certain debt instruments. See *U.S. Savings Bonds and Discount on Debt Instruments*, earlier.

**Example.** On September 1, 1999, you loaned another individual \$2,000 at 12%, compounded annually. You are not in the business of lending money. The note stated that principal and interest would be due on August 31, 2001. In 2001, you received \$2,508.80 (\$2,000 principal and \$508.80 interest). If you use the cash method, you must include in income on your 2001 return the \$508.80 interest you received in that year.

**Constructive receipt.** You constructively receive income when it is credited to your account or made available to you. You do not need to have physical possession of it. For example, you are considered to receive interest, dividends, or other earnings on any deposit or account in a bank, savings and loan, or similar financial institution, or interest on life insurance policy dividends left to accumulate, when they are credited to your account and subject to your withdrawal. This is true even if they are not yet entered in your passbook.

You constructively receive income on the deposit or account even if you must:

- 1) Make withdrawals in multiples of even amounts,
- 2) Give a notice to withdraw before making the withdrawal,
- 3) Withdraw all or part of the account to withdraw the earnings, or
- 4) Pay a penalty on early withdrawals, unless the interest you are to receive on an early withdrawal or redemption is substantially less than the interest payable at maturity.

**Accrual method.** If you use an accrual method, you report your interest income when you earn it, whether or not you have received it. Interest is earned over the term of the debt instrument.

**Example.** If, in the previous example, you use an accrual method, you must include the interest in your income as you earn it. You would report the interest as follows: 1999, \$80; 2000, \$249.60; and 2001, \$179.20.

**Coupon bonds.** Interest on coupon bonds is taxable in the year the coupon becomes due and payable. It does not matter when you mail the coupon for payment.

## How To Report Interest Income

### Terms you may need to know (see Glossary):

Nominee

Original issue discount (OID)

Generally, you report all of your taxable interest income on line 8a, Form 1040; line 8a, Form 1040A; or line 2, Form 1040EZ.

You cannot use Form 1040EZ if your interest income is more than \$400. Instead, you must use Form 1040A or Form 1040.

In addition, you cannot use Form 1040EZ if you must use Form 1040, as described later, or if any of the statements listed under *Schedule B*, later, are true.

**Form 1040A.** You must complete Part I of Schedule 1 (Form 1040A) if you file Form 1040A and any of the following are true.

- 1) Your taxable interest income is more than \$400.
- 2) You are claiming the interest exclusion under the Education Savings Bond Program (discussed earlier).
- 3) You received interest from a seller-financed mortgage, and the buyer used the property as a home.
- 4) You received a Form 1099–INT for tax-exempt interest.
- 5) You received a Form 1099–INT for U.S. savings bond interest that includes amounts you reported before 2001.
- 6) You received, as a nominee, interest that actually belongs to someone else.
- 7) You received a Form 1099–INT for interest on frozen deposits.

List each payer's name and the amount of interest income received from each payer on line 1. If you received a Form 1099–INT or Form 1099–OID from a brokerage firm, list the brokerage firm as the payer.

You cannot use Form 1040A if you must use Form 1040, as described next.

**Form 1040.** You must use Form 1040 instead of Form 1040A or Form 1040EZ if:

- 1) You forfeited interest income because of the early withdrawal of a time deposit,
- 2) You received or paid accrued interest on securities transferred between interest payment dates,
- 3) You had a financial account in a foreign country, unless the combined value of all foreign accounts was \$10,000 or less during all of 2001 or the accounts were with certain U.S. military banking facilities,
- 4) You acquired taxable bonds after 1987 and choose to reduce interest income from the bonds by any amortizable bond premium (discussed in chapter 3 under *Bond Premium Amortization*), or

- 5) You are reporting OID in an amount more or less than the amount shown on Form 1099–OID.

**Schedule B.** You must complete Part I of Schedule B (Form 1040) if you file Form 1040 and any of the following apply.

- 1) Your taxable interest income is more than \$400.
- 2) You are claiming the interest exclusion under the Education Savings Bond Program (discussed earlier).
- 3) You had a foreign account.
- 4) You received interest from a seller-financed mortgage, and the buyer used the property as a home.
- 5) You received a Form 1099–INT for tax-exempt interest.
- 6) You received a Form 1099–INT for U.S. savings bond interest that includes amounts you reported before 2001.
- 7) You received, as a nominee, interest that actually belongs to someone else.
- 8) You received a Form 1099–INT for interest on frozen deposits.
- 9) You received a Form 1099–INT for interest on a bond that you bought between interest payment dates.
- 10) Statement (4) or (5) in the preceding list is true.

On line 1, Part I, list each payer's name and the amount received from each. If you received a Form 1099–INT or Form 1099–OID from a brokerage firm, list the brokerage firm as the payer.

**Reporting tax-exempt interest.** Report the total of your tax-exempt interest (such as interest or accrued OID on certain state and municipal bonds) and exempt-interest dividends from a mutual fund on line 8b of Form 1040A or Form 1040. If you file Form 1040EZ, print "TEI" in the space to the right of the words "Form 1040EZ" on line 2. After "TEI," show the amount of your tax-exempt interest, but do not add tax-exempt interest in the total on Form 1040EZ, line 2.

You should not have received a Form 1099–INT for tax-exempt interest. But if you did, you must fill in Schedule 1 (Form 1040A) or Schedule B (Form 1040). See the Schedule 1 or Schedule B instructions for how to report this. Be sure to also show this tax-exempt interest on line 8b.



*Do not report interest from an individual retirement arrangement (IRA) as tax-exempt interest.*

**Form 1099–INT.** Your taxable interest income, except for interest from U.S. savings bonds and Treasury obligations, is shown in box 1 of Form 1099–INT. Add this amount to any other taxable interest income you received. You must report all of your taxable interest income even if you do not receive a Form 1099–INT.

If you forfeited interest income because of the early withdrawal of a time deposit, the deductible amount will be shown on Form 1099–INT, in box 2. See *Penalty on early withdrawal of savings*, later.



CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.		Payer's RTN (optional)	OMB No. 1545-0112	<b>2001</b> Interest Income
			Form <b>1099-INT</b>	
PAYER'S Federal identification number	RECIPIENT'S identification number	1 Interest income not included in box 3 \$		<b>Copy B</b> <b>For Recipient</b> This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
RECIPIENT'S name		2 Early withdrawal penalty \$	3 Interest on U.S. Savings Bonds and Treas. obligations \$	
Street address (including apt. no.)		4 Federal income tax withheld \$	5 Investment expenses \$	
City, state, and ZIP code		6 Foreign tax paid \$	7 Foreign country or U.S. possession	
Account number (optional)				

Form **1099-INT**

(Keep for your records.)

Department of the Treasury - Internal Revenue Service

Box 3 of Form 1099-INT shows the amount of interest income you received from U.S. savings bonds, Treasury bills, Treasury notes, and Treasury bonds. Add the amount shown in box 3 to any other taxable interest income you received, unless part of the amount in box 3 was previously included in your interest income. If part of the amount shown in box 3 was previously included in your interest income, see *U.S. savings bond interest previously reported, later*. If you redeemed U.S. savings bonds you bought after 1989 and you paid qualified educational expenses, see *Interest excluded under the Education Savings Bond Program, later*.

Box 4 (federal income tax withheld) of Form 1099-INT will contain an amount if you were subject to backup withholding. Report the amount from box 4 on Form 1040EZ, line 8, on Form 1040A, line 37, or on Form 1040, line 59.

Box 5 of Form 1099-INT shows investment expenses you may be able to deduct as an itemized deduction. Chapter 3 discusses investment expenses.

You may be able to take a credit for the amount shown in box 6 (foreign tax paid) unless you deduct any amount on Schedule A of Form 1040 as "Other taxes." To take the credit, you may have to file **Form 1116, Foreign Tax Credit**. For more information, see Publication 514, *Foreign Tax Credit for Individuals*.

**Form 1099-OID.** The taxable OID on a discounted obligation for the part of the year you owned it is shown in box 1 of Form 1099-OID. Include this amount in your total taxable interest income. But see *Refiguring OID shown on Form 1099-OID under Original Issue Discount (OID)*, earlier.

You must report all taxable OID even if you do not receive a Form 1099-OID.

Box 2 of Form 1099-OID shows any taxable interest on the obligation other than OID. Add this amount to the OID shown in box 1 and include the result in your total taxable income.

If you forfeited interest or principal on the obligation because of an early withdrawal, the deductible amount will be shown in box 3. See *Penalty on early withdrawal of savings, later*.

Box 4 of Form 1099-OID will contain an amount if you were subject to backup withholding. Report the amount from box 4 on Form 1040EZ, line 8, on Form 1040A, line 37, or on Form 1040, line 59.

Box 7 of Form 1099-OID shows investment expenses you may be able to deduct as an itemized deduction. Chapter 3 discusses investment expenses.

**U.S. savings bond interest previously reported.** If you received a Form 1099-INT for U.S. savings bond interest, the form may show interest you do not have to report. See *Form 1099-INT for U.S. savings bond interest under U.S. Savings Bonds, earlier*.

On line 1, Part I of Schedule B (Form 1040), or on line 1, Part I of Schedule 1 (Form 1040A), report all the interest shown on your Form 1099-INT. Then follow these steps.

- 1) Several lines above line 2, enter a subtotal of all interest listed on line 1.
- 2) Below the subtotal print "U.S. Savings Bond Interest Previously Reported" and enter amounts previously reported or interest accrued before you received the bond.
- 3) Subtract these amounts from the subtotal and enter the result on line 2.

**Example 1.** Your parents bought U.S. savings bonds for you when you were a child. The bonds were issued in your name, and the interest on the bonds was reported each year as it accrued. (See *Choice to report interest each year under U.S. Savings Bonds, earlier*.)

In April 2001, you redeemed one of the bonds — a \$1,000 series EE bond. The bond was originally issued in March 1983. When you redeemed the bond, you received \$1,600.80 for it.

The Form 1099-INT you received shows interest income of \$1,100.80. However, since the interest on your savings bonds was reported yearly, you need only include the \$42.80 interest that accrued from January 2001 to April 2001.

You received no other taxable interest for 2001. You file Form 1040A.

On line 1, Part I of Schedule 1 (Form 1040A), enter your interest income as shown on Form 1099-INT — \$1,100.80. (If you had other taxable interest income, you would enter it next and then enter a subtotal, as described earlier, before going to the next step.) Several lines above line 2, print "U.S. Savings Bond Interest Previously Reported" and enter \$1,058.00 (\$1,100.80 - \$42.80). Subtract \$1,058.00 from \$1,100.80 and enter \$42.80 on line 2. Enter \$42.80 on line 4 of Schedule 1 and on line 8a of Form 1040A.

**Example 2.** Your uncle died and left you a \$1,000 series EE bond. You redeem the bond when it reaches maturity.

Your uncle paid \$500 for the bond, so \$500 of the amount you receive upon redemption is interest income. Your uncle's executor included in your uncle's final return \$200 of the interest that had accrued at the time of your uncle's death. You have to include only \$300 in your income.

The bank where you redeem the bond gives you a Form 1099-INT showing interest income of \$500. You also receive a Form 1099-INT showing taxable interest income of \$300 from your savings account.

You file Form 1040 and you complete Schedule B. On line 1 of Schedule B, you list the \$500 and \$300 interest amounts shown on your Forms 1099. Several lines above line 2, you put a subtotal of \$800. Below this subtotal, print "U.S. Savings Bond Interest Previously Reported" and enter the \$200 interest included in your uncle's final return. Subtract the \$200 from the subtotal and write \$600 on line 2. You then complete the rest of the form.

**Worksheet for savings bonds distributed from a retirement or profit-sharing plan.** If you cashed a savings bond acquired in a taxable distribution from a retirement or profit-sharing plan (as discussed under *U.S. Savings Bonds, earlier*), your interest income does not include

the interest accrued before the distribution and taxed as a distribution from the plan.



Use the worksheet below to figure the amount you subtract from the interest shown on Form 1099–INT.

- A. Write the amount of cash received upon redemption of the bond . . . . . \_\_\_\_\_
- B. Write the value of the bond at the time of distribution by the plan . . . . . \_\_\_\_\_
- C. Subtract the amount on line B from the amount on line A. This is the amount of interest accrued on the bond since it was distributed by the plan . . . . . \_\_\_\_\_
- D. Write the amount of interest shown on your Form 1099–INT . . . . . \_\_\_\_\_
- E. Subtract the amount on line C from the amount on line D. This is the amount you include in “U.S. Savings Bond Interest Previously Reported” . . . . . \_\_\_\_\_

Your employer should tell you the value of each bond on the date it was distributed.

**Example.** You received a distribution of series EE U.S. savings bonds in January 2000 from your company’s profit-sharing plan.

In April 2001, you redeemed a \$100 series EE bond that was part of the distribution you received in 2000. You received \$93.04 for the bond the company bought in May 1990. The value of the bond at the time of distribution in 2000 was \$87.68. (This is the amount you included on your 2000 return.) The bank gave you a Form 1099–INT that shows \$43.04 interest (the total interest from the date the bond was purchased to the date of redemption). Since a part of the interest was included in your income in 2000, you need to include in your 2001 income only the interest that accrued after the bond was distributed to you.

On line 1 of Schedule B (Form 1040), include all the interest shown on your Form 1099–INT as well as any other taxable interest income you received. Several lines above line 2, put a subtotal of all interest listed on line 1. Below this subtotal print “U.S. Savings Bond Interest Previously Reported” and enter the amount figured on the worksheet below.

- A. Write the amount of cash received upon redemption of the bond . . . . . \$93.04
- B. Write the value of the bond at the time of distribution by the plan . . . . . 87.68
- C. Subtract the amount on line B from the amount on line A. This is the amount of interest accrued on the bond since it was distributed by the plan . . . . . 5.36
- D. Write the amount of interest shown on your Form 1099–INT . . . . . \$43.04
- E. Subtract the amount on line C from the amount on line D. This is the amount you include in “U.S. Savings Bond Interest Previously Reported” . . . . . \$37.68

Subtract \$37.68 from the subtotal and enter the result on line 2 of Schedule B. You then complete the rest of the form.

**Interest excluded under the Education Savings Bond Program.** Use Form 8815, to figure your interest exclusion when you redeem qualified savings bonds and pay qualified higher educational expenses during the same year.

For more information on the exclusion and qualified higher educational expenses, see the earlier discussion under *Education Savings Bond Program*.

You must show your total interest from qualified savings bonds that you cashed during 2001

on line 6 of Form 8815 and on line 1 of either Schedule 1 (Form 1040A) or Schedule B (Form 1040). After completing Form 8815, enter the result from line 14 (Form 8815) on line 3 of Schedule 1 (Form 1040A) or line 3 of Schedule B (Form 1040).

**Interest on seller-financed mortgage.** If an individual buys his or her home from you in a sale that you finance, you must report the buyer’s name, address, and social security number on line 1 of Schedule 1 (Form 1040A) or line 1 of Schedule B (Form 1040). If you do not, you may have to pay a \$50 penalty. The buyer may have to pay a \$50 penalty if he or she does not give you this information.

You must also give your name, address, and social security number (or employer identification number) to the buyer. If you do not, you may have to pay a \$50 penalty.

**Frozen deposits.** Even if you receive a Form 1099–INT for interest on deposits that you could not withdraw at the end of 2001, you must exclude these amounts from your gross income. (See *Interest income on frozen deposits* under *Interest Income*, earlier.) Do not include this income on line 8a of Form 1040A or Form 1040. In Part I of Schedule 1 (Form 1040A) or Part I of Schedule B (Form 1040), include the full amount of interest shown on your Form 1099–INT on line 1. Several lines above line 2, put a subtotal of all interest income. Below this subtotal, write “Frozen Deposits” and show the amount of interest that you are excluding. Subtract this amount from the subtotal and write the result on line 2.

**Accrued interest on bonds.** If you received a Form 1099–INT that reflects accrued interest paid on a bond you bought between interest payment dates, include the full amount shown as interest on the Form 1099–INT on line 1, Part I of Schedule B (Form 1040). Then, below a subtotal of all interest income listed, print “Accrued Interest” and the amount of accrued interest that you paid to the seller. That amount is taxable to the seller, not you. Subtract that amount from the interest income subtotal. Enter the result on line 2 and also on Form 1040, line 8a.

For more information, see *Bonds Sold Between Interest Dates*, earlier.

**Nominee distributions.** If you received a Form 1099–INT that includes an amount you received as a nominee for the real owner, report the full amount shown as interest on the Form 1099–INT on line 1, Part I of Schedule 1 (Form 1040A) or Schedule B (Form 1040). Then, below a subtotal of all interest income listed, write “Nominee Distribution” and the amount that actually belongs to someone else. Subtract that amount from the interest income subtotal. Enter the result on line 2 and also on line 8a of Form 1040A or 1040.

**File Form 1099–INT with the IRS.** If you received interest as a nominee in 2001, you must file a Form 1099–INT for that interest with the IRS. Send Copy A of Form 1099–INT with a Form 1096, *Annual Summary and Transmittal of U.S. Information Returns*, to your Internal Revenue Service Center by February 28, 2002 (April 1, 2002 if you file Form 1099–INT electronically). Give the actual owner of the interest Copy B of the Form 1099–INT by January 31, 2002. On Form 1099–INT, you should be listed

as the “Payer.” Prepare one Form 1099–INT for each other owner and show that person as the “Recipient.” However, you do not have to file Form 1099–INT to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see the *General Instructions for Forms 1099, 1098, 5498, and W2–G*.

Similar rules apply to OID reported to you as a nominee on Form 1099–OID. You must file a Form 1099–OID with Form 1096 to show the proper distributions of the OID.

**Example.** You and your sister have a joint savings account that paid \$1,500 interest for 2001. Your sister deposited 30% of the funds in this account, and you and she have agreed to share the yearly interest income in proportion to the amount that each of you has invested. Because your social security number was given to the bank, you received a Form 1099–INT for 2001 that includes the interest income belonging to your sister. This amount is \$450, or 30% of the total interest of \$1,500.

You must give your sister a Form 1099–INT by January 31, 2002, showing \$450 of interest income that she earned for 2001. You must also send a copy of the nominee Form 1099–INT, along with Form 1096, to the Internal Revenue Service Center by February 28, 2002 (April 1, 2002, if you file form 1099–INT electronically). Show your own name, address, and social security number as that of the “Payer” on the Form 1099–INT. Show your sister’s name, address, and social security number in the blocks provided for identification of the “Recipient.”

When you prepare your own federal income tax return, report the total amount of interest income, \$1,500, on line 1, Part I of Schedule 1 (Form 1040A) or line 1, Part I of Schedule B (Form 1040), and identify the name of the bank that paid this interest. Show the amount belonging to your sister, \$450, as a subtraction from a subtotal of all interest on Schedule 1 (or Schedule B) and identify this subtraction as a “Nominee Distribution.” (Your sister will report the \$450 of interest income on her own tax return, if she has to file a return, and identify you as the payer of that amount.)

**Original issue discount (OID) adjustment.** If you are reporting OID in an amount greater or less than the amount shown on Form 1099–OID or other written statement (such as for a REMIC regular interest), include the full amount of OID shown on your Form 1099–OID or other statement on line 1, Part I of Schedule B (Form 1040). If the OID to be reported is less than the amount shown on Form 1099–OID, show the OID you do not have to report below a subtotal of the interest and OID listed. Identify the amount as “OID Adjustment” and subtract it from the subtotal. If the OID to be reported is greater than the amount shown on Form 1099–OID, show the additional OID below the subtotal. Identify the amount as “OID Adjustment” and add it to the subtotal.

**Penalty on early withdrawal of savings.** If you withdraw funds from a time-savings or other deferred interest account before maturity, you may be charged a penalty. The Form 1099–INT or similar statement given to you by the financial institution will show the total amount of interest in box 1 and will show the penalty separately in

box 2. You must include in income all the interest shown in box 1. You can deduct the penalty on line 30, Form 1040. Deduct the entire penalty even if it is more than your interest income.

## Dividends and Other Corporate Distributions

Dividends are distributions of money, stock, or other property paid to you by a corporation. You also may receive dividends through a partnership, an estate, a trust, or an association that is taxed as a corporation. However, some amounts you receive that are called dividends are actually interest income. (See *Dividends that are actually interest under Taxable Interest — General*, earlier.)

The most common kinds of distributions are:

- Ordinary dividends,
- Capital gain distributions, and
- Nontaxable distributions.

Most distributions are paid in cash (check). However, distributions can consist of more stock, stock rights, other property, or services.

**Form 1099–DIV.** Most corporations use Form 1099–DIV, *Dividends and Distributions*, to show you the distributions you received from them during the year. Keep this form with your records. You do not have to attach it to your tax return. Even if you do not receive Form 1099–DIV, you must still report all of your taxable dividend income.

**Nominees.** If someone receives distributions as a nominee for you, that person will give you a Form 1099–DIV, which will show distributions received on your behalf.

If you receive a Form 1099–DIV that includes amounts belonging to another person, see *Nominees under How To Report Dividend Income*, later, for more information.

**Form 1099–MISC.** Certain substitute payments in lieu of dividends or tax-exempt interest that are received by a broker on your behalf must be reported to you on Form 1099–MISC, *Miscellaneous Income*, or a similar statement. See also *Reporting Substitute Payments under Short Sales* in chapter 4.

**Incorrect amount shown on a Form 1099.** If you receive a Form 1099 that shows an incorrect amount (or other incorrect information), you should ask the issuer for a corrected form. The new Form 1099 you receive will be marked “Corrected.”

**Dividends on stock sold.** If stock is sold, exchanged, or otherwise disposed of after a dividend is declared, but before it is paid, the owner of record (usually the payee shown on the dividend check) must include the dividend in income.

**Dividends received in January.** If a regulated investment company (mutual fund) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend or capital gain distribution) in October, November,

or December payable to shareholders of record on a date in one of those months but actually pays the dividend during January of the next calendar year, you are considered to have received the dividend on December 31. You report the dividend in the year it was declared.

## Ordinary Dividends

Ordinary (taxable) dividends are the most common type of distribution from a corporation. They are paid out of the earnings and profits of a corporation and are ordinary income to you. This means they are not capital gains. You can assume that any dividend you receive on common or preferred stock is an ordinary dividend unless the paying corporation tells you otherwise. Ordinary dividends will be shown in box 1 of the Form 1099–DIV you receive.

**Dividends used to buy more stock.** The corporation in which you own stock may have a **dividend reinvestment plan**. This plan lets you choose to use your dividends to buy (through an agent) more shares of stock in the corporation instead of receiving the dividends in cash. If you are a member of this type of plan and you use your dividends to buy more stock at a price equal to its fair market value, you still must report the dividends as income.

If you are a member of a dividend reinvestment plan that lets you buy more stock at a price less than its fair market value, you must report as dividend income the fair market value of the additional stock on the dividend payment date.

You also must report as dividend income any service charge subtracted from your cash dividends before the dividends are used to buy the additional stock. But you may be able to deduct the service charge. See *Expenses of Producing Income* in chapter 3.

In some dividend reinvestment plans, you can invest more cash to buy shares of stock at a price less than fair market value. If you choose to do this, you must report as dividend income the difference between the cash you invest and the fair market value of the stock you buy. When figuring this amount, use the fair market value of the stock on the dividend payment date.

**Money market funds.** Report amounts you receive from money market funds as dividend income. Money market funds are a type of mutual fund and should not be confused with bank money market accounts that pay interest.

## Capital Gain Distributions

Capital gain distributions (also called capital gain dividends) are paid to you or credited to your account by **regulated investment companies** (commonly called **mutual funds**) and **real estate investment trusts (REITs)**. They will be shown in box 2a of the Form 1099–DIV you receive from the mutual fund or REIT.

Report capital gain distributions as long-term capital gains, regardless of how long you owned your shares in the mutual fund or REIT. See *Capital gain distributions under How To Report Dividend Income*, later in this chapter.

**Undistributed capital gains of mutual funds and REITs.** Some mutual funds and REITs keep their long-term capital gains and pay tax on them. You must treat your share of these gains as distributions, even though you did not actu-

ally receive them. However, they are not included on Form 1099–DIV. Instead, they are reported to you on **Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains**.

The Form 2439 will also show how much, if any, of the undistributed capital gains is:

- Qualified 5-year gain (box 1c),
- Unrecaptured section 1250 gain (box 1d), or
- Gain from qualified small business stock (section 1202 gain, box 1e).

For information about these terms, see *Capital Gain Tax Rates* in chapter 4.

Report undistributed capital gains (box 1a of Form 2439) as long-term capital gains in column (f) on line 11 of Schedule D (Form 1040). Enter on line 2 of the *Qualified 5-Year Gain Worksheet* in the Schedule D instructions the part reported to you as qualified 5-year gain. Enter on line 11 of the *Unrecaptured Section 1250 Gain Worksheet* in the Schedule D instructions the part reported to you as unrecaptured section 1250 gain. For any gain on qualified small business stock, follow the reporting instructions under *Section 1202 Exclusion* in chapter 4.

The tax paid on these gains by the mutual fund or REIT is shown in box 2 of Form 2439. You take credit for this tax by including it on line 65, Form 1040, and checking box a on that line. Attach Copy B of Form 2439 to your return, and keep Copy C for your records.

**Basis adjustment.** Increase your basis in your mutual fund, or your interest in a REIT, by the difference between the gain you report and the credit you claim for the tax paid.

## Nontaxable Distributions

You may receive a return of capital or a tax-free distribution of more shares of stock or stock rights. These distributions are not treated the same as ordinary dividends or capital gain distributions.

## Return of Capital

A return of capital is a distribution that is not paid out of the earnings and profits of a corporation. It is a return of your investment in the stock of the company. You should receive a Form 1099–DIV or other statement from the corporation showing you what part of the distribution is a return of capital. On Form 1099–DIV, a nontaxable return of capital will be shown in box 3. If you do not receive such a statement, you report the distribution as an ordinary dividend.

**Basis adjustment.** A return of capital reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. If you buy stock in a corporation in different lots at different times, and you cannot definitely identify the shares subject to the return of capital, reduce the basis of your earliest purchases first.

When the basis of your stock has been reduced to zero, report any additional return of capital that you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long

you have held the stock. See *Holding Period* in chapter 4.

**Example.** You bought stock in 1989 for \$100. In 1992, you received a return of capital of \$80. You did not include this amount in your income, but you reduced the basis of your stock to \$20. You received a return of capital of \$30 in 2001. The first \$20 of this amount reduced your basis to zero. You report the other \$10 as a long-term capital gain for 2001. You must report as a long-term capital gain any return of capital you receive on this stock in later years.

**Liquidating distributions.** Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. You will receive Form 1099-DIV from the corporation showing you the amount of the liquidating distribution in box 8 or 9.

Any liquidating distribution you receive is not taxable to you until you have recovered the basis of your stock. After the basis of your stock has been reduced to zero, you must report the liquidating distribution as a capital gain (except in certain instances involving collapsible corporations). Whether you report the gain as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period* in chapter 4.

**Stock acquired at different times.** If you acquired stock in the same corporation in more than one transaction, you own more than one block of stock in the corporation. If you receive distributions from the corporation in complete liquidation, you must divide the distribution among the blocks of stock you own in the following proportion: the number of shares in that block over the total number of shares you own. Divide distributions in partial liquidation among that part of the stock that is redeemed in the partial liquidation. After the basis of a block of stock is reduced to zero, you must report the part of any later distribution for that block as a capital gain.

**Distributions less than basis.** If the total liquidating distributions you receive are less than the basis of your stock, you may have a capital loss. You can report a capital loss only after you have received the final distribution in liquidation that results in the redemption or cancellation of the stock. Whether you report the loss as a long-term or short-term capital loss depends on how long you held the stock. See *Holding Period* in chapter 4.

## Distributions of Stock and Stock Rights

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as “stock options”) are distributions by a corporation of rights to acquire the corporation’s stock. Generally, stock dividends and stock rights are not taxable to you, and you do not report them on your return.

**Taxable stock dividends and stock rights.** Distributions of stock dividends and stock rights are taxable to you if any of the following apply.

- 1) You or any other shareholder has the choice to receive cash or other property instead of stock or stock rights.
- 2) The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation’s assets or earnings and profits to other shareholders.
- 3) The distribution is in convertible preferred stock and has the same result as in (2).
- 4) The distribution gives preferred stock to some common stock shareholders and common stock to other common stock shareholders.
- 5) The distribution is on preferred stock. (The distribution, however, is not taxable if it is an increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right.)

The term “stock” includes rights to acquire stock, and the term “shareholder” includes a holder of rights or convertible securities.

If you receive taxable stock dividends or stock rights, include their fair market value at the time of the distribution in your income.

**Constructive distributions.** You must treat certain transactions that increase your proportionate interest in the earnings and profits or assets of a corporation as if they were distributions of stock or stock rights. These constructive distributions are taxable if they have the same result as a distribution described in (2), (3), (4), or (5) of the above discussion.

This treatment applies to a change in your stock’s conversion ratio or redemption price, a difference between your stock’s redemption price and issue price, a redemption that is not treated as a sale or exchange of your stock, and any other transaction having a similar effect on your interest in the corporation.

**Preferred stock redeemable at a premium.** If you hold preferred stock having a redemption price higher than its issue price, the difference (the redemption premium) generally is taxable as a constructive distribution of additional stock on the preferred stock.

For stock issued before October 10, 1990, you include the redemption premium in your income ratably over the period during which the stock cannot be redeemed. For stock issued after October 9, 1990, you include the redemption premium on the basis of its economic accrual over the period during which the stock cannot be redeemed, as if it were original issue discount on a debt instrument. See *Original Issue Discount (OID)*, earlier in this chapter.

The redemption premium is not a constructive distribution, and therefore is not taxable, in the following situations.

- 1) The stock was issued before October 10, 1990 (before December 20, 1995, if redeemable solely at the option of the issuer), and the redemption premium is “reasonable.” (For stock issued before October 10, 1990, only the part of the redemption premium that is not “reasonable” is a constructive distribution.) The redemption premium is reasonable if it is not more

than 10% of the issue price on stock not redeemable for 5 years from the issue date or is in the nature of a penalty for making a premature redemption.

- 2) The stock was issued after October 9, 1990 (after December 19, 1995, if redeemable solely at the option of the issuer), and the redemption premium is “de minimis.” The redemption premium is de minimis if it is less than one-fourth of 1% (.0025) of the redemption price multiplied by the number of full years from the date of issue to the date redeemable.
- 3) The stock was issued after October 9, 1990, and must be redeemed at a specified time or is redeemable at your option, but the redemption is unlikely because it is subject to a contingency outside your control (not including the possibility of default, insolvency, etc.).
- 4) The stock was issued after December 19, 1995, and is redeemable solely at the option of the issuer, but the redemption premium is in the nature of a penalty for premature redemption or redemption is not more likely than not to occur. The redemption will be treated under a “safe harbor” as not more likely than not to occur if all of the following are true.
  - a) You and the issuer are not related under the rules discussed in chapter 4 under *Related Party Transactions*, substituting “20%” for “50%.”
  - b) There are no plans, arrangements, or agreements that effectively require or are intended to compel the issuer to redeem the stock.
  - c) The redemption would not reduce the stock’s yield.

**Basis.** Your basis in stock or stock rights received in a taxable distribution is their fair market value when distributed. If you receive stock or stock rights that are not taxable to you, see *Stocks and Bonds* in chapter 4 for information on how to figure their basis.

**Fractional shares.** You may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which fractional shares are not issued, but instead are sold, and the cash proceeds are given to the shareholders. Any cash you receive for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. You must determine your gain or loss and report it as a capital gain or loss on Schedule D (Form 1040). Your gain or loss is the difference between the cash you receive and the basis of the fractional shares sold.

**Example.** You own one share of common stock that you bought on January 3, 1993, for \$100. The corporation declared a common stock dividend of 5% on June 30, 2001. The fair market value of the stock at the time the stock dividend was declared was \$200. You were paid \$10 for the fractional-share stock dividend under

CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1 Ordinary dividends	OMB No. 1545-0110  <b>2001</b>  Form <b>1099-DIV</b>	<b>Dividends and Distributions</b>
		\$		
		2a Total capital gain distr.		
\$				
PAYER'S Federal identification number		2b 28% rate gain	2d Unrecap. sec. 1250 gain	<b>Copy B For Recipient</b>  This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
		\$		
RECIPIENT'S identification number	2c Qualified 5-year gain	3 Nontaxable distributions		
\$	\$	\$		
RECIPIENT'S name		2e Section 1202 gain	5 Investment expenses	
		\$	\$	
Street address (including apt. no.)		4 Federal income tax withheld	7 Foreign country or U.S. possession	
		\$	\$	
City, state, and ZIP code		6 Foreign tax paid	9 Noncash liquidation distr.	
		\$	\$	
Account number (optional)		8 Cash liquidation distr.	\$	

Form **1099-DIV**

(Keep for your records.)

Department of the Treasury - Internal Revenue Service

a plan described in the above paragraph. You figure your gain or loss as follows:

Fair market value of old stock	\$200.00
Fair market value of stock dividend (cash received)	+10.00
Fair market value of old stock and stock dividend	<u>\$210.00</u>
Basis (cost) of old stock after the stock dividend (( $\$200 \div \$210$ ) $\times$ $\$100$ )	\$ 95.24
Basis (cost) of stock dividend (( $\$10 \div \$210$ ) $\times$ $\$100$ )	+ 4.76
Total	<u>\$100.00</u>
Cash received	\$ 10.00
Basis (cost) of stock dividend	- 4.76
<b>Gain</b>	<u>\$ 5.24</u>

Because you had held the share of stock for more than 1 year at the time the stock dividend was declared, your gain on the stock dividend is a long-term capital gain.

**Scrip dividends.** A corporation that declares a stock dividend may issue you a scrip certificate that entitles you to a fractional share. The certificate is generally nontaxable when you receive it. If you choose to have the corporation sell the certificate for you and give you the proceeds, your gain or loss is the difference between the proceeds and the part of your basis in the corporation's stock that is allocated to the certificate.

However, if you receive a scrip certificate that you can choose to redeem for cash instead of stock, the certificate is taxable when you receive it. You must include its fair market value in income on the date you receive it.

## Other Distributions

You may receive any of the following distributions during the year.

**Exempt-interest dividends.** Exempt-interest dividends you receive from a regulated investment company (mutual fund) are not included in your taxable income. You will receive a notice from the mutual fund telling you the amount of the exempt-interest dividends you received.

Exempt-interest dividends are not shown on Form 1099-DIV or Form 1099-INT.

**Information reporting requirement.** Although exempt-interest dividends are not taxable, you must show them on your tax return if you have to file a return. This is an information reporting requirement and does not change the exempt-interest dividends to taxable income. See *Reporting tax-exempt interest* under *How To Report Interest Income*, earlier.

**Alternative minimum tax treatment.** Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax. See Form 6251 and its instructions for more information.

**Dividends on insurance policies.** Insurance policy dividends that the insurer keeps and uses to pay your premiums are not taxable. However, you must report as taxable interest income the interest that is paid or credited on dividends left with the insurance company.

If dividends on an insurance contract (other than a modified endowment contract) are distributed to you, they are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract. (For information on the treatment of a distribution from a modified endowment contract, see *Distribution Before Annuity Starting Date From a Nonqualified Plan* under *Taxation of Nonperiodic Payments* in Publication 575, *Pension and Annuity Income*.) Report any taxable distributions on insurance policies on line 16b (Form 1040) or line 12b (Form 1040A).

**Dividends on veterans' insurance.** Dividends you receive on veterans' insurance policies are not taxable. In addition, interest on dividends left with the Department of Veterans Affairs is not taxable.

**Patronage dividends.** Generally, patronage dividends you receive in money from a cooperative organization are included in your income.

Do not include in your income patronage dividends you receive on:

- 1) Property bought for your personal use, or
- 2) Capital assets or depreciable property bought for use in your business. But you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

**Alaska Permanent Fund dividends.** Do not report these amounts as dividends. Instead, report these amounts on line 21 of Form 1040, line 13 of Form 1040A, or line 3 of Form 1040EZ.

## How To Report Dividend Income

### Terms you may need to know (see Glossary):

Nominee

Restricted stock

Generally, you can use either Form 1040 or Form 1040A to report your dividend income. Report the total of your ordinary dividends on line 9 of Form 1040 or Form 1040A.

If you receive capital gain distributions, you may be able to use Form 1040A or you may have to use Form 1040. See *Capital gain distributions*, later. If you receive nontaxable distributions required to be reported as capital gains, you must use Form 1040. You cannot use Form 1040EZ if you receive any dividend income.

**Form 1099-DIV.** If you owned stock on which you received \$10 or more in dividends and other distributions, you should receive a Form 1099-DIV. Even if you do not receive a Form 1099-DIV, you must report all of your taxable dividend income.

See Form 1099-DIV for more information on how to report dividend income.

**Form 1040A.** You must complete Part II of Schedule 1 (Form 1040A) and attach it to your Form 1040A, if:

- 1) Your ordinary dividends (box 1 of Form 1099–DIV) are more than \$400, or
- 2) You received, as a nominee, dividends that actually belong to someone else.

List on line 5 each payer's name and the amount of ordinary dividends you received. If you received a Form 1099–DIV from a brokerage firm, list the brokerage firm as the payer.

Enter on line 6 the total of the amounts listed on line 5. Also enter this total on line 9, Form 1040A.

**Form 1040.** You must fill in Part II of Schedule B and attach it to your Form 1040, if:

- 1) Your ordinary dividends (box 1 of Form 1099–DIV) are more than \$400, or
- 2) You received, as a nominee, dividends that actually belong to someone else.

If your ordinary dividends are more than \$400, you must also complete Part III of Schedule B.

List on line 5, Part II of Schedule B, each payer's name and the amount of ordinary dividends you received. If your securities are held by a brokerage firm (in "street name"), list the name of the brokerage firm that is shown on Form 1099–DIV as the payer. If your stock is held by a nominee who is the owner of record, and the nominee credited or paid you dividends on the stock, show the name of the nominee and the dividends you received or for which you were credited.

Enter on line 6 the total of the amounts listed on line 5. (However, if you hold stock as a nominee, see *Nominees*, later.) Also enter this total on line 9, Form 1040.

**Dividends received on restricted stock.** Restricted stock is stock that you get from your employer for services you perform and that is nontransferable and subject to a substantial risk of forfeiture. You do not have to include the value of the stock in your income when you receive it. However, if you get dividends on restricted stock, you must include them in your income as wages, not dividends. See *Restricted Property* in Publication 525 for information on restricted stock dividends.

Your employer should include these dividends in the wages shown on your Form W–2. If you also get a Form 1099–DIV for these dividends, list them on line 5 of Schedule B (Form 1040), with the other dividends you received. Enter a subtotal of all your dividend income several lines above line 6. Below the subtotal, write "Dividends on restricted stock reported as wages on line 7, Form 1040," and enter the amount of the dividends included in your wages on line 7, Form 1040. Subtract this amount from the subtotal and enter the result on line 6, Part II of Schedule B.

**Election.** You can choose to include the value of restricted stock in gross income as pay for services. If you make this choice, report the dividends on the stock like any other dividends. List them on line 5, Part II of Schedule B, along with your other dividends (if the amount of ordinary dividends received from all sources is more than \$400). If you receive both a Form 1099–DIV and a Form W–2 showing these

dividends, do not include the dividends in your wages reported on line 7, Form 1040. Attach a statement to your Form 1040 explaining why the amount shown on line 7 of your Form 1040 is different from the amount shown on your Form W–2.

**Independent contractor.** If you received restricted stock for services as an independent contractor, the rules in the previous discussion apply. Generally, you must treat dividends you receive on the stock as income from self-employment.

**Capital gain distributions.** How to report capital gain distributions depends on whether you have any other capital gains or losses. If you do, report capital gain distributions (box 2a of Form 1099–DIV) in column (f) of line 13, Part II of Schedule D (Form 1040). If you do not have any other capital gains or losses, you may be able to report your capital gain distributions directly on line 13 of Form 1040 or line 10 of Form 1040A. In either case, see *Reporting Capital Gains and Losses* in chapter 4 for more information.

The mutual fund or real estate investment trust (REIT) making the distribution should tell you how much of it is:

- Qualified 5-year gain (box 2c),
- Unrecaptured section 1250 gain (box 2d), or
- Section 1202 gain (box 2e).

For information about these terms, see *Capital Gain Tax Rates* in chapter 4.

Enter on line 2 of the *Qualified 5-Year Gain Worksheet* in the Schedule D instructions the part reported to you as qualified 5-year gain. Enter on line 11 of the *Unrecaptured Section 1250 Gain Worksheet* in the Schedule D instructions the part reported to you as unrecaptured section 1250 gain. If you have a gain on qualified small business stock (section 1202 gain), follow the reporting instructions under *Section 1202 Exclusion* in chapter 4.

**Nontaxable (return of capital) distributions.** Report return of capital distributions (box 3 of Form 1099–DIV) only after your basis in the stock has been reduced to zero. After the basis of your stock has been reduced to zero, you must show this amount on line 1, Part I of Schedule D, if you held the stock 1 year or less. Show it on line 8, Part II of Schedule D, if you held the stock for more than 1 year. Print "Dividend R.O.C. Exceeding Basis" in column (a) of Schedule D and the name of the company. Report your gain in column (f). Your gain is the amount of the distribution that is more than your basis in the stock.

**Nominees.** If you received ordinary dividends as a nominee (that is, the dividends are in your name but actually belong to someone else), include them on line 5 of Schedule 1 (Form 1040A) or Schedule B (Form 1040). Several lines above line 6, put a subtotal of all dividend income listed on line 5. Below this subtotal, write "Nominee Distributions" and show the amounts received as a nominee. Subtract the total of your nominee distributions from the subtotal. Enter the result on line 6.

**File Form 1099–DIV with the IRS.** If you received dividends as a nominee in 2001, you

must file a Form 1099–DIV for those dividends with the IRS. Send the Form 1099–DIV with a **Form 1096, Annual Summary and Transmittal of U.S. Information Returns**, to your Internal Revenue Service Center by February 28, 2002 (April 1, 2002, if you file Form 1099–DIV electronically). Give the actual owner of the dividends Copy B of the Form 1099–DIV by January 31, 2002. On Form 1099–DIV, you should be listed as the "Payer." The other owner should be listed as the "Recipient." You do not, however, have to file a Form 1099–DIV to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see the *General Instructions for Forms 1099, 1098, 5498, and W–2G*.

**Liquidating distributions.** If you receive a liquidating distribution on stock, the corporation will give you a Form 1099–DIV showing the amount of the liquidating distribution in boxes 8 and 9.

For a discussion of the treatment of liquidating distributions, see *Return of Capital under Nontaxable Distributions*, earlier in this chapter.

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## Stripped Preferred Stock

If the dividend rights are stripped from certain preferred stock, the holder of the stripped preferred stock may have to include amounts in income equal to the amounts that would have been included if the stock were a bond with original issue discount (OID).

**Stripped preferred stock defined.** Stripped preferred stock is any stock that meets both of the following tests.

- 1) There has been a separation in ownership between the stock and any dividend on the stock that has not become payable.
- 2) The stock:
  - a) Is limited and preferred as to dividends,
  - b) Does not participate in corporate growth to any significant extent, and
  - c) Has a fixed redemption price.

**Treatment of buyer.** If you buy stripped preferred stock after April 30, 1993, you must include certain amounts in your gross income while you hold the stock. These amounts are ordinary income. They are equal to the amounts you would have included in gross income if the stock were a bond that:

- 1) Was issued on the purchase date of the stock, and
- 2) Has OID equal to:
  - a) The redemption price for the stock, minus
  - b) The price at which you bought the stock.

Report these amounts as other income on line 21 of Form 1040. For information about OID, see *Original Issue Discount (OID)*, earlier.

This treatment also applies to you if you acquire the stock in such a way (for example, by gift) that your basis in the stock is determined by using a buyer's basis.

**Treatment of person stripping stock.** If you strip the rights to one or more dividends from stripped preferred stock, you are treated as having purchased the stock. You are treated as making the purchase on the date you disposed of the dividend rights. Your adjusted basis in the stripped preferred stock is treated as your purchase price. The rules described in *Treatment of buyer*, earlier, apply to you.

## REMICs, FASITs, and Other CDOs

Holders of interests in real estate mortgage investment conduits (REMICs), financial asset securitization investment trusts (FASITs), and other collateralized debt obligations (CDOs) must follow special rules for reporting income and any expenses from these investment products.

### REMICs

A **real estate mortgage investment conduit (REMIC)** is an entity that is formed for the purpose of holding a fixed pool of mortgages secured by interests in real property. A REMIC issues regular and residual interests to investors. For tax purposes, a REMIC is generally treated as a partnership with the residual interest holders treated as the partners. The regular interests are treated as debt instruments.

REMIC income or loss is not income or loss from a passive activity.

For more information about the qualifications and the tax treatment that apply to a REMIC and the interests of investors in a REMIC, see sections 860A through 860G of the Internal Revenue Code, and the regulations under those sections.

### Regular Interest

A REMIC can have several classes (also known as "tranches") of regular interests. A regular interest unconditionally entitles the holder to receive a specified principal amount (or other similar amount).

A REMIC regular interest is treated as a debt instrument for income tax purposes. Accordingly, the OID, market discount, and income reporting rules that apply to bonds and other debt instruments as described earlier in this publication under *Discount on Debt Instruments* apply, with certain modifications discussed below.

Generally, you report your income from a regular interest on line 8a, Form 1040. For more information on how to report interest and OID, see *How To Report Interest Income*, earlier.

**Holders must use accrual method.** Holders of regular interests must use an accrual method of accounting to report OID and interest income.

Because income under an accrual method is not determined by the receipt of cash, you may have to include OID or interest income in your taxable income even if you have not received any cash payments.

**Forms 1099-INT and 1099-OID.** You should receive a copy of Form 1099-INT or Form 1099-OID from the REMIC. You will also receive a written statement by March 15, 2002 (if you are a calendar year taxpayer), that provides additional information. The statement should contain enough information to enable you to figure your accrual of market discount or amortizable bond premium.

Form 1099-INT shows the amount of interest income that accrued to you for the period you held the regular interest.

Form 1099-OID shows the amount of OID and interest, if any, that accrued to you for the period you held the regular interest. You will not need to make any adjustments to the amounts reported even if you held the regular interest for only a part of the calendar year. However, if you bought the regular interest at a premium or acquisition premium, see *Refiguring OID shown on Form 1099-OID* under *Original Issue Discount (OID)*, earlier.

**You may not get a Form 1099.** Corporations and other persons specified in Regulation 1.6049-7(c) will not receive Forms 1099. These persons and fiscal year taxpayers may obtain tax information by contacting the REMIC or the issuer of the CDO, if they hold directly from the REMIC or issuer of the CDO. Publication 938, *Real Estate Mortgage Investment Conduits (REMICs) Reporting Information*, explains how to request this information.



Publication 938 is available only on the Internet at [www.irs.gov](http://www.irs.gov).

If you hold a regular interest or CDO through a nominee (rather than directly), you can request the information from the nominee in the manner prescribed in Regulation 1.6049-7(f)(7)(i).

**Allocated investment expenses.** Regular interest holders in a REMIC may be allowed to deduct the REMIC's investment expenses, but only if the REMIC is a **single-class** REMIC. A single-class REMIC is one that generally would be classified as a trust for tax purposes if it had not elected REMIC status.

The single-class REMIC will report your share of its investment expenses in box 5 of Form 1099-INT or box 7 of Form 1099-OID. It will also include this amount in box 1 of Form 1099-INT or box 2 of Form 1099-OID, and on the additional written statement.

You may be able to take a deduction for these expenses subject to a 2% limit that also applies to certain other miscellaneous itemized deductions. See chapter 3 for more information.

**Redemption of regular interests at maturity.** Redemption of debt instruments at their maturity is treated as a sale or exchange. You must report redemptions on your tax return whether or not you realize gain or loss on the transaction. Your basis is your adjusted issue price, which includes any OID you previously reported in income.

Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or exchanged that instrument. A debt instrument is retired when it is reacquired or redeemed by the issuer and canceled.

### **Sale or exchange of a regular interest.**

Some of your gain on the sale or exchange of a REMIC regular interest may be ordinary income. The ordinary income part, if any, is:

- The amount that would have been included in your income if the yield to maturity on the regular interest had been 110% of the applicable federal rate at the beginning of your holding period minus
- The amount you included in your income.

### Residual Interest

A residual interest is an interest in a REMIC that is not a regular interest. It is designated as a residual interest by the REMIC.

If you acquire a residual interest in a REMIC, you must take into account, on a quarterly basis, your daily portion of the taxable income or net loss of the REMIC for each day during the tax year that you hold the residual interest. You must report these amounts as ordinary income or loss.

**Basis in the residual interest.** Your basis in the residual interest is increased by the amount of taxable income you take into account. Your basis is decreased (but not below zero) by the amount of cash or the fair market value of any property distributed to you, and by the amount of any net loss you have taken into account. If you sell your residual interest, you must adjust your basis to reflect your share of the REMIC's taxable income or net loss immediately before the sale. See *Wash Sales*, in chapter 4, for more information about selling a residual interest.

**Treatment of distributions.** You must include in your gross income the part of any distribution that is more than your adjusted basis. Treat the distribution as a gain from the sale or exchange of your residual interest.

**Schedule Q.** If you hold a REMIC residual interest, you should receive Schedule Q (Form 1066), *Quarterly Notice to Residual Interest Holder of REMIC Taxable Income or Net Loss Allocation*, and instructions from the REMIC each quarter. Schedule Q will indicate your share of the REMIC's quarterly taxable income (or loss). Do not attach the Schedule Q to your tax return. Keep it for your records.

Use Part IV of Schedule E (Form 1040) to report your total share of the REMIC's taxable income (or loss) for each quarter included in your tax year.

For more information about reporting your income (or loss) from a residual interest in a REMIC, follow the Schedule Q (Form 1066) and Schedule E (Form 1040) instructions.

**Expenses.** Subject to the 2%-of-adjusted-gross-income limit, you may be able to claim a miscellaneous itemized deduction for certain ordinary and necessary expenses that you paid or incurred in connection with your investment in a REMIC. These expenses may include certain expense items incurred by the REMIC and passed through to you. The REMIC will report

these expenses to you on line 3b of Schedule Q. See chapter 3 for information on how to report these expenses.

## Collateralized Debt Obligations (CDOs)

A **collateralized debt obligation (CDO)** is a debt instrument, other than a REMIC regular interest, that is secured by a pool of mortgages or other evidence of debt and that has principal payments that are subject to acceleration. (Note: While REMIC regular interests are collateralized debt obligations, they have unique rules that do not apply to CDOs issued before 1987.) CDOs, also known as “pay-through bonds,” are commonly divided into different classes (also called “tranches”).

CDOs can be secured by a pool of mortgages, automobile loans, equipment leases, or credit card receivables.

For more information about the qualifications and the tax treatment that apply to an issuer of a CDO, see section 1272(a)(6) of the Internal Revenue Code and the regulations under that section.

The OID, market discount, and income-reporting rules that apply to bonds and other debt instruments, as described earlier in this chapter under *Discount on Debt Instruments*, also apply to a CDO.

You must include interest income from your CDO in your gross income under your regular method of accounting. Also include any OID accrued on your CDO during the tax year.

Generally, you report your income from a CDO on line 8a, Form 1040. For more information about reporting these amounts on your return, see *How To Report Interest Income*, earlier.

**Forms 1099-INT and 1099-OID.** You should receive a copy of Form 1099-INT or Form 1099-OID. You will also receive a written statement by March 15, 2002, that provides additional information. The statement should contain enough information about the CDO to enable you to figure your accrual of market discount or amortizable bond premium.

Form 1099-INT shows the amount of interest income paid to you for the period you held the CDO.

Form 1099-OID shows the amount of OID accrued to you and the interest, if any, paid to you for the period you held the CDO. You should not need to make any adjustments to the amounts reported even if you held the CDO for only a part of the calendar year. However, if you bought the CDO at a premium or acquisition premium, see *Refiguring OID shown on Form 1099-OID* under *Original Issue Discount (OID)*, earlier.

If you did not receive a Form 1099, see *You may not get a Form 1099* under *REMICs*, earlier.

## FASITs

A **financial asset securitization investment trust (FASIT)** is an entity that securitizes debt obligations such as credit card receivables, home equity loans, and automobile loans.

A regular interest in a FASIT is treated as a debt instrument. The rules described under *Collateralized Debt Obligations (CDOs)*, earlier, apply to a regular interest in a FASIT, except that a

holder of a regular interest in a FASIT must use an accrual method of accounting to report OID and interest income.

For more information about FASITs, see sections 860H through 860L of the Internal Revenue Code.

## S Corporations

In general, an S corporation does not pay a tax on its income. Instead, its income and expenses are passed through to the shareholders, who then report these items on their own income tax returns.

If you are an S corporation shareholder, all current year income or loss and other tax items are taxed to you at the corporation's year end (generally, the end of the calendar year) whether or not you actually receive any amount. Generally, those items increase or decrease the basis of your S corporation stock as appropriate. For more information on basis adjustments for S corporation stock, see *Stocks and Bonds under Basis of Investment Property* in chapter 4.

Generally, S corporation distributions, except dividend distributions, are considered a return of capital and reduce your basis in the stock of the corporation. The part of any distribution that is more than your basis is treated as a gain from the sale or exchange of property. The corporation's distributions may be in the form of cash or property.

S corporation distributions are not treated as dividends except in certain cases in which the corporation has accumulated earnings and profits from years before it became an S corporation.

**Reporting S corporation income, deductions, and credits.** The S corporation should send you a copy of Schedule K-1 (Form 1120S) showing your share of the S corporation's income, credits, and deductions for the tax year. You must report your distributive share of the S corporation's income, gain, loss, deductions, or credits on the appropriate lines and schedules of your Form 1040.

For more information about your treatment of S corporation tax items, see *Shareholder's Instructions for Schedule K-1 (Form 1120S)*.

**Limit on losses and deductions.** The deduction for your share of losses and deductions shown on Schedule K-1 (Form 1120S) is limited to the adjusted basis of your stock and any debt the corporation owes you. Any loss or deduction not allowed because of this limit is carried over and treated as a loss or deduction in the next tax year.

**Passive activity losses.** Rules apply that limit losses from passive activities. Your copy of Schedule K-1 and its instructions will explain the limits and tell you where on your return to report your share of S corporation items from passive activities.

**Form 8582.** If you have a passive activity loss from an S corporation, you must complete Form 8582, *Passive Activity Loss Limitations*, to figure the amount of the allowable loss to enter on your return. See Publication 925 for more information.

## Investment Clubs

An investment club is formed when a group of friends, neighbors, business associates, or others pool their money to invest in stock or other securities. The club may or may not have a written agreement, a charter, or bylaws.

Usually the group operates informally with members pledging to pay a regular amount into the club monthly. Some clubs have a committee that gathers information on securities, selects the most promising securities, and recommends that the club invest in them. Other clubs rotate these responsibilities among all their members. Most clubs require all members to vote for or against all investments, sales, trades, and other transactions.

**Identifying number.** Each club must have an employer identification number (EIN) to use when filing its return. The club's EIN also may have to be given to the payer of dividends or other income from investments recorded in the club's name. To obtain an EIN, first get **Form SS-4, Application for Employer Identification Number**, from the Internal Revenue Service or your nearest Social Security Administration office. See chapter 5 of this publication for more information about how to get this form.

**Investments in name of member.** When an investment is recorded in the name of one club member, this member must give his or her social security number (SSN) to the payer of investment income. (When an investment is held in the names of two or more club members, the SSN of only one member must be given to the payer.) This member is considered as the record owner for the actual owner, the investment club. This member is a “nominee” and must file an information return with the IRS. For example, the nominee member must file Form 1099-DIV for dividend income, showing the club as the owner of the dividend, his or her SSN, and the EIN of the club.

**Tax treatment of the club.** Generally, an investment club is treated as a partnership for federal tax purposes unless it chooses otherwise. In some situations, however, it is taxed as a corporation or a trust.

**Clubs formed before 1997.** Before 1997, the rules for determining how an investment club is treated were different from those explained in the following discussions. An investment club that existed before 1997 is treated for later years the same way it was treated before 1997, unless it chooses to be treated a different way under the new rules. To make that choice, the club must file **Form 8832, Entity Classification Election**.

## Club as a Partnership

If your club is not taxed as a corporation or a trust, it will be treated as a partnership.

**Club files Form 1065.** If your investment club is treated as a partnership, it must file Form 1065. However, as a partner in the club, you must report on your individual return your share of the club's income, gains, losses, deductions, and credits for the club's tax year. (Its tax year generally must be the same tax year as that of the partners owning a majority interest.) You must report these items whether or not you actu-



ally receive any distribution from the partnership.

You should receive a copy of Schedule K-1 (Form 1065), *Partner's Share of Income, Credits, Deductions, etc.*, from the partnership. The amounts shown on Schedule K-1 are your share of the partnership's income, deductions, and credits. Report each amount on the appropriate lines and schedules of your income tax return.

The club's expenses for producing or collecting income, for managing investment property, or for determining any tax are listed separately on Schedule K-1. Each individual partner who itemizes deductions on Schedule A (Form 1040) can deduct his or her share of those expenses. The expenses are listed on line 22 of Schedule A along with other miscellaneous itemized deductions subject to the 2% limit. See chapter 3 for more information on the 2% limit.

For more information about reporting your income from a partnership, see the Schedule K-1 instructions. Also see Publication 541, *Partnerships*.

**Passive activity losses.** Rules apply that limit losses from passive activities. Your copy of Schedule K-1 (Form 1065) and its instructions will tell you where on your return to report your share of partnership items from passive activities. If you have a passive activity loss from a partnership, you must complete **Form 8582** to figure the amount of the allowable loss to enter on your tax return.

**No social security coverage for investment club earnings.** If an investment club partnership's activities are limited to investing in savings certificates, stock, or securities, and col-

lecting interest or dividends for its members' accounts, a member's share of income is not earnings from self-employment. You cannot voluntarily pay the self-employment tax to increase your social security coverage and ultimate benefits.

## Club as a Corporation

An investment club formed after 1996 is taxed as a corporation if:

- 1) It is formed under a federal or state law that refers to it as incorporated or as a corporation, body corporate, or body politic,
- 2) It is formed under a state law that refers to it as a joint-stock company or joint-stock association, or
- 3) It chooses to be taxed as a corporation.

**Choosing to be taxed as a corporation.** To choose to be taxed as a corporation, the club cannot be a trust (see *Club as a Trust*, later) or otherwise subject to special treatment under the tax law. The club must file Form 8832 to make the choice.

**Club files Form 1120.** If your club is taxed as a corporation, it must file Form 1120 (or Form 1120-A). In that case, you do not report any of its income or expenses on your individual return. All ordinary income and expenses and capital gains and losses must be reported on the Form 1120 (or Form 1120-A). Any distribution the club makes that qualifies as a dividend must be

reported on Form 1099-DIV if total distributions to the shareholder are \$10 or more for the year.

You must report any distributions that you receive from the club on your individual return. You should receive a copy of Form 1099-DIV from the club showing the distributions you received.

Some corporations can choose not to be taxed and have earnings taxed to the shareholders. See *S Corporations*, earlier.

For more information about corporations, see Publication 542, *Corporations*.

## Club as a Trust

In a few cases, an investment club is taxed as a trust. In general, a trust is an arrangement through which trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. An arrangement is treated as a trust for tax purposes if its purpose is to vest in trustees responsibility for protecting and conserving property for beneficiaries who cannot share in that responsibility and so are not associates in a joint enterprise for the conduct of business for profit. If you need more information about trusts, see section 301.7701-4 of the regulations.

**Club files Form 1041.** If your club is taxed as a trust, it must file Form 1041. You should receive a copy of Schedule K-1 (Form 1041) from the trust. Report the amounts shown on Schedule K-1 on the appropriate lines and schedules of your income tax return.

## 2.

# Tax Shelters

## Introduction

Investments that yield tax benefits are sometimes called “tax shelters.” In some cases, Congress has concluded that the loss of revenue is an acceptable side effect of special tax provisions designed to encourage taxpayers to make certain types of investments. In many cases, however, losses from tax shelters produce little or no benefit to society, or the tax benefits are exaggerated beyond those intended. Those cases are called “abusive tax shelters.” An investment that is considered a tax shelter is subject to restrictions, including the requirement that it be registered, as discussed later, unless it is a projected income investment (defined later).

## Topics

This chapter discusses:

- How to recognize an abusive tax shelter,
- Rules enacted by Congress to curb tax shelters,
- Investors’ reporting requirements, and
- Penalties that may apply.

## Useful Items

You may want to see:

### Publication

- 538** Accounting Periods and Methods
- 556** Examination of Returns, Appeal Rights, and Claims for Refund
- 561** Determining the Value of Donated Property
- 925** Passive Activity and At-Risk Rules

### Form (and Instructions)

- 8271** Investor Reporting of Tax Shelter Registration Number
- 8275** Disclosure Statement
- 8275–R** Regulation Disclosure Statement

See chapter 5 for information about getting these publications and forms.

## Abusive Tax Shelters

Abusive tax shelters are marketing schemes that involve artificial transactions with little or no economic reality. They often make use of unrealistic allocations, inflated appraisals, losses in connection with nonrecourse loans, mismatching of income and deductions, financing techniques that do not conform to standard commercial business practices, or the mischaracter-

ization of the substance of the transaction. Despite appearances to the contrary, the taxpayer generally risks little.

Abusive tax shelters commonly involve package deals that are designed from the start to generate losses, deductions, or credits that will be far more than present or future investment. Or, they may promise investors from the start that future inflated appraisals will enable them, for example, to reap charitable contribution deductions based on those appraisals. (But see the appraisal requirements discussed under *Curbing Abusive Tax Shelters*.) They are commonly marketed in terms of the ratio of tax deductions allegedly available to each dollar invested. This ratio (or “write-off”) is frequently said to be several times greater than one-to-one.

Since there are many abusive tax shelters, it is not possible to list all the factors you should consider in determining whether an offering is an abusive tax shelter. However, you should ask the following questions, which might provide a clue to the abusive nature of the plan.

- Do the tax benefits far outweigh the economic benefits?
- Is this a transaction you would seriously consider, apart from the tax benefits, if you hoped to make a profit?
- Do shelter assets really exist and, if so, are they insured for less than their purchase price?
- Is there a nontax justification for the way profits and losses are allocated to partners?
- Do the facts and supporting documents make economic sense? In that connection, are there sales and resales of the tax shelter property at ever increasing prices?
- Does the investment plan involve a gimmick, device, or sham to hide the economic reality of the transaction?
- Does the promoter offer to backdate documents after the close of the year? Are you instructed to backdate checks covering your investment?
- Is your debt a real debt or are you assured by the promoter that you will never have to pay it?
- Does this transaction involve laundering United States-source income through foreign corporations incorporated in a tax haven and owned by United States shareholders?

## Curbing Abusive Tax Shelters

Congress has enacted a series of income tax laws designed to halt the growth of abusive tax shelters. These provisions include the following.

- 1) **Passive activity losses and credits.** The passive activity loss and credit rules limit the amount of losses and credits that can be claimed from passive activities and limit the amount that can offset nonpassive income, such as certain portfolio income from investments. For more detailed information about determining and reporting in-

come, losses, and credits from passive activities, see Publication 925.

- 2) **Registration of tax shelters.** Generally, the organizers of certain tax shelters must register the shelter with the IRS. The IRS will then assign the tax shelter a registration number. If you are an investor in a tax shelter, the seller (or the transferor) must provide you with the tax shelter registration number at the time of sale (or transfer) or within 20 days after the seller or transferor receives the number if that date is later. See *Investor Reporting*, later, for more information about reporting this number when filing your tax return.
- 3) **List of tax shelter investors.** Organizers and sellers of any potentially abusive tax shelter must maintain a list identifying each investor. The list must be available for inspection by the IRS, and the information required to be included on the list generally must be kept for 7 years. See *Transfer of interests in a tax shelter*, later, for more information.
- 4) **Appraisals of donated property.** Generally, if you donate property valued at more than \$5,000 (\$10,000 in the case of privately traded stock), you must get a written “qualified” appraisal of the property’s fair market value and attach an appraisal summary to your income tax return. The appraisal must be done by a “qualified” appraiser who is not the taxpayer, a party to a transaction in which the taxpayer acquired the property, the donee, or an employee or related party of any of the preceding persons. (Related parties are defined under *Related Party Transactions* in chapter 4.) For more information about appraisals, see Publication 561.
- 5) **Interest on penalties.** If you are assessed an accuracy-related or civil fraud penalty (as discussed under *Penalties*, later), interest will be imposed on the amount of the penalty from the due date of the return (including any extensions) to the date you pay the penalty.
- 6) **Accounting methods and capitalization rules.** Tax shelters generally cannot use the cash method of accounting. Also, uniform capitalization rules generally apply to producing property or acquiring it for resale. Under those rules, the direct cost and part of the indirect cost of the property must be capitalized or included in inventory. For more information, see Publication 538.

**Projected income investment.** Special rules apply to a projected income investment. To qualify as a projected income investment, a tax shelter must not be expected to reduce the **cumulative tax liability** of any investor during any year of the first 5 years ending after the date the investment was offered for sale. In addition, the assets of a projected income investment must not include or relate to more than an incidental interest in:

- 1) Master sound recordings,
- 2) Motion picture or television films,

- 3) Videotapes,
- 4) Lithograph plates,
- 5) Copyrights,
- 6) Literary, musical, or artistic compositions, or
- 7) Collectibles (such as works of art, rugs, antiques, metals, gems, stamps, coins, or alcoholic beverages).

Tax shelters that qualify as projected income investments are not subject to the registration rules for tax shelters, described earlier. However, the requirement to maintain a list of investors that is in effect for tax shelters also applies to any projected income investment, except for one an investor later transfers. See *Transfer of interests in a tax shelter*, later.

A tax shelter that previously qualified as a projected income investment may later be disqualified if, in one of its first 5 years, it reduces the cumulative tax liability of any investor. In that case, the tax shelter becomes subject to the registration rules for tax shelters, described earlier.

**Pre-filing notification letter.** If you are an investor in an abusive tax shelter promotion, the IRS may send you a “pre-filing notification letter” if it determines that it is highly likely that there is:

- 1) A gross valuation overstatement, or
- 2) A false or fraudulent statement regarding the tax benefits to be derived from the tax shelter entity or arrangement.

This letter will advise you that, based upon a review of the promotion, it is believed that the purported tax benefits are not allowable. The letter also will advise you of the possible tax consequences if you claim the benefits on your income tax return.

You also may receive a notification letter after you file your tax return. If you have already claimed the benefits on your tax return, you will be advised that you can file an amended return. However, any penalties that apply still can be asserted.

If you claim the benefits after receiving the pre-filing notification or if you fail to amend your return, you will be notified that your tax return is being examined. Normal audit and appeal procedures will be followed during the examination, and accuracy-related, civil or criminal fraud, and other penalties will be considered and, when appropriate, asserted. For information on the examination of returns, see Publication 556.

**Revenue rulings.** The IRS has published numerous revenue rulings concluding that the claimed tax benefits of various abusive tax shelters should be disallowed. A revenue ruling is the conclusion of the IRS on how the law is applied to a particular set of facts. Revenue rulings are published in the *Internal Revenue Bulletin* for taxpayers’ guidance and information and also for use by IRS officials. So, if your return is examined and an abusive tax shelter is identified and challenged, a published revenue ruling dealing with that type of shelter, which disallows certain claimed tax shelter benefits, could serve as the basis for the examining official’s challenge of the tax benefits that you claimed. In such a case, the examiner will not compromise even if you or your representative

believe that you have authority for the positions taken on your tax return.



*The courts have generally been unsympathetic to taxpayers involved in abusive tax shelter schemes and have ruled in favor of the IRS in the majority of the cases in which these shelters have been challenged.*

## Investor Reporting

If you include on your tax return any deduction, loss, credit or other tax benefit, or any income, from an interest in a tax shelter required to be registered, you must report the registration number that the tax shelter provided to you. (See *Registration of tax shelters*, earlier.) Complete and attach **Form 8271** to your return to report the number and to provide other information about the tax shelter and its benefits. You must also attach Form 8271 to any application for tentative refund (Form 1045) and to any amended return (Form 1040X) on which these benefits are claimed or income is reported. If you do not include the registration number with your return, you will be subject to a penalty of \$250 for each such failure, unless the failure is due to reasonable cause.

**Transfer of interests in a tax shelter.** If you hold an investment interest in a tax shelter and later transfer that interest to another person, you must provide the tax shelter’s registration number to each person to whom you transferred your interest. (However, this does not apply if your interest is in a projected income investment, described earlier.) You must also provide a notice substantially in the following form:

You have acquired an interest in [name and address of tax shelter] whose taxpayer identification number is [if any]. The Internal Revenue Service has issued [name of tax shelter] the following tax shelter registration number: [number]. You must report this registration number to the Internal Revenue Service, if you claim any deduction, loss, credit, or other tax benefit or report any income by reason of your investment in [name of tax shelter]. You must report the registration number (as well as the name and taxpayer identification number of [name of tax shelter]) on Form 8271. Form 8271 must be attached to the return on which you claim the deduction, loss, credit, or other tax benefit or report any income. Issuance of a registration number does not indicate that this investment or the claimed tax benefits have been reviewed, examined, or approved by the Internal Revenue Service.

The following requirements also apply.

- 1) **Maintaining a list.** You must maintain a list identifying each person to whom you transferred your interest. Or, you may require a designated person or seller to maintain the list. However, see *Special rule for projected income investment*, later, for an exception to this requirement. If you choose to delegate this requirement, you must give the designated person or seller all of the information that you would otherwise have to maintain on the list.
- 2) **Providing notice.** If the tax shelter is not a projected income investment, described earlier, you must provide a notice to each person to whom you transferred your inter-

est. This notice must be substantially in the following form:

You have acquired an interest in [name and address of tax shelter]. If you transfer your interest in this tax shelter to another person, you are required by the Internal Revenue Service to keep a list containing that person’s name, address, taxpayer identification number, the date on which you transferred the interest, and the name, address, and tax shelter registration number of this tax shelter. If you do not want to keep such a list, you must (1) send the information specified above to [name and address of designated person], who will keep the list for this tax shelter, and (2) give a copy of this notice to the person to whom you transfer your interest.

If you do not maintain the required list of investors, or do not delegate a designated person or seller to maintain the list, you will be subject to a penalty of \$50 for each person required to be on the list. But, you will not have to pay the penalty if you can show that the failure to comply with this requirement was due to reasonable cause and not willful neglect. The maximum penalty under this provision is \$100,000 for each tax shelter in each calendar year.

**Special rule for projected income investment.** If you are an investor who later transfers an interest in a projected income investment, described earlier, you are not required to maintain a list of investors unless the tax shelter was no longer a projected income investment, or otherwise became subject to the registration requirements, before the transfer.

## Penalties

Investing in an abusive tax shelter may be an expensive proposition when you consider all of the consequences. First, the promoter generally charges a substantial fee. If your return is examined by the IRS and a tax deficiency is determined, you will be faced with payment of more tax, interest on the underpayment, possibly a 20% accuracy-related penalty, or a 75% civil fraud penalty. You may also be subject to the penalty for failure to pay tax. These penalties are explained in the following paragraphs.

**Accuracy-related penalties.** An accuracy-related penalty of 20% can be imposed for underpayments of tax due to:

- 1) Negligence or disregard of rules or regulations,
- 2) Substantial understatement of tax, or
- 3) Substantial valuation misstatement.

This penalty will not be imposed if you can show that you had reasonable cause for any understatement of tax and that you acted in good faith.

If you are charged an accuracy-related penalty, interest will be imposed on the amount of the penalty from the due date of the return (including extensions) to the date you pay the penalty.

**Negligence or disregard of rules or regulations.** The penalty for negligence or disregard of rules or regulations is imposed only on the part of the underpayment that is due to negligence or disregard of rules or regulations. The penalty will not be charged if you can show that you had reasonable cause for understating your tax and that you acted in good faith.

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code.

Disregard includes any careless, reckless, or intentional disregard. The penalty for disregard of rules and regulations can be avoided if both of the following are true.

- You have a reasonable basis for your position on the tax issue.
- You make an adequate disclosure of your position.

Use **Form 8275** to make your disclosure, and attach it to your tax return. To disclose a position contrary to a regulation, use **Form 8275-R**.

**Substantial understatement of tax.** An understatement is considered to be substantial if it is more than the greater of:

- 1) 10% of the tax required to be shown on the return, or
- 2) \$5,000.

An "understatement" is the amount of tax required to be shown on your return for a tax year minus the amount of tax shown on the return, reduced by any rebates. The term "rebate" generally means a decrease in the tax shown on your original return as the result of your filing an amended return or claim for refund.

Two special rules apply in the case of an understatement due to a tax shelter.

- 1) An understatement of tax does not include any tax due to a tax shelter item (such as an item of income, gain, loss, deduction, or credit) if you had substantial authority for

the tax treatment of the item and reasonably believed that the tax treatment chosen was more likely than not the proper one.

- 2) Disclosure of the tax shelter item on a tax return does not reduce the amount of the understatement.

For other than tax shelters, you can file Form 8275 or Form 8275-R to disclose items that could cause a substantial understatement of income tax. In that way, you can avoid the substantial understatement penalty if you have a reasonable basis for your position on the tax issue.

Also, the understatement penalty will not be imposed if you can show that there was reasonable cause for the underpayment caused by the understatement and that you acted in good faith. An important factor in establishing reasonable cause and good faith will be the extent of your effort to determine your proper tax liability under the law.

**Valuation misstatement.** In general, you are liable for a 20% penalty for a substantial valuation misstatement if all of the following are true.

- 1) The value or adjusted basis of any property claimed on the return is 200% or more of the correct amount.
- 2) You underpaid your tax by more than \$5,000 because of the misstatement.
- 3) You cannot establish that you had reasonable cause for the underpayment and that you acted in good faith.

You may be assessed a penalty of 40% for a **gross valuation misstatement**. If you misstate the value or the adjusted basis of property by 400% or more of the amount determined to be correct, you will be assessed a penalty of 40%, instead of 20%, of the amount you underpaid because of the gross valuation misstatement. The penalty rate is also 40% if the property's correct value or adjusted basis is zero.

**Civil fraud penalty.** If there is any underpayment of tax on your return due to fraud, a penalty of 75% of the underpayment will be added to your tax.

**Joint return.** The fraud penalty on a joint return applies to a spouse only if some part of the underpayment is due to the fraud of that spouse.

**Failure to pay tax.** If a deficiency is assessed and is not paid within 10 days of the demand for payment, an investor can be penalized with up to a 25% addition to tax if the failure to pay continues.

## Whether To Invest

In light of the adverse tax consequences and the substantial amount of penalties and interest that will result if the claimed tax benefits are disallowed, you should consider tax shelter investments carefully and seek competent legal and financial advice.

# 3.

## Investment Expenses

### Terms you may need to know (see Glossary):

At-risk rules  
Passive activity  
Portfolio income

### Topics

This chapter discusses:

- Limits on deductions,
- Interest expenses,
- Bond premium amortization,
- Expenses of producing income,
- Nondeductible expenses, and
- How to report investment expenses.

### Useful Items

You may want to see:

#### Publication

- 535** Business Expenses
- 925** Passive Activity and At-Risk Rules
- 929** Tax Rules for Children and Dependents
- 936** Home Mortgage Interest Deduction

#### Form (and Instructions)

- Schedule A (Form 1040)** Itemized Deductions
- 4952** Investment Interest Expense Deduction

See chapter 5 for information about getting these publications and forms.

## Limits on Deductions

Your deductions for investment expenses may be limited by:

- The at-risk rules,
- The passive activity loss limits,
- The limit on investment interest, or
- The 2% limit on certain miscellaneous itemized deductions.

The at-risk rules and passive activity rules are explained briefly in this section. The limit on investment interest is explained later in this

chapter under *Interest Expenses*. The 2% limit is explained later in this chapter under *Expenses of Producing Income*.

**At-risk rules.** Special at-risk rules apply to most income-producing activities. These rules limit the amount of loss you can deduct to the amount you risk losing in the activity. Generally, this is the amount of cash and the adjusted basis of property you contribute to the activity. It also includes money you borrow for use in the activity if you are personally liable for repayment or if you use property not used in the activity as security for the loan. For more information, see Publication 925.

**Passive activity losses and credits.** The amount of losses and tax credits you can claim from passive activities is limited. Generally, you are allowed to deduct passive activity losses only up to the amount of your passive activity income. Also, you can use credits from passive activities only against tax on the income from passive activities. There are exceptions for certain activities, such as rental real estate activities.

**Passive activity.** A passive activity generally is any activity involving the conduct of any trade or business in which you do not materially participate and any rental activity. However, if you are involved in renting real estate, the activity is not a passive activity if both of the following are true.

- 1) More than one-half of the personal services you perform during the year in all trades or businesses are performed in real property trades or businesses in which you materially participate.
- 2) You perform more than 750 hours of services during the year in real property trades or businesses in which you materially participate.

The term **trade or business** generally means any activity that involves the conduct of a trade or business, is conducted in anticipation of starting a trade or business, or involves certain research or experimental expenditures. However, it does not include rental activities or certain activities treated as incidental to holding property for investment.

You are considered to materially participate in an activity if you are involved on a regular, continuous, and substantial basis in the operations of the activity.

**Other income (nonpassive income).** Generally, you can use losses from passive activities only to offset income from passive activities. You generally cannot use passive activity losses to offset your other income, such as your wages or your portfolio income. **Portfolio income** includes gross income from interest, dividends, annuities, or royalties that is not derived in the ordinary course of a trade or business. It also includes gains or losses (not derived in the ordinary course of a trade or business) from the sale or trade of property (other than an interest in a passive activity) producing portfolio income or held for investment. This includes capital gain distributions from mutual funds and real estate investment trusts.

You cannot use passive activity losses to offset Alaska Permanent Fund dividends.

**Expenses.** Do not include in the computation of your passive activity income or loss:

- 1) Expenses (other than interest) that are clearly and directly allocable to your portfolio income, or
- 2) Interest expense properly allocable to portfolio income.

However, this interest and other expenses may be subject to other limits. These limits are explained in the rest of this chapter.

**Additional information.** For more information about determining and reporting income and losses from passive activities, see Publication 925.

## Interest Expenses

This section discusses interest expenses you may be able to deduct as an investor.

For information on business interest, see chapter 5 of Publication 535.

You cannot deduct personal interest expenses other than qualified home mortgage interest, as explained in Publication 936, and interest on certain student loans, as explained in Publication 970, *Tax Benefits for Higher Education*.

### Investment Interest

If you borrow money to buy property you hold for investment, the interest you pay is investment interest. You can deduct investment interest subject to the limit discussed later. However, you cannot deduct interest you incurred to produce tax-exempt income. See *Tax-exempt income* under *Nondeductible Expenses*, later. Nor can you deduct interest expenses on straddles, also discussed under *Nondeductible Expenses*.

Investment interest does not include any qualified home mortgage interest or any interest taken into account in computing income or loss from a passive activity.

**Investment property.** Property held for investment includes property that produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business. It also includes property that produces gain or loss (not derived in the ordinary course of a trade or business) from the sale or trade of property producing these types of income or held for investment (other than an interest in a passive activity). Investment property also includes an interest in a trade or business activity in which you did not materially participate (other than a passive activity).

**Partners, shareholders, and beneficiaries.** To determine your investment interest, combine your share of investment interest from a partnership, S corporation, estate, or trust with your other investment interest.

### Allocation of Interest Expense

If you borrow money for business or personal purposes as well as for investment, you must allocate the debt among those purposes. Only the interest expense on the part of the debt used for investment purposes is treated as invest-

ment interest. The allocation is not affected by the use of property that secures the debt.

**Example 1.** You borrow \$10,000 and use \$8,000 to buy stock. You use the other \$2,000 to buy items for your home. Since 80% of the debt is used for, and allocated to, investment purposes, 80% of the interest on that debt is investment interest. The other 20% is nondeductible personal interest.

**Debt proceeds received in cash.** If you receive debt proceeds in cash, the proceeds are generally not treated as investment property.

**Debt proceeds deposited in account.** If you deposit debt proceeds in an account, that deposit is treated as investment property, regardless of whether the account bears interest. But, if you withdraw the funds and use them for another purpose, you must reallocate the debt to determine the amount considered to be for investment purposes.

**Example 2.** Assume in *Example 1* that you borrowed the money on March 1 and immediately bought the stock for \$8,000. You did not buy the household items until June 1. You had deposited the \$2,000 in the bank. You had no other transactions on the bank account and made no principal payments on the debt. The \$2,000 is treated as being used for an investment purpose for the 3-month period. Your total interest expense for 3 months on this debt is investment interest. In June, you must begin to allocate 80% of the debt and the interest expense to investment purposes and 20% to personal purposes.

**Amounts paid within 30 days.** If you receive loan proceeds in cash or if the loan proceeds are deposited in an account, you can treat any payment (up to the amount of the proceeds) made from any account you own, or from cash, as made from those proceeds. This applies to any payment made within **30 days** before or after the proceeds are received in cash or deposited in your account.

If you received the loan proceeds in cash, you can treat the payment as made on the date you received the cash instead of the date you actually made the payment.

**Payments on debt may require new allocation.** As you repay a debt used for more than one purpose, you must reallocate the balance. You must first reduce the amount allocated to personal purposes by the repayment. You then reallocate the rest of the debt to find what part is for investment purposes.

**Example 3.** If, in *Example 2*, you repay \$500 on November 1, the entire repayment is applied against the amount allocated to personal purposes. The debt balance is now allocated as \$8,000 for investment purposes, and \$1,500 for personal purposes. Until the next reallocation is necessary, 84% ( $\$8,000 \div \$9,500$ ) of the debt and the interest expense is allocated to investment.

**Pass-through entities.** If you use borrowed funds to buy an interest in a partnership or S corporation, then the interest on those funds must be allocated based on the assets of the entity. If you contribute to the capital of the

entity, you can make the allocation using any reasonable method.

**Additional allocation rules.** For more information about allocating interest expense, see chapter 5 of Publication 535.

## When To Deduct Investment Interest

If you use the cash method of accounting, you must pay the interest before you can deduct it.

If you use an accrual method of accounting, you can deduct interest over the period it accrues, regardless of when you pay it. For an exception, see *Unpaid expenses owed to related party* under *When To Report Investment Expenses*, later in this chapter.

**Example.** You borrowed \$1,000 on September 6, 2001, payable in 90 days at 12% interest. On December 5, 2001, you paid this with a new note for \$1,030, due on March 5, 2002. If you use the cash method of accounting, you cannot deduct any part of the \$30 interest on your return for 2001 because you did not actually pay it. If you use an accrual method, you may be able to deduct a portion of the interest on the loans through December 31, 2001, on your return for 2001.

**Interest paid in advance.** Generally, if you pay interest in advance for a period that goes beyond the end of the tax year, you must spread the interest over the tax years to which it belongs under the OID rules. You can deduct in each year only the interest for that year.

**Interest on margin accounts.** If you are a cash method taxpayer, you can deduct interest on margin accounts to buy taxable securities as investment interest in the year you paid it. You are considered to have paid interest on these accounts only when you actually pay the broker or when payment becomes available to the broker through your account. Payment may become available to the broker through your account when the broker collects dividends or interest for your account, or sells securities held for you or received from you.

You cannot deduct any interest on money borrowed for personal reasons.

**Deferral of interest deduction for market discount bonds.** The amount you can deduct for interest expense you paid or accrued during the year to buy or carry a market discount bond may be limited. This limit does not apply if you accrue the market discount and include it in your income currently.

Under this limit, the interest is deductible only to the extent it is more than:

- 1) The total interest and OID includible in gross income for the bond for the year, plus
- 2) The market discount for the number of days you held the bond during the year.

Figure the amount in (2) above using the rules for figuring accrued market discount in chapter 1 under *Market Discount Bonds*.

**Disallowed interest expense.** In the year you dispose of the bond, you can deduct the amount of any interest expense you were not allowed to deduct in earlier years.

## Choosing to deduct disallowed interest expense before the year of disposition.

You can choose to deduct disallowed interest expense in any year before the year you dispose of the bond, up to your net interest income from the bond during the year. The rest of the disallowed interest expense remains deductible in the year you dispose of the bond.

**Net interest income.** This is the interest income (including OID) from the bond that you include in income for the year, minus the interest expense paid or accrued during the year to purchase or carry the bond.

**Deferral of interest deduction for short-term obligations.** If the current income inclusion rules discussed in chapter 1 under *Discount on Short-Term Obligations* do not apply to you, the amount you can deduct for interest expense you paid or accrued during the year to buy or carry a short-term obligation is limited.

The interest is deductible only to the extent it is more than:

- 1) The amount of acquisition discount or OID on the obligation for the tax year, plus
- 2) The amount of any interest payable on the obligation for the year that is not included in income because of your accounting method (other than interest taken into account in determining the amount of acquisition discount or OID).

The method of determining acquisition discount and OID for short-term obligations is discussed in chapter 1 under *Discount on Short-Term Obligations*.

**Disallowed interest expense.** In the year you dispose of the obligation, or if you choose, in another year in which you have net interest income from the obligation, you can deduct the amount of any interest expense you were not allowed to deduct for an earlier year. Follow the same rules provided in the earlier discussion under *Deferral of interest deduction for market discount bonds*.

## Limit on Deduction

Generally, your deduction for investment interest expense is limited to the amount of your **net investment income**.

You can carry over the amount of investment interest that you could not deduct because of this limit to the next tax year. The interest carried over is treated as investment interest paid or accrued in that next year.

You can carry over disallowed investment interest to the next tax year even if it is more than your taxable income in the year the interest was paid or accrued.

## Net Investment Income

Determine the amount of your net investment income by subtracting your investment expenses (other than interest expense) from your investment income.

**Investment income.** This generally includes your gross income from property held for investment (such as interest, dividends, annuities, and royalties). Investment income does not include Alaska Permanent Fund dividends.

**Choosing to include net capital gain.** Investment income generally does not include net capital gain from disposing of investment property (including capital gain distributions from mutual funds). However, you can choose to include all or part of your net capital gain in investment income.

You make this choice by completing line 4e of Form 4952 according to its instructions.

If you choose to include any amount of your net capital gain in investment income, you must reduce your net capital gain that is eligible for the lower capital gains tax rates by the same amount.

For more information about the capital gains rates, see *Capital Gain Tax Rates* in chapter 4.



*Before making this choice, consider the overall effect on your tax liability. Compare your tax if you make this choice with your tax if you do not.*

**Investment income of child reported on parent's return.** Investment income includes the part of your child's interest and dividend income that you choose to report on your return. If the child does not have Alaska Permanent Fund dividends or capital gain distributions, this is the amount on line 6 of **Form 8814, Parents' Election To Report Child's Interest and Dividends**. Include it on line 4a of Form 4952.

**Example.** Your 8-year-old son has interest income of \$2,000, which you choose to report on your own return. You enter \$2,000 on lines 1a and 4 of Form 8814 and \$500 on line 6 of Form 8814 and line 21 of Form 1040. Your investment income includes this \$500.

**Child's Alaska Permanent Fund dividends.** If part of the amount you report is your child's Alaska Permanent Fund dividends, that part does not count as investment income. To figure the amount of your child's income that you can consider your investment income, start with the amount on line 6 of Form 8814. Multiply that amount by a percentage that is equal to the Alaska Permanent Fund dividends divided by the total amount of interest and dividend income on lines 1a and 2 of Form 8814. Subtract the result from the amount on line 6 of Form 8814.

**Example.** Your 10-year-old child has taxable interest income of \$4,000 and Alaska Permanent Fund dividends of \$2,000. You choose to report this on your return. You enter \$4,000 on line 1a of Form 8814, \$2,000 on line 2, and \$6,000 on line 4. You then enter \$4,500 on line 6 of Form 8814 and line 21 of Form 1040. You figure the amount of your child's income that you can consider your investment income as follows:

$$\$4,500 - (\$4,500 \times (\$2,000 \div \$6,000)) = \$3,000$$

You include this \$3,000 on line 4a of Form 4952.

**Child's capital gain distributions.** If part of the amount you report is your child's capital gain distributions, that part (which is reported on line 13 of Schedule D or line 13 of Form 1040) generally does not count as investment income. However, you can choose to include all or part of it in investment income, as explained in *Choosing to include net capital gain*, earlier.

Your investment income also includes the amount on line 6 of Form 8814 (or, if applicable,

the amount figured under *Child's Alaska Permanent Fund dividends*, earlier).

**Investment expenses.** Investment expenses include all income-producing expenses (other than interest expense) relating to investment property that are allowable deductions after applying the 2% limit that applies to miscellaneous itemized deductions. Use the smaller of:

- 1) The investment expenses included on line 22 of Schedule A (Form 1040), or
- 2) The amount on line 26 of Schedule A.

See *Expenses of Producing Income*, later, for a discussion of the 2% limit.

**Losses from passive activities.** Income or expenses that you used in computing income or loss from a passive activity are not included in determining your investment income or investment expenses (including investment interest expense). See Publication 925 for information about passive activities.

**Example.** Ted is a partner in a partnership that operates a business. However, he does not materially participate in the partnership's business. Ted's interest in the partnership is considered a passive activity.

Ted's investment income from interest and dividends is \$10,000. His investment expenses (other than interest) are \$3,200 after taking into account the 2% limit on miscellaneous itemized deductions. His investment interest expense is \$8,000. Ted also has income from the partnership of \$2,000.

Ted figures his net investment income and the limit on his investment interest expense deduction in the following way:

Total investment income	\$10,000
Minus: Investment expenses (other than interest)	3,200
Net investment income	<u>\$6,800</u>

Deductible investment interest expense for the year	<u>\$6,800</u>
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The \$2,000 of income from the passive activity is not used in determining Ted's net investment income. His investment interest deduction for the year is limited to \$6,800, the amount of his net investment income.

## Form 4952

Use Form 4952, *Investment Interest Expense Deduction*, to figure your deduction for investment interest.

**Example.** Jane Smith is single. Her 2001 income includes \$3,000 in dividends and a net capital gain of \$9,000 from the sale of investment property. She incurred \$12,500 of investment interest expense. Her other investment expenses directly connected with the production of investment income total \$980 after applying the 2% limit on miscellaneous itemized deductions on Schedule A (Form 1040).

For 2001, Jane chooses to include all of her net capital gain in investment income. Her total investment income is \$12,000 (\$3,000 dividends + \$9,000 net capital gain). Her net investment income is \$11,020 (\$12,000 total

investment income – \$980 other investment expenses).

Jane's Form 4952 is illustrated at the end of the chapter. Her investment interest expense deduction is limited to \$11,020, the amount of her net investment income. The \$1,480 disallowed investment interest expense is carried forward to 2002.

**Exception to use of Form 4952.** You do not have to complete Form 4952 or attach it to your return if you meet all of the following tests.

- Your investment interest expense is not more than your investment income from interest and ordinary dividends.
- You do not have any other deductible investment expenses.
- You have no carryover of investment interest expense from 2000.

If you meet all of these tests, you can deduct all of your investment interest.

## Bond Premium Amortization

If you pay a premium to buy a bond, the premium is part of your basis in the bond. If the bond yields taxable interest, you can choose to amortize the premium. This generally means that each year, over the life of the bond, you use a part of the premium to reduce the amount of interest includible in your income. If you make this choice, you must reduce your basis in the bond by the amortization for the year.

If the bond yields tax-exempt interest, you must amortize the premium. This amortized amount is not deductible in determining taxable income. However, each year you must reduce your basis in the bond by the amortization for the year.

**Bond premium.** Bond premium is the amount by which your basis in the bond right after you get it is more than the total of all amounts payable on the bond after you get it (other than payments of qualified stated interest). For example, a bond with a maturity value of \$1,000 generally would have a \$50 premium if you buy it for \$1,050.

**Basis.** In general, your basis for figuring bond premium amortization is the same as your basis for figuring any loss on the sale of the bond. However, you may need to use a different basis for convertible bonds, bonds you got in a trade, and bonds whose basis has to be determined using the basis of the person who transferred the bond to you. See section 1.171-1(e) of the regulations.

**Dealers.** A dealer in taxable bonds (or anyone who holds them mainly for sale to customers in the ordinary course of a trade or business or who would properly include bonds in inventory at the close of the tax year) cannot claim a deduction for amortizable bond premium.

See section 75 of the Internal Revenue Code for the treatment of bond premium by a dealer in tax-exempt bonds.

## How To Figure Amortization

For bonds issued after September 27, 1985, you must amortize bond premium using a constant yield method on the basis of the bond's yield to maturity, determined by using the bond's basis and compounding at the close of each accrual period.

**Constant yield method.** Figure the bond premium amortization for each accrual period as follows.

**Step 1: determine your yield.** Your yield is the discount rate that, when used in figuring the present value of all remaining payments to be made on the bond (including payments of qualified stated interest), produces an amount equal to your basis in the bond. Figure the yield as of the date you got the bond. It must be constant over the term of the bond and must be figured to at least two decimal places when expressed as a percentage.

If you do not know the yield, consult your broker or tax advisor.

**Step 2: determine the accrual periods.** You can choose the accrual periods to use. They may be of any length and may vary in length over the term of the bond, but each accrual period can be no longer than 1 year and each scheduled payment of principal or interest must occur either on the first or the final day of an accrual period. The computation is simplest if accrual periods are the same as the intervals between interest payment dates.

**Step 3: determine the bond premium for the accrual period.** To do this, multiply your adjusted acquisition price at the beginning of the accrual period by your yield. Then subtract the result from the qualified stated interest for the period.

Your adjusted acquisition price at the beginning of the first accrual period is the same as your basis. After that, it is your basis decreased by the amount of bond premium amortized for earlier periods and the amount of any payment previously made on the bond other than a payment of qualified stated interest.

**Example.** On February 1, 2000, you bought a taxable bond for \$110,000. The bond has a stated principal amount of \$100,000, payable at maturity on February 1, 2007, making your premium \$10,000 (\$110,000 – \$100,000). The bond pays qualified stated interest of \$10,000 on February 1 of each year. Your yield is 8.0745% compounded annually. You choose to use annual accrual periods ending on February 1 of each year. To find your bond premium amortization for the accrual period ending on February 1, 2001, you multiply the adjusted acquisition price at the beginning of the period (\$110,000) by your yield. When you subtract the result (\$8,882) from the qualified stated interest for the period (\$10,000), you find that your bond premium amortization for the period is \$1,118.

**Special rules.** For special rules that apply to variable rate bonds, inflation-indexed bonds, and bonds that provide for alternative payment schedules or remote or incidental contingencies, see section 1.171–3 of the regulations.

## Bonds Issued Before September 28, 1985

For these bonds, you can amortize bond premium using any reasonable method. Reasonable methods include:

- 1) The straight-line method, and
- 2) The Revenue Ruling 82–10 method.

**Straight-line method.** Under this method, the amount of your bond premium amortization is the same each month. Divide the number of months you held the bond during the year by the number of months from the beginning of the tax year (or, if later, the date of acquisition) to the date of maturity or earlier call date. Then multiply the result by the bond premium (reduced by any bond premium amortization claimed in earlier years). This gives you your bond premium amortization for the year.

**Revenue Ruling 82–10 method.** Under this method, the amount of your bond premium amortization increases each month over the life of the bond. This method is explained in Revenue Ruling 82–10.

## Choosing To Amortize

You choose to amortize the premium on taxable bonds by reporting the amortization for the year on your income tax return for the first tax year for which you want the choice to apply. You should attach a statement to your return that you are making this choice under section 171. See *How To Report Amortization*, next.

This choice is binding for the year you make it and for later tax years. It applies to all taxable bonds you own in the year you make the choice and also to those you acquire in later years.

You can change your decision to amortize bond premium only with the written approval of the IRS. To request approval, use Form 3115, *Application for Change in Accounting Method*.

## How To Report Amortization

Subtract the bond premium amortization from your interest income from these bonds.

Report the bond's interest on line 1 of Schedule B (Form 1040). Several lines above line 2, put a subtotal of all interest listed on line 2, put a subtotal of all interest listed on line 2, below this subtotal, print "ABP Adjustment," and the amortization amount. Subtract this amount from the subtotal, and enter the result on line 2.

**Bond premium amortization more than interest.** If the amount of your bond premium amortization for an accrual period is more than the qualified stated interest for the period, you can deduct the difference as a miscellaneous itemized deduction on line 27 of Schedule A (Form 1040).

But your deduction is limited to the amount by which your total interest inclusions on the bond in prior accrual periods is more than your total bond premium deductions on the bond in prior periods. Any amount you cannot deduct because of this limit can be carried forward to the next accrual period.

**Pre-1998 election to amortize bond premium.** Generally, if you first elected to amortize bond premium before 1998, the above treatment of

the premium does not apply to bonds you acquired before 1988.

**Bonds acquired before October 23, 1986.** The amortization of the premium on these bonds is a miscellaneous itemized deduction not subject to the 2%-of-adjusted-gross-income limit.

**Bonds acquired after October 22, 1986, but before 1988.** The amortization of the premium on these bonds is investment interest expense subject to the investment interest limit, unless you choose to treat it as an offset to interest income on the bond.

## Expenses of Producing Income

You deduct investment expenses (other than interest expenses) as **miscellaneous itemized deductions** on Schedule A (Form 1040). To be deductible, these expenses must be ordinary and necessary expenses paid or incurred:

- 1) To produce or collect income, or
- 2) To manage property held for producing income.

The expenses must be directly related to the income or income-producing property, and the income must be taxable to you.

The deduction for most income-producing expenses is subject to a **2% limit** that also applies to certain other miscellaneous itemized deductions. The amount deductible is limited to the total of these miscellaneous deductions that is more than 2% of your adjusted gross income.

For information on how to report expenses of producing income, see *How To Report Investment Expenses*, later.

**Attorney or accounting fees.** You can deduct attorney or accounting fees that are necessary to produce or collect taxable income. However, in some cases, attorney or accounting fees are part of the basis of property. See *Basis of Investment Property* in chapter 4.

**Automatic investment service and dividend reinvestment plans.** A bank may offer its checking account customers an automatic investment service so that, for a charge, each customer can choose to invest a part of the checking account each month in common stock. Or, a bank that is a dividend disbursing agent for a number of publicly-owned corporations may set up an automatic dividend reinvestment service. Through that service, cash dividends are reinvested in more shares of stock, after the bank deducts a service charge.

A corporation in which you own stock also may have a dividend reinvestment plan. This plan lets you choose to use your dividends to buy more shares of stock in the corporation instead of receiving the dividends in cash.

You can deduct the monthly service charge you pay to a bank to participate in an automatic investment service. If you participate in a dividend reinvestment plan, you can deduct any service charge subtracted from your cash dividends before the dividends are used to buy more shares of stock. Deduct the charges in the year you pay them.



**Clerical help and office rent.** You can deduct office expenses, such as rent and clerical help, that you pay in connection with your investments and collecting the taxable income on them.

**Cost of replacing missing securities.** To replace your taxable securities that are mislaid, lost, stolen, or destroyed, you may have to post an indemnity bond. You can deduct the premium you pay to buy the indemnity bond and the related incidental expenses.

You may, however, get a refund of part of the bond premium if the missing securities are recovered within a specified time. Under certain types of insurance policies, you can recover some of the expenses.

If you receive the refund in the tax year you pay the amounts, you can deduct only the difference between the expenses paid and the amount refunded. If the refund is made in a later tax year, you must include the refund in income in the year you received it, but only to the extent that the expenses decreased your tax in the year you deducted them.

**Fees to collect income.** You can deduct fees you pay to a broker, bank, trustee, or similar agent to collect investment income, such as your taxable bond or mortgage interest, or your dividends on shares of stock.

**Fees to buy or sell.** You cannot deduct a fee you pay to a broker to acquire investment property, such as stocks or bonds. You must add the fee to the cost of the property. See *Basis of Investment Property* in chapter 4.

You cannot deduct any broker's fees, commissions, or option premiums you pay (or that were netted out) in connection with the sale of investment property. They can be used only to figure gain or loss from the sale. See *Reporting Capital Gains and Losses*, in chapter 4, for more information about the treatment of these sale expenses.

**Investment counsel and advice.** You can deduct fees you pay for counsel and advice about investments that produce taxable income. This includes amounts you pay for investment advisory services.

**Safe deposit box rent.** You can deduct rent you pay for a safe deposit box if you use the box to store taxable income-producing stocks, bonds, or other investment-related papers and documents. If you also use the box to store tax-exempt securities or personal items, you can deduct only part of the rent. See *Tax-exempt income* under *Nondeductible Expenses*, later, to figure what part you can deduct.

**State and local transfer taxes.** You cannot deduct the state and local transfer taxes you pay when you buy or sell securities. If you pay these transfer taxes when you buy securities, you must treat them as part of the cost of the property. If you pay these transfer taxes when you sell securities, you must treat them as a reduction in the amount realized.

**Trustee's commissions for revocable trust.** If you set up a revocable trust and have its income distributed to you, you can deduct the commission you pay the trustee for managing the trust to the extent it is to produce or collect taxable income or to manage property. However, you cannot deduct any part of the commission that is for producing or collecting

tax-exempt income or for managing property that produces tax-exempt income.

If you are a cash-basis taxpayer and pay the commissions for several years in advance, you must deduct a part of the commission each year. You cannot deduct the entire amount in the year you pay it.

**Investment expenses from pass-through entities.** If you hold an interest in a partnership, S corporation, real estate mortgage investment conduit (REMIC), or a nonpublicly offered regulated investment company (mutual fund), you can deduct your share of that entity's investment expenses. A partnership or S corporation will show your share of these expenses on your Schedule K-1. A nonpublicly offered mutual fund will indicate your share of these expenses in box 5 of Form 1099-DIV, or on an equivalent statement. Publicly-offered mutual funds are discussed later.

If you hold an interest in a REMIC, any expenses relating to your residual interest investment will be shown on line 3b of **Schedule Q (Form 1066)**. Any expenses relating to your regular interest investment will appear in box 5 of Form 1099-INT or box 7 of Form 1099-OID.

Report your share of these investment expenses on Schedule A (Form 1040), subject to the 2% limit, in the same manner as your other investment expenses.

**Including mutual fund or REMIC expenses in income.** Your share of the investment expenses of a REMIC or a nonpublicly offered mutual fund, as described above, are considered to be indirect deductions through that pass-through entity. You must include in your gross income an amount equal to the amount of the expenses allocated to you, whether or not you are able to claim a deduction for those expenses. If you are a shareholder in a nonpublicly offered mutual fund, you must include on your return the full amount of ordinary dividends or other distributions of stock, as shown in box 1 of Form 1099-DIV or an equivalent statement. If you are a residual interest holder in a REMIC, you must report as ordinary income on Schedule E (Form 1040) the total amounts shown on lines 1b and 3b of Schedule Q (Form 1066). If you are a REMIC regular interest holder, you must include the amount of any expense allocation you received on line 8a of Form 1040.

**Publicly-offered mutual funds.** Publicly-offered mutual funds, generally, are funds that are traded on an established securities exchange. These funds do not pass investment expenses through to you. Instead, the dividend income they report to you in box 1 of Form 1099-DIV is already reduced by your share of investment expenses. Therefore, you cannot deduct the expenses on your return.

Include the amount from box 1 of Form 1099-DIV in your income.

## Nondeductible Expenses

Some expenses that you incur as an investor are not deductible.

**Stockholders' meetings.** You cannot deduct transportation and other expenses that you pay

to attend stockholders' meetings of companies in which you have no interest other than owning stock. This is true even if your purpose in attending is to get information that would be useful in making further investments.

**Investment-related seminar.** You cannot deduct expenses for attending a convention, seminar, or similar meeting for investment purposes.

**Single-premium life insurance, endowment, and annuity contracts.** You cannot deduct interest on money you borrow to buy or carry a single-premium life insurance, endowment, or annuity contract.

**Used as collateral.** If you use a single premium annuity contract as collateral to obtain or continue a mortgage loan, you cannot deduct any interest on the loan that is collateralized by the annuity contract. Figure the amount of interest expense disallowed by multiplying the current interest rate on the mortgage loan by the lesser of the amount of the annuity contract used as collateral or the amount of the loan.

**Borrowing on insurance.** Generally, you cannot deduct interest on money you borrow to buy or carry a life insurance, endowment, or annuity contract if you plan to systematically borrow part or all of the increases in the cash value of the contract. This rule applies to the interest on the total amount borrowed to buy or carry the contract, not just the interest on the borrowed increases in the cash value.

**Tax-exempt income.** You cannot deduct expenses you incur to produce tax-exempt income. Nor can you deduct interest on money you borrow to buy tax-exempt securities or shares in a regulated investment company (mutual fund) that distributes only exempt-interest dividends.

**Short-sale expenses.** The rule disallowing a deduction for interest expenses on tax-exempt securities applies to amounts you pay in connection with personal property used in a short sale or amounts paid by others for the use of any collateral in connection with the short sale. However, it does not apply to the expenses you incur if you deposit cash as collateral for the property used in the short sale and the cash does not earn a material return during the period of the sale. Short sales are discussed in chapter 4.

**Expenses for both tax-exempt and taxable income.** You may have expenses that are for both tax-exempt and taxable income. If you cannot specifically identify what part of the expenses is for each type of income, you can divide the expenses, using reasonable proportions based on facts and circumstances. You must attach a statement to your return showing how you divided the expenses and stating that each deduction claimed is not based on tax-exempt income.

One accepted method for dividing expenses is to do it in the same proportion that each type of income is to the total income. If the expenses relate in part to capital gains and losses, include the gains, but not the losses, in figuring this proportion. To find the part of the expenses that is for the tax-exempt income, divide your tax-exempt income by the total income and multiply your expenses by the result.

**Example.** You received \$6,000 interest; \$4,800 was tax-exempt and \$1,200 was taxable. In earning this income, you had \$500 of expenses. You cannot specifically identify the amount of each expense item that is for each income item, so you must divide your expenses. 80% (\$4,800 tax-exempt interest divided by \$6,000 total interest) of your expenses is for the tax-exempt income. You cannot deduct \$400 (80% of \$500) of the expenses. You can deduct \$100 (the rest of the expenses) because they are for the taxable interest.

**State income taxes.** If you itemize your deductions, you can deduct, as taxes, state income taxes on interest income that is exempt from federal income tax. But you cannot deduct, as either taxes or investment expenses, state income taxes on other exempt income.

**Interest expense and carrying charges on straddles.** You cannot deduct interest and carrying charges that are allocable to personal property that is part of a straddle. The nondeductible interest and carrying charges are added to the basis of the straddle property. However, this treatment does not apply if:

- 1) All the offsetting positions making up the straddle either consist of one or more qualified covered call options and the optioned stock or consist of section 1256 contracts (and the straddle is not part of a larger straddle), or
- 2) The straddle is a hedging transaction.

For information about straddles, including definitions of the terms used in this discussion, see chapter 4.

Interest includes any amount you pay or incur in connection with personal property used in a short sale. However, you must first apply the rules discussed in *Short Sale Expenses* under *Short Sales* in chapter 4.

To determine the interest on market discount bonds and short-term obligations that are part of a straddle, you must first apply the rules discussed under *Deferral of interest deduction for market discount bonds* and *Deferral of interest deduction for short-term obligations* (both under *Interest Expenses*, earlier).

**Nondeductible amount.** Figure the nondeductible amount of interest and carrying charges on straddle property as follows.

- 1) Add:

- a) Interest on indebtedness incurred or continued to buy or carry the personal property, and
  - b) All other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property.
- 2) Subtract from the amount in (1):
- a) Interest (including OID) includible in gross income for the year on the personal property,
  - b) Any income from the personal property treated as ordinary income on the disposition of short-term government obligations or as ordinary income under the market discount and short-term bond provisions — see *Discount on Debt Instruments* in chapter 1,
  - c) The dividends includible in gross income for the year from the personal property, and
  - d) Any payment on a loan of the personal property for use in a short sale that is includible in gross income.

**Basis adjustment.** Add the nondeductible amount to the basis of your straddle property.

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## How To Report Investment Expenses

To deduct your investment expenses, you must itemize deductions on Schedule A (Form 1040). Enter your deductible investment interest expense on line 13, Schedule A. Include any deductible short sale expenses. (See *Short Sales* in chapter 4 for information on these expenses.) Also attach a completed Form 4952 if you used that form to figure your investment interest expense.

Enter the total amount of your other investment expenses (other than interest expenses) on line 22, Schedule A. List the type and amount of each expense on the dotted lines next to line 22. (If necessary, you can show the required information on an attached statement.) Include

the total on line 23 with your other miscellaneous deductions that are subject to the 2% limit.

For information on how to report amortizable bond premium, see *Bond Premium Amortization*, earlier in this chapter.

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## When To Report Investment Expenses

If you use the cash method to report income and expenses, you generally deduct your expenses, except for certain prepaid interest, in the year you pay them.

If you use an accrual method, you generally deduct your expenses when you incur a liability for them, rather than when you pay them.

Also see *When To Deduct Investment Interest*, earlier in this chapter.

**Unpaid expenses owed to related party.** If you use an accrual method, you cannot deduct interest and other expenses owed to a related cash-basis person until payment is made and the amount is includible in the gross income of that person. The relationship, for purposes of this rule, is determined as of the end of the tax year for which the interest or expense would otherwise be deductible. If a deduction is denied under this rule, this rule will continue to apply even if your relationship with the person ceases to exist before the amount is includible in the gross income of that person.

This rule generally applies to those relationships listed in chapter 4 under *Related Party Transactions*. It also applies to accruals by partnerships to partners, partners to partnerships, shareholders to S corporations, and S corporations to shareholders.

The postponement of deductions for unpaid expenses and interest under the related party rule does not apply to original issue discount (OID), regardless of when payment is made. This rule also does not apply to loans with below-market interest rates or to certain payments for the use of property and services when the lender or recipient has to include payments periodically in income, even if a payment has not been made.

## Investment Interest Expense Deduction

▶ Attach to your tax return.

Name(s) shown on return

*Jane Smith*

Identifying number  
111-00-1111

### Part I Total Investment Interest Expense

1 Investment interest expense paid or accrued in 2001. See instructions . . . . .	<b>1</b>	12,500	
2 Disallowed investment interest expense from 2000 Form 4952, line 7. . . . .	<b>2</b>	0	
<b>3 Total investment interest expense.</b> Add lines 1 and 2 . . . . .	<b>3</b>	12,500	

### Part II Net Investment Income

4a Gross income from property held for investment (excluding any net gain from the disposition of property held for investment) . . . . .				<b>4a</b>	3,000	
b Net gain from the disposition of property held for investment . . . . .	<b>4b</b>	9,000				
c Net capital gain from the disposition of property held for investment . . . . .	<b>4c</b>	9,000				
d Subtract line 4c from line 4b. If zero or less, enter -0-. . . . .				<b>4d</b>	0	
e Enter the amount from line 4c that you elect to include in investment income. Do not enter more than the amount on line 4b. See instructions. ▶ . . . . .				<b>4e</b>	9,000	
f Investment income. Add lines 4a, 4d, and 4e. See instructions. . . . .				<b>4f</b>	12,000	
5 Investment expenses. See instructions. . . . .				<b>5</b>	980	
<b>6 Net investment income.</b> Subtract line 5 from line 4f. If zero or less, enter -0-. . . . .				<b>6</b>	11,020	

### Part III Investment Interest Expense Deduction

7 Disallowed investment interest expense to be carried forward to 2002. Subtract line 6 from line 3. If zero or less, enter -0- . . . . .	<b>7</b>	1,480	
<b>8 Investment interest expense deduction.</b> Enter the <b>smaller</b> of line 3 or 6. See instructions . . . . .	<b>8</b>	11,020	

## 4.

# Sales and Trades of Investment Property

## Introduction

This chapter explains the tax treatment of sales and trades of investment property.

**Investment property.** This is property that produces investment income. Examples include stocks, bonds, and Treasury bills and notes. Property used in a trade or business is not investment property.

**Form 1099-B.** If you sold property such as stocks, bonds, or certain commodities through a broker during the year, you should receive, for each sale, a Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*, or an equivalent statement from the broker. You should receive the statement by January 31 of the next year. It will show the gross proceeds from the sale. The IRS will also get a copy of Form 1099-B from the broker.

Use Form 1099-B (or an equivalent statement received from your broker) to complete Schedule D of Form 1040. For more information, see *Form 1099-B transactions* under *Reporting Capital Gains and Losses*, later.

**Other property transactions.** Certain transfers of property are discussed in other IRS publications. These include:

- Sale of your main home, discussed in Publication 523, *Selling Your Home*,
- Installment sales, covered in Publication 537, *Installment Sales*,
- Various types of transactions involving business property, discussed in Publication 544, *Sales and Other Dispositions of Assets*,
- Transfers of property at death, covered in Publication 559, *Survivors, Executors, and Administrators*, and
- Disposition of an interest in a passive activity, discussed in Publication 925, *Passive Activity and At-Risk Rules*.

## Topics

This chapter discusses:

- What a sale or trade is,
- Basis,
- Adjusted basis,
- Figuring gain or loss,
- Nontaxable trades,

- Capital gains and losses, and
- How to report your gain or loss.

## Useful Items

You may want to see:

### Publication

- **551** Basis of Assets
- **564** Mutual Fund Distributions

### Form (and Instructions)

- **Schedule D (Form 1040)** Capital Gains and Losses
- **6781** Gains and Losses From Section 1256 Contracts and Straddles
- **8582** Passive Activity Loss Limitations
- **8824** Like-Kind Exchanges

See chapter 5 for information about getting these publications and forms.

## What Is a Sale or Trade?

### Terms you may need to know (see Glossary):

Equity option  
Futures contract  
Marked to market  
Nonequity option  
Options dealer  
Regulated futures contract  
Section 1256 contract  
Short sale

This section explains what is a sale or trade. It also explains certain transactions and events that are treated as sales or trades.

A sale is generally a transfer of property for money or a mortgage, note, or other promise to pay money. A trade is a transfer of property for other property or services, and may be taxed in the same way as a sale.

**Sale and purchase.** Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. The sale and purchase are two separate transactions. But see *Like-Kind Exchanges* under *Nontaxable Trades*, later.

**Redemption of stock.** A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

**Dividend versus sale or trade.** Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

- 1) The redemption is not essentially equivalent to a dividend — see *Dividends and Other Corporate Distributions* in chapter 1,
- 2) There is a substantially disproportionate redemption of stock,
- 3) There is a complete redemption of all the stock of the corporation owned by the shareholder, or
- 4) The redemption is a distribution in partial liquidation of a corporation.

**Redemption or retirement of bonds.** A redemption or retirement of bonds or notes at their maturity generally is treated as a sale or trade. See *Stocks, stock rights, and bonds* and *Discounted Debt Instruments* under *Capital or Ordinary Gain or Loss*, later.

In addition, a significant modification of a bond is treated as a trade of the original bond for a new bond. For details, see section 1.1001-3 of the regulations.

**Surrender of stock.** A surrender of stock by a dominant shareholder who retains control of the corporation is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

**Trade of investment property for an annuity.** The transfer of investment property to a corporation, trust, fund, foundation, or other organization, in exchange for a fixed annuity contract that will make guaranteed annual payments to you for life, is a taxable trade. If the present value of the annuity is more than your basis in the property traded, you have a taxable gain in the year of the trade. Figure the present value of the annuity according to factors used by commercial insurance companies issuing annuities.

**Transfer by inheritance.** The transfer of property of a decedent to the executor or administrator of the estate, or to the heirs or beneficiaries, is not a sale or other disposition. No taxable gain or deductible loss results from the transfer.

**Termination of certain rights and obligations.** The cancellation, lapse, expiration, or other termination of a right or obligation with respect to property that is a capital asset (or that would be a capital asset if you acquired it) is treated as a sale. Any gain or loss is treated as a capital gain or loss.

This rule does not apply to the retirement of a debt instrument. See *Redemption or retirement of bonds*, earlier.

## Worthless Securities

Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that became worthless during the tax year are treated as though they were sold on the last day of the tax year. This affects whether your capital loss is long-term or short-term. See *Holding Period*, later.

If you are a cash basis taxpayer and make payments on a negotiable promissory note that you issued for stock that became worthless, you can deduct these payments as losses in the years you actually make the payments. Do not

deduct them in the year the stock became worthless.

**How to report loss.** Report worthless securities on line 1 or line 8 of Schedule D (Form 1040), whichever applies. In columns (c) and (d), print "Worthless." Enter the amount of your loss in parentheses in column (f).

**Filing a claim for refund.** If you do not claim a loss for a worthless security on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the loss. You must use Form 1040X, *Amended U.S. Individual Income Tax Return*, to amend your return for the year the security became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. (Claims not due to worthless securities or bad debts generally must be filed within 3 years from the date a return is filed, or 2 years from the date the tax is paid.) For more information about filing a claim, see Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

## Constructive Sales of Appreciated Financial Positions

You are treated as having made a constructive sale when you enter into certain transactions involving an appreciated financial position (defined later) in stock, a partnership interest, or certain debt instruments. You must recognize gain as if the position were disposed of at its fair market value on the date of the constructive sale. This gives you a new holding period for the position that begins on the date of the constructive sale. Then, when you close the transaction, you reduce your gain (or increase your loss) by the gain recognized on the constructive sale.

**Constructive sale.** You are treated as having made a constructive sale of an appreciated financial position if you:

- 1) Enter into a short sale of the same or substantially identical property,
- 2) Enter into an offsetting notional principal contract relating to the same or substantially identical property,
- 3) Enter into a futures or forward contract to deliver the same or substantially identical property (including a forward contract that provides for cash settlement), or
- 4) Acquire the same or substantially identical property (if the appreciated financial position is a short sale, an offsetting notional principal contract, or a futures or forward contract).

You are also treated as having made a constructive sale of an appreciated financial position if a person related to you enters into a transaction described above with a view toward avoiding the constructive sale treatment. For this purpose, a related person is any related party described under *Related Party Transactions*, later in this chapter.

**Exception for nonmarketable securities.** A contract for sale of any stock, debt instrument, or partnership interest that is not a marketable

security is not a constructive sale if it settles within 1 year of the date you enter into it.

**Exception for certain closed transactions.** Do not treat a transaction as a constructive sale if all of the following are true.

- 1) You closed the transaction before the end of the 30th day after the end of your tax year.
- 2) You held the appreciated financial position throughout the 60-day period beginning on the date you closed the transaction.
- 3) Your risk of loss was not reduced at any time during that 60-day period by holding certain other positions.

If a closed transaction is reestablished in a substantially similar position during the 60-day period beginning on the date the first transaction was closed, this exception still applies if the reestablished position is closed before the end of the 30th day after the end of your tax year in which the first transaction was closed and, after that closing, (2) and (3) above are true.

**Appreciated financial position.** This is any interest in stock, a partnership interest, or a debt instrument (including a futures or forward contract, a short sale, or an option) if disposing of the interest would result in a gain.

**Exceptions.** An appreciated financial position does not include the following.

- 1) Any position from which all of the appreciation is accounted for under marked to market rules, including section 1256 contracts (described later under *Section 1256 Contracts Marked to Market*).
- 2) Any position in a debt instrument if:
  - a) The position unconditionally entitles the holder to receive a specified principal amount,
  - b) The interest payments (or other similar amounts) with respect to the position are payable at a fixed rate or a variable rate described in section 1.860G-1(a)(3) of the regulations, and
  - c) The position is not convertible, either directly or indirectly, into stock of the issuer (or any related person).
- 3) Any hedge with respect to a position described in (2).

**Certain trust instruments treated as stock.** For the constructive sale rules, an interest in an actively traded trust is treated as stock unless substantially all of the value of the property held by the trust is debt that qualifies for the exception to the definition of an appreciated financial position (explained in (2) above).

**Sale of appreciated financial position.** A transaction treated as a constructive sale of an appreciated financial position is not treated as a constructive sale of any other appreciated financial position, as long as you continue to hold the original position. However, if you hold another appreciated financial position and dispose of the original position before closing the transaction that resulted in the constructive sale, you are treated as if, at the same time, you construc-

tively sold the other appreciated financial position.

## Section 1256 Contracts Marked to Market

If you hold a section 1256 contract at the end of the tax year, you generally must treat it as sold at its fair market value on the last business day of the tax year.

### Section 1256 Contract

A section 1256 contract is any:

- 1) Regulated futures contract,
- 2) Foreign currency contract,
- 3) Nonequity option,
- 4) Dealer equity option, or
- 5) Dealer securities futures contract.

**Regulated futures contract.** This is a contract that:

- 1) Provides that amounts that must be deposited to, or can be withdrawn from, your margin account depend on daily market conditions (a system of marking to market), and
- 2) Is traded on, or subject to the rules of, a qualified board of exchange. A qualified board of exchange is a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, any board of trade or exchange approved by the Secretary of the Treasury, or a national securities exchange registered with the Securities and Exchange Commission.

**Foreign currency contract.** This is a contract that:

- 1) Requires delivery of a foreign currency that has positions traded through regulated futures contracts (or settlement of which depends on the value of that type of foreign currency),
- 2) Is traded in the interbank market, and
- 3) Is entered into at arm's length at a price determined by reference to the price in the interbank market.

Bank forward contracts with maturity dates that are longer than the maturities ordinarily available for regulated futures contracts are considered to meet the definition of a foreign currency contract if the above three conditions are satisfied.

Special rules apply to certain foreign currency transactions. These transactions may result in ordinary gain or loss treatment. For details, see Internal Revenue Code section 988 and regulations sections 1.988-1(a)(7) and 1.988-3.

**Nonequity option.** This is any listed option (defined later) that is not an equity option. Nonequity options include debt options, commodity futures options, currency options, and broad-based stock index options. A broad-based stock index is based upon the

value of a group of diversified stocks or securities (such as the Standard and Poor's 500 index).

Warrants based on a stock index that are economically, substantially identical in all material respects to options based on a stock index are treated as options based on a stock index.

**Cash-settled options.** Cash-settled options based on a stock index and either traded on or subject to the rules of a qualified board of exchange are nonequity options if the Securities and Exchange Commission (SEC) determines that the stock index is broad based.

This rule does not apply to options established before the SEC determines that the stock index is broad based.

**Listed option.** This is any option that is traded on, or subject to the rules of, a qualified board or exchange (as discussed earlier under *Regulated futures contract*). A listed option, however, does not include an option that is a right to acquire stock from the issuer.

**Dealer equity option.** This is any listed option that, for an options dealer:

- 1) Is an equity option,
- 2) Is bought or granted by that dealer in the normal course of the dealer's business activity of dealing in options, and
- 3) Is listed on the qualified board of exchange where that dealer is registered.

An **options dealer** is any person registered with an appropriate national securities exchange as a market maker or specialist in listed options.

**Equity option.** This is any option:

- 1) To buy or sell stock, or
- 2) That is valued directly or indirectly by reference to any stock or narrow-based security index.

Equity options include options on a group of stocks only if the group is a narrow-based stock index.

**Dealer securities futures contract.** For any dealer in securities futures contracts or options on those contracts, this is a securities futures contract (or option on such a contract) that:

- 1) Is entered into by the dealer (or, in the case of an option, is purchased or granted by the dealer) in the normal course of the dealer's activity of dealing in this type of contract (or option), and
- 2) Is traded on a qualified board or exchange (as defined under *Regulated futures contract*, earlier).

A securities futures contract that is not a dealer securities futures contract is treated as described later under *Securities Futures Contracts*.

## Marked to Market Rules

A section 1256 contract that you hold at the end of the tax year will generally be treated as sold at its fair market value on the last business day of the tax year, and you must recognize any gain or loss that results. That gain or loss is taken into

account in figuring your gain or loss when you later dispose of the contract, as shown in the example under *60/40 rule*, below.

**Hedging exception.** The marked to market rules do not apply to hedging transactions. See *Hedging Transactions*, later.

**60/40 rule.** Under the marked to market system, 60% of your capital gain or loss will be treated as a long-term capital gain or loss, and 40% will be treated as a short-term capital gain or loss. This is true regardless of how long you actually held the property.

**Example.** On June 23, 2000, you bought a regulated futures contract for \$50,000. On December 31, 2000 (the last business day of your tax year), the fair market value of the contract was \$57,000. You recognized a \$7,000 gain on your 2000 tax return, treated as 60% long-term and 40% short-term capital gain.

On February 2, 2001, you sold the contract for \$56,000. Because you recognized a \$7,000 gain on your 2000 return, you recognize a \$1,000 loss (\$57,000 – \$56,000) on your 2001 tax return, treated as 60% long-term and 40% short-term capital loss.

**Limited partners or entrepreneurs.** The 60/40 rule does not apply to dealer equity options or dealer securities futures contracts that result in capital gain or loss allocable to limited partners or limited entrepreneurs (defined later under *Hedging Transactions*). Instead, these persons should treat all these gains or losses as short term under the marked to market system.

**Terminations and transfers.** The marked to market rules also apply if your obligation or rights under section 1256 contracts are terminated or transferred during the tax year. In this case, use the fair market value of each section 1256 contract at the time of termination or transfer to determine the gain or loss. Terminations or transfers may result from any offsetting, delivery, exercise, assignment, or lapse of your obligation or rights under section 1256 contracts.

**Loss carryback election.** An individual or partnership having a net section 1256 contracts loss (defined later) for 2001 can elect to carry this loss back 3 years, instead of carrying it over to the next year. See *How To Report*, later, for information about reporting this election on your return.

The loss carried back to any year under this election cannot be more than the net section 1256 contracts gain in that year. In addition, the amount of loss carried back to an earlier tax year cannot increase or produce a net operating loss for that year.

The loss is carried to the earliest carryback year first, and any unabsorbed loss amount can then be carried to each of the next 2 tax years. In each carryback year, treat 60% of the carryback amount as a long-term capital loss and 40% as a short-term capital loss from section 1256 contracts.

If only a portion of the net section 1256 contracts loss is absorbed by carrying the loss back, the unabsorbed portion can be carried forward, under the capital loss carryover rules, to the year following the loss. (See *Capital Losses under Reporting Capital Gains and Losses*, later.) Figure your capital loss carryover as if, for the loss year, you had an additional short-term capital

gain of 40% of the amount of net section 1256 contracts loss absorbed in the carryback years and an additional long-term capital gain of 60% of the absorbed loss. In the carryover year, treat any capital loss carryover from losses on section 1256 contracts as if it were a loss from section 1256 contracts for that year.

**Net section 1256 contracts loss.** This loss is the lesser of:

- 1) The net capital loss for your tax year determined by taking into account only the gains and losses from section 1256 contracts, or
- 2) The capital loss carryover to the next tax year determined without this election.

**Net section 1256 contracts gain.** This gain is the lesser of:

- 1) The capital gain net income for the carryback year determined by taking into account only gains and losses from section 1256 contracts, or
- 2) The capital gain net income for that year.

Figure your net section 1256 contracts gain for any carryback year without regard to the net section 1256 contracts loss for the loss year or any later tax year.

**Traders in section 1256 contracts.** Gain or loss from the trading of section 1256 contracts is capital gain or loss subject to the marked to market rules. However, this does not apply to contracts held for purposes of hedging property if any loss from the property would be an ordinary loss.

**Treatment of underlying property.** The determination of whether an individual's gain or loss from any property is ordinary or capital gain or loss is made without regard to the fact that the individual is actively engaged in dealing in or trading section 1256 contracts related to that property.

## How To Report

If you disposed of regulated futures or foreign currency contracts in 2001 (or had unrealized profit or loss on these contracts that were open at the end of 2000 or 2001), you should receive Form 1099-B, or an equivalent statement, from your broker.

**Form 6781.** Use Part I of Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles*, to report your gains and losses from all section 1256 contracts that are open at the end of the year or that were closed out during the year. This includes the amount shown in box 9 of Form 1099-B. Then enter the net amount of these gains and losses on Schedule D (Form 1040). Include a copy of Form 6781 with your income tax return.

If the Form 1099-B you receive includes a straddle or hedging transaction, defined later, it may be necessary to show certain adjustments on Form 6781. Follow the Form 6781 instructions for completing Part I.

**Loss carryback election.** To carry back your loss under the election procedures described earlier, file Form 1040X or appropriate amended

return for the year to which you are carrying the loss with an amended Form 6781 attached. Follow the instructions for completing Form 6781 for the loss year to make this election.

## Hedging Transactions

The marked to market rules, described earlier, do not apply to hedging transactions. A transaction is a hedging transaction if both of the following conditions are met.

- 1) You entered into the transaction in the normal course of your trade or business primarily to manage the risk of:
  - a) Price changes or currency fluctuations on ordinary property you hold (or will hold), or
  - b) Interest rate or price changes, or currency fluctuations, on your current or future borrowings or ordinary obligations.
- 2) You clearly identified the transaction as being a hedging transaction before the close of the day on which you entered into it.

This hedging transaction exception does not apply to transactions entered into by or for any syndicate. A **syndicate** is a partnership, S corporation, or other entity (other than a regular corporation) that allocates more than 35% of its losses to limited partners or limited entrepreneurs. A **limited entrepreneur** is a person who has an interest in an enterprise (but not as a limited partner) and who does not actively participate in its management. However, an interest is not considered held by a limited partner or entrepreneur if the interest holder actively participates (or did so for at least 5 full years) in the management of the entity, or is the spouse, child (including a legally adopted child), grandchild, or parent of an individual who actively participates in the management of the entity.

**Hedging loss limit.** If you are a limited partner or entrepreneur in a syndicate, the amount of a hedging loss you can claim is limited. A “hedging loss” is the amount by which the allowable deductions in a tax year that resulted from a hedging transaction (determined without regard to the limit) are more than the income received or accrued during the tax year from this transaction.

Any hedging loss that is allocated to you for the tax year is limited to your taxable income for that year from the trade or business in which the hedging transaction occurred. Ignore any hedging transaction items in determining this taxable income. If you have a hedging loss that is disallowed because of this limit, you can carry it over to the next tax year as a deduction resulting from a hedging transaction.

If the hedging transaction relates to property other than stock or securities, the limit on hedging losses applies if the limited partner or entrepreneur is an individual.

The limit on hedging losses does not apply to any hedging loss to the extent that it is more than all your unrecognized gains from hedging transactions at the end of the tax year that are from the trade or business in which the hedging

transaction occurred. The term “unrecognized gain” has the same meaning as defined under *Straddles*, later.

**Sale of property used in a hedge.** Once you identify personal property as being part of a hedging transaction, you must treat gain from its sale or exchange as ordinary income, not capital gain.

## Self-Employment Income

Gains and losses derived in the ordinary course of a commodity or option dealer’s trading in section 1256 contracts and property related to these contracts are included in net earnings from self-employment. In addition, the rules relating to contributions to self-employment retirement plans apply. For information on retirement plan contributions, see chapter 3 of Publication 535, *Business Expenses*, Publication 560, *Retirement Plans for Small Business*, and Publication 590, *Individual Retirement Arrangements (IRAs)*.

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## Basis of Investment Property

### Terms you may need to know (see Glossary):

Basis

Fair market value

Original issue discount (OID)

Basis is a way of measuring your investment in property for tax purposes. You must know the basis of your property to determine whether you have a gain or loss on its sale or other disposition.

Investment property you buy normally has an original basis equal to its cost. If you get property in some way other than buying it, such as by gift or inheritance, its fair market value may be important in figuring the basis.

### Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations, or other property or services.

**Unstated interest.** If you buy property under a deferred-payment plan that charges little or no interest, you may have to treat part of the purchase price as interest. You must subtract this amount, if any, from your cost to find your basis. For more information, see *Unstated Interest* in Publication 537.

### Basis Other Than Cost

There are times when you must use a basis other than cost. In these cases, you may need to know the property’s fair market value or the adjusted basis of the previous owner.

**Fair market value.** This is the price at which the property would change hands between a

buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts. Sales of similar property, around the same date, may be helpful in figuring fair market value.

## Property Received for Services

If you receive investment property for services, you must include the property’s fair market value in income. The amount you include in income then becomes your basis in the property. If the services were performed for a price that was agreed to beforehand, this price will be accepted as the fair market value of the property if there is no evidence to the contrary.

**Restricted property.** If you receive, as payment for services, property that is subject to certain restrictions, your basis in the property generally is its fair market value when it becomes substantially vested. Property becomes substantially vested when it is transferable or is no longer subject to substantial risk of forfeiture, whichever happens first. See *Restricted Property* in Publication 525 for more information.

**Bargain purchases.** If you buy investment property at less than fair market value, as payment for services, you must include the difference in income. Your basis in the property is the price you pay plus the amount you include in income.

## Property Received in Taxable Trades

If you received investment property in trade for other property, the basis of the new property is its fair market value at the time of the trade unless you received the property in a nontaxable trade.

**Example.** You trade A Company stock for B Company stock having a fair market value of \$1,200. If the adjusted basis of the A Company stock is less than \$1,200, you have a taxable gain on the trade. If the adjusted basis of the A company stock is more than \$1,200, you have a deductible loss on the trade. The basis of your B Company stock is \$1,200. If you later sell the B Company stock for \$1,300, you will have a gain of \$100.

## Property Received in Nontaxable Trades

If you have a nontaxable trade, you do not recognize gain or loss until you dispose of the property you received in the trade. See *Nontaxable Trades*, later.

The basis of property you received in a nontaxable or partly nontaxable trade is generally the same as the adjusted basis of the property you gave up. Increase this amount by any cash you paid, additional costs you had, and any gain recognized. Reduce this amount by any cash or unlike property you received, any loss recognized, and any liability of yours that was assumed or treated as assumed.

## Property Received From Your Spouse

If property is transferred to you from your spouse (or former spouse, if the transfer is incident to your divorce), your basis is the same as your spouse's or former spouse's adjusted basis just before the transfer. See *Transfers Between Spouses*, later.



**Recordkeeping.** The transferor must give you the records necessary to determine the adjusted basis and holding period of the property as of the date of the transfer.

## Property Received as a Gift

To figure your basis in property that you received as a gift, you must know its adjusted basis to the donor just before it was given to you, its fair market value at the time it was given to you, the amount of any gift tax paid on it, and the date it was given to you.

**Fair market value less than donor's adjusted basis.** If the fair market value of the property at the time of the gift was less than the donor's adjusted basis just before the gift, your basis for **gain** on its sale or other disposition is the same as the donor's adjusted basis plus or minus any required adjustments to basis during the period you hold the property. Your basis for **loss** is its fair market value at the time of the gift plus or minus any required adjustments to basis during the period you hold the property.

**No gain or loss.** If you use the basis for figuring a gain and the result is a loss, and then use the basis for figuring a loss and the result is a gain, you will have neither a gain nor a loss.

**Example.** You receive a gift of investment property having an adjusted basis of \$10,000 at the time of the gift. The fair market value at the time of the gift is \$9,000. You later sell the property for \$9,500. You have neither gain nor loss. Your basis for figuring gain is \$10,000, and \$10,000 minus \$9,500 results in a \$500 loss. Your basis for figuring loss is \$9,000, and \$9,500 minus \$9,000 results in a \$500 gain.

**Fair market value equal to or more than donor's adjusted basis.** If the fair market value of the property at the time of the gift was equal to or more than the donor's adjusted basis just before the gift, your basis for **gain or loss** on its sale or other disposition is the donor's adjusted basis plus or minus any required adjustments to basis during the period you hold the property. Also, you may be allowed to add to the donor's adjusted basis all or part of any gift tax paid, depending on the date of the gift.

**Gift received before 1977.** If you received property as a gift before 1977, your basis in the property is the donor's adjusted basis increased by the total gift tax paid on the gift. However, your basis cannot be more than the fair market value of the gift at the time it was given to you.

**Example 1.** You were given XYZ Company stock in 1976. At the time of the gift, the stock had a fair market value of \$21,000. The donor's adjusted basis was \$20,000. The donor paid a gift tax of \$500 on the gift. Your basis for gain or

loss is \$20,500, the donor's adjusted basis plus the amount of gift tax paid.

**Example 2.** The facts are the same as in Example 1 except that the gift tax paid was \$1,500. Your basis is \$21,000, the donor's adjusted basis plus the gift tax paid, but limited to the fair market value of the stock at the time of the gift.

**Gift received after 1976.** If you received property as a gift after 1976, your basis is the donor's adjusted basis increased by the part of the gift tax paid that was for the net increase in value of the gift. You figure this part by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) is the net increase in value of the gift and the denominator (bottom part) is the amount of the gift.

The net increase in value of the gift is the fair market value of the gift minus the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift.

**Example.** In 2001, you received a gift of property from your mother. At the time of the gift, the property had a fair market value of \$100,000 and an adjusted basis to her of \$40,000. The amount of the gift for gift tax purposes was \$90,000 (\$100,000 minus the \$10,000 annual exclusion), and your mother paid a gift tax of \$21,000. You figure your basis in the following way:

Fair market value . . . . .	\$100,000
Minus: Adjusted basis . . . . .	40,000
Net increase in value of gift . . . . .	<u>\$ 60,000</u>
Gift tax paid . . . . .	\$ 21,000
Multiplied by .667 (\$60,000 ÷ \$90,000)	.667
Gift tax due to net increase in value . .	<u>\$ 14,007</u>
Plus: Adjusted basis of property to your mother . . . . .	40,000
<b>Your basis in the property</b>	<u><b>\$ 54,007</b></u>

**Part sale, part gift.** If you get property in a transfer that is partly a sale and partly a gift, your basis is the larger of the amount you paid for the property or the transferor's adjusted basis in the property at the time of the transfer. Add to that amount the amount of any gift tax paid on the gift, as described in the preceding discussion. For figuring loss, your basis is limited to the property's fair market value at the time of the transfer.

**Gift tax information.** For information on gift tax, see Publication 950, *Introduction to Estate and Gift Taxes*.

## Property Received as Inheritance

If you inherited property, your basis in that property generally is its fair market value (its appraised value on the federal estate tax return) on:

- 1) The date of the decedent's death, or
- 2) The later alternate valuation date if the estate qualifies for, and elects to use, alternate valuation.

If no federal estate tax return was filed, use the appraised value on the date of death for state inheritance or transmission taxes.

**Appreciated property you gave the decedent.** Your basis in certain appreciated property that you inherited is the decedent's adjusted basis in the property immediately before death rather than its fair market value. This applies to appreciated property that you or your spouse gave the decedent as a gift during the one-year period ending on the date of death. Appreciated property is any property whose fair market value on the day you gave it to the decedent was more than its adjusted basis.

**More information.** See Publication 551, *Basis of Assets*, for more information on the basis of inherited property, including community property, a joint tenancy or tenancy by the entirety, a qualified joint interest, and a farm or business.

## Adjusted Basis

Before you can figure any gain or loss on a sale, exchange, or other disposition of property or figure allowable depreciation, depletion, or amortization, you usually must make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the **adjusted basis**.

Adjustments to the basis of stocks and bonds are explained in the following discussion. For information about other adjustments to basis, see Publication 551.

## Stocks and Bonds

The basis of stocks or bonds you own generally is the purchase price plus the costs of purchase, such as commissions and recording or transfer fees. If you acquired stock or bonds other than by purchase, your basis is usually determined by fair market value or the previous owner's adjusted basis as discussed earlier under *Basis Other Than Cost*.

The basis of stock must be adjusted for certain events that occur after purchase. For example, if you receive more stock from nontaxable stock dividends or stock splits, you must reduce the basis of your original stock. You must also reduce your basis when you receive nontaxable distributions, because these are a return of capital.

**Identifying stock or bonds sold.** If you can adequately identify the shares of stock or the bonds you sold, their basis is the cost or other basis of the particular shares of stock or bonds.

**Identification not possible.** If you buy and sell securities at various times in varying quantities and you cannot adequately identify the shares you sell, the basis of the securities you sell is the basis of the securities you acquired first. Except for certain mutual fund shares, discussed later, you cannot use the average price per share to figure gain or loss on the sale of the shares.

**Example.** You bought 100 shares of stock of XYZ Corporation in 1988 for \$10 a share. In January 1989 you bought another 200 shares for \$11 a share. In July 1989 you gave your son 50 shares. In December 1991 you bought 100 shares for \$9 a share. In April 2001 you sold 130 shares. You cannot identify the shares you disposed of, so you must use the stock you acquired first to figure the basis. The shares of stock you gave your son had a basis of \$500 (50



× \$10). You figure the basis of the 130 shares of stock you sold in 2001 as follows:

50 shares (50 × \$10) balance of stock bought in 1988 . . . . .	\$ 500
80 shares (80 × \$11) stock bought in January 1989 . . . . .	880
<b>Total basis of stock sold in 2001</b>	<u>\$1,380</u>

**Adequate identification.** You will make an adequate identification if you show that certificates representing shares of stock from a lot that you bought on a certain date or for a certain price were delivered to your broker or other agent.

**Broker holds stock.** If you have left the stock certificates with your broker or other agent, you will make an adequate identification if you:

- 1) Tell your broker or other agent the particular stock to be sold or transferred at the time of the sale or transfer, and
- 2) Receive a written confirmation of this from your broker or other agent within a reasonable time.

**Single stock certificate.** If you bought stock in different lots at different times and you hold a single stock certificate for this stock, you will make an adequate identification if you:

- 1) Tell your broker or other agent the particular stock to be sold or transferred when you deliver the certificate to your broker or other agent, and
- 2) Receive a written confirmation of this from your broker or other agent within a reasonable time.

Stock identified this way is the stock sold or transferred even if stock certificates from a different lot are delivered to the broker or other agent.

If you sell part of the stock represented by a single certificate directly to the buyer instead of through a broker, you will make an adequate identification if you keep a written record of the particular stock that you intend to sell.

**Bonds.** These methods of identification also apply to bonds sold or transferred.

**Shares in a mutual fund or REIT.** The basis of shares in a regulated investment company (mutual fund) or a real estate investment trust (REIT) is generally figured in the same way as the basis of other stock.

**Mutual fund load charges.** Your cost basis in a mutual fund often includes a sales fee, also known as a load charge. But, in certain cases, you cannot include the entire amount of a load charge in your basis if the charge gives you a reinvestment right. For more information, see Publication 564.

**Choosing average basis for mutual fund shares.** You can choose to use the average basis of mutual fund shares if you acquired the shares at various times and prices and left them on deposit in an account kept by a custodian or agent. The methods you can use to figure average basis are explained in Publication 564.

**Undistributed capital gains.** If you had to include in your income any undistributed capital

gains of the mutual fund or REIT, increase your basis in the stock by the difference between the amount you included and the amount of tax paid for you by the fund or REIT. See *Undistributed capital gains of mutual funds and REITs* under *Capital Gain Distributions* in chapter 1.

**Automatic investment service.** If you participate in an automatic investment service, your basis for each share of stock, including fractional shares, bought by the bank or other agent is the purchase price plus a share of the broker's commission.

**Dividend reinvestment plans.** If you participate in a dividend reinvestment plan and receive stock from the corporation at a discount, your basis is the full fair market value of the stock on the dividend payment date. You must include the amount of the discount in your income.

**Public utilities.** If, before 1986, you excluded from income the value of stock you had received under a qualified public utility reinvestment plan, your basis in that stock is zero.

**Stock dividends.** Stock dividends are distributions made by a corporation of its own stock. Generally, stock dividends are not taxable to you. However, see *Distributions of Stock and Stock Rights* under *Nontaxable Distributions* in chapter 1 for some exceptions. If the stock dividends are not taxable, you must divide your basis for the old stock between the old and new stock.

**New and old stock identical.** If the new stock you received as a nontaxable dividend is identical to the old stock on which the dividend was declared, divide the adjusted basis of the old stock by the number of shares of old and new stock. The result is your basis for each share of stock.

**Example 1.** You owned one share of common stock that you bought for \$45. The corporation distributed two new shares of common stock for each share held. You then had three shares of common stock. Your basis in each share is \$15 ( $\$45 \div 3$ ).

**Example 2.** You owned two shares of common stock. You had bought one for \$30 and the other for \$45. The corporation distributed two new shares of common stock for each share held. You had six shares after the distribution—three with a basis of \$10 each ( $\$30 \div 3$ ) and three with a basis of \$15 each ( $\$45 \div 3$ ).

**New and old stock not identical.** If the new stock you received as a nontaxable dividend is not identical to the old stock on which it was declared, the basis of the new stock is calculated differently. Divide the adjusted basis of the old stock between the old and the new stock in the ratio of the fair market value of each lot of stock to the total fair market value of both lots on the date of distribution of the new stock.

**Example.** You bought a share of common stock for \$100. Later, the corporation distributed a share of preferred stock for each share of common stock held. At the date of distribution, your common stock had a fair market value of \$150 and the preferred stock had a fair market value of \$50. You figure the basis of the old and new stock by dividing your \$100 basis between

them. The basis of your common stock is \$75 ( $\$150/\$200 \times \$100$ ), and the basis of the new preferred stock is \$25 ( $\$50/\$200 \times \$100$ ).

**Stock bought at various times.** Figure the basis of stock dividends received on stock you bought at various times and at different prices by allocating to each lot of stock the share of the stock dividends due to it.

**Taxable stock dividends.** If your stock dividend is taxable when you receive it, the basis of your new stock is its fair market value on the date of distribution. The basis of your old stock does not change.

**Stock splits.** Figure the basis of stock splits in the same way as stock dividends if identical stock is distributed on the stock held.

**Stock rights.** A stock right is a right to acquire a corporation's stock. It may be exercised, it may be sold if it has a market value, or it may expire. Stock rights are rarely taxable when you receive them. See *Distributions of Stock and Stock Rights* under *Nontaxable Distributions* in chapter 1.

**Taxable stock rights.** If you receive stock rights that are taxable, the basis of the rights is their fair market value at the time of distribution. The basis of the old stock does not change.

**Nontaxable stock rights.** If you receive nontaxable stock rights and allow them to expire, they have no basis.

If you exercise or sell the nontaxable stock rights and if, at the time of distribution, the stock rights had a fair market value of 15% or more of the fair market value of the old stock, you must divide the adjusted basis of the old stock between the old stock and the stock rights. Use a ratio of the fair market value of each to the total fair market value of both at the time of distribution.

If the fair market value of the stock rights was less than 15%, their basis is zero. However, you can choose to divide the basis of the old stock between the old stock and the stock rights. To make the choice, attach a statement to your return for the year in which you received the rights, stating that you choose to divide the basis of the stock.

**Basis of new stock.** If you exercise the stock rights, the basis of the new stock is its cost plus the basis of the stock rights exercised.

**Example.** You own 100 shares of ABC Company stock, which cost you \$22 per share. The ABC Company gave you 10 nontaxable stock rights that would allow you to buy 10 more shares at \$26 per share. At the time the stock rights were distributed, the stock had a market value of \$30, not including the stock rights. Each stock right had a market value of \$3. The market value of the stock rights was less than 15% of the market value of the stock, but you chose to divide the basis of your stock between the stock and the rights. You figure the basis of the rights and the basis of the old stock as follows:

- 100 shares × \$22 = \$2,200, basis of old stock
- 100 shares × \$30 = \$3,000, market value of old stock
- 10 rights × \$3 = \$30, market value of rights

$(\$3,000 + \$3,030) \times \$2,200 = \$2,178.22$ , new basis of old stock

$(\$30 + \$3,030) \times \$2,200 = \$21.78$ , basis of rights

If you sell the rights, the basis for figuring gain or loss is \$2.18 ( $\$21.78 \div 10$ ) per right. If you exercise the rights, the basis of the stock you acquire is the price you pay (\$26) plus the basis of the right exercised (\$2.18), or \$28.18 per share. The remaining basis of the old stock is \$21.78 per share.

#### Investment property received in liquidation.

In general, if you receive investment property as a distribution in partial or complete liquidation of a corporation and if you recognize gain or loss when you acquire the property, your basis in the property is its fair market value at the time of the distribution.

**S corporation stock.** You must **increase** your basis in stock of an S corporation by your pro rata share of the following items.

- All income items of the S corporation, including tax-exempt income, that are separately stated and passed through to you as a shareholder.
- The nonseparately stated income of the S corporation.
- The amount of the deduction for depletion (other than oil and gas depletion) that is more than the basis of the property being depleted.

You must **decrease** your basis in stock of an S corporation by your pro rata share of the following items.

- Distributions by the S corporation that were not included in your income.
- All loss and deduction items of the S corporation that are separately stated and passed through to you.
- Any nonseparately stated loss of the S corporation.
- Any expense of the S corporation that is not deductible in figuring its taxable income and not properly chargeable to a capital account.
- The amount of your deduction for depletion of oil and gas wells to the extent the deduction is not more than your share of the adjusted basis of the wells.

However, your basis in the stock cannot be reduced below zero.

#### Specialized small business investment company stock or partnership interest.

If you bought this stock or interest as replacement property for publicly traded securities you sold at a gain, you must reduce the basis of the stock or interest by the amount of any postponed gain on that sale. See *Rollover of Gain From Publicly Traded Securities*, later.

**Qualified small business stock.** If you bought this stock as replacement property for other qualified small business stock you sold at a gain, you must reduce the basis of this replacement stock by the amount of any postponed gain on the earlier sale. See *Gains on Qualified Small Business Stock*, later.

**Short sales.** If you cannot deduct payments you make to a lender in lieu of dividends on stock used in a short sale, the amount you pay to the lender is a capital expense, and you must add it to the basis of the stock used to close the short sale.

See *Short Sale Expenses*, later, for information about deducting payments in lieu of dividends.

**Premiums on bonds.** If you buy a bond at a premium, the premium is treated as part of your basis in the bond. If you choose to amortize the premium paid on a taxable bond, you must reduce the basis of the bond by the amortized part of the premium each year over the life of the bond.

Although you cannot deduct the premium on a tax-exempt bond, you must amortize it to determine your adjusted basis in the bond. You must reduce the basis of the bond by the premium you amortized for the period you held the bond.

See *Bond Premium Amortization* in chapter 3 for more information.

**Market discount on bonds.** If you include market discount on a bond in income currently, increase the basis of your bond by the amount of market discount you include in your income. See *Market Discount Bonds* in chapter 1 for more information.

**Acquisition discount on short-term obligations.** If you include acquisition discount on a short-term obligation in your income currently, increase the basis of the obligation by the amount of acquisition discount you include in your income. See *Discount on Short-Term Obligations* in chapter 1 for more information.

**Original issue discount (OID) on debt instruments.** Increase the basis of a debt instrument by the amount of OID that you include in your income. See *Original Issue Discount (OID)* in chapter 1.

**Discounted tax-exempt obligations.** OID on tax-exempt obligations is generally not taxable. However, when you dispose of a tax-exempt obligation issued after September 3, 1982, that you acquired after March 1, 1984, you must accrue OID on the obligation to determine its adjusted basis. The accrued OID is added to the basis of the obligation to determine your gain or loss.

For information on determining OID on a long-term obligation, see *Debt Instruments Issued After July 1, 1982, and Before 1985* or *Debt Instruments Issued After 1984*, whichever applies, in Publication 1212 under *Figuring OID on Long-Term Debt Instruments*.

If the tax-exempt obligation has a maturity of 1 year or less, accrue OID under the rules for acquisition discount on **short-term obligations**. See *Discount on Short-Term Obligations* in chapter 1.

**Stripped tax-exempt obligation.** If you acquired a stripped tax-exempt bond or coupon after October 22, 1986, you must accrue OID on it to determine its adjusted basis when you dispose of it. For stripped tax-exempt bonds or coupons acquired after June 10, 1987, part of this OID may be taxable. You accrue the OID on these obligations in the manner described in chapter 1 under *Stripped Bonds and Coupons*.

Increase your basis in the stripped tax-exempt bond or coupon by the taxable and nontaxable accrued OID. Also increase your basis by the interest that accrued (but was not paid, and was not previously reflected in your basis) before the date you sold the bond or coupon. In addition, for bonds acquired after June 10, 1987, add to your basis any accrued market discount not previously reflected in basis.

## How To Figure Gain or Loss

You figure gain or loss on a sale or trade of property by comparing the amount you realize with the adjusted basis of the property.

**Gain.** If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain.

**Loss.** If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

**Amount realized.** The amount you realize from a sale or trade of property is everything you receive for the property. This includes the money you receive plus the fair market value of any property or services you receive.

If you finance the buyer's purchase of your property and the debt instrument does not provide for adequate stated interest, the unstated interest will reduce the amount realized. For more information, see Publication 537.

**Fair market value.** Fair market value is the price at which property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

The fair market value of notes or other debt instruments you receive as a part of the sale price is usually the best amount you can get from selling them to, or discounting them with, a bank or other buyer of debt instruments.

**Example.** You trade A Company stock with an adjusted basis of \$7,000 for B Company stock with a fair market value of \$10,000, which is your amount realized. Your gain is \$3,000 (\$10,000 minus \$7,000). If you also receive a note for \$6,000 that has a discount value of \$4,000, your gain is \$7,000 (\$10,000 plus \$4,000 minus \$7,000).

**Debt paid off.** A debt against the property, or against you, that is paid off as a part of the transaction or that is assumed by the buyer must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize generally includes the full amount of the note assumed by the buyer even if the amount of the note is more than the fair market value of the property.

**Example.** You sell stock that you had pledged as security for a bank loan of \$8,000. Your basis in the stock is \$6,000. The buyer pays off your bank loan and pays you \$20,000 in cash. The amount realized is \$28,000 (\$20,000

plus \$8,000). Your gain is \$22,000 (\$28,000 minus \$6,000).

**Payment of cash.** If you trade property and cash for other property, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting the cash you pay and the adjusted basis of the property you traded in from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

**No gain or loss.** You may have to use a basis for figuring gain that is different from the basis used for figuring loss. In this case, you may have neither a gain nor a loss. See *No gain or loss* in the discussion on the basis of property you received as a gift under *Basis Other Than Cost*, earlier.

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## Nontaxable Trades

This section discusses trades that generally do not result in a taxable gain or a deductible loss. For more information on nontaxable trades, see chapter 1 of Publication 544.

### Like-Kind Exchanges

If you trade business or investment property for other business or investment property of a like kind, you do not pay tax on any gain or deduct any loss until you sell or dispose of the property you receive. To be nontaxable, a trade must meet all six of the following conditions.

- 1) The property must be business or investment property. You must hold both the property you trade and the property you receive for productive use in your trade or business or for investment. Neither property may be property used for personal purposes, such as your home or family car.
- 2) The property must not be held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise.
- 3) The property must not be stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest, including partnership interests. However, you can have a nontaxable trade of corporate stocks under a different rule, as discussed later.
- 4) There must be a trade of like property. The trade of real estate for real estate, or personal property for similar personal property, is a trade of like property. The trade of an apartment house for a store building, or a panel truck for a pickup truck, is a trade of like property. The trade of a piece of machinery for a store building is not a trade of like property. Real property located in the United States and real property located outside the United States are not like property. Also, personal property used predominantly within the United States and personal property used

predominantly outside the United States are not like property.

- 5) The property to be received must be identified within 45 days after the date you transfer the property given up in the trade.
- 6) The property to be received must be received by the earlier of:
  - a) The 180th day after the date on which you transfer the property given up in the trade, or
  - b) The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

If you trade property with a related party in a like-kind exchange, a special rule may apply. See *Related Party Transactions*, later in this chapter. Also, see chapter 1 of Publication 544 for more information on exchanges of business property and special rules for exchanges using qualified intermediaries or involving multiple properties.

**Partly nontaxable exchange.** If you receive cash or unlike property in addition to the like property, and the preceding six conditions are met, you have a partly nontaxable trade. You are taxed on any gain you realize, but only up to the amount of the cash and the fair market value of the unlike property you receive. You cannot deduct a loss.

**Like property and unlike property transferred.** If you give up unlike property in addition to the like property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and its fair market value.

**Like property and money transferred.** If conditions (1) — (6) are met, you have a nontaxable trade even if you pay money in addition to the like property.

**Basis of property received.** You figure your basis in property received in a nontaxable or partly nontaxable trade as explained earlier under *Basis Other Than Cost*, earlier.

**How to report.** You must report the trade of like property on **Form 8824**. If you figure a recognized gain or loss on Form 8824, report it on Schedule D of Form 1040 or on **Form 4797, Sales of Business Property**, whichever applies.

For information on using Form 4797, see chapter 4 of Publication 544.

### Corporate Stocks

The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

**Corporate reorganizations.** In some instances, a company will give you common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation. If this is a result of a merger, recapitalization, transfer to a controlled corporation, bankruptcy, corporate division, corporate acquisition, or other corporate reorganization, you do not recognize gain or loss.

**Example.** On April 18, 2001, KP1 Corporation was acquired by KP2 Corporation. You held 100 shares of KP1 stock with a basis of \$3,500. As a result of the acquisition, you received 70 shares of KP2 stock in exchange for your KP1 stock. You do not recognize gain or loss on the transaction. Your basis in the 70 shares of the new stock is still \$3,500.

**Stock for stock of the same corporation.** You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two stockholders as well as a trade between a stockholder and the corporation.

**Money or other property received.** If in an otherwise nontaxable trade you receive money or other property in addition to stock, then your gain on the trade, if any, is taxed, but only up to the amount of the money or other property. Any loss is not recognized.

**Nonqualified preferred stock.** Nonqualified preferred stock is generally treated as property other than stock. Generally, this applies to preferred stock with one or more of the following features.

- The holder has the right to require the issuer or a related person to redeem or purchase the stock.
- The issuer or a related person is required to redeem or purchase the stock.
- The issuer or a related person has the right to redeem the stock, and on the issue date, it is more likely than not that the right will be exercised.
- The dividend rate on the stock varies with reference to interest rates, commodity prices, or similar indices.

For a detailed definition of nonqualified preferred stock, see section 351(g)(2) of the Internal Revenue Code.

**Convertible stocks and bonds.** You generally will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate.

**Example.** In November, you bought for \$1 a right issued by XYZ Corporation entitling you, on payment of \$99, to subscribe to a bond issued by that corporation.

On December 2, you subscribed to the bond, which was issued on December 9. The bond contained a clause stating that you would receive one share of XYZ Corporation common stock on surrender of one bond and the payment of \$50.

Later, you presented the bond and \$50 and received one share of XYZ Corporation common stock. You did not have a recognized gain or loss. This is true whether the fair market value of the stock was more or less than \$150 on the date of the conversion.

The basis of your share of stock is \$150 (\$1 + \$99 + \$50). Your holding period is split. Your holding period for the part based on your ownership of the bond (\$100 basis) begins on December 2. Your holding period for the part based on

your cash investment (\$50 basis) begins on the day after you acquired the share of stock.

**Bonds for stock of another corporation.** Generally, if you convert the bonds of one corporation into common stock of another corporation, according to the terms of the bond issue, you must recognize gain or loss up to the difference between the fair market value of the stock received and the adjusted basis of the bonds exchanged. In some instances, however, such as trades that are part of mergers or other corporate reorganizations, you will have no recognized gain or loss if certain requirements are met. For more information about the tax consequences of converting securities of one corporation into common stock of another corporation, under circumstances such as those just described, consult the respective corporations and the terms of the bond issue. This information is also available on the prospectus of the bond issue.

**Property for stock of a controlled corporation.** If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

If you are in a bankruptcy or a similar proceeding and you transfer property to a controlled corporation under a plan, other than a reorganization, you must recognize gain to the extent the stock you receive in the exchange is used to pay off your debts.

For this purpose, to be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of non-voting stock of the corporation.

If this provision applies to you, you must attach to your return a complete statement of all facts pertinent to the exchange.

**Money or other property received.** If, in an otherwise nontaxable trade of property for corporate stock, you also receive money or property other than stock, you may have a taxable gain. However, you are taxed only up to the amount of money plus the fair market value of the other property you receive. The rules for figuring taxable gain in this situation generally follow those for a partially nontaxable exchange discussed earlier under *Like-Kind Exchanges*. If the property you give up includes depreciable property, the taxable gain may have to be reported as ordinary income because of depreciation. (See chapter 3 of Publication 544.) No loss is recognized.

Nonqualified preferred stock (described earlier under *Stock for stock of the same corporation*) received is generally treated as property other than stock.

**Basis of stock or other property received.** The basis of the stock you receive is generally the adjusted basis of the property you transfer. Increase this amount by any amount that was treated as a dividend, plus any gain recognized on the trade. Decrease this amount by any cash you received and the fair market value of any other property you received.

The basis of any other property you receive is its fair market value on the date of the trade.

## Insurance Policies and Annuities

You will not have a recognized gain or loss if you trade:

- 1) A life insurance contract for another life insurance contract or for an endowment or annuity contract,
- 2) An endowment contract for an annuity contract or for another endowment contract that provides for regular payments beginning at a date not later than the beginning date under the old contract, or
- 3) An annuity contract for another annuity contract.

The insured or annuitant must be the same under both contracts. Exchanges of contracts not included in this list, such as an annuity contract for an endowment contract, or an annuity or endowment contract for a life insurance contract, are taxable.

## Demutualization of Life Insurance Companies

A life insurance company may change from a mutual company to a stock company. This is commonly called demutualization. If you were a policyholder or annuitant of the mutual company, you may have received either stock in the stock company or cash in exchange for your equity interest in the mutual company.

If the demutualization transaction qualifies as a tax-free reorganization under section 368(a)(1) of the Internal Revenue Code, no gain or loss is recognized on the exchange. Your holding period for the new stock includes the period you held an equity interest in the mutual company as a policyholder or annuitant.

If the demutualization transaction does not qualify as a tax-free reorganization under section 368(a)(1) of the Internal Revenue Code, you must recognize a capital gain or loss. Your holding period for the stock does not include the period you held an equity interest in the mutual company.

If you received cash in exchange for your equity interest, you must recognize a capital gain or loss. If you held an equity interest for more than 1 year, your gain or loss is long-term.

## U.S. Treasury Notes or Bonds

You can trade certain issues of U.S. Treasury obligations for other issues, designated by the Secretary of the Treasury, with no gain or loss recognized on the trade.

See the discussion in chapter 1 under *U.S. Treasury Bills, Notes, and Bonds* for information about income from these investments.

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## Transfers Between Spouses

Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse or, if incident to a divorce, a former spouse. This nonrecognition rule does not apply if the recipient spouse or former spouse is a nonresident alien. The rule also does not apply to a transfer in trust to the extent the adjusted basis of the property is less than the amount of the liabilities assumed plus any liabilities on the property.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the recipient as a gift and is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within 1 year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage. For more information, see *Property Settlements* in Publication 504, *Divorced or Separated Individuals*.

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## Related Party Transactions

Special rules apply to the sale or trade of property between related parties.

### Gain on Sale or Trade of Depreciable Property

Your gain from the sale or trade of property to a related party may be ordinary income, rather than capital gain, if the property can be depreciated by the party receiving it. See chapter 3 in Publication 544 for more information.

### Like-Kind Exchanges

Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. See *Like-Kind Exchanges*, earlier, under *Non-taxable Trades*.

This rule also applies to trades of property between related parties, defined next under *Losses on Sales or Trades of Property*. However, if either you or the related party disposes of the like property within 2 years after the trade, you both must report any gain or loss not recognized on the original trade on your return for the year in which the later disposition occurs.

This rule generally does not apply to:

- Dispositions due to the death of either related party,

- Involuntary conversions (see chapter 1 of Publication 544), or
- Trades and later dispositions whose main purpose is not the avoidance of federal income tax.

If a property holder's risk of loss on the property is substantially diminished during any period, that period is not counted in determining whether the property was disposed of within 2 years. The property holder's risk of loss is substantially diminished by:

- The holding of a put on the property,
- The holding by another person of a right to acquire the property, or
- A short sale or any other transaction.

## Losses on Sales or Trades of Property

You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following **related parties**.

- 1) Members of your family. This includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- 2) A partnership in which you directly or indirectly own more than 50% of the capital interest or the profits interest.
- 3) A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock (see *Constructive ownership of stock*, later).
- 4) A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between the following related parties.

- 1) A grantor and fiduciary, or the fiduciary and beneficiary, of any trust.
- 2) Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- 3) A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust.
- 4) A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership.
- 5) Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.

- 6) Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- 7) An executor and a beneficiary of an estate (except in the case of a sale or trade to satisfy a pecuniary bequest).
- 8) Two corporations that are members of the same controlled group (under certain conditions, however, these losses are not disallowed but must be deferred).
- 9) Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital interests or the profit interests in both partnerships.

**Multiple property sales or trades.** If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

**Indirect transactions.** You cannot deduct your loss on the sale of stock through your broker if, under a prearranged plan, a related party buys the same stock you had owned. This does not apply to a trade between related parties through an exchange that is purely coincidental and is not prearranged.

**Constructive ownership of stock.** In determining whether a person directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

**Rule 1.** Stock directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

**Rule 2.** An individual is considered to own the stock that is directly or indirectly owned by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

**Rule 3.** An individual owning, other than by applying rule 2, any stock in a corporation is considered to own the stock that is directly or indirectly owned by or for his or her partner.

**Rule 4.** When applying rule 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rule 2 or rule 3 is not treated as owned by that individual for again applying either rule 2 or rule 3 to make another person the constructive owner of the stock.

**Property received from a related party.** If you sell or trade at a gain property that you acquired from a related party, you recognize the gain only to the extent that it is more than the loss previously disallowed to the related party. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the related party's loss was disallowed because of the wash sale rules, described later under *Wash Sales*.

**Example 1.** Your brother sells you stock for \$7,600. His cost basis is \$10,000. Your brother cannot deduct the loss of \$2,400. Later, you sell the same stock to an unrelated party for \$10,500, realizing a gain of \$2,900. Your reportable gain is \$500 — the \$2,900 gain minus the \$2,400 loss not allowed to your brother.

**Example 2.** If, in Example 1, you sold the stock for \$6,900 instead of \$10,500, your recognized loss is only \$700 — your \$7,600 basis minus \$6,900. You cannot deduct the loss that was not allowed to your brother.

## Capital Gains and Losses

### Terms you may need to know (see Glossary):

Call  
Commodity future  
Conversion transaction  
Forward contract  
Limited partner  
Listed option  
Nonequity option  
Options dealer  
Put  
Regulated futures contract  
Section 1256 contract  
Straddle  
Wash sale

This section discusses the tax treatment of gains and losses from different types of investment transactions.

**Character of gain or loss.** You need to classify your gains and losses as either ordinary or capital gains or losses. You then need to classify your capital gains and losses as either short term or long term. If you have long-term gains and losses, you must identify your 28% rate gains and losses. If you have a net capital gain, you must also identify your qualified 5-year gain and any unrecaptured section 1250 gain.

The correct classification and identification helps you figure the limit on capital losses and the correct tax on capital gains. For information about determining whether your capital gain or loss is short term or long term, see *Holding Period*, later. For information about 28% rate gain or loss, qualified 5-year gain, and unrecaptured section 1250 gain, see *Reporting Capital Gains and Losses* and *Capital Gains Tax Rates*, later.

## Capital or Ordinary Gain or Loss

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. Generally, a sale or trade of

a capital asset (defined next) results in a capital gain or loss. A sale or trade of a noncapital asset generally results in ordinary gain or loss. Depending on the circumstances, a gain or loss on a sale or trade of property used in a trade or business may be treated as either capital or ordinary, as explained in Publication 544. In some situations, part of your gain or loss may be a capital gain or loss, and part may be an ordinary gain or loss.

## Capital Assets and Noncapital Assets

For the most part, everything you own and use for personal purposes, pleasure, or investment is a **capital asset**. Some examples are:

- Stocks or bonds held in your personal account,
- A house owned and used by you and your family,
- Household furnishings,
- A car used for pleasure or commuting,
- Coin or stamp collections,
- Gems and jewelry, and
- Gold, silver, or any other metal.

Any property you own is a capital asset, except the following **noncapital assets**.

- 1) **Property held mainly for sale to customers** or property that will physically become a part of the merchandise that is for sale to customers.
- 2) **Depreciable property** used in your trade or business, even if fully depreciated.
- 3) **Real property** used in your trade or business.
- 4) **A copyright, a literary, musical, or artistic composition, a letter or memorandum**, or similar property —
  - a) Created by your personal efforts,
  - b) Prepared or produced for you (in the case of a letter, memorandum, or similar property), or
  - c) Acquired under circumstances (for example, by gift) entitling you to the basis of the person who created the property or for whom it was prepared or produced.
- 5) **Accounts or notes receivable** acquired in the ordinary course of a trade or business for services rendered or from the sale of property described in (1).
- 6) **U.S. Government publications** that you received from the government free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications free or for less than the normal sales price.
- 7) **Certain commodities derivative financial instruments** held by commodities derivatives dealers. For more information,

see section 1221 of the Internal Revenue Code.

- 8) **Hedging transactions**, but only if the transaction is clearly identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into. For more information, see the definition of “hedging transaction” earlier, and the discussion of hedging transactions under *Commodity Futures*, later.
- 9) **Supplies** of a type you regularly use or consume in the ordinary course of your trade or business.

**Investment property.** Investment property is a capital asset. Any gain or loss from its sale or trade generally is a capital gain or loss.

**Gold, silver, stamps, coins, gems, etc.** These are capital assets except when they are held for sale by a dealer. Any gain or loss from their sale or trade generally is a capital gain or loss.

**Stocks, stock rights, and bonds.** All of these, including stock received as a dividend, are capital assets except when they are held for sale by a securities dealer. However, see *Losses on Section 1244 (Small Business) Stock and Losses on Small Business Investment Company Stock*, later.

**Personal use property.** Property held for personal use only, rather than for investment, is a capital asset, and you must report a gain from its sale as a capital gain. However, you cannot deduct a loss from selling personal use property.

## Discounted Debt Instruments

Treat your gain or loss on the sale, redemption, or retirement of a bond or other debt instrument originally issued at a discount or bought at a discount as capital gain or loss, except as explained in the following discussions.

**Short-term government obligations.** Treat gains on short-term federal, state, or local government obligations (other than tax-exempt obligations) as ordinary income up to your ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than 1 year from the date of issue.

**Acquisition discount** is the stated redemption price at maturity minus your basis in the obligation.

However, do not treat these gains as income to the extent you previously included the discount in income. See *Discount on Short-Term Obligations* in chapter 1 for more information.

**Short-term nongovernment obligations.** Treat gains on short-term nongovernment obligations as ordinary income up to your ratable share of OID. This treatment applies to obligations that have a fixed maturity date of not more than 1 year from the date of issue.

However, to the extent you previously included the discount in income, you do not have to include it in income again. See *Discount on Short-Term Obligations*, in chapter 1, for more information.

**Tax-exempt state and local government bonds.** If these bonds were originally issued at a discount before September 4, 1982, or you

acquired them before March 2, 1984, treat your part of the OID as tax-exempt interest. To figure your gain or loss on the sale or trade of these bonds, reduce the amount realized by your part of the OID.

If the bonds were issued after September 3, 1982, and acquired after March 1, 1984, increase the adjusted basis by your part of the OID to figure gain or loss. For more information on the basis of these bonds, see *Discounted tax-exempt obligations* under *Stocks and Bonds*, earlier in this chapter.

Any gain from market discount is usually taxable on disposition or redemption of tax-exempt bonds. If you bought the bonds before May 1, 1993, the gain from market discount is capital gain. If you bought the bonds after April 30, 1993, the gain from market discount is ordinary income.

You figure market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders. For more information, see *Market Discount Bonds* in chapter 1.

A loss on the sale or other disposition of a tax-exempt state or local government bond is deductible as a capital loss.

**Redeemed before maturity.** If a state or local bond that was issued **before June 9, 1980**, is redeemed before it matures, the OID is not taxable to you.

If a state or local bond issued **after June 8, 1980**, is redeemed before it matures, the part of the OID that is earned while you hold the bond is not taxable to you. However, you must report the unearned part of the OID as a capital gain.

**Example.** On July 1, 1990, the date of issue, you bought a 20-year, 6% municipal bond for \$800. The face amount of the bond was \$1,000. The \$200 discount was OID. At the time the bond was issued, the issuer had no intention of redeeming it before it matured. The bond was callable at its face amount beginning 10 years after the issue date.

The issuer redeemed the bond at the end of 11 years (July 1, 2001) for its face amount of \$1,000 plus accrued annual interest of \$60. The OID earned during the time you held the bond, \$73, is not taxable. The \$60 accrued annual interest also is not taxable. However, you must report the unearned part of the OID (\$127) as a capital gain.

**Long-term debt instruments issued after 1954 and before May 28, 1969 (or before July 2, 1982, if a government instrument).** If you

sell, trade, or redeem for a gain one of these debt instruments, the part of your gain that is not more than your ratable share of the OID at the time of sale or redemption is ordinary income. The rest of the gain is capital gain. If, however, there was an intention to call the debt instrument before maturity, all of your gain that is not more than the entire OID is treated as ordinary income at the time of the sale. This treatment of taxable gain also applies to corporate instruments issued after May 27, 1969, under a written commitment that was binding on May 27, 1969, and at all times thereafter.

**Example.** You bought a 30-year, 6% government bond for \$700 at original issue on April

1, 1982, and sold it for \$900 on April 20, 2001, for a \$200 gain. The redemption price is \$1,000. At the time of original issue, there was no intention to call the bond before maturity. You have held the bond for 228 full months. Do not count the additional days that are less than a full month. The number of complete months from date of issue to date of maturity is 360 (30 years). The fraction 228/360 multiplied by the discount of \$300 (\$1,000 – \$700) is equal to \$190. This is your ratable share of OID for the period you owned the bond. You must treat any part of the gain up to \$190 as ordinary income. As a result, \$190 is treated as ordinary income and \$10 is capital gain.

**Long-term debt instruments issued after May 27, 1969 (or after July 1, 1982, if a government instrument).** If you hold one of these debt instruments, you must include a part of the OID in your gross income each year that you own the instrument. Your basis in that debt instrument is increased by the amount of OID that you have included in your gross income. See *Original Issue Discount (OID)* in chapter 1.

If you sell or trade the debt instrument before maturity, your gain is a capital gain. However, if at the time the instrument was originally issued there was an intention to call it before its maturity, your gain generally is ordinary income to the extent of the entire OID reduced by any amounts of OID previously includible in your income. In this case, the rest of the gain is a capital gain.

An intention to call a debt instrument before maturity means there is a written or oral agreement or understanding not provided for in the debt instrument between the issuer and original holder that the issuer will redeem the debt instrument before maturity. In the case of debt instruments that are part of an issue, the agreement or understanding must be between the issuer and the original holders of a substantial amount of the debt instruments in the issue.

**Example 1.** On February 4, 1999, you bought at original issue for \$7,600, Jones Corporation's 10-year, 5% bond which has a stated redemption price at maturity of \$10,000. On February 3, 2001, you sold the bond for \$9,040. Assume you have included \$334 of the OID in your gross income and increased your basis in the bond by that amount. This includes the amount accrued for 2001. Your basis is now \$7,934. If at the time of the original issue there was no intention to call the bond before maturity, your gain of \$1,106 (\$9,040 amount realized minus \$7,934 adjusted basis) is capital gain.

**Example 2.** If, in *Example 1*, at the time of original issue there was an intention to call the bond before maturity, your entire gain is ordinary income. You figure this as follows:

1) Entire OID (\$10,000 stated redemption price at maturity minus \$7,600 issue price)	\$2,400
2) Minus: Amount previously included in income	334
3) Maximum amount of ordinary income	<u>\$2,066</u>

Because the amount in (3) is more than your gain of \$1,106, your entire gain is ordinary income.

**Market discount bonds.** If the debt instrument has market discount and you chose to include the discount in income as it accrued, increase your basis in the debt instrument by the

accrued discount to figure capital gain or loss on its disposition. If you did not choose to include the discount in income as it accrued, you must report gain as ordinary interest income up to the instrument's accrued market discount. See *Market Discount Bonds* in chapter 1. The rest of the gain is capital gain.

However, a different rule applies if you dispose of a market discount bond that was:

- 1) Issued before July 19, 1984, and
- 2) Purchased by you before May 1, 1993.

In that case, any gain is treated as interest income up to the amount of your deferred interest deduction for the year you dispose of the bond. The rest of the gain is capital gain. (Deferred interest deduction for market discount bonds is discussed in chapter 3 under *When To Deduct Investment Interest*.)

Report the sale or trade of a market discount bond on Schedule D (Form 1040), line 1 or line 8. If the sale or trade results in a gain and you did not choose to include market discount in income currently, enter "Accrued Market Discount" on the next line in column (a) and the amount of the accrued market discount as a loss in column (f). Also report the amount of accrued market discount in column (f) as interest income on Schedule B (Form 1040), line 1, and identify it as "Accrued Market Discount."

**Retirement of debt instrument.** Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or traded that instrument.

**Notes of individuals.** If you hold an obligation of an individual that was issued with OID after March 1, 1984, you generally must include the OID in your income currently, and your gain or loss on its sale or retirement is generally capital gain or loss. An exception to this treatment applies if the obligation is a loan between individuals and all of the following requirements are met.

- 1) The lender is not in the business of lending money.
- 2) The amount of the loan, plus the amount of any outstanding prior loans, is \$10,000 or less.
- 3) Avoiding federal tax is not one of the principal purposes of the loan.

If the exception applies, or the obligation was issued before March 2, 1984, you do not include the OID in your income currently. When you sell or redeem the obligation, the part of your gain that is not more than your accrued share of the OID at that time is ordinary income. The rest of the gain, if any, is capital gain. Any loss on the sale or redemption is capital loss.

## Bearer Obligations

You cannot deduct any loss on an obligation required to be in registered form that is instead held in bearer form. In addition, any gain on the sale or other disposition of the obligation is ordinary income. However, if the issuer was subject to a tax when the obligation was issued, then you can deduct any loss, and any gain may qualify for capital gain treatment.

**Obligations required to be in registered form.** Any obligation must be in registered form unless:

- 1) It is issued by a natural person,
- 2) It is not of a type offered to the public,
- 3) It has a maturity at the date of issue of not more than 1 year, or
- 4) It was issued before 1983.

## Deposit in Insolvent or Bankrupt Financial Institution

If you lose money you have on deposit in a qualified financial institution that becomes insolvent or bankrupt, you may be able to deduct your loss in one of three ways.

- 1) Ordinary loss,
- 2) Casualty loss, or
- 3) Nonbusiness bad debt (short-term capital loss).

**Ordinary loss or casualty loss.** If you can reasonably estimate your loss, you can choose to treat the estimated loss as either an ordinary loss or a casualty loss in the current year. Either way, you claim the loss as an itemized deduction.

If you claim an ordinary loss, report it as a miscellaneous itemized deduction on line 22 of Schedule A (Form 1040). The maximum amount you can claim is \$20,000 (\$10,000 if you are married filing separately) reduced by any expected state insurance proceeds. Your loss is subject to the 2%-of-adjusted-gross-income limit. You cannot choose to claim an ordinary loss if any part of the deposit is federally insured.

If you claim a casualty loss, attach **Form 4684, *Casualties and Thefts***, to your return. Each loss must be reduced by \$100. Your total casualty losses for the year are reduced by 10% of your adjusted gross income.

You cannot choose either of these methods if:

- 1) You own at least 1% of the financial institution,
- 2) You are an officer of the institution, or
- 3) You are related to such an owner or officer. You are related if you and the owner or officer are "related parties," as defined earlier under *Related Party Transactions*, or if you are the aunt, uncle, nephew, or niece of the owner or officer.

If the actual loss that is finally determined is more than the amount you deducted as an estimated loss, you can claim the excess loss as a bad debt. If the actual loss is less than the amount deducted as an estimated loss, you must include in income (in the final determination year) the excess loss claimed. See *Recoveries* in Publication 525, *Taxable and Nontaxable Income*.

**Nonbusiness bad debt.** If you do not choose to deduct your estimated loss as a casualty loss or an ordinary loss, you wait until the year the amount of the actual loss is determined and deduct it as a nonbusiness bad debt in that year. Report it as a short-term capital loss on Sched-

ule D (Form 1040), as explained under *Nonbusiness Bad Debts*, later.

## Sale of Annuity

The part of any gain on the sale of an annuity contract before its maturity date that is based on interest accumulated on the contract is ordinary income.

## Conversion Transactions

Generally, all or part of a gain on a conversion transaction is treated as ordinary income. This applies to gain on the disposition or other termination of any position you held as part of a conversion transaction that you entered into after April 30, 1993.

A conversion transaction is any transaction that meets both of these tests.

- 1) Substantially all of your expected return from the transaction is due to the time value of your net investment. In other words, the return on your investment is, in substance, like interest on a loan.
- 2) The transaction is one of the following.
  - a) A straddle as defined under *Straddles*, later, but including any set of offsetting positions on stock.
  - b) Any transaction in which you acquire property (whether or not actively traded) at substantially the same time that you contract to sell the same property, or substantially identical property, at a price set in the contract.
  - c) Any other transaction that is marketed or sold as producing capital gains from a transaction described in (1).

**Amount treated as ordinary income.** The amount of gain treated as ordinary income is the smaller of:

- 1) The gain recognized on the disposition or other termination of the position, or
- 2) The “applicable imputed income amount.”

**Applicable imputed income amount.** Figure this amount as follows.

- 1) Figure the amount of interest that would have accrued on your net investment in the conversion transaction for the period ending on the earlier of:
  - a) The date when you dispose of the position, or
  - b) The date when the transaction stops being a conversion transaction.

To figure this amount, use an interest rate equal to 120% of the “applicable rate,” defined later.

- 2) Subtract from (1) the amount treated as ordinary income from any earlier disposition or other termination of a position held as part of the same conversion transaction.

**Applicable rate.** If the term of the conversion transaction is indefinite, the applicable rate is the federal short-term rate in effect under section 6621(b) of the Internal Revenue Code during the period of the conversion transaction, compounded daily.

In all other cases, the applicable rate is the “applicable federal rate” determined as if the conversion transaction were a debt instrument and compounded semi-annually.

The rates discussed above are published by the IRS in the *Internal Revenue Bulletin*. Or, you can contact the IRS to get these rates. See chapter 5 for information on contacting IRS.

**Net investment.** To determine your net investment in a conversion transaction, include the fair market value of any position at the time it becomes part of the transaction. This means that your net investment generally will be the total amount you invested, less any amount you received for entering into the position (for example, a premium you received for writing a call).

**Position with built-in loss.** A special rule applies when a position with a built-in loss becomes part of a conversion transaction. A built-in loss is any loss that you would have realized if you had disposed of or otherwise terminated the position at its fair market value at the time it became part of the conversion transaction.

When applying the conversion transaction rules to a position with a built-in loss, use the position’s fair market value at the time it became part of the transaction. But, when you dispose of or otherwise terminate the position in a transaction in which you recognize gain or loss, you must recognize the built-in loss. The conversion transaction rules do not affect whether the built-in loss is treated as an ordinary or capital loss.

**Netting rule for certain conversion transactions.** Before determining the amount of gain treated as ordinary income, you can net certain gains and losses from positions of the same conversion transaction. To do this, you have to dispose of all the positions within a 14-day period that is within a single tax year. You cannot net the built-in loss against the gain.



You can net gains and losses only if you identify the conversion transaction as an identified netting transaction on your books and records. Each position of the conversion transaction must be identified before the end of the day on which the position becomes part of the conversion transaction. For conversion transactions entered into before February 20, 1996, this requirement is met if the identification was made by that date.

**Options dealers and commodities traders.** These rules do not apply to options dealers and commodities traders.

**How to report.** Use Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles*, to report conversion transactions. See the instructions for lines 11 and 13 of Form 6781.

## Commodity Futures

A commodity futures contract is a standardized, exchange-traded contract for the sale or

purchase of a fixed amount of a commodity at a future date for a fixed price.

If the contract is a regulated futures contract, the rules described earlier under *Section 1256 Contracts Marked To Market* apply to it.

The termination of a commodity futures contract generally results in capital gain or loss unless the contract is a hedging transaction.

**Hedging transaction.** A futures contract that is a hedging transaction generally produces ordinary gain or loss. A futures contract is a hedging transaction if you enter into the contract in the ordinary course of your business primarily to manage the risk of interest rate or price changes or currency fluctuations on borrowings, ordinary property, or ordinary obligations. (Generally, ordinary property or obligations are those that cannot produce capital gain or loss under any circumstances.) For example, the offset or exercise of a futures contract that protects against price changes in your business inventory results in an ordinary gain or loss.

For more information about hedging transactions, see section 1.1221–2 of the regulations. Also, see *Hedging Transactions under Section 1256 Contracts Marked To Market*, earlier.



If you have numerous transactions in the commodity futures market during the year, the burden of proof is on you to show which transactions are hedging transactions. Clearly identify any hedging transactions on your books and records before the end of the day you entered into the transaction. It may be helpful to have separate brokerage accounts for your hedging and nonhedging transactions. For specific requirements concerning identification of hedging transactions and the underlying item, items, or aggregate risk that is being hedged, see section 1.1221–2(e) of the regulations.

## Gains From Certain Constructive Ownership Transactions

If you have a gain from a constructive ownership transaction entered into after July 11, 1999, involving a financial asset (discussed later) and the gain normally would be treated as long-term capital gain, all or part of the gain may be treated instead as ordinary income. In addition, if any gain is treated as ordinary income, your tax is increased by an interest charge.

**Constructive ownership transactions.** The following are constructive ownership transactions.

- 1) A notional principal contract in which you have the right to receive substantially all of the investment yield on a financial asset and you are obligated to reimburse substantially all of any decline in value of the financial asset.
- 2) A forward or futures contract to acquire a financial asset.
- 3) The holding of a call option and writing of a put option on a financial asset at substantially the same strike price and maturity date.

This provision does not apply if all the positions are marked to market. Marked to market rules for section 1256 contracts are discussed in



detail under *Section 1256 Contracts Marked to Market*, earlier.

**Financial asset.** A financial asset, for this purpose, is any equity interest in a pass-through entity. Pass-through entities include partnerships, S corporations, trusts, regulated investment companies, and real estate investment trusts.

**Amount of ordinary income.** Long-term capital gain is treated as ordinary income to the extent it is more than the **net underlying long-term capital gain**. The net underlying long-term capital gain is the amount of net capital gain you would have realized if you acquired the asset for its fair market value on the date the constructive ownership transaction was opened, and sold the asset for its fair market value on the date the transaction was closed. If you do not establish the amount of net underlying long-term capital gain by clear and convincing evidence, it is treated as zero.

**More information.** For more information, see section 1260 of the Internal Revenue Code.

### Losses on Section 1244 (Small Business) Stock

You can deduct as an ordinary loss, rather than as a capital loss, a loss on the sale, trade, or worthlessness of section 1244 stock. Report the loss on **Form 4797, Sales of Business Property**, line 10.

Any gain on section 1244 stock is a capital gain if the stock is a capital asset in your hands. Do not offset gains against losses that are within the ordinary loss limit, explained later in this discussion, even if the transactions are in stock of the same company. Report the gain on Schedule D of Form 1040.

If you must figure a net operating loss, any ordinary loss from the sale of section 1244 stock is a business loss.

**Ordinary loss limit.** The amount that you can deduct as an ordinary loss is limited to \$50,000 each year. On a joint return the limit is \$100,000, even if only one spouse has this type of loss. If your loss is \$110,000 and your spouse has no loss, you can deduct \$100,000 as an ordinary loss on a joint return. The remaining \$10,000 is a capital loss.

**Section 1244 (small business) stock.** This is stock that was issued for money or property (other than stock and securities) in a domestic small business corporation. During its 5 most recent tax years before the loss, this corporation must have derived more than 50% of its gross receipts from other than royalties, rents, dividends, interest, annuities, and gains from sales and trades of stocks or securities. If the corporation was in existence for at least 1 year, but less than 5 years, the 50% test applies to the tax years ending before the loss. If the corporation was in existence less than 1 year, the 50% test applies to the entire period the corporation was in existence before the day of the loss. However, if the corporation's deductions (other than the net operating loss and dividends received deductions) were more than its gross income during this period, this 50% test does not apply.

The corporation must have been largely an operating company for ordinary loss treatment to apply.

If the stock was issued before July 19, 1984, the stock must be common stock. If issued after July 18, 1984, the stock may be either common or preferred. For more information about the requirements of a small business corporation or the qualifications of section 1244 stock, see section 1244 of the Internal Revenue Code and its regulations.

**The stock must be issued to the person taking the loss.** You must be the original owner of the stock to be allowed ordinary loss treatment. To claim a deductible loss on stock issued to your partnership, you must have been a partner when the stock was issued and have remained so until the time of the loss. You add your distributive share of the partnership loss to any individual section 1244 stock loss you may have before applying the ordinary loss limit.

**Stock distributed by partnership.** If your partnership distributes the stock to you, you cannot treat any later loss on that stock as an ordinary loss.

**Stock sold through underwriter.** Stock sold through an underwriter is not section 1244 stock unless the underwriter only acted as a selling agent for the corporation.

**Stock dividends and reorganizations.** Stock you receive as a stock dividend qualifies as section 1244 stock if:

- 1) You receive it from a small business corporation in which you own stock, and
- 2) The stock you own meets the requirements when the stock dividend is distributed.

If you trade your section 1244 stock for new stock in the same corporation in a reorganization that qualifies as a recapitalization or that is only a change in identity, form, or place of organization, the new stock is section 1244 stock if the stock you trade meets the requirements when the trade occurs.

If you hold section 1244 stock and other stock in the same corporation, not all of the stock you receive as a stock dividend or in a reorganization will qualify as section 1244 stock. Only that part based on the section 1244 stock you hold will qualify.

**Example.** Your basis for 100 shares of X common stock is \$1,000. These shares qualify as section 1244 stock. If, as a nontaxable stock dividend, you receive 50 more shares of common stock, the basis of which is determined from the 100 shares you own, the 50 shares are also section 1244 stock.

If you also own stock in the corporation that is not section 1244 stock when you receive the stock dividend, you must divide the shares you receive as a dividend between the section 1244 stock and the other stock. Only the shares from the former can be section 1244 stock.

**Contributed property.** To determine ordinary loss on section 1244 stock you receive in a trade for property, you have to reduce the basis of the stock if:

- 1) The adjusted basis (for figuring loss) of the property, immediately before the trade, was more than its fair market value, and
- 2) The basis of the stock is determined by the basis of the property.

Reduce the basis of the stock by the difference between the adjusted basis of the property and its fair market value at the time of the trade. You reduce the basis only to figure the ordinary loss. Do not reduce the basis of the stock for any other purpose.

**Example.** You transfer property with an adjusted basis of \$1,000 and a fair market value of \$250 to a corporation for its section 1244 stock. The basis of your stock is \$1,000, but to figure the ordinary loss under these rules, the basis of your stock is \$250 (\$1,000 minus \$750). If you later sell the section 1244 stock for \$200, your \$800 loss is an ordinary loss of \$50 and a capital loss of \$750.

**Contributions to capital.** If the basis of your section 1244 stock has increased, through contributions to capital or otherwise, you must treat this increase as applying to stock that is not section 1244 stock when you figure an ordinary loss on its sale.

**Example.** You buy 100 shares of section 1244 stock for \$10,000. You are the original owner. You later make a \$2,000 contribution to capital that increases the total basis of the 100 shares to \$12,000. You then sell the 100 shares for \$9,000 and have a loss of \$3,000. You can deduct only \$2,500 ( $\$3,000 \times \$10,000/\$12,000$ ) as an ordinary loss under these rules. The remaining \$500 is a capital loss.



**Recordkeeping.** You must keep records sufficient to show your stock qualifies as section 1244 stock. Your records must also distinguish your section 1244 stock from any other stock you own in the corporation.

### Losses on Small Business Investment Company Stock

A small business investment company (SBIC) is one that is licensed and operated under the Small Business Investment Act of 1958.

If you are an investor in SBIC stock, you can deduct as an ordinary loss, rather than a capital loss, a loss from the sale, trade, or worthlessness of that stock. A gain from the sale or trade of that stock is a capital gain. Do not offset your gains and losses, even if they are on stock of the same company.

**How to report.** You report this type of ordinary loss on line 10, Part II, of Form 4797. In addition to the information required by the form, you must include the name and address of the company that issued the stock. Report a capital gain from the sale of SBIC stock on Schedule D of Form 1040.

**Short sale.** If you close a short sale of SBIC stock with other SBIC stock that you bought only for that purpose, any loss you have on the sale is a capital loss. See *Short Sales*, later in this chapter, for more information.

## Holding Period

If you sold or traded investment property, you must determine your holding period for the property. Your holding period determines whether any capital gain or loss was a short-term or a long-term capital gain or loss.

**Long-term or short-term.** If you hold investment property *more than 1 year*, any capital gain or loss is a **long-term** capital gain or loss. If you hold the property *1 year or less*, any capital gain or loss is a **short-term** capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The day you disposed of the property is part of your holding period.

**Example.** If you bought investment property on February 5, 2000, and sold it on February 5, 2001, your holding period is not more than 1 year and you have a short-term capital gain or loss. If you sold it on February 6, 2001, your holding period is more than 1 year and you have a long-term capital gain or loss.

**Securities traded on an established market.** For securities traded on an established securities market, your holding period begins the day after the **trade date** you bought the securities, and ends on the trade date you sold them.



*Do not confuse the trade date with the settlement date, which is the date by which the stock must be delivered and payment must be made.*

**Example.** You are a cash method, calendar year taxpayer. You sold stock at a gain on December 28, 2001. According to the rules of the stock exchange, the sale was closed by delivery of the stock 3 trading days after the sale, on January 3, 2002. You received payment of the sale price on that same day. Report your gain on your 2001 return, even though you received the payment in 2002. The gain is long term or short term depending on whether you held the stock more than 1 year. Your holding period ended on December 28. If you had sold the stock at a loss, you would also report it on your 2001 return.

**U.S. Treasury notes and bonds.** The holding period of U.S. Treasury notes and bonds sold at auction on the basis of yield starts the day after the Secretary of the Treasury, through news releases, gives notification of acceptance to successful bidders. The holding period of U.S. Treasury notes and bonds sold through an offering on a subscription basis at a specified yield starts the day after the subscription is submitted.

**Automatic investment service.** In determining your holding period for shares bought by the bank or other agent, full shares are considered bought first and any fractional shares are considered bought last. Your holding period starts on the day after the bank's purchase date. If a share was bought over more than one purchase date, your holding period for that share is a split holding period. A part of the share is considered to have been bought on each date that stock was bought by the bank with the proceeds of available funds.

**Nontaxable trades.** If you acquire investment property in a trade for other investment property

and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period for the new property begins on the day following the date you acquired the old property.

**Property received as a gift.** If you receive a gift of property and your basis is determined by the donor's adjusted basis, your holding period is considered to have started on the same day the donor's holding period started.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

**Inherited property.** If you inherit investment property, your capital gain or loss on any later disposition of that property is treated as a long-term capital gain or loss. This is true regardless of how long you actually held the property.

**Real property bought.** To figure how long you have held real property bought under an unconditional contract, begin counting on the day after you received title to it or on the day after you took possession of it and assumed the burdens and privileges of ownership, whichever happened first. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

**Real property repossessed.** If you sell real property but keep a security interest in it, and then later repossess the property under the terms of the sales contract, your holding period for a later sale includes the period you held the property before the original sale and the period after the repossession. Your holding period does not include the time between the original sale and the repossession. That is, it does not include the period during which the first buyer held the property.

**Stock dividends.** The holding period for stock you received as a taxable stock dividend begins on the date of distribution.

The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a **spin-off**, which is a distribution of stock or securities in a controlled corporation.

**Nontaxable stock rights.** Your holding period for nontaxable stock rights begins on the same day as the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

**Section 1256 contracts.** Gains or losses on section 1256 contracts open at the end of the year, or terminated during the year, are treated as 60% long term and 40% short term, regardless of how long the contracts were held. See *Section 1256 Contracts Marked to Market*, earlier.

**Option exercised.** Your holding period for property you acquire when you exercise an option begins the day after you exercise the option.

**Wash sales.** Your holding period for substantially identical stock or securities you acquire in a

wash sale includes the period you held the old stock or securities.

**Qualified small business stock.** Your holding period for stock you acquired in a tax-free rollover of gain from a sale of qualified small business stock, described later, includes the period you held the old stock.

**Commodity or securities futures.** Futures transactions in any commodity subject to the rules of a board of trade or commodity exchange are long term if the contract was held for more than 6 months.

Your holding period for a commodity received in satisfaction of a commodity futures contract or securities futures contract, other than a regulated futures contract subject to Internal Revenue Code section 1256, includes your holding period for the futures contract if you held the contract as a capital asset.

**Securities futures contract.** Your holding period for a security received in satisfaction of a securities futures contract, other than one that is a section 1256 contract, includes your holding period for the futures contract if you held the contract as a capital asset.

**Loss on mutual fund or REIT stock held 6 months or less.** If you hold stock in a **regulated investment company** (commonly called a **mutual fund**) or **real estate investment trust (REIT)** for 6 months or less and then sell it at a loss (other than under a periodic liquidation plan), special rules may apply.

**Capital gain distributions received.** The loss (after reduction for any exempt-interest dividends you received, as explained next) is treated as a long-term capital loss up to the total of any capital gain distributions you received and your share of any undistributed capital gains. Any remaining loss is short-term capital loss.

**Exempt-interest dividends on mutual fund stock.** If you received exempt-interest dividends on the stock, at least part of your loss is disallowed. You can deduct only the amount of loss that is more than the exempt-interest dividends.

## Nonbusiness Bad Debts

If someone owes you money that you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless.

There are two kinds of bad debts — business and nonbusiness. A business bad debt, generally, is one that comes from operating your trade or business and is deductible as a business loss. All other bad debts are nonbusiness bad debts and are deductible as short-term capital losses.

**Example.** An architect made personal loans to several friends who were not clients. She could not collect on some of these loans. They are deductible only as nonbusiness bad debts because the architect was not in the business of lending money and the loans do not have any relationship to her business.

**Business bad debts.** For information on business bad debts of an employee, see Publication

529. For information on other business bad debts, see chapter 11 of Publication 535.

**Deductible nonbusiness bad debts.** To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partly worthless nonbusiness debt.

**Genuine debt required.** A debt must be genuine for you to deduct a loss. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money.

**Loan or gift.** For a bad debt, you must show that there was an intention at the time of the transaction to make a loan and not a gift. If you lend money to a relative or friend with the understanding that it may not be repaid, it is considered a gift and not a loan. You cannot take a bad debt deduction for a gift. There cannot be a bad debt unless there is a true creditor-debtor relationship between you and the person or organization that owes you the money.

When minor children borrow from their parents to pay for their basic needs, there is no genuine debt. A bad debt cannot be deducted for such a loan.

**Basis in bad debt required.** To deduct a bad debt, you must have a basis in it — that is, you must have already included the amount in your income or loaned out your cash. For example, you cannot claim a bad debt deduction for court-ordered child support not paid to you by your former spouse. If you are a cash method taxpayer (most individuals are), you generally cannot take a bad debt deduction for unpaid salaries, wages, rents, fees, interest, dividends, and similar items.

**When deductible.** You can take a bad debt deduction only in the year the debt becomes worthless. You do not have to wait until a debt is due to determine whether it is worthless. A debt becomes worthless when there is no longer any chance that the amount owed will be paid.

It is not necessary to go to court if you can show that a judgment from the court would be uncollectible. You must only show that you have taken reasonable steps to collect the debt. Bankruptcy of your debtor is generally good evidence of the worthlessness of at least a part of an unsecured and unpreferred debt.

If your bad debt is the loss of a deposit in a financial institution, see *Deposit in Insolvent or Bankrupt Financial Institution*, earlier.

**Filing a claim for refund.** If you do not deduct a bad debt on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the bad debt. To do this, use Form 1040X to amend your return for the year the debt became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. (Claims not due to bad debts or worthless securities generally must be filed within 3 years from the date a return is filed, or 2 years from the date the tax is paid.) For more information about filing a claim, see Publication 556, *Examination of Returns, Appeal Rights, and Claims for Refund*.

**Loan guarantees.** If you guarantee a debt that becomes worthless, you cannot take a bad

debt deduction for your payments on the debt unless you can show either that your reason for making the guarantee was to protect your investment or that you entered the guarantee transaction with a profit motive. If you make the guarantee as a favor to friends and do not receive any consideration in return, your payments are considered a gift and you cannot take a deduction.

**Example 1.** Henry Lloyd, an officer and principal shareholder of the Spruce Corporation, guaranteed payment of a bank loan the corporation received. The corporation defaulted on the loan and Henry made full payment. Because he guaranteed the loan to protect his investment in the corporation, Henry can take a nonbusiness bad debt deduction.

**Example 2.** Milt and John are co-workers. Milt, as a favor to John, guarantees a note at their local credit union. John does not pay the note and declares bankruptcy. Milt pays off the note. However, since he did not enter into the guarantee agreement to protect an investment or to make a profit, Milt cannot take a bad debt deduction.

**Deductible in year paid.** Unless you have rights against the borrower, discussed next, a payment you make on a loan you guaranteed is deductible in the year you make the payment.

**Rights against the borrower.** When you make payment on a loan that you guaranteed, you may have the right to take the place of the lender (the right of subrogation). The debt is then owed to you. If you have this right, or some other right to demand payment from the borrower, you cannot take a bad debt deduction until these rights become totally worthless.

**Debts owed by political parties.** You cannot take a nonbusiness bad debt deduction for any worthless debt owed to you by:

- 1) A political party,
- 2) A national, state, or local committee of a political party, or
- 3) A committee, association, or organization that either accepts contributions or spends money to influence elections.

**Mechanics' and suppliers' liens.** Workers and material suppliers may file liens against property because of debts owed by a builder or contractor. If you pay off the lien to avoid foreclosure and loss of your property, you are entitled to repayment from the builder or contractor. If the debt is uncollectible, you can take a bad debt deduction.

**Insolvency of contractor.** You can take a bad debt deduction for the amount you deposit with a contractor if the contractor becomes insolvent and you are unable to recover your deposit. If the deposit is for work unrelated to your trade or business, it is a nonbusiness bad debt deduction.

**Secondary liability on home mortgage.** If the buyer of your home assumes your mortgage, you may remain secondarily liable for repayment of the mortgage loan. If the buyer defaults on the loan and the house is then sold for less than the amount outstanding on the

mortgage, you may have to make up the difference. You can take a bad debt deduction for the amount you pay to satisfy the mortgage, if you cannot collect it from the buyer.

**Worthless securities.** If you own securities that become totally worthless, you can take a deduction for a loss, but not for a bad debt. See *Worthless Securities* under *What Is a Sale or Trade*, earlier in this chapter.

**Recovery of a bad debt.** If you deducted a bad debt and in a later tax year you recover (collect) all or part of it, you may have to include the amount you recover in your gross income. However, you can exclude from gross income the amount recovered up to the amount of the deduction that did not reduce your tax in the year deducted. See *Recoveries* in Publication 525.

**How to report bad debts.** Deduct nonbusiness bad debts as short-term capital losses on Schedule D (Form 1040).

In Part I, line 1 of Schedule D, enter the name of the debtor and "statement attached" in column (a). Enter the amount of the bad debt in parentheses in column (f). Use a separate line for each bad debt.

For each bad debt, attach a statement to your return that contains:

- 1) A description of the debt, including the amount, and the date it became due,
- 2) The name of the debtor, and any business or family relationship between you and the debtor,
- 3) The efforts you made to collect the debt, and
- 4) Why you decided the debt was worthless. For example, you could show that the borrower has declared bankruptcy, or that legal action to collect would probably not result in payment of any part of the debt.

**S corporation shareholder.** If you are a shareholder in an S corporation, your share of any nonbusiness bad debt will be shown on a schedule attached to your Schedule K-1 (Form 1120S) that you receive from the corporation.

## Short Sales

A short sale occurs when you agree to sell property you do not own (or own but do not wish to sell). You make this type of sale in two steps.

- 1) **You sell short.** You borrow property and deliver it to a buyer.
- 2) **You close the sale.** At a later date, you either buy substantially identical property and deliver it to the lender or make delivery out of property that you held at the time of the sale.

You do not realize gain or loss until delivery of property to close the short sale. You will have a capital gain or loss if the property used to close the short sale is a capital asset.

**Exception if property becomes worthless.** A different rule applies if the property sold short becomes substantially worthless. In that case, you must recognize gain as if the short sale were closed when the property became substantially worthless.

**Exception for constructive sales.** Entering into a short sale may cause you to be treated as having made a constructive sale of property. In that case, you will have to recognize gain on the date of the constructive sale. For details, see *Constructive Sales of Appreciated Financial Positions*, earlier.

**Example.** On May 1, 2001, you bought 100 shares of Baker Corporation stock for \$1,000. On September 3, 2001, you sold short 100 shares of similar Baker stock for \$1,600. You made no other transactions involving Baker stock for the rest of 2001 and the first 30 days of 2002. Your short sale is treated as a constructive sale of an appreciated financial position because a sale of your Baker stock on the date of the short sale would have resulted in a gain. You recognize a \$600 short-term capital gain from the constructive sale and your new holding period in the Baker stock begins on September 3.

## Short-Term or Long-Term Capital Gain or Loss

As a general rule, you determine whether you have short-term or long-term capital gain or loss on a short sale by the amount of time you actually hold the property eventually delivered to the lender to close the short sale.

**Example.** Even though you do not own any stock of the Ace Corporation, you contract to sell 100 shares of it, which you borrow from your broker. After 13 months, when the price of the stock has risen, you buy 100 shares of Ace Corporation stock and immediately deliver them to your broker to close out the short sale. Your loss is a short-term capital loss because your holding period for the delivered property is less than one day.

**Special rules.** Special rules may apply to gains and losses from short sales of stocks, securities, and commodity futures (other than certain straddles) if you held or acquired property substantially identical property to that sold short. But if the amount of property you sold short is more than the amount of that substantially identical property, the special rules do not apply to the gain or loss on the excess.

**Gains and holding period.** If you held the substantially identical property for 1 year or less on the date of the short sale, or if you acquired the substantially identical property after the short sale and by the date of closing the short sale, then:

**Rule 1.** Your gain, if any, when you close the short sale is a short-term capital gain, and

**Rule 2.** The holding period of the substantially identical property begins on the date of the closing of the short sale or on the date of the sale of this property, whichever comes first.

**Losses.** If, on the date of the short sale, you held substantially identical property for more than 1 year, any loss you realize on the short sale is a long-term capital loss, even if you held the property used to close the sale for 1 year or less. Certain losses on short sales of stock or

securities are also subject to wash sale treatment. For information, see *Wash Sales*, later.

**Mixed straddles.** Under certain elections, you can avoid the treatment of loss from a short sale as long term under the special rule. These elections are for positions that are part of a mixed straddle. See *Other elections* under *Mixed Straddles*, later, for more information about these elections.

## Reporting Substitute Payments

If any broker transferred your securities for use in a short sale, or similar transaction, and received certain substitute dividend payments on your behalf while the short sale was open, that broker must give you a **Form 1099-MISC** or a similar statement, reporting the amount of these payments. Form 1099-MISC must be used for those substitute payments totaling \$10 or more that are known on the payment's record date to be in lieu of an exempt-interest dividend, a capital gain dividend, a return of capital distribution, or a dividend subject to a foreign tax credit, or that are in lieu of tax-exempt interest. Do not treat these substitute payments as dividends or interest. Instead, report the substitute payments shown on Form 1099-MISC as "Other income" on line 21 of Form 1040.

**Substitute payment.** A substitute payment means a payment in lieu of:

- 1) Tax-exempt interest (including OID) that has accrued while the short sale was open, and
- 2) A dividend, if the ex-dividend date is after the transfer of stock for use in a short sale and before the closing of the short sale.

## Short Sale Expenses

If you borrow stock to make a short sale, you may have to remit to the lender payments in lieu of the dividends distributed while you maintain your short position. You can deduct these payments only if you hold the short sale open at least 46 days (more than 1 year in the case of an extraordinary dividend as defined below) and you itemize your deductions.

You deduct these expenses as investment interest on Schedule A (Form 1040). See *Interest Expenses* in chapter 3 for more information.

If you close the short sale by the 45th day after the date of the short sale (1 year or less in the case of an extraordinary dividend), you cannot deduct the payment in lieu of the dividend that you make to the lender. Instead, you must increase the basis of the stock used to close the short sale by that amount.

To determine how long a short sale is kept open, do not include any period during which you hold, have an option to buy, or are under a contractual obligation to buy substantially identical stock or securities.

If your payment is made for a liquidating distribution or nontaxable stock distribution, or if you buy more shares equal to a stock distribution issued on the borrowed stock during your short position, you have a capital expense. You must add the payment to the cost of the stock sold short.

**Exception.** If you close the short sale within 45 days, the deduction for amounts you pay in lieu of dividends will be disallowed only to the extent the payments are more than the amount that you receive as ordinary income from the lender of the stock for the use of collateral with the short sale. This exception does not apply to payments in place of extraordinary dividends.

**Extraordinary dividends.** If the amount of any dividend you receive on a share of preferred stock equals or exceeds 5% (10% in the case of other stock) of the amount realized on the short sale, the dividend you receive is an extraordinary dividend.

## Wash Sales

You cannot deduct losses from sales or trades of stock or securities in a wash sale.

A wash sale occurs when you sell or trade stock or securities at a loss and within 30 days before or after the sale you:

- 1) Buy substantially identical stock or securities,
- 2) Acquire substantially identical stock or securities in a fully taxable trade, or
- 3) Acquire a contract or option to buy substantially identical stock or securities.

If you sell stock and your spouse or a corporation you control buys substantially identical stock, you also have a wash sale.

If your loss was disallowed because of the wash sale rules, add the disallowed loss to the cost of the new stock or securities. The result is your basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities. Your holding period for the new stock or securities begins on the same day as the holding period of the stock or securities sold.

**Example 1.** You buy 100 shares of X stock for \$1,000. You sell these shares for \$750 and within 30 days from the sale you buy 100 shares of the same stock for \$800. Because you bought substantially identical stock, you cannot deduct your loss of \$250 on the sale. However, you add the disallowed loss of \$250 to the cost of the new stock, \$800, to obtain your basis in the new stock, which is \$1,050.

**Example 2.** You are an employee of a corporation that has an incentive pay plan. Under this plan, you are given 10 shares of the corporation's stock as a bonus award. You include the fair market value of the stock in your gross income as additional pay. You later sell these shares at a loss. If you receive another bonus award of substantially identical stock within 30 days of the sale, you cannot deduct your loss on the sale.

**Options and futures contracts.** The wash sale rules apply to losses from sales or trades of contracts and options to acquire or sell stock or securities. They do not apply to losses from sales or trades of commodity futures contracts and foreign currencies. See *Coordination of Loss Deferral Rules and Wash Sale Rules* under *Straddles*, later, for information about the tax treatment of losses on the disposition of positions in a straddle.

**Warrants.** The wash sale rules apply if you sell common stock at a loss and, at the same time, buy warrants for common stock of the same corporation. But if you sell warrants at a loss and, at the same time, buy common stock in the same corporation, the wash sale rules apply only if the warrants and stock are considered substantially identical, as discussed next.

**Substantially identical.** In determining whether stock or securities are substantially identical, you must consider all the facts and circumstances in your particular case. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. However, they may be substantially identical in some cases. For example, in a reorganization, the stocks and securities of the predecessor and successor corporations may be substantially identical.

Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, where the bonds or preferred stock are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may make these bonds or preferred stock and the common stock substantially identical. For example, preferred stock is substantially identical to the common stock if the preferred stock:

- 1) Is convertible into common stock,
- 2) Has the same voting rights as the common stock,
- 3) Is subject to the same dividend restrictions,
- 4) Trades at prices that do not vary significantly from the conversion ratio, and
- 5) Is unrestricted as to convertibility.

**More or less stock bought than sold.** If the number of shares of substantially identical stock or securities you buy within 30 days before or after the sale is either more or less than the number of shares you sold, you must determine the particular shares to which the wash sale rules apply. You do this by matching the shares bought with an equal number of the shares sold. Match the shares bought in the same order that you bought them, beginning with the first shares bought. The shares or securities so matched are subject to the wash sale rules.

**Example 1.** You bought 100 shares of M stock on September 24, 2000, for \$5,000. On December 21, 2000, you bought 50 shares of substantially identical stock for \$2,750. On December 28, 2000, you bought 25 shares of substantially identical stock for \$1,125. On January 4, 2001, you sold for \$4,000 the 100 shares you bought in September. You have a \$1,000 loss on the sale. However, because you bought 75 shares of substantially identical stock within 30 days of the sale, you cannot deduct the loss (\$750) on 75 shares. You can deduct the loss (\$250) on the other 25 shares. The basis of the 50 shares bought on December 21, 2000, is increased by two-thirds ( $50 \div 75$ ) of the \$750 disallowed loss. The new basis of those shares is \$3,250 (\$2,750 + \$500). The basis of the 25 shares bought on December 28, 2000, is in-

creased by the rest of the loss to \$1,375 (\$1,125 + \$250).

**Example 2.** You bought 100 shares of M stock on September 24, 2000. On February 1, 2001, you sold those shares at a \$1,000 loss. On each of the 4 days from February 13, 2001, to February 16, 2001, you bought 50 shares of substantially identical stock. You cannot deduct your \$1,000 loss. You must add half the disallowed loss (\$500) to the basis of the 50 shares bought on February 13. Add the other half (\$500) to the basis of the shares bought on February 14.

**Loss and gain on same day.** Loss from a wash sale of one block of stock or securities cannot be used to reduce any gains on identical blocks sold the same day.

**Example.** During 1996, you bought 100 shares of X stock on each of three occasions. You paid \$158 a share for the first block of 100 shares, \$100 a share for the second block, and \$95 a share for the third block. On December 23, 2001, you sold 300 shares of X stock for \$125 a share. On January 6, 2002, you bought 250 shares of identical X stock. You cannot deduct the loss of \$33 a share on the first block because within 30 days after the date of sale you bought 250 identical shares of X stock. In addition, you cannot reduce the gain realized on the sale of the second and third blocks of stock by this loss.

**Dealers.** The wash sale rules do not apply to a dealer in stock or securities if the loss is from a transaction made in the ordinary course of business.

**Short sales.** The wash sale rules apply to a loss realized on a short sale if you sell, or enter into another short sale of, substantially identical stock or securities within a period beginning 30 days before the date the short sale is complete and ending 30 days after that date.

For purposes of the wash sale rules, a short sale is considered complete on the date the short sale is entered into, if:

- 1) On that date, you own stock or securities identical to those sold short (or by that date you enter into a contract or option to acquire that stock or those securities), and
- 2) You later deliver the stock or securities to close the short sale.

Otherwise, a short sale is not considered complete until the property is delivered to close the sale.

**Example.** On June 2, you buy 100 shares of stock for \$1,000. You sell short 100 shares of the stock for \$750 on October 6. On October 7, you buy 100 shares of the same stock for \$750. You close the short sale on November 17 by delivering the shares bought on June 2. You cannot deduct the \$250 loss (\$1,000 - \$750) because the date of entering into the short sale (October 6) is considered the date the sale is complete for wash sale purposes and you bought substantially identical stock within 30 days from that date.

**Residual Interests in a REMIC.** The wash sale rules generally will apply to the sale of your residual interest in a real estate mortgage investment conduit (REMIC) if, during the period

beginning 6 months before the sale of the interest and ending 6 months after that sale, you acquire any residual interest in any REMIC or any interest in a taxable mortgage pool that is comparable to a residual interest. REMICs are discussed in chapter 1.

**How to report.** Report a wash sale or trade on line 1 or line 8 of Schedule D (Form 1040), whichever is appropriate. Show the full amount of the loss in parentheses in column (f). On the next line, enter "Wash Sale" in column (a) and the amount of the loss not allowed as a positive amount in column (f).

## Securities Futures Contracts

A securities futures contract is a contract of sale for future delivery of a single security or of a narrow-based security index.

Gain or loss from the contract generally will be treated in a manner similar to gain or loss from transactions in the underlying security. This means gain or loss from the sale or exchange of the contract will generally have the same character as gain or loss from transactions in the property to which the contract relates. Any capital gain or loss on a sale or exchange of a contract to sell property will be considered short-term, regardless of how long you hold the contract. These contracts are not section 1256 contracts (unless they are dealer securities futures contracts).

## Options

Options are generally subject to the rules described in this section. If the option is part of a straddle, the loss deferral rules covered later under *Straddles* may also apply. For special rules that apply to nonequity options and dealer equity options, see *Section 1256 Contracts Marked to Market*, earlier.

Gain or loss from the sale or trade of an option to buy or sell property that is a capital asset in your hands, or would be if you acquired it, is capital gain or loss. If the property is not, or would not be, a capital asset, the gain or loss is ordinary gain or loss.

**Example 1.** You purchased an option to buy 100 shares of XYZ Company stock. The stock increases in value and you sell the option for more than you paid for it. Your gain is capital gain because the stock underlying the option would have been a capital asset in your hands.

**Example 2.** The facts are the same as in Example 1, except that the stock decreases in value and you sell the option for less than you paid for it. Your loss is a capital loss.

**Option not exercised.** If you have a loss because you did not exercise an option to buy or sell, you are considered to have sold or traded the option on the date that it expired.

**Writer of option.** If you write (grant) an option, how you report your gain or loss depends on whether it was exercised.

If you are not in the business of writing options and an option you write on stocks, securities, commodities, or commodity futures is not exercised, the amount you receive is a short-term capital gain.

If an option requiring you to buy or sell property is exercised, see *Writers of calls and puts*, later.

**Section 1256 contract options.** Gain or loss is recognized on the exercise of an option on a section 1256 contract. Section 1256 contracts are defined under *Section 1256 Contracts Marked to Market*, earlier.

**Cash settlement option.** A cash settlement option is treated as an option to buy or sell property. A cash settlement option is any option that on exercise is settled in, or could be settled in, cash or property other than the underlying property.

**How to report.** Gain or loss from the closing or expiration of an option that is not a section 1256 contract, but that is a capital asset in your hands, is reported on Schedule D (Form 1040).

If an option you purchased expired, enter the expiration date in column (c) and write "Expired" in column (d).

If an option that you wrote expired, enter the expiration date in column (b) and write "Expired" in column (e).

## Calls and Puts

Calls and puts are options on securities and are covered by the rules just discussed for options. The following are specific applications of these rules to holders and writers of options that are bought, sold, or "closed out" in transactions on a national securities exchange, such as the Chicago Board Options Exchange. (But see *Section 1256 Contracts Marked to Market*, earlier, for special rules that may apply to nonequity options and dealer equity options.) These rules are also presented in *Table 4-1*.

Calls and puts are issued by writers (grantors) to holders for cash premiums. They are ended by exercise, closing transaction, or lapse.

A **call option** is the right to buy from the writer of the option, at any time before a specified future date, a stated number of shares of stock at a specified price. Conversely, a **put option** is the right to sell to the writer, at any time before a specified future date, a stated number of shares at a specified price.

**Holders of calls and puts.** If you buy a call or a put, you may not deduct its cost. It is a capital expenditure.

If you sell the call or the put before you exercise it, the difference between its cost and the amount you receive for it is either a long-term or short-term capital gain or loss, depending on how long you held it.

If the option expires, its cost is either a long-term or short-term capital loss, depending on your holding period, which ends on the expiration date.

If you exercise a call, add its cost to the basis of the stock you bought. If you exercise a put, reduce your amount realized on the sale of the underlying stock by the cost of the put when figuring your gain or loss. Any gain or loss on the sale of the underlying stock is long term or short term depending on your holding period for the underlying stock.

**Put option as short sale.** Buying a put option is generally treated as a short sale, and the exercise, sale, or expiration of the put is a clos-

ing of the short sale. See *Short Sales*, earlier. If you have held the underlying stock for 1 year or less at the time you buy the put, any gain on the exercise, sale, or expiration of the put is a short-term capital gain. The same is true if you buy the underlying stock after you buy the put but before its exercise, sale, or expiration. Your holding period for the underlying stock begins on the earliest of:

- 1) The date you dispose of the stock,
- 2) The date you exercise the put,
- 3) The date you sell the put, or
- 4) The date the put expires.

**Writers of calls and puts.** If you write (grant) a call or a put, do not include the amount you receive for writing it in your income at the time of receipt. Carry it in a deferred account until:

- 1) Your obligation expires,
- 2) You sell, in the case of a call, or buy, in the case of a put, the underlying stock when the option is exercised, or
- 3) You engage in a closing transaction.

If your obligation expires, the amount you received for writing the call or put is short-term capital gain.

If a call you write is exercised and you sell the underlying stock, increase your amount realized on the sale of the stock by the amount you received for the call when figuring your gain or loss. The gain or loss is long term or short term depending on your holding period of the stock.

If a put you write is exercised and you buy the underlying stock, decrease your basis in the stock by the amount you received for the put. Your holding period for the stock begins on the date you buy it, not on the date you wrote the put.

If you enter into a closing transaction by paying an amount equal to the value of the call or put at the time of the payment, the difference between the amount you pay and the amount you receive for the call or put is a short-term capital gain or loss.

### Examples of non-dealer transactions.

- 1) **Expiration.** Ten JJJ call options were issued on April 8, 2001, for \$4,000. These equity options expired in December 2001, without being exercised. If you were a holder (buyer) of the options, you would recognize a short-term capital loss of \$4,000. If you were a writer of the options, you would recognize a short-term capital gain of \$4,000.
- 2) **Closing transaction.** The facts are the same as in (1), except that on May 10, 2001, the options were sold for \$6,000. If you were the holder of the options who sold them, you would recognize a short-term capital gain of \$2,000. If you were the writer of the options and you bought them back, you would recognize a short-term capital loss of \$2,000.
- 3) **Exercise.** The facts are the same as in (1), except that the options were exercised on May 27, 2001. The buyer adds the cost of the options to the basis of the stock bought through the exercise of the options.

The writer adds the amount received from writing the options to the amount realized from selling the stock.

- 4) **Section 1256 contracts.** The facts are the same as in (1), except the options were nonequity options, subject to the rules for section 1256 contracts. If you were a buyer of the options, you would recognize a short-term capital loss of \$1,600, and a long-term capital loss of \$2,400. If you were a writer of the options, you would recognize a short-term capital gain of \$1,600, and a long-term capital gain of \$2,400. See *Section 1256 Contracts Marked to Market*, earlier, for more information.

## Straddles

This section discusses the loss deferral rules that apply to the sale or other disposition of positions in a straddle. These rules do not apply to the straddles described under *Exceptions*, later.

A straddle is any set of offsetting positions on personal property. For example, a straddle may consist of a security and a written option to buy and a purchased option to sell on the same number of shares of the security, with the same exercise price and period.

**Personal property.** This is any property of a type that is actively traded. It includes stock options and contracts to buy stock, but generally does not include stock.

**Straddle rules for stock.** Although stock is generally excluded from the definition of personal property when applying the straddle rules, it is included in the following two situations.

- 1) The stock is part of a straddle in which at least one of the offsetting positions is either:
  - a) An option to buy or sell the stock or substantially identical stock or securities,
  - b) A securities futures contract on the stock or substantially identical stock or securities, or
  - c) A position on substantially similar or related property (other than stock).
- 2) The stock is in a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

**Position.** A position is an interest in personal property. A position can be a forward or futures contract, or an option.

An interest in a loan that is denominated in a **foreign currency** is treated as a position in that currency. For the straddle rules, foreign currency for which there is an active interbank market is considered to be actively-traded personal property. See also *Foreign currency contract* under *Section 1256 Contracts Marked to Market*, earlier.

**Offsetting position.** This is a position that substantially reduces any risk of loss you may have from holding another position. However, if a position is part of a straddle that is not an

Table 4–1. **Puts and Calls**

Puts		
When a put:	If you are the holder:	If you are the writer:
Is exercised	Reduce your amount realized from sale of the underlying stock by the cost of the put.	Reduce your basis in the stock you buy by the amount you received for the put.
Expires	Report the cost of the put as a capital loss.*	Report the amount you received for the put as a short-term capital gain.
Is sold by the holder	Report the difference between the cost of the put and the amount you receive for it as a capital gain or loss.*	This does not affect you. (But if you buy back the put, report the difference between the amount you pay and the amount you received for the put as a short-term capital gain or loss.)

Calls		
When a call:	If you are the holder:	If you are the writer:
Is exercised	Add the cost of the call to your basis in the stock purchased.	Increase your amount realized on sale of the stock by the amount you received for the call.
Expires	Report the cost of the call as a capital loss on the date it expires.*	Report the amount you received for the call as a short-term capital gain.
Is sold by the holder	Report the difference between the cost of the call and the amount you receive for it as a capital gain or loss.*	This does not affect you. (But if you buy back the call, report the difference between the amount you pay and the amount you received for the call as a short-term capital gain or loss.)

\* See *Holders of calls and puts* and *Writers of calls and puts* in the accompanying text to find whether your gain or loss is short term or long term.

identified straddle (described later), do not treat it as offsetting to a position that is part of an identified straddle.

**Presumed offsetting positions.** If you establish two or more positions, an offsetting position will be presumed under any of the following conditions, unless otherwise rebutted.

- 1) The positions are established in the same personal property (or in a contract for this property), and the value of one or more positions varies inversely with the value of one or more of the other positions.
- 2) The positions are in the same personal property, even if this property is in a substantially changed form, and the positions' values vary inversely as described in the first condition.
- 3) The positions are in debt instruments with a similar maturity, and the positions' values vary inversely as described in the first condition.
- 4) The positions are sold or marketed as offsetting positions, whether or not the positions are called a straddle, spread, butterfly, or any similar name.

- 5) The aggregate margin requirement for the positions is lower than the sum of the margin requirements for each position if held separately.

**Related persons.** To determine if two or more positions are offsetting, you will be treated as holding any position that your spouse holds during the same period. If you take into account part or all of the gain or loss for a position held by a flowthrough entity, such as a partnership or trust, you are also considered to hold that position.

### Loss Deferral Rules

Generally, you can deduct a loss on the disposition of one or more positions only to the extent that the loss is more than any unrecognized gain you have on offsetting positions. Unused losses are treated as sustained in the next tax year.

**Unrecognized gain.** This is:

- 1) The amount of gain you would have had on an open position if you had sold it on the last business day of the tax year at its fair market value, and

- 2) The amount of gain realized on a position if, as of the end of the tax year, gain has been realized, but not recognized.

**Example.** On July 1, 2001, you entered into a straddle. On December 16, 2001, you closed one position of the straddle at a loss of \$15,000. On December 31, 2001, the end of your tax year, you have an unrecognized gain of \$12,750 in the offsetting open position. On your 2001 return, your deductible loss on the position you closed is limited to \$2,250 (\$15,000 – \$12,750). You must carry forward to 2002 the unused loss of \$12,750.

**Exceptions.** The loss deferral rules do not apply to:

- 1) A straddle that is an **identified straddle** at the end of the tax year,
- 2) Certain straddles consisting of **qualified covered call options** and the stock to be purchased under the options,
- 3) **Hedging transactions**, described earlier under *Section 1256 Contracts Marked to Market*, and
- 4) Straddles consisting entirely of **section 1256 contracts**, as described earlier under *Section 1256 Contracts Marked to Market* (but see *Identified straddle*, next).

**Identified straddle.** Losses from positions in an identified straddle are deferred until you dispose of all the positions in the straddle.

Any straddle (other than a straddle described in (2) or (3) above) is an identified straddle if all of the following conditions exist.

- 1) You clearly identified the straddle on your records before the close of the day on which you acquired it.
- 2) All of the original positions that you identify were acquired on the same day.
- 3) All of the positions included in item (2) were disposed of on the same day during the tax year, or none of the positions were disposed of by the end of the tax year.
- 4) The straddle is not part of a larger straddle.

**Qualified covered call options and optioned stock.** A straddle is not subject to the loss deferral rules for straddles if both of the following are true.

- 1) All of the offsetting positions consist of one or more qualified covered call options and the stock to be purchased from you under the options.
- 2) The straddle is not part of a larger straddle.

But see *Special year-end rule*, later, for an exception.

A qualified covered call option is any option you grant to purchase stock you hold (or stock you acquire in connection with granting the option), but only if all of the following are true.

- 1) The option is traded on a national securities exchange or other market approved by the Secretary of the Treasury.

- 2) The option is granted more than 30 days before its expiration date.
- 3) The option is not a deep-in-the-money option.
- 4) You are not an options dealer who granted the option in connection with your activity of dealing in options.
- 5) Gain or loss on the option is capital gain or loss.

A **deep-in-the-money** option is an option with a strike price lower than the lowest qualified benchmark (LQB). The strike price is the price at which the option is to be exercised. The LQB is the highest available strike price that is less than the applicable stock price. However, the LQB for an option with a term of more than 90 days and a strike price of more than \$50 is the second highest available strike price that is less than the applicable stock price. Strike prices are listed in the financial section of many newspapers.

The availability of strike prices for equity options with flexible terms does not affect the determination of the LQB for an option that is not an equity option with flexible terms.

The **applicable stock price** for any stock for which an option has been granted is:

- 1) The closing price of the stock on the most recent day on which that stock was traded before the date on which the option was granted, or
- 2) The opening price of the stock on the day on which the option was granted, but only if that price is greater than 110% of the price determined in (1).

If the applicable stock price is \$25 or less, the LQB will be treated as not less than 85% of the applicable stock price. If the applicable stock price is \$150 or less, the LQB will be treated as not less than an amount that is \$10 below the applicable stock price.

**Example.** On May 13, 2001, you held XYZ stock and you wrote an XYZ/September call option with a strike price of \$120. The closing price of one share of XYZ stock on May 12, 2001, was \$130.25. The strike prices of all XYZ/September call options offered on May 13, 2001, were as follows: \$110, \$115, \$120, \$125, \$130, and \$135. Because the option has a term of more than 90 days, the LQB is \$125, the second highest strike price that is less than \$130.25, the applicable stock price. The call option is a deep-in-the-money option because its strike price is lower than the LQB. Therefore, the option is not a qualified covered call option, and the loss deferral rules apply if you closed out the option or the stock at a loss during the year.

**Capital loss on qualified covered call options.** If you hold stock and you write a qualified covered call option on that stock with a strike price less than the applicable stock price, treat any loss from the option as long-term capital loss if, at the time the loss was realized, gain on the sale or exchange of the stock would be treated as long-term capital gain. The holding period of the stock does not include any period during which you are the writer of the option.

**Special year-end rule.** The loss deferral rules for straddles apply if all of the following are true.

- 1) The qualified covered call options are closed or the stock is disposed of at a loss during any tax year.
- 2) Gain on disposition of the stock or gain on the options is includible in gross income in a later tax year.
- 3) The stock or options were held less than 30 days after the closing of the options or the disposition of the stock.

## How To Report Gains and Losses (Form 6781)

Report each position (whether or not it is part of a straddle) on which you have unrecognized gain at the end of the tax year and the amount of this unrecognized gain in Part III of Form 6781. Use Part II of Form 6781 to figure your gains and losses on straddles before entering these amounts on Schedule D (Form 1040). Include a copy of Form 6781 with your income tax return.

## Coordination of Loss Deferral Rules and Wash Sale Rules

Rules similar to the wash sale rules apply to any disposition of a position or positions of a straddle. First apply Rule 1, explained next, then apply Rule 2. However, Rule 1 applies only if stocks or securities make up a position that is part of the straddle. If a position in the straddle does not include stock or securities, use Rule 2.

**Rule 1.** You cannot deduct a loss on the disposition of shares of stock or securities that make up the positions of a straddle if, within a period beginning 30 days before the date of that disposition and ending 30 days after that date, you acquired substantially identical stock or securities. Instead, the loss will be carried over to the following tax year, subject to any further application of Rule 1 in that year. This rule will also apply if you entered into a contract or option to acquire the stock or securities within the time period described above. See *Loss carryover*, later, for more information about how to treat the loss in the following tax year.

**Dealers.** If you are a dealer in stock or securities, this loss treatment will not apply to any losses you sustained in the ordinary course of your business.

**Example.** You are not a dealer in stock or securities. On December 2, 2001, you bought stock in XX Corporation (XX stock) and an offsetting put option. On December 13, 2001, there was \$20 of unrealized gain in the put option and you sold the XX stock at a \$20 loss. By December 16, 2001, the value of the put option had declined, eliminating all unrealized gain in the position. On December 16, 2001, you bought a second XX stock position that is substantially identical to the XX stock you sold on December 13, 2001. At the end of the year there is no unrecognized gain in the put option or in the XX stock. Under these circumstances, the \$20 loss will be disallowed for 2001 under Rule 1 because, within a period beginning 30 days before December 13, 2001, and ending 30 days after that date, you bought stock substantially identical to the XX stock you sold.

**Rule 2.** You cannot deduct a loss on the disposition of less than all of the positions of a straddle (your loss position) to the extent that any unrecognized gain at the close of the tax year in one or more of the following positions is more than the amount of any loss disallowed under Rule 1:

- 1) Successor positions,
- 2) Offsetting positions to the loss position, or
- 3) Offsetting positions to any successor position.

**Successor position.** A successor position is a position that is or was at any time offsetting to a second position, if both of the following conditions are met.

- 1) The second position was offsetting to the loss position that was sold.
- 2) The successor position is entered into during a period beginning 30 days before, and ending 30 days after, the sale of the loss position.

**Example 1.** On November 1, 2001, you entered into offsetting long and short positions in non-section 1256 contracts. On November 12, 2001, you disposed of the long position at a \$10 loss. On November 14, 2001, you entered into a new long position (successor position) that is offsetting to the retained short position, but that is not substantially identical to the long position disposed of on November 12, 2001. You held both positions through year end, at which time there was \$10 of unrecognized gain in the successor long position and no unrecognized gain in the offsetting short position. Under these circumstances, the entire \$10 loss will be disallowed for 2001 because there is \$10 of unrecognized gain in the successor long position.

**Example 2.** The facts are the same as in Example 1, except that at year end you have \$4 of unrecognized gain in the successor long position and \$6 of unrecognized gain in the offsetting short position. Under these circumstances, the entire \$10 loss will be disallowed for 2001 because there is a total of \$10 of unrecognized gain in the successor long position and offsetting short position.

**Example 3.** The facts are the same as in Example 1, except that at year end you have \$8 of unrecognized gain in the successor long position and \$8 of unrecognized loss in the offsetting short position. Under these circumstances, \$8 of the total \$10 realized loss will be disallowed for 2001 because there is \$8 of unrecognized gain in the successor long position.

**Loss carryover.** If you have a disallowed loss that resulted from applying Rule 1 and Rule 2, you must carry it over to the next tax year and apply Rule 1 and Rule 2 to that carryover loss. For example, a loss disallowed in 2000 under Rule 1 will not be allowed in 2001, unless the substantially identical stock or securities (which caused the loss to be disallowed in 2000) were disposed of during 2001. In addition, the carryover loss will not be allowed in 2001 if Rule 1 or Rule 2 disallows it.



**Example.** The facts are the same as in the example under Rule 1 above, except that on December 31, 2002, you sell the XX stock at a \$20 loss and there is \$40 of unrecognized gain in the put option. Under these circumstances, you cannot deduct in 2002 either the \$20 loss disallowed in 2001 or the \$20 loss you incurred for the December 31, 2002, sale of XX stock. Rule 1 does not apply because the substantially identical XX stock was sold during the year and no substantially identical stock or securities were bought within the 61-day period. However, Rule 2 does apply because there is \$40 of unrecognized gain in the put option, an offsetting position to the loss positions.

**Capital loss carryover.** If the sale of a loss position would have resulted in a capital loss, you treat the carryover loss as a capital loss on the date it is allowed, even if you would treat the gain or loss on any successor positions as ordinary income or loss. Likewise, if the sale of a loss position (in the case of section 1256 contracts) would have resulted in a 60% long-term capital loss and a 40% short-term capital loss, you treat the carryover loss under the 60/40 rule, even if you would treat any gain or loss on any successor positions as 100% long-term or short-term capital gain or loss.

**Exceptions.** The rules for coordinating straddle losses and wash sales do not apply to the following loss situations.

- 1) Loss on the sale of one or more positions in a hedging transaction. (Hedging transactions are described under *Section 1256 Contracts Marked to Market, earlier.*)
- 2) Loss on the sale of a loss position in a mixed straddle account. (See the discussion later on the mixed straddle account election.)
- 3) Loss on the sale of a position that is part of a straddle consisting only of section 1256 contracts.

## Holding Period and Loss Treatment Rules

The holding period of a position in a straddle generally begins no earlier than the date on which the straddle ends (the date you no longer hold an offsetting position). This rule does not apply to any position you held more than 1 year before you established the straddle. But see *Exceptions, later.*

**Example.** On March 6, 2000, you acquired gold. On January 4, 2001, you entered into an offsetting short gold forward contract (nonregulated futures contract). On April 1, 2001, you disposed of the short gold forward contract at no gain or loss. On April 8, 2001, you sold the gold at a gain. Because the gold had been held for 1 year or less before the offsetting short position was entered into, the holding period for the gold begins on April 1, 2001, the date the straddle ended. Gain recognized on the sale of the gold will be treated as short-term capital gain.

**Loss treatment.** Treat the loss on the sale of one or more positions (the loss position) of a straddle as a long-term capital loss if both of the following are true.

- 1) You held (directly or indirectly) one or more offsetting positions to the loss position on the date you entered into the loss position.
- 2) You would have treated all gain or loss on one or more of the straddle positions as long-term capital gain or loss if you had sold these positions on the day you entered into the loss position.

**Mixed straddles.** Special rules apply to a loss position that is part of a mixed straddle and that is a non-section 1256 position. A **mixed straddle** is a straddle:

- 1) That is not part of a larger straddle,
- 2) In which all positions are held as capital assets,
- 3) In which at least one (but not all) of the positions is a section 1256 contract, and
- 4) For which the mixed straddle election (Election A, discussed later) has not been made.

Treat the loss as 60% long-term capital loss and 40% short-term capital loss, if all of the following conditions apply.

- 1) Gain or loss from the sale of one or more of the straddle positions that are section 1256 contracts would be considered gain or loss from the sale or exchange of a capital asset.
- 2) The sale of no position in the straddle, other than a section 1256 contract, would result in a long-term capital gain or loss.
- 3) You have not made a straddle-by-straddle identification election (Election B) or mixed straddle account election (Election C), both discussed later.

**Example.** On March 1, 2001, you entered into a long gold forward contract. On July 15, 2001, you entered into an offsetting short gold regulated futures contract. You did not make an election to offset gains and losses from positions in a mixed straddle. On August 9, 2001, you disposed of the long forward contract at a loss. Because the gold forward contract was part of a mixed straddle and the disposition of this non-section 1256 position would not result in long-term capital loss, the loss recognized on the termination of the gold forward contract will be treated as a 60% long-term and 40% short-term capital loss.

**Exceptions.** The special holding period and loss treatment for straddle positions does not apply to positions that:

- 1) Constitute part of a hedging transaction,
- 2) Are included in a straddle consisting only of section 1256 contracts, or
- 3) Are included in a mixed straddle account (Election C), discussed later.

## Mixed Straddles

If you disposed of a position in a mixed straddle and make one of the elections described in the

following discussions, report your gain or loss as indicated in those discussions. If you do not make any of the elections, report your gain or loss in Part II of Form 6781. If you disposed of the section 1256 component of the straddle, enter the recognized loss (line 10, column (h)) or your gain (line 12, column (f)) in Part I of Form 6781, on line 1. Do not include it on line 11 or 13 (Part II).

**Mixed straddle election (Election A).** You can elect out of the marked to market rules, discussed under *Section 1256 Contracts Marked to Market, earlier*, for all section 1256 contracts that are part of a mixed straddle. Instead, the gain and loss rules for straddles will apply to these contracts. However, if you make this election for an option on a section 1256 contract, the gain or loss treatment discussed earlier under *Options* will apply, subject to the gain and loss rules for straddles.

You can make this election if:

- 1) At least one (but not all) of the positions is a section 1256 contract, and
- 2) Each position forming part of the straddle is clearly identified as being part of that straddle on the day the first section 1256 contract forming part of the straddle is acquired.

If you make this election, it will apply for all later years as well. It cannot be revoked without the consent of the IRS. If you made this election, check box A of Form 6781. Do not report the section 1256 component in Part I.

**Other elections.** You can avoid the 60% long-term capital loss treatment required for a non-section 1256 loss position that is part of a mixed straddle, described earlier, if you choose either of the two following elections to offset gains and losses for these positions.

- 1) **Election B.** Make a separate identification of the positions of each mixed straddle for which you are electing this treatment (the straddle-by-straddle identification method).
- 2) **Election C.** Establish a mixed straddle account for a class of activities for which gains and losses will be recognized and offset on a periodic basis.

These two elections are alternatives to the mixed straddle election. You can choose only one of the three elections. Use Form 6781 to indicate your election choice by checking box A, B, or C, whichever applies.

**Straddle-by-straddle identification election (Election B).** Under this election, you must clearly identify each position that is part of the identified mixed straddle by the earlier of:

- 1) The close of the day the identified mixed straddle is established, or
- 2) The time the position is disposed of.

If you dispose of a position in the mixed straddle before the end of the day on which the straddle is established, this identification must be made by the time you dispose of the position. You are presumed to have properly identified a mixed straddle if independent verification is used.

The basic tax treatment of gain or loss under this election depends on which side of the straddle produced the total net gain or loss. If the net

gain or loss from the straddle is due to the section 1256 contracts, gain or loss is treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss. Enter the net gain or loss in Part I of Form 6781 and identify the election by checking box B.

If the net gain or loss is due to the non-section 1256 positions, gain or loss is short-term capital gain or loss. Enter the net gain or loss on Part I of Schedule D and identify the election.

For the specific application of the rules of this election, see regulations section 1.1092(b)-3T.

**Example.** On April 1, you entered into a non-section 1256 position and an offsetting section 1256 contract. You also made a valid election to treat this straddle as an identified mixed straddle. On April 8, you disposed of the non-section 1256 position at a \$600 loss and the section 1256 contract at an \$800 gain. Under these circumstances, the \$600 loss on the non-section 1256 position will be offset against the \$800 gain on the section 1256 contract. The net gain of \$200 from the straddle will be treated as 60% long-term capital gain and 40% short-term capital gain because it is due to the section 1256 contract.

**Mixed straddle account (Election C).** You may elect to establish one or more accounts for determining gains and losses from all positions in a mixed straddle. You must establish a separate mixed straddle account for each separate designated class of activities.

Generally, you must determine gain or loss for each position in a mixed straddle account as of the close of each business day of the tax year. You offset the net section 1256 contracts against the net non-section 1256 positions to determine the “daily account net gain or loss.”

If the daily account amount is due to non-section 1256 positions, the amount is treated as short-term capital gain or loss. If the daily account amount is due to section 1256 contracts, the amount is treated as 60% long-term and 40% short-term capital gain or loss.

On the last business day of the tax year, you determine the “annual account net gain or loss” for each account by netting the daily account amounts for that account for the tax year. The “total annual account net gain or loss” is determined by netting the annual account amounts for all mixed straddle accounts that you had established.

The net amounts keep their long-term or short-term classification. However, no more than 50% of the total annual account net gain for the tax year can be treated as long-term capital gain. Any remaining gain is treated as short-term capital gain. Also, no more than 40% of the total annual account net loss can be treated as short-term capital loss. Any remaining loss is treated as long-term capital loss.

The election to establish one or more mixed straddle accounts for each tax year must be made by the due date (without extensions) of your income tax return for the immediately preceding tax year. If you begin trading in a new class of activities during a tax year, you must make the election for the new class of activities by the later of either:

- 1) The due date of your return for the immediately preceding tax year (without extensions), or
- 2) 60 days after you entered into the first mixed straddle in the new class of activities.

You make the election on Form 6781 by checking box C. Attach Form 6781 to your income tax return for the immediately preceding tax year, or file it within 60 days, if that applies. Report the annual account net gain or loss from a mixed straddle account in Part II of Form 6781. In addition, you must attach a statement to Form 6781 specifically designating the class of activities for which a mixed straddle account is established.

For the specific application of the rules of this election, see regulations section 1.1092(b)-4T.

**Interest expense and carrying charges relating to mixed straddle account positions.** You cannot deduct interest and carrying charges that are allocable to any positions held in a mixed straddle account. Treat these charges as an adjustment to the annual account net gain or loss and allocate them proportionately between the net short-term and the net long-term capital gains or losses.

To find the amount of interest and carrying charges that is not deductible and that must be added to the annual account net gain or loss, apply the rules described in chapter 3 under *Interest expense and carrying charges on straddles* to the positions held in the mixed straddle account.

## Sales of Stock to ESOPs or Certain Cooperatives

If you sold qualified securities held for at least 3 years to an employee stock ownership plan (ESOP) or eligible worker-owned cooperative, you may be able to elect to postpone all or part of the gain on the sale if you bought qualified replacement property (certain securities) within the period that began 3 months before the sale and ended 12 months after the sale. If you make the election, you must recognize gain on the sale only to the extent the proceeds from the sale exceed the cost of the qualified replacement property.

You must reduce the basis of the replacement property by any postponed gain. If you dispose of any replacement property, you may have to recognize all of the postponed gain.

Generally, to qualify for the election the ESOP or cooperative must own at least 30% of the outstanding stock of the corporation that issued the qualified securities. Also, the qualified replacement property must have been issued by a domestic operating corporation.

**How to make the election.** You must make the election no later than the due date (including extensions) for filing your tax return for the year in which you sold the stock. If your original return was filed on time, you may make the election on an amended return filed no later than 6 months after the due date of your return (excluding extensions). Print “Filed pursuant to section 301.9100-2” at the top of the amended return, and file it at the same address you used for your original return.

**How to report and postpone gain.** Report the entire gain realized on line 8 of Schedule D. To make the choice to postpone gain, enter “Section 1042 election” in column (a) of the line directly below the line on which you reported the gain. Enter in column (f) the amount of the gain you are postponing or expecting to postpone. Enter it as a loss (in parentheses). If the actual postponed gain is different from the amount you report, file an amended return.

Also attach the following statements.

- 1) A “statement of election” that indicates you are making an election under section 1042(a) of the Internal Revenue Code and that includes the following information.
  - a) A description of the securities sold, the date of the sale, the amount realized on the sale, and the adjusted basis of the securities.
  - b) The name of the ESOP or cooperative to which the qualified securities were sold.
  - c) For a sale that was part of a single, interrelated transaction under a prearranged agreement between taxpayers involving other sales of qualified securities, the names and identifying numbers of the other taxpayers under the agreement and the number of shares sold by the other taxpayers.
- 2) A notarized “statement of purchase” describing the qualified replacement property, date of purchase, and the cost of the property and declaring the property to be qualified replacement property for the qualified stock you sold. The statement must have been notarized no later than 30 days after the purchase. If you have not yet purchased the qualified replacement property, you must attach the notarized “statement of purchase” to your income tax return for the year following the election year (or the election will not be valid).
- 3) A verified written statement of the domestic corporation whose employees are covered by the ESOP acquiring the securities, or of any authorized officer of the cooperative, consenting to the taxes under sections 4978 and 4979A of the Internal Revenue Code on certain dispositions, and prohibited allocations of the stock purchased by the ESOP or cooperative.

**More information.** For details, see section 1042 of the Internal Revenue Code and Temporary Regulations section 1.1042-1T.

## Rollover of Gain From Publicly Traded Securities

You may qualify for a tax-free rollover of certain gains from the sale of publicly traded securities. This means that if you buy certain replacement property and make the choice described in this section, you postpone part or all of your gain.

You postpone the gain by adjusting the basis of the replacement property as described in *Basis of replacement property*, later. This

postpones your gain until the year you dispose of the replacement property.

You qualify to make this choice if you meet all the following tests.

- 1) You sell publicly traded securities at a gain. Publicly traded securities are securities traded on an established securities market.
- 2) Your gain from the sale is a capital gain.
- 3) During the 60-day period beginning on the date of the sale, you buy replacement property. This replacement property must be either common stock or a partnership interest in a **specialized small business investment company (SSBIC)**. This is any partnership or corporation licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993.

**Amount of gain recognized** If you make the choice described in this section, you must recognize gain only up to the following amount:

- 1) The amount realized on the sale, minus
- 2) The cost of any common stock or partnership interest in an SSBIC that you bought during the 60-day period beginning on the date of sale (and did not previously take into account on an earlier sale of publicly traded securities).

If this amount is less than the amount of your gain, you can postpone the rest of your gain, subject to the limit described next. If this amount is equal to or more than the amount of your gain, you must recognize the full amount of your gain.

**Limit on gain postponed.** The amount of gain you can postpone each year is limited to the smaller of:

- 1) \$50,000 (\$25,000 if you are married and file a separate return), or
- 2) \$500,000 (\$250,000 if you are married and file a separate return), minus the amount of gain you postponed for all earlier years.

**Basis of replacement property.** You must subtract the amount of postponed gain from the basis of your replacement property.

**How to report and postpone gain.** Report the entire gain realized from the sale on line 1 or line 8 of Schedule D (Form 1040), whichever is appropriate. To make the choice to postpone gain, enter "SSBIC Rollover" in column (a) of the line directly below the line on which you reported the gain. Enter the amount of gain postponed in column (f). Enter it as a loss (in parentheses).

Also, attach a schedule showing how you figured the postponed gain, the name of the SSBIC in which you purchased common stock or a partnership interest, the date of that purchase, and your new basis in that SSBIC stock or partnership interest.

You must make the choice to postpone gain no later than the due date (including extensions) for filing your tax return for the year in which you sold the securities. If your original return was filed on time, you may make the choice on an amended return filed no later than 6 months after the due date of your return (excluding ex-

tensions). Print "Filed pursuant to section 301.9100-2" at the top of the amended return, and file it at the same address you used for your original return.

Your choice is revocable with the consent of the IRS.

## Gains on Qualified Small Business Stock

This section discusses two provisions of the law that may apply to gain from the sale or trade of qualified small business stock. You may qualify for a tax-free **rollover** of all or part of the gain. You may be able to **exclude** part of the gain from your income.

**Qualified small business stock.** This is stock that meets all the following tests.

- 1) It must be stock in a C corporation.
- 2) It must have been originally issued after August 10, 1993.
- 3) The corporation must have total gross assets of \$50 million or less at all times after August 9, 1993, and before it was issued the stock. Its total gross assets immediately after it issued the stock must also be \$50 million or less.

When figuring the corporation's total gross assets, you must also count the assets of any predecessor of the corporation. In addition, you must treat all corporations that are members of the same parent-sub-  
sidiary controlled group as one corporation.

- 4) You must have acquired the stock at its original issue, directly or through an underwriter, in exchange for money or other property (not including stock), or as pay for services provided to the corporation (other than services performed as an underwriter of the stock). In certain cases, your stock may also meet this test if you acquired it from another person who met this test, or through a conversion or trade of qualified small business stock that you held.
- 5) The corporation must have met the **active business test**, defined next, and must have been a C corporation during substantially all the time you held the stock.
- 6) Within the period beginning 2 years before and ending 2 years after the stock was issued, the corporation cannot have bought more than a de minimis amount of its stock from you or a related party.
- 7) Within the period beginning 1 year before and ending 1 year after the stock was issued, the corporation cannot have bought more than a de minimis amount of its stock from anyone, unless the total value of the stock it bought is 5% or less of the total value of all its stock.

For more information about tests 6 and 7, see the regulations under section 1202 of the Internal Revenue Code.

**Active business test.** A corporation meets this test for any period of time if, during that period, both the following are true.

- 1) It was an **eligible corporation**, defined below.

- 2) It used at least 80% (by value) of its assets in the active conduct of at least one **qualified trade or business**, defined below.

**Exception for SSBIC.** Any specialized small business investment company (SSBIC) is treated as meeting the active business test. An SSBIC is an eligible corporation that is licensed to operate under section 301(d) of the Small Business Investment Act of 1958 as in effect on May 13, 1993.

**Eligible corporation.** This is any U.S. corporation other than:

- 1) A Domestic International Sales Corporation (DISC) or a former DISC,
- 2) A corporation that has made, or whose subsidiary has made, an election under section 936 of the Internal Revenue Code, concerning the Puerto Rico and possession tax credit,
- 3) A regulated investment company,
- 4) A real estate investment trust (REIT),
- 5) A real estate mortgage investment conduit (REMIC),
- 6) A financial asset securitization investment trust (FASIT), or
- 7) A cooperative.

**Qualified trade or business.** This is any trade or business other than:

- 1) One involving services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services,
- 2) One whose principal asset is the reputation or skill of one or more employees,
- 3) Any banking, insurance, financing, leasing, investing, or similar business,
- 4) Any farming business (including the business of raising or harvesting trees),
- 5) Any business involving the production or extraction of products for which percentage depletion can be claimed, or
- 6) Any business of operating a hotel, motel, restaurant, or similar business.

## Rollover of Gain

You may qualify for a tax-free rollover of capital gain from the sale of qualified small business stock held more than 6 months. This means that, if you buy certain replacement stock and make the choice described in this section, you postpone part or all of your gain.

You postpone the gain by adjusting the basis of the replacement stock as described in *Basis of replacement stock*, below. This postpones your gain until the year you dispose of the replacement stock.

You can make this choice if you meet all the following tests.

- 1) You buy replacement stock during the 60-day period beginning on the date of the sale.

- 2) The replacement stock is qualified small business stock.
- 3) The replacement stock continues to meet the active business requirement for small business stock for at least the first 6 months after you buy it.

**Amount of gain recognized.** If you make the choice described in this section, you must recognize the capital gain only up to the following amount:

- 1) The amount realized on the sale, minus
- 2) The cost of any qualified small business stock you bought during the 60-day period beginning on the date of sale (and did not previously take into account on an earlier sale of qualified small business stock).

If this amount is less than the amount of your capital gain, you can postpone the rest of that gain. If this amount equals or is more than the amount of your capital gain, you must recognize the full amount of your gain.

**Basis of replacement stock.** You must subtract the amount of postponed gain from the basis of your replacement stock.

**Holding period of replacement stock.** Your holding period for the replacement stock includes your holding period for the stock sold, except for the purpose of applying the 6-month holding period requirement for choosing to roll over the gain on its sale.

**Pass-through entity.** A pass-through entity (a partnership, S corporation, or mutual fund or other regulated investment company) also may make the choice to postpone gain. The benefit of the postponed gain applies to your share of the entity's postponed gain if you held an interest in the entity for the entire period the entity held the stock.

If a pass-through entity sold qualified small business stock held for more than 6 months and you held an interest in the entity for the entire period the entity held the stock, you also may choose to postpone gain if you, rather than the pass-through entity, buy the replacement stock within the 60-day period.

**How to report gain.** Report the entire gain realized from the sale on line 1 or line 8 of Schedule D (Form 1040), whichever is appropriate. To make the choice to postpone the gain, enter "Section 1045 Rollover" in column (a) of the line directly below the line on which you reported the gain. Enter the amount of gain postponed in column (f). Enter it as a loss (in parentheses).

You must make the choice to postpone gain no later than the due date (including extensions) for filing your tax return for the year in which the stock was sold. If your original return was filed on time, you may make the choice on an amended return filed no later than 6 months after the due date of your return (excluding extensions). Print "Filed pursuant to section 301.9100-2" at the top of the amended return, and file it at the same address you used for your original return.

## Section 1202 Exclusion

You generally can exclude from your income one-half of your gain from the sale or trade of qualified small business stock held by you for more than 5 years. The taxable part of your gain equal to your section 1202 exclusion is a 28% rate gain. See *Capital Gain Tax Rates*, later.

**SSBIC stock.** If the stock is specialized small business investment company (SSBIC) stock that you bought as replacement property for publicly traded securities you sold at a gain, you must reduce the basis of the stock by the amount of any postponed gain on that earlier sale, as explained earlier under *Rollover of Gain From Publicly Traded Securities*. But do not reduce your basis by that amount when figuring your section 1202 exclusion.

**Limit on eligible gain.** The amount of your gain from the stock of any one issuer that is eligible for the exclusion in 2001 is limited to the greater of:

- 1) Ten times your basis in all qualified stock of the issuer that you sold or exchanged during the year, or
- 2) \$10 million (\$5 million for married individuals filing separately) minus the amount of gain from the stock of the same issuer that you used to figure your exclusion in earlier years.

**How to report gain.** Report the entire gain realized from the sale in column (f) of line 8 of Schedule D (Form 1040). Report an amount equal to the excluded gain in column (g). Directly below the line on which you report the gain, enter "Section 1202 exclusion" in column (a) and enter the amount of the exclusion in column (f). Enter it as a loss (in parentheses).

**More information.** For information about additional requirements that may apply, see section 1202 of the Internal Revenue Code.

## Rollover of Gain From Sale of Empowerment Zone Assets

You may qualify for a tax-free rollover of certain gains from the sale of qualified empowerment zone assets. This means that if you buy certain replacement property and make the choice described in this section, you postpone part or all of the recognition of your gain.

You qualify to make this choice if you meet all the following tests.

- 1) You hold a qualified empowerment zone asset for more than 1 year and sell it at a gain.
- 2) Your gain from the sale is a capital gain.
- 3) During the 60-day period beginning on the date of the sale, you buy a replacement qualified empowerment zone asset in the same zone as the asset sold.

**Qualified empowerment zone asset.** This means certain stock or partnership interests in an enterprise zone business. It also includes certain tangible property used in an enterprise zone business. You must have acquired the asset after December 21, 2000.

**Amount of gain recognized.** If you make the choice described in this section, you must recognize gain only up to the following amount:

- 1) The amount realized on the sale, minus
- 2) The cost of any qualified empowerment zone asset that you bought during the 60-day period beginning on the date of sale (and did not previously take into account in rolling over gain on an earlier sale of qualified empowerment zone assets).

If this amount is equal to or more than the amount of your gain, you must recognize the full amount of your gain. If this amount is less than the amount of your gain, you can postpone the rest of your gain by adjusting the basis of your replacement property as described next.

**Basis of replacement property.** You must subtract the amount of postponed gain from the basis of the qualified empowerment zone assets you bought as replacement property.

**How to report and postpone gain.** Report the entire gain realized from the sale on line 8 of Schedule D (Form 1040). To make the choice to postpone gain, enter "Section 1397B Rollover" in column (a) of the line directly below the line on which you reported the gain. Enter the amount of gain postponed in column (f). Enter it as a loss (in parentheses).

Also attach a statement describing:

- 1) How you figured the postponed gain,
- 2) The name of the empowerment zone(s) in which the property sold and purchased is located,
- 3) The qualified empowerment zone asset(s) purchased, including the date of purchase, and
- 4) Your adjusted basis in the asset(s).

**More information.** For more information about empowerment zones, see Publication 954, *Tax Incentives for Empowerment Zones and Other Distressed Communities*. For more information about this rollover of gain, see section 1397B of the Internal Revenue Code.

## Reporting Capital Gains and Losses

This section discusses how to report your capital gains and losses on Schedule D (Form 1040). Enter your sales and trades of stocks, bonds, etc., and real estate (if not required to be reported on another form) on line 1 of Part I or line 8 of Part II, as appropriate. Include all these transactions even if you did not receive a Form 1099-B or 1099-S (or substitute statement). You can use Schedule D-1 as a continuation schedule to report more transactions.

Be sure to add all sales price entries in column (d) of lines 1 and 2 and enter the total on line 3. Also add all sales price entries in column (d) of lines 8 and 9 and enter the total on line 10. Then add the following amounts reported to you for 2001 on Forms 1099-B and Forms 1099-S (or on substitute statements):

- 1) Proceeds from transactions involving stocks, bonds, and other securities, and
- 2) Gross proceeds from real estate transactions (other than the sale of your main home if you had no taxable gain) not reported on another form or schedule.

If this total is more than the total of lines 3 and 10, attach a statement to your return explaining the difference.

**Installment sales.** You cannot use the installment method to report a gain from the sale of stock or securities traded on an established securities market. You must report the entire gain in the year of sale (the year in which the trade date occurs).

**At-risk rules.** Special at-risk rules apply to most income-producing activities. These rules limit the amount of loss you can deduct to the amount you risk losing in the activity. The at-risk rules also apply to a loss from the sale or trade of an asset used in an activity to which the at-risk rules apply. For more information, see Publication 925, *Passive Activity and At-Risk Rules*. Use **Form 6198, At-Risk Limitations**, to figure the amount of loss you can deduct.

**Passive activity gains and losses.** If you have gains or losses from a passive activity, you may also have to report them on **Form 8582**. In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its separate instructions for more information about reporting capital gains and losses from a passive activity.

**Form 1099–B transactions.** If you sold property, such as stocks, bonds, or certain commodities, through a broker, you should receive Form 1099–B or an equivalent statement from the broker. Use the Form 1099–B or equivalent statement to complete Schedule D.

Report the gross proceeds shown in box 2 of Form 1099–B as the **gross sales price** in column (d) of either line 1 or line 8 of Schedule D, whichever applies. However, if the broker advises you, in box 2 of Form 1099–B, that gross proceeds (gross sales price) less commissions and option premiums were reported to the IRS, enter that **net sales price** in column (d) of either line 1 or line 8 of Schedule D, whichever applies.

If the net amount is entered in column (d), do not include the commissions and option premiums in column (e).

**Section 1256 contracts and straddles.** Use Form 6781 to report gains and losses from section 1256 contracts and straddles before entering these amounts on Schedule D. Include a copy of Form 6781 with your income tax return.

**Market discount bonds.** Report the sale or trade of a market discount bond on Schedule D (Form 1040), line 1 or line 8. If the sale or trade results in a gain and you did not choose to include market discount in income currently, enter “Accrued Market Discount” on the next line in column (a) and the amount of the accrued market discount as a loss in column (f). Also report the amount of accrued market discount as interest income on Schedule B (Form 1040), line 1, and identify it as “Accrued Market Discount.”

**Form 1099–S transactions.** If you sold or traded reportable real estate, you generally should receive from the real estate reporting

person a Form 1099–S, *Proceeds From Real Estate Transactions*, showing the gross proceeds.

“Reportable real estate” is defined as any present or future ownership interest in any of the following:

- 1) Improved or unimproved land, including air space,
- 2) Inherently permanent structures, including any residential, commercial, or industrial building,
- 3) A condominium unit and its accessory fixtures and common elements, including land, and
- 4) Stock in a cooperative housing corporation (as defined in section 216 of the Internal Revenue Code).

A “real estate reporting person” could include the buyer’s attorney, your attorney, the title or escrow company, a mortgage lender, your broker, the buyer’s broker, or the person acquiring the biggest interest in the property.

Your Form 1099–S will show the gross proceeds from the sale or exchange in box 2. Follow the instructions for Schedule D to report these transactions, and include them on line 1 or 8 as appropriate.

It is unlawful for any real estate reporting person to separately charge you for complying with the requirement to file Form 1099–S.

**Sale of property bought at various times.** If you sell a block of stock or other property that you bought at various times, report the short-term gain or loss from the sale on one line in Part I of Schedule D and the long-term gain or loss on one line in Part II. Print “Various” in column (b) for the “Date acquired.” See the *Comprehensive Example* later in this chapter.

**Sale expenses.** Add to your cost or other basis any expense of sale such as broker’s fees, commissions, state and local transfer taxes, and option premiums. Enter this adjusted amount in column (e) of either Part I or Part II of Schedule D, whichever applies, unless you reported the net sales price amount in column (d).

**Short-term gains and losses.** Capital gain or loss on the sale or trade of investment property held 1 year or less is a short-term capital gain or loss. You report it in Part I of Schedule D. If the amount you report in column (f) is a loss, show it in parentheses.

You combine your share of short-term capital gain or loss from partnerships, S corporations, and fiduciaries, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on line 7 of Schedule D.

**Long-term gains and losses.** A capital gain or loss on the sale or trade of investment property held more than 1 year is a long-term capital gain or loss. You report it in Part II of Schedule D. If the amount you report in column (f) is a loss, show it in parentheses.

You also report the following in Part II of Schedule D:

- 1) Undistributed long-term capital gains from a regulated investment company (mutual fund) or real estate investment trust (REIT),

- 2) Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries,
- 3) All capital gain distributions from mutual funds and REITs not reported directly on line 10 of Form 1040A or line 13 of Form 1040, and
- 4) Long-term capital loss carryovers.

The result after combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss (line 16 of Schedule D).

**28% rate gain or loss.** Enter in column (g) the amount, if any, from column (f) that is a 28% rate gain or loss. Enter any loss in parentheses. A 28% rate gain or loss is:

- Any collectibles gain or loss, or
- The part of your gain on qualified small business stock that is equal to the section 1202 exclusion.

For more information, see *Capital Gain Tax Rates*, later.

**Capital gain distributions only.** You do not have to file Schedule D if **all** of the following are true.

- 1) The only amounts you would have to report on Schedule D are capital gain distributions from box 2a of Form 1099–DIV (or substitute statement).
- 2) You do not have an amount in box 2b, 2c, 2d, or 2e of any Form 1099–DIV (or substitute statement).
- 3) You do not file Form 4952 or, if you do, the amount on line 4e of that form is not more than zero.

If all the above statements are true, report your capital gain distributions directly on line 13 of Form 1040 and check the box on that line. Also, use the *Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax.

You can report your capital gain distributions on line 10 of Form 1040A, instead of on Form 1040, if both of the following are true.

- 1) None of the Forms 1099–DIV (or substitute statements) you received have an amount in box 2b, 2c, 2d, or 2e.
- 2) You do not have to file Form 1040 for any other reason. (For example, you must not have any other capital gains or any capital losses.)

**Total net gain or loss.** To figure your total net gain or loss, combine your net short-term capital gain or loss (line 7) with your net long-term capital gain or loss (line 16). Enter the result on line 17, Part III of Schedule D. If your losses are more than your gains, see *Capital Losses*, next. If both lines 16 and 17 are gains and line 39 of Form 1040 is more than zero, see *Capital Gain Tax Rates*, later.

## Capital Losses

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on line 13 of Form 1040, enclosed in parentheses.

**Table 4–2. What Is Your Maximum Capital Gain Tax Rate?**

<b>IF your net capital gain is from . . .</b>	<b>THEN your capital gain rate is . . .</b>
Collectibles gain	28%
Gain on qualified small business stock equal to the section 1202 exclusion	28%
Unrecaptured section 1250 gain	25%
Other gain <sup>1</sup> , and the regular tax rate that would apply is 27.5% or higher	20%
Other gain <sup>1</sup> , and the regular tax rate that would apply is lower than 27.5%	8% or 10%

<sup>1</sup> “Other gain” means any gain that is not collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain.

<sup>2</sup> The rate is 8% only for qualified 5-year gain.

**Limit on deduction.** Your allowable capital loss deduction, figured on Schedule D, is the lesser of:

- 1) \$3,000 (\$1,500 if you are married and file a separate return), or
- 2) Your total net loss as shown on line 17 of Schedule D.

You can use your total net loss to reduce your income dollar for dollar, up to the \$3,000 limit.

**Capital loss carryover.** If you have a total net loss on line 17 of Schedule D that is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

When you figure the amount of any capital loss carryover to the next year, you must take the current year’s allowable deduction into account, whether or not you claimed it.

When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year’s long-term capital gains before it reduces that year’s short-term capital gains.

**Figuring your carryover.** The amount of your capital loss carryover is the amount of your total net loss that is more than the lesser of:

- 1) Your allowable capital loss deduction for the year, or
- 2) Your taxable income increased by your allowable capital loss deduction for the year and your deduction for personal exemptions.

If your deductions are more than your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Complete the *Capital Loss Carryover Worksheet* in the Schedule D (Form 1040) instructions to determine the part of your capital loss for 2001 that you can carry over to 2002.

**Example.** Bob and Gloria sold securities in 2001. The sales resulted in a capital loss of \$7,000. They had no other capital transactions. Their taxable income was \$26,000. On their joint 2001 return, they can deduct \$3,000. The unused part of the loss, \$4,000 (\$7,000 – \$3,000), can be carried over to 2002.

If their capital loss had been \$2,000, their capital loss deduction would have been \$2,000. They would have no carryover.

**Use short-term losses first.** When you figure your capital loss carryover, use your short-term capital losses first, even if you incurred them after a long-term capital loss. If you have not reached the limit on the capital loss deduction after using the short-term capital loss, use the long-term capital losses until you reach the limit.

**Decedent’s capital loss.** A capital loss sustained by a decedent during his or her last tax year (or carried over to that year from an earlier year) can be deducted only on the final return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. The decedent’s estate cannot deduct any of the loss or carry it over to following years.

**Joint and separate returns.** If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separate returns, any capital loss carryover from the joint return can be deducted only on the return of the spouse who actually had the loss.

## Capital Gain Tax Rates

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gain rates.

The term “net capital gain” means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

The maximum capital gain rate can be 8%, 10%, 20%, 25%, or 28%. See *Table 4–2* for details.

The maximum capital gain rate does not apply if it is higher than your regular tax rate.

**8% rate.** Beginning in 2001, the 10% capital gain rate is lowered to 8% for “qualified 5-year gain.”

**Qualified 5-year gain.** This is long-term capital gain from the sale of property that you held for more than 5 years and that would otherwise be subject to the 10% capital gain rate.

**Example.** You have a net capital gain from selling collectibles, so the capital gain rate would be 28%. Because you are single and your taxable income is \$25,000, your regular tax rate is 15%. All your taxable income will be taxed at the 15% rate. The 28% rate does not apply.

**Investment interest deducted.** If you claim a deduction for investment interest, you may have

to reduce the amount of your net capital gain that is eligible for the capital gain tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on lines 21–23 of Schedule D. For more information about the limit on investment interest, see *Interest Expenses* in chapter 3.

## Using the Capital Gain Rates

The part of a net capital gain that is subject to each rate is determined under the following rules.

- 1) In each of the following groups, long-term capital gains are netted with long-term capital losses.
  - a) A 28% group, consisting of collectibles gains and losses, gain on qualified small business stock equal to the section 1202 exclusion, and long-term capital loss carryovers.
  - b) A 25% group, consisting of unrecaptured section 1250 gain.
  - c) A 20% group, consisting of gains and losses that are not in the 28% or 25% group. (This includes gains that may be taxed at a rate of 10% or 8%.)
- 2) A net short-term capital loss reduces any net gain from the 28% group, then any gain from the 25% group, and finally any net gain from the 20% group.
- 3) A net loss from the 28% group reduces any gain from the 25% group, and then any net gain from the 20% group.
- 4) A net loss from the 20% group reduces any net gain from the 28% group, and then any net gain from the 25% group.

**Collectibles gain or loss.** This is gain or loss from the sale or trade of a work of art, rug, antique, metal (such as gold, silver, and platinum bullion), gem, stamp, coin, or alcoholic beverage held more than 1 year.

Collectibles gain includes gain from the sale of an interest in a partnership, S corporation, or trust attributable to unrealized appreciation of collectibles.

**Gain on qualified small business stock.** If you realized a gain from qualified small business stock that you held more than 5 years, you generally can exclude one-half of your gain from

your income. The taxable part of your gain equal to your section 1202 exclusion is a 28% rate gain. See *Gains on Qualified Small Business Stock*, earlier in this chapter.

**Unrecaptured section 1250 gain.** Generally, this is any part of your capital gain from selling section 1250 property (real property) that is due to depreciation (but not more than your net section 1231 gain), reduced by any net loss in the 28% group. Use the worksheet in the Schedule D instructions to figure your unrecaptured section 1250 gain. For more information about section 1250 property and section 1231 gain, see chapter 3 of Publication 544.

**Using Schedule D.** You apply these rules by using Part IV of Schedule D (Form 1040) to figure your tax.

Use Part IV if both of the following are true.

- 1) You have a net capital gain. You have a net capital gain if both lines 16 and 17 of Schedule D are gains. (Line 16 is your net long-term capital gain or loss. Line 17 is your net short-term capital gain or loss combined with any net short-term capital gain or loss.)
- 2) Your taxable income on Form 1040, line 39, is more than zero.

If you have any collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain, you may also have to use the *Schedule D Tax Worksheet* in the Schedule D instructions to figure your tax. See the directions below line 19 of Schedule D.

See the *Comprehensive Example*, later, for an example of how to figure your tax on Schedule D using the capital gain rates.

**Using Capital Gain Tax Worksheet.** If you have capital gain distributions but do not have to file Schedule D (Form 1040), figure your tax using the *Capital Gain Tax Worksheet* in the instructions for Form 1040A or Form 1040, whichever you file. For more information, see *Capital gain distributions only*, earlier.

**Alternative minimum tax.** These capital gain rates are also used in figuring alternative minimum tax.

## New 18% Rate Beginning in 2006

Beginning in 2006, the 20% capital gain rate will be lowered to 18% for qualified 5-year gain from property with a holding period that begins after 2000.

**Election to recognize gain on assets held on January 1, 2001.** Taxpayers who own certain assets on January 1, 2001, can choose to treat those assets as sold and repurchased on the same date, if they pay tax for 2001 on any resulting gain.

The purpose of the election is to make any future gain on the asset eligible for the 18% rate by giving the asset a new holding period. The holding period of any asset for which you make this election begins on the date of the deemed sale and repurchase.

You can make this election for either of the following types of assets:

- **Readily tradable stock that is a capital asset** that you held on January 1, 2001,

and did not sell before January 2, 2001. If you make the election, you treat this stock as sold on January 2, 2001, at its closing market price on that date. You then treat it as reacquired on that date for the same amount. For this purpose, readily tradable stock includes shares issued by an open-end mutual fund.

- **Any other capital asset or property used in a trade or business** that you held on January 1, 2001. If you make the election, you treat this type of asset as sold on January 1, 2001, for its fair market value on that date. You then treat it as reacquired on that date for the same amount.

Any gain on a deemed sale resulting from this election must be recognized. However, any loss is not allowed.

For the election to apply, you cannot dispose of the asset (in a transaction in which gain or loss is recognized in whole or in part) within the 1-year period beginning on the date the asset would have been treated as sold under the election.

**How to make the election.** Report the deemed sale on your tax return for the tax year that includes the date of the deemed sale. If you are a calendar year taxpayer, this is your 2001 tax return. Attach a statement to the return stating that you are making an election under section 311 of the Taxpayer Relief Act of 1997 and specifying the assets for which you are making the election. Once made, the election is irrevocable.

If the deemed sale results in a loss, enter zero instead of the amount of the loss.

## Special Rules for Traders in Securities

Special rules apply if you are a trader in securities in the **business** of buying and selling securities for your own account. To be engaged in business as a trader in securities, you must meet all the following conditions.

- You must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation.
- Your activity must be substantial.
- You must carry on the activity with continuity and regularity.

The following facts and circumstances should be considered in determining if your activity is a securities trading business.

- Typical holding periods for securities bought and sold.
- The frequency and dollar amount of your trades during the year.
- The extent to which you pursue the activity to produce income for a livelihood.
- The amount of time you devote to the activity.

If your trading activities are not a business, you are considered an investor, and not a trader. It does not matter whether you call yourself a trader or a “day trader.”

**Note.** You may be a trader in some securities and have other securities you hold for investment. The special rules discussed here do not apply to the securities held for investment. You must keep detailed records to distinguish the securities. The securities held for investment must be identified as such in your records on the day you got them (for example, by holding them in a separate brokerage account).

## How To Report

Transactions from trading activities result in capital gains and losses and must be reported on Schedule D (Form 1040). Losses from these transactions are subject to the limit on capital losses explained earlier in this chapter.

**Mark-to-market election made.** If you made the mark-to-market election, you should report all gains and losses from trading as ordinary gains and losses in Part II of Form 4797, instead of as capital gains and losses on Schedule D. In that case, securities held at the end of the year in your business as a trader are **marked to market** by treating them as if they were sold (and reacquired) for fair market value on the last business day of the year. But do not mark to market any securities you held for investment. Report sales from those securities on Schedule D, not Form 4797.

**Expenses.** Interest expense and other investment expenses that an investor would deduct on Schedule A (Form 1040) are deducted by a trader on Schedule C (Form 1040), *Profit or Loss From Business*, if the expenses are from the trading business. Commissions and other costs of acquiring or disposing of securities are not deductible but must be used to figure gain or loss. The limit on investment interest expense, which applies to investors, does not apply to interest paid or incurred in a trading business.

**Self-employment tax.** Gains and losses from selling securities as part of a trading business are not subject to self-employment tax. This is true whether the election is made or not.

## How To Make the Mark-to-Market Election

To make the mark-to-market election **for 2002**, you must file a statement by April 15, 2002. This statement should be attached to either your 2001 individual income tax return or a request for an extension of time to file that return. The statement must include the following information.

- 1) That you are making an election under section 475(f) of the Internal Revenue Code.
- 2) The first tax year for which the election is effective.
- 3) The trade or business for which you are making the election.

If you are not required to file a 2001 income tax return, you make the election by placing the

above statement in your books and records no later than March 15, 2002. Attach a copy of the statement to your 2002 return.

After making the election to change to the mark-to-market method of accounting, you must change your method of accounting for securities under Revenue Procedure 99-49. Revenue Procedure 99-49 requires you to file Form 3115, *Application for Change in Accounting Method*. Follow its instructions. Label the Form 3115 as filed under "Section 10A of the APPENDIX of Rev. Proc. 99-49."

Once you make the election, it will apply to 2002 and all later tax years, unless you get permission from IRS to revoke it. The effect of making the election is described under *Mark-to-market election made, earlier*.

For more information on this election, see Revenue Procedure 99-17, 1999-1 CB 503.

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## Comprehensive Example

Emily Jones is single and, in addition to wages from her job, she has income from stocks and other securities. For the 2001 tax year, she had the following capital gains and losses, which she reports on Schedule D. Her filled-in Schedule D is shown at the end of this example.

**Capital gains and losses—Schedule D.** Emily sold stock in two different companies that she held for less than a year. In June, she sold 100 shares of Trucking Co. stock that she had bought in February. She had an adjusted basis of \$1,150 in the stock and sold it for \$400, for a loss of \$750. In July, she sold 25 shares of Computer Co. stock that she bought in June. She had an adjusted basis in the stock of \$2,000 and sold it for \$2,500, for a gain of \$500. She reports these short-term transactions on line 1 in Part I of Schedule D.

Emily had three other stock sales that she reports as long-term transactions on line 8 in

Part II of Schedule D. In February, she sold 60 shares of Car Co. for \$2,100. She had inherited the Car stock from her father. Its fair market value at the time of his death was \$2,500, which became her basis. Her loss on the sale is \$400. Because she had inherited the stock, her loss is a long-term loss, regardless of how long she and her father actually held the stock. She enters the loss in column (f) of line 8.

In June, she sold 500 shares of Furniture Co. stock for \$5,000. She had bought 100 of those shares in 1990, for \$1,000. She had bought 100 more shares in 1992 for \$2,200, and an additional 300 shares in 1995 for \$1,500. Her total basis in the stock is \$4,700. She has a \$300 (\$5,000 - \$4,700) gain on this sale, which she enters in column (f) of line 8. Because she held all 500 shares for more than 5 years, the entire gain is qualified 5-year gain.

In December, she sold 20 shares of Toy Co. stock for \$4,100. This was qualified small business stock that she had bought in September 1997. Her basis is \$1,100, so she has a \$3,000 gain, which she enters in column (f) of line 8. Because she held the stock more than 5 years, she has a \$1,500 section 1202 exclusion. She enters that amount in column (g) as a 28% rate gain and claims the exclusion on the line below by entering \$1,500 as a loss in column (f).

She received a Form 1099-B (not shown) from her broker for each of these transactions. The entries shown in box 2 total \$14,100.

**Reconciliation of Forms 1099-B.** Emily makes sure that the total of the amounts reported in column (d) of lines 3 and 10 of Schedule D is not less than the total of the amounts shown on the Forms 1099-B she received from her broker. For 2001, the total of lines 3 and 10 of Schedule D is \$14,100, which is the same amount reported by the broker on Forms 1099-B.

**Form 6781.** During 2001, Emily had a realized loss from a regulated futures contract of

\$11,000. She also had an unrealized marked to market gain on open contracts of \$27,000 at the end of 2001. She had reported an unrealized marked to market gain of \$1,000 on her 2000 tax return. (This \$1,000 must be subtracted from her 2001 profit.) These amounts are shown in boxes 6, 7, and 8 of the Form 1099-B she received from her broker. Box 9 shows her combined profit of \$15,000 (\$27,000 - \$1,000 - \$11,000). She reports this gain in Part I of Form 6781 (not shown). She shows 40% as short-term gain on line 4 of Schedule D and 60% as long-term gain on line 11 of Schedule D.

The Form 1099-B that Emily received from her broker, XYZ Trading Co., is shown later.

**Capital loss carryover from 2000.** Emily has a capital loss carryover to 2001 of \$800, of which \$300 is short-term capital loss, and \$500 is long-term capital loss. She enters these amounts on lines 6 and 14 of Schedule D.

She kept the completed *Capital Loss Carryover Worksheet* in her 2000 Schedule D instructions (not shown), so she could properly report her loss carryover for the 2001 tax year without refiguring it.

**Tax computation.** Because Emily has gains on both lines 16 and 17 of Schedule D and has taxable income, she goes to Part IV of Schedule D to figure her tax. But because line 15 of schedule D is more than zero (due to her section 1202 gain from selling qualified small business stock), she must also use the *Schedule D Tax Worksheet* to figure her tax. She must also complete the *Qualified 5-Year Gain Worksheet* (not shown) in her Schedule D instructions.

After entering the gain from line 17 on line 13 of her Form 1040, she completes the rest of Form 1040 through line 39. She enters the amount from that line, \$30,000, on line 1 of the *Schedule D Tax Worksheet*. After filling out the rest of that worksheet, she figures her tax is \$4,348. This is less than the tax she would have figured without the capital gain tax rates, \$4,876.



**SCHEDULE D  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

Name(s) shown on Form 1040

**Capital Gains and Losses**

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).  
▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074

**2001**

Attachment  
Sequence No. **12**

Your social security number

111 00 111

Emily Jones

**Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
1 100 sh Trucking Co.	2-12-01	6-12-01	400	1,150	(750)	
25 sh Computer Co.	6-29-01	7-30-01	2,500	2,000	500	
2 Enter your short-term totals, if any, from Schedule D-1, line 2 . . . . .						
3 <b>Total short-term sales price amounts.</b> Add lines 1 and 2 in column (d) . . . . .			2,900			
4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .					6,000	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .						
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 2000 Capital Loss Carryover Worksheet . . . . .					( 300 )	
7 <b>Net short-term capital gain or (loss).</b> Combine lines 1 through 6 in column (f).					5,450	

**Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year**

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8 60 sh Car Co.	INHERITED	2-3-01	2,100	2,500	(400)	
500 sh Furniture Co.	VARIOUS	6-29-01	5,000	4,700	300	
20 sh Toy Co.	9-20-96	12-15-01	4,100	1,100	3,000	1,500
Section 1202 exclusion					(1,500)	
9 Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . .						
10 <b>Total long-term sales price amounts.</b> Add lines 8 and 9 in column (d) . . . . .			11,200			
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .					9,000	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1. . . . .						
13 Capital gain distributions. See page D-1 of the instructions . . . . .						
14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 2000 Capital Loss Carryover Worksheet . . . . .					( 500 )	( 500 )
15 Combine lines 8 through 14 in column (g) . . . . .						1,000
16 <b>Net long-term capital gain or (loss).</b> Combine lines 8 through 14 in column (f) <b>Next:</b> Go to Part III on the back.					9,900	

\* **28% rate gain or loss** includes all "collectibles gains and losses" (as defined on page D-6 of the instructions) and up to 50% of the eligible gain on qualified small business stock (see page D-4 of the instructions).

**Part III Taxable Gain or Deductible Loss**

<b>17</b>	Combine lines 7 and 16 and enter the result. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13, and complete Form 1040 through line 39 . . . . .	<b>17</b>	15,350
	<b>Next:</b> • If both lines 16 and 17 are gains <b>and</b> Form 1040, line 39, is more than zero, complete Part IV below. • Otherwise, skip the rest of Schedule D and complete Form 1040.		
<b>18</b>	If line 17 is a loss, enter here and on Form 1040, line 13, the <b>smaller</b> of (a) that loss or (b) (\$3,000) (or, if married filing separately, (\$1,500)). Then complete Form 1040 through line 37	<b>18</b>	( )
	<b>Next:</b> • If the loss on line 17 is more than the loss on line 18 <b>or</b> if Form 1040, line 37, is less than zero, skip <b>Part IV</b> below and complete the <b>Capital Loss Carryover Worksheet</b> on page D-6 of the instructions before completing the rest of Form 1040. • Otherwise, skip <b>Part IV</b> below and complete the rest of Form 1040.		

**Part IV Tax Computation Using Maximum Capital Gains Rates**

<b>19</b>	Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-7 of the instructions . . . . .	<b>19</b>	-0-
	<b>If line 15 or line 19 is more than zero, complete the worksheet on page D-9 of the instructions to figure the amount to enter on lines 22, 29, and 40 below, and skip all other lines below. Otherwise, go to line 20.</b>		
<b>20</b>	Enter your taxable income from Form 1040, line 39 . . . . .	<b>20</b>	
<b>21</b>	Enter the <b>smaller</b> of line 16 or line 17 of Schedule D . . . . .	<b>21</b>	
<b>22</b>	If you are deducting investment interest expense on Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0-	<b>22</b>	-0-
<b>23</b>	Subtract line 22 from line 21. If zero or less, enter -0-	<b>23</b>	
<b>24</b>	Subtract line 23 from line 20. If zero or less, enter -0-	<b>24</b>	
<b>25</b>	Figure the tax on the amount on line 24. Use the Tax Table or Tax Rate Schedules, whichever applies	<b>25</b>	
<b>26</b>	Enter the <b>smaller</b> of: • The amount on line 20 <b>or</b> • \$45,200 if married filing jointly or qualifying widow(er); \$27,050 if single; \$36,250 if head of household; or \$22,600 if married filing separately	<b>26</b>	
	<b>If line 26 is greater than line 24, go to line 27. Otherwise, skip lines 27 through 33 and go to line 34.</b>		
<b>27</b>	Enter the amount from line 24 . . . . .	<b>27</b>	
<b>28</b>	Subtract line 27 from line 26. If zero or less, enter -0- and go to line 34	<b>28</b>	
<b>29</b>	Enter your qualified 5-year gain, if any, from line 7 of the worksheet on page D-8 . . . . .	<b>29</b>	300
<b>30</b>	Enter the <b>smaller</b> of line 28 or line 29 . . . . .	<b>30</b>	
<b>31</b>	Multiply line 30 by 8% (.08) . . . . .	<b>31</b>	
<b>32</b>	Subtract line 30 from line 28 . . . . .	<b>32</b>	
<b>33</b>	Multiply line 32 by 10% (.10) . . . . .	<b>33</b>	
	<b>If the amounts on lines 23 and 28 are the same, skip lines 34 through 37 and go to line 38.</b>		
<b>34</b>	Enter the <b>smaller</b> of line 20 or line 23 . . . . .	<b>34</b>	
<b>35</b>	Enter the amount from line 28 (if line 28 is blank, enter -0-) . . . . .	<b>35</b>	
<b>36</b>	Subtract line 35 from line 34 . . . . .	<b>36</b>	
<b>37</b>	Multiply line 36 by 20% (.20) . . . . .	<b>37</b>	
<b>38</b>	Add lines 25, 31, 33, and 37 . . . . .	<b>38</b>	
<b>39</b>	Figure the tax on the amount on line 20. Use the Tax Table or Tax Rate Schedules, whichever applies	<b>39</b>	
<b>40</b>	<b>Tax on all taxable income (including capital gains).</b> Enter the <b>smaller</b> of line 38 or line 39 here and on Form 1040, line 40 . . . . .	<b>40</b>	4,348



Complete this worksheet only if line 15 or line 19 of Schedule D is more than zero. Otherwise, complete Part IV of Schedule D to figure your tax. **Exception: Do not** use Schedule D, Part IV, or this worksheet to figure your tax if line 16 or line 17 of Schedule D or Form 1040, line 39, is zero or less; instead, see the instructions for Form 1040, line 40.

1.	Enter your taxable income from Form 1040, line 39 . . . . .		1.	<u>30,000</u>
2.	Enter the <b>smaller</b> of line 16 or line 17 of Schedule D . . . . .	2.	<u>9,900</u>	
3.	If you are filing Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0-. <b>Also enter this amount on Schedule D, line 22</b> . . . . .	3.	<u>-0-</u>	
4.	Subtract line 3 from line 2. If zero or less, enter -0- . . . . .	4.	<u>9,900</u>	
5.	Combine lines 7 and 15 of Schedule D. If zero or less, enter -0- . . . . .	5.	<u>6,450</u>	
6.	Enter the <b>smaller</b> of line 5 above or Schedule D, line 15, but not less than zero . . . . .	6.	<u>1,000</u>	
7.	Enter the amount from Schedule D, line 19 . . . . .	7.	<u>-0-</u>	
8.	Add lines 6 and 7 . . . . .	8.	<u>1,000</u>	
9.	Subtract line 8 from line 4. If zero or less, enter -0- . . . . .	9.	<u>8,900</u>	
10.	Subtract line 9 from line 1. If zero or less, enter -0- . . . . .	10.	<u>21,100</u>	
11.	Enter the <b>smaller</b> of:			
	• The amount on line 1 <b>or</b>			
	• \$45,200 if married filing jointly or qualifying widow(er);			
	\$27,050 if single;			
	\$36,250 if head of household; or			
	\$22,600 if married filing separately	11.	<u>27,050</u>	
12.	Enter the <b>smaller</b> of line 10 or line 11 . . . . .	12.	<u>21,100</u>	
13.	Subtract line 4 from line 1. If zero or less, enter -0- . . . . .	13.	<u>20,100</u>	
14.	Enter the <b>larger</b> of line 12 or line 13 . . . . .	▶ 14.	<u>21,100</u>	
15.	Figure the tax on the amount on line 14. Use the Tax Table or Tax Rate Schedules, whichever applies ▶	15.	<u>3,169</u>	
<b>If lines 11 and 12 are the same, skip lines 16 through 21 and go to line 22. Otherwise, go to line 16.</b>				
16.	Subtract line 12 from line 11 . . . . .	▶ 16.	<u>5,950</u>	
17.	Enter your qualified 5-year gain, if any, from line 7 of the worksheet on page D-8. <b>Also enter this amount on Schedule D, line 29</b> . . . . .	17.	<u>300</u>	
18.	Enter the <b>smaller</b> of line 16 above or line 17 above . . . . .	18.	<u>300</u>	
19.	Multiply line 18 by 8% (.08) . . . . .	19.	<u>24</u>	
20.	Subtract line 18 from line 16 . . . . .	20.	<u>5,650</u>	
21.	Multiply line 20 by 10% (.10) . . . . .	21.	<u>565</u>	
<b>If lines 1 and 11 are the same, skip lines 22 through 34 and go to line 35. Otherwise, go to line 22.</b>				
22.	Enter the <b>smaller</b> of line 1 or line 9 . . . . .	22.	<u>8,900</u>	
23.	Enter the amount from line 16 (if line 16 is blank, enter -0-). . . . .	23.	<u>5,950</u>	
24.	Subtract line 23 from line 22 . . . . .	▶ 24.	<u>2,950</u>	
25.	Multiply line 24 by 20% (.20) . . . . .	25.	<u>590</u>	
<b>If line 7 is zero or blank, skip lines 26 through 31 and go to line 32. Otherwise, go to line 26.</b>				
26.	Enter the <b>smaller</b> of line 4 or line 7 . . . . .	26.	<u>          </u>	
27.	Add lines 4 and 14 . . . . .	27.	<u>          </u>	
28.	Enter the amount from line 1 above . . . . .	28.	<u>          </u>	
29.	Subtract line 28 from line 27. If zero or less, enter -0- . . . . .	29.	<u>          </u>	
30.	Subtract line 29 from line 26. If zero or less, enter -0- . . . . .	▶ 30.	<u>          </u>	
31.	Multiply line 30 by 25% (.25) . . . . .	31.	<u>          </u>	
<b>If line 6 is zero, skip lines 32 through 34 and go to line 35. Otherwise, go to line 32.</b>				
32.	Add lines 14, 16, 24, and 30 . . . . .	32.	<u>30,000</u>	
33.	Subtract line 32 from line 1 . . . . .	33.	<u>-0-</u>	
34.	Multiply line 33 by 28% (.28) . . . . .	34.	<u>-0-</u>	
35.	Add lines 15, 19, 21, 25, 31, and 34 . . . . .	35.	<u>4,348</u>	
36.	Figure the tax on the amount on line 1. Use the Tax Table or Tax Rate Schedules, whichever applies . . . . .	36.	<u>4,876</u>	
37.	<b>Tax on all taxable income (including capital gains).</b> Enter the <b>smaller</b> of line 35 or line 36. Also enter this amount on Schedule D, line 40, <b>and</b> Form 1040, line 40 . . . . .	37.	<u>4,348</u>	

CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.  XYZ Trading Co. 203 Bond St. Any City, PA 18605		1a Date of sale	OMB No. 1545-0715  <b>2001</b> Form <b>1099-B</b>	<b>Proceeds From                  Broker and                  Barter Exchange                  Transactions</b>
		1b CUSIP no.		
PAYER'S Federal identification number 10-1111111		RECIPIENT'S identification number 111-00-1111	2 Stocks, bonds, etc. \$	Reported to IRS } <input type="checkbox"/> Gross proceeds } <input type="checkbox"/> Gross proceeds less commissions and option premiums
RECIPIENT'S name  Emily Jones		3 Bartering \$	4 Federal income tax withheld \$	
Street address (including apt. no.) 8307 Daisy Lane City, state, and ZIP code Hometown, AL 36309		5 Description RFC <b>Regulated Futures Contracts</b>		<b>Copy B                  For Recipient</b>  This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Account number (optional)		6 Profit or (loss) realized in 2001 \$ (11,000)	7 Unrealized profit or (loss) on open contracts—12/31/2000 \$ 1,000	
		8 Unrealized profit or (loss) on open contracts—12/31/2001 \$ 27,000	9 Aggregate profit or (loss) \$ 15,000	

Form **1099-B**

(Keep for your records.)

Department of the Treasury - Internal Revenue Service

## 5.

# How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

**Contacting your Taxpayer Advocate.** If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1-877-777-4778**.
- Call the IRS at **1-800-829-1040**.
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1-800-829-4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS*.

**Free tax services.** To find out what services are available, get Publication 910, *Guide to Free Tax Services*. It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.



**Personal computer.** With your personal computer and modem, you can access the IRS on the Internet at [www.irs.gov](http://www.irs.gov). While visiting our web site, you can:

- Find answers to questions you may have.
- Download forms and publications or search for forms and publications by topic or keyword.
- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.

- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at [ftp.irs.gov](http://ftp.irs.gov).



**TaxFax Service.** Using the phone attached to your fax machine, you can receive forms and instructions by calling **703-368-9694**. Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at **703-487-4608**.



**Phone.** Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1-800-829-3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1-800-829-1040**.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1-800-829-4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1-800-829-4477** to listen to pre-recorded messages covering various tax topics.

**Evaluating the quality of our telephone services.** To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our telephone services in several ways.

- A second IRS representative sometimes monitors live telephone calls. That person only evaluates the IRS assistor and does not keep a record of any taxpayer's name or tax identification number.
- We sometimes record telephone calls to evaluate IRS assistors objectively. We hold these recordings no longer than one week and use them only to measure the quality of assistance.
- We value our customers' opinions. Throughout this year, we will be surveying our customers for their opinions on our service.



**Walk-in.** You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county governments, credit unions, and office supply stores have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.



**Mail.** You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:**  
Western Area Distribution Center  
Rancho Cordova, CA 95743-0001
- **Central part of U.S.:**  
Central Area Distribution Center  
P.O. Box 8903  
Bloomington, IL 61702-8903
- **Eastern part of U.S. and foreign addresses:**  
Eastern Area Distribution Center  
P.O. Box 85074  
Richmond, VA 23261-5074



**CD-ROM.** You can order IRS Publication 1796, *Federal Tax Products on CD-ROM*, and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms and instructions.
- Popular tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1-877-233-6767** or on the Internet at [www.irs.gov](http://www.irs.gov). The first release is available in mid-December and the final release is available in late January.

IRS Publication 3207, *Small Business Resource Guide*, is an interactive CD-ROM that contains information important to small businesses. It is available in mid-February. You can get one free copy by calling **1-800-829-3676** or visiting the IRS web site at [www.irs.gov](http://www.irs.gov).

# Glossary

The definitions in this glossary are the meanings of the terms as used in this publication. The same term used in another publication may have a slightly different meaning.

**Accrual method:** An accounting method under which you report your income when you earn it, whether or not you have received it. You generally deduct your expenses when you incur a liability for them, rather than when you pay them.

**At-risk rules:** Rules that limit the amount of loss you may deduct to the amount you risk losing in the activity.

**Basis:** Basis is the amount of your investment in property for tax purposes. The basis of property you buy is usually the cost. Basis is used to figure gain or loss on the sale or disposition of investment property.

**Below-market loan:** A demand loan (defined later) on which interest is payable at a rate below the applicable federal rate, or a term loan where the amount loaned is more than the present value of all payments due under the loan.

**Call:** An option that entitles the purchaser to buy, at any time before a specified future date, property such as a stated number of shares of stock at a specified price.

**Cash method:** An accounting method under which you report your income in the year in which you actually or constructively receive it. You generally deduct your expenses in the year you pay them.

**Commodities trader:** A person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission.

**Commodity future:** A contract made on a commodity exchange, calling for the sale or purchase of a fixed amount of a commodity at a future date for a fixed price.

**Conversion transaction:** Any transaction that you entered into after April 30, 1993 that meets both of these tests.

- 1) Substantially all of your expected return from the transaction is due to the time value of your net investment.

2) The transaction is one of the following.

- a) A straddle, including any set of offsetting positions on stock.
- b) Any transaction in which you acquire property (whether or not actively traded) at substantially the same time that you contract to sell the same property or substantially identical property at a price set in the contract.
- c) Any other transaction that is marketed or sold as producing capital gains from a transaction described in (1).

**Demand loan:** A loan payable in full at any time upon demand by the lender.

**Dividend:** A distribution of money or other property made by a corporation to its shareholders out of its earnings and profits.

**Equity option:** Any option:

- 1) To buy or sell stock, or
- 2) That is valued directly or indirectly by reference to any stock or narrow-based security index.

**Fair market value:** The price at which property would change hands between a willing buyer and a willing seller, both having reasonable knowledge of the relevant facts.

**Forgone interest:** The amount of interest that would be payable for any period if interest accrued at the applicable federal rate and was payable annually on December 31, minus any interest payable on the loan for that period.

**Forward contract:** A contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price.

**Futures contract:** A non-exchange-traded contract to buy or sell a specified commodity or financial instrument at a specified price at a specified future date. See also *Commodity future*.

**Gift loan:** Any below-market loan where the forgone interest is in the nature of a gift.

**Interest:** Compensation for the use or forbearance of money.

**Investment interest:** The interest you paid or accrued on money you borrowed that is allocable to property held for investment.

**Limited partner:** A partner whose participation in partnership activities is restricted, and whose personal liability for partnership debts is limited to the amount of money or other property that he or she contributed or may have to contribute.

**Listed option:** Any option that is traded on, or subject to the rules of, a qualified board or exchange.

**Marked to market rule:** The treatment of each section 1256 contract (defined later) held by a taxpayer at the close of the year as if it were sold for its fair market value on the last business day of the year.

**Market discount:** The stated redemption price of a bond at maturity minus your basis in the bond immediately after you acquire it. Market discount arises when the value of a debt obligation decreases after its issue date.

**Market discount bond:** Any bond having market discount except:

- 1) Short-term obligations with fixed maturity dates of up to 1 year from the date of issue,
- 2) Tax-exempt obligations that you bought before May 1, 1993,
- 3) U.S. savings bonds, and
- 4) Certain installment obligations.

**Nominee:** A person who receives, in his or her name, income that actually belongs to someone else.

**Nonequity option:** Any listed option that is not an equity option, such as debt options, commodity futures options, currency options, and broad-based stock index options.

**Options dealer:** Any person registered with an appropriate national securities exchange as a market maker or specialist in listed options.

**Original issue discount (OID):** The amount by which the stated redemption price at maturity of a debt instrument is more than its issue price.

**Passive activity:** An activity involving the conduct of a trade or business in which you do not materially participate and any rental activity. However, the rental of real estate is not a passive activity if both of the following are true.

- 1) More than one-half of the personal services you perform during the year in all trades or businesses are performed in real property trades or businesses in which you materially participate.
- 2) You perform more than 750 hours of services during the year in real property trades or businesses in which you materially participate.

**Portfolio income:** Gross income from interest, dividends, annuities, or royalties that is not derived in the ordinary course of a trade or business. It includes gains from the sale or trade of property (other than an interest in a passive activity) producing portfolio income or held for investment.

**Premium:** The amount by which your cost or other basis in a bond right after you get it is more than the total of all amounts payable on the bond after you get it (other than payments of qualified stated interest).

**Private activity bond:** A bond that is part of a state or local government bond issue of which:

- 1) More than 10% of the proceeds are to be used for a private business use, and
- 2) More than 10% of the payment of the principal or interest is:
  - a) Secured by an interest in property to be used for a private business use (or payments for the property), or
  - b) Derived from payments for property (or borrowed money) used for a private business use.

**Put:** An option that entitles the purchaser to sell, at any time before a specified future date, property such as a stated number of shares of stock at a specified price.

**Real estate mortgage investment conduit (REMIC):** An entity that is formed for the purpose of holding a fixed pool of mortgages

secured by interests in real property, with multiple classes of interests held by investors. These interests may be either regular or residual.

**Regulated futures contract:** A section 1256 contract that:

- 1) Provides that amounts that must be deposited to, or may be withdrawn from, your margin account depend on daily market conditions (a system of marking to market), and
- 2) Is traded on, or subject to the rules of, a qualified board of exchange, such as a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission or any board of trade or exchange approved

by the Secretary of the Treasury.

**Restricted stock:** Stock you get for services you perform that is nontransferable and is subject to a substantial risk of forfeiture.

**Section 1256 contract:** Any:

- 1) Regulated futures contract,
- 2) Foreign currency contract as defined in chapter 4 under *Section 1256 Contracts Marked to Market*,
- 3) Nonequity option, or
- 4) Dealer equity option.

**Securities futures contract:** A contract of sale for future delivery of a single security or of a narrow-based security index.

**Short sale:** The sale of property that you generally do not own. You borrow the property to deliver to a buyer and, at a later date, you buy substantially identical property and deliver it to the lender.

**Straddle:** Generally, a set of offsetting positions on personal property. A straddle may consist of a security and a written option to buy and a purchased option to sell on the same number of shares of the security, with the same exercise price and period.

**Stripped preferred stock:** Stock that meets the following tests.

- 1) There has been a separation in ownership between the stock and any dividend on the stock that has not become payable.
- 2) The stock:

- a) Is limited and preferred as to dividends,
- b) Does not participate in corporate growth to any significant extent, and
- c) Has a fixed redemption price.

**Term loan:** Any loan that is not a demand loan.

**Wash sale:** A sale of stock or securities at a loss within 30 days before or after you buy or acquire in a fully taxable trade, or acquire a contract or option to buy, substantially identical stock or securities.

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