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# Investment Income and Expenses (Including Capital Gains and Losses)

For use in preparing  
**1997** Returns



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## Important Changes for 1997

**Maximum tax rate on net capital gain.** The maximum tax rate on a net capital gain has been reduced for most sales and exchanges after May 6, 1997. The maximum rate may be 10%, 20%, 25%, or 28%, depending on the situation. See *Maximum Tax Rates on Net Capital Gain* in chapter 4 for more information.

**Capital gain distributions.** You must report your capital gain distributions on Schedule D (Form 1040) in all cases. This is so that you can benefit from the new maximum capital gains rates.

**Tax-free rollover for small business stock.** Gain from a sale of qualified small business stock after August 5, 1997, may qualify for a tax-free rollover if you buy certain replace-

ment stock. See *Sales of Small Business Stock* in chapter 4 for more information.

**Appreciated financial position.** You must recognize gain from the constructive sale of an appreciated financial position after June 8, 1997. See *Constructive Sales of Appreciated Financial Positions* in chapter 4 for more information.

**Short sale of property that becomes worthless.** Beginning August 6, 1997, if property you sold short becomes substantially worthless, you must recognize gain as if the short sale were closed when the property became substantially worthless. See chapter 4 for more information on short sales.

**REIT's undistributed capital gains.** For tax years beginning after August 5, 1997, a real estate investment trust (REIT) can keep its long-term capital gains and pay the tax on them, in the same way as a mutual fund. Your share of the gains and the tax paid will be reported to you on Form 2439. For more information, see *Undistributed capital gains of mutual funds and REITs under Capital Gain Distributions* in chapter 1.

**S corporations.** The requirements a corporation must meet to qualify as an S corporation are less restrictive than before. See *S Corporations* in chapter 1.

**Investment clubs.** New rules apply to whether an investment club is taxed as a partnership, a corporation, or a trust. See *Investment Clubs* in chapter 1.

**Inflation-indexed debt instruments.** New rules apply to inflation-indexed debt instruments issued after January 5, 1997. See *Inflation-Indexed Debt Instruments under Original Issue Discount (OID)* in chapter 1.

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## Important Changes for 1998

**Exclusion for small business stock.** Beginning in 1998, you may have to pay tax on only one-half of your gain from the sale or exchange of qualified small business stock. This applies only to stock originally issued after August 10, 1993, and held by you for

more than 5 years. For more information, see *Sales of Small Business Stock* in chapter 4.

**Exclusion for DC Zone assets.** Beginning in 1998, if you acquire a District of Columbia Enterprise Zone (DC Zone) asset and hold it more than 5 years, you will not have to include any qualified capital gain from its sale or exchange 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 553, *Highlights of 1997 Tax Changes*.

**Education Savings Bond Program.** Beginning in 1998, when figuring the amount of interest on qualified U.S. savings bonds that you can exclude from gross income under this program, count any contribution to a qualified state tuition program as a qualified higher educational expense. Do not count any expense you use to claim the Hope scholarship credit or the lifetime learning credit. For more information about this exclusion, see *Education Savings Bond Program* in chapter 1. For more information about the Hope scholarship credit or the lifetime learning credit, see Publication 553, *Highlights of 1997 Tax Changes*, or new Publication 970, *Tax Benefits for Higher Education* (scheduled to be available in March 1998).

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## Important Reminders

**Interest exclusion under Education Savings Bond Program for 1994 or 1995.** You may be entitled to a refund if you paid tax for 1994 or 1995 on U.S. savings bond interest because your income was too high to take the full exclusion allowed under this program. See *Modified adjusted gross income limit under Education Savings Bond Program* in chapter 1.

**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 Corporations*.

**Foreign-source income.** If you are a U.S. citizen with investment income from sources outside the United States (foreign income), you must report all 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 with the IRS. It usually takes about 30 days to get an ITIN. 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.

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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.

# 1.

## Investment Income

### Topics

This chapter discusses:

- Interest income,
- Dividends and other corporate distributions,
- Real estate mortgage investment conduits (REMICs) 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 Dividend Income
- Schedule 1 (Form 1040A)** Interest and Dividend Income for Form 1040A Filers
- 1099** 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 \$1,300
- 8814** Parents' Election To Report Child's Interest and Dividends
- 8815** Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989
- 8818** Optional Form To Record Redemption of Series EE 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.** As an important part of your records, you should keep a list showing sources and amounts of investment income that you receive during the year.

**Tax on investment income of a child under age 14.** Part of a child's 1997 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, 1998.
- 2) The child had more than \$1,300 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 1997.

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, or 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 items 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 this number 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 this 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, 31% of the amount you are paid.

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 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 a 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
- 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 an 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 social security or employer identification number, you can stop it by following the instructions the payer must give you.

**Other payments subject to backup withholding.** Transactions made by brokers or barter exchanges may be subject to backup withholding.

Backup withholding may also apply to certain other reportable payments made in the course of the payer's trade or business. It applies if you do not give the payer your identification number (or the IRS notifies the payer that you gave an incorrect number) and:

- You are paid \$600 or more during the year,
- The payer had to file an information return for you for the prior year, or
- The payer had to impose backup withholding on payments to you in the prior year.

**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, *Interest Income*) 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-8, Certificate of Foreign Status**, or a similar form, to certify exempt status. However, Form W-8 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.** In a joint account, two or more persons hold property as joint tenants, tenants by the entirety, or tenants in common. That property can include a savings account, bonds, or stock. Each person may receive a share of any interest or dividends from the property. Each person's share 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, is a true gift for federal gift tax purposes.

Income from property transferred under these laws is taxable to the child unless it is used in any way to satisfy a legal obligation of support of that child. The income is taxable to the person having the legal obligation to support the child (the parent or guardian) to the extent that it is used for the child's support.

**Savings account with parent as trustee.** Interest income derived 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.** A 20% accuracy-related penalty 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.

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## 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

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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, *Interest Income*, 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 is shown on any Form 1099-INT that you receive for the tax year. You must also report all of your interest income 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** 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 tax-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 are required to file. This is an information-reporting requirement and does not convert the exempt-interest dividend to taxable income. See *How To Report Interest Income*, later.

**Note:** Exempt-interest dividends may be treated as tax-exempt interest on specified private activity bonds. Specified private activity bonds are discussed later under *State or Local Government Obligations*. The interest on these bonds is a "tax preference item" that may be subject to the alternative minimum tax. See Form 6251 and its instructions for more information.

**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.

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 file Form 1040A	If you 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
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 can't use Form 1040EZ.
Taxable interest that totals more than \$400	Line 8a; also use Schedule B	Line 8a; also use Schedule 1	
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	
Gain or loss from sale of stocks and bonds	Line 13; also use Schedule D	You can't use Form 1040A.	
Gain or loss from exchanges of like investment property	Line 13; also use Schedule D and Form 8824		

## Taxable Interest — General

Taxable interest includes interest you receive from bank accounts, loans you make to others, and interest from most 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, and interest is paid at fixed intervals of 1 year or less during the term of the account, you 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 give a single payment of interest 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 make a deposit in a deferred interest account that has a term of 1 year or less, and you paid a penalty because you withdrew funds before the end of the term, you must include in income all the in-

terest shown in box 1 of the Form 1099-INT you receive. You can deduct the entire penalty shown in box 2 on line 29 of Form 1040, even if it is more than your interest income.

**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, subject to certain limits. These limits are discussed in chapter 3 under *Limit on Investment Interest*.

**Example.** You deposit \$5,000 with a bank and borrow \$5,000 from the bank to make up the \$10,000 minimum deposit required to buy a 6-month money market certificate. The certificate earns \$575 at maturity in 1997, but you receive only \$265 which represents the \$575 you earned minus \$310 interest charged on your \$5,000 loan. The bank gives you a Form 1099-INT for 1997 showing the \$575 interest you earned. The bank also gives you a statement showing that you paid \$310 interest for 1997. 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 investment interest expense limit.

**Gift for opening account.** The fair market value of gifts or services you receive for making long-term deposits or for opening an account in a savings institution is interest. Report it in income in the year you receive it.

**Example.** You open a savings account at your local bank. The account earns \$20 interest. You also receive a \$10 calculator. If no other interest is credited to your account during the year, the Form 1099-INT you receive would show \$30 interest income for the year.

**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 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.** Deferred payments you receive under a contract for the sale or exchange of property usually contain interest that is taxable. If little or no interest is provided for in certain contracts with payments due more than 1 year after the date of sale, each payment due more than 6 months after the date of sale may be treated as containing interest. These unstated interest rules apply to certain payments received on account of a **seller-financed** sale or exchange of property. See *Unstated Interest* in Publication 537, *Installment Sales*.

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

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

**Individual Retirement Arrangements (IRAs).** Interest that you earn on an IRA is tax deferred. You generally do not include it in your income until you make withdrawals from the IRA. See Publication 590, *Individual Retirement Arrangements (IRAs)*, for more information.

**Interest income on frozen deposits.** Exclude from your gross income interest credited on frozen deposits that you could not withdraw by the end of the year. A frozen deposit is an account from which you are unable to withdraw funds 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 1997, see *Frozen deposits under How To Report Interest Income* for information about reporting this interest income exclusion on your 1997 tax return.

The interest you exclude must be reported in the later tax year when you can withdraw it from your account.

**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. Your net amount withdrawn was \$80. You must exclude \$20. You must include \$80 in your income for the year.

**Interest on money deposited with a stockbroker.** If you deposit money with your stockbroker who agrees to credit your account with an amount that is computed at the prevailing prime rate of interest and that can be used only to offset commissions due on future transactions, the amount credited is not interest until it is actually applied to the commissions payable.

**Bonds traded flat.** If you purchase bonds 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 later paid. Such payments are returns of capital which reduce the remaining cost basis. Interest which accrues after the date of purchase, however, is taxable interest income for the year in which received or accrued. See *Bonds Sold Between Interest Dates*, later in this chapter.

## Below-Market Loans

If you make a below-market loan, you must report as interest income any forgone interest (defined next) arising 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 only if it is not personal interest.

**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.

**Below-market loans.** A below-market loan is a loan on which no interest is charged or on which interest is charged at a rate below the applicable federal rate. A below-market loan is generally recharacterized 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 which requires the payment of interest at the applicable federal rate, and
- 2) An additional payment to the borrower.

The borrower is generally treated as transferring the additional payment back to the lender as interest.

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.

See *Gift and demand loans* and *Term loans*, later, for explanations of the amount and timing of these deemed transactions.

**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 gift loan is any below-market loan where the forgone interest is in the nature of a gift.

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.

**Exception for loans of \$10,000 or less.** The rules for below-market loans do not apply to certain loans on days on which the total outstanding amount of loans between the borrower and lender is \$10,000 or less. The rules do not apply on those days to:

- 1) Gift loans between individuals if the gift loan is not directly used to purchase or carry income-producing assets, or
- 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 (a loan other than a loan payable in full at any time upon demand by the lender) 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.

**Age 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 1997, this exception applies only to the part of the total outstanding loan balance that is \$131,300 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 tax 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 and which 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 exempt 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 facts 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.

**Gift and demand loans.** A lender who makes a below-market gift loan or demand loan is treated as transferring an additional payment to the borrower (as a gift, dividend, etc.) in an amount equal to the forgone interest. The borrower is treated as transferring the forgone interest back to the lender and may be entitled to an interest expense deduction. The lender must report that amount as interest income. These transfers are considered to occur annually, generally on December 31.

A demand loan is a loan payable in full at any time upon demand by the lender.

**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.

**Term loans.** A lender who makes a below-market term loan (a loan that is not a demand 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.

**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

You earn interest on U.S. savings bonds in one of two ways. On some bonds, interest is paid at stated intervals by interest checks or coupons. Other bonds are issued at a discount and pay all interest at redemption or maturity. The interest on the latter is the difference between what you pay for the bond and its redemption or maturity value.

This section provides tax information on different types of 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  
P.O. Box 1328  
Parkersburg, WV 26106-1328



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

**Accrual-basis 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.

Under an **accrual method** of accounting, you report your income when you earn it, whether or not you have received it. You deduct your expenses when you become liable for them rather than when you have paid them.

**Cash-basis 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.

Under the **cash method** of accounting, you report your income in the year you actually or constructively receive it. You generally deduct your expenses in the year you pay them.

**Series HH bonds.** These bonds are issued at face value. Interest is paid twice a year by check or by direct deposit to your bank account. If you are a cash-basis 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-basis taxpayer, you must report the interest when you receive it.

**Series EE bonds.** These bonds are issued at a discount. You pay less than the face value for the bonds. The face value is payable to you at maturity. The difference between the purchase price and the redemption value is taxable interest. Series EE bonds were first offered in 1980. Before 1980, **Series E bonds** were issued. If you own either Series EE or Series E bonds and use the cash method of reporting income, you can:

- 1) Postpone reporting the interest until the earlier of the year you cash or dispose of the bonds or the year in which they finally mature (**method 1**), or
- 2) Choose to report the increase in redemption value as interest each year (**method 2**).

**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 or Series E 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. 97-37."
- 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 a statement that you agree to all the terms and conditions of Revenue Procedure 97-37.
- 6) 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).



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

Commissioner of Internal Revenue  
Attn: CC:DOM:IT&A  
P.O. Box 7604  
Benjamin Franklin Station  
Washington, DC 20044

(If you use a private delivery service, send the copy to the Commissioner of Internal Revenue, CC:DOM:IT&A, 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, Application for Change in Accounting Method**. In that case, follow the instructions for the form.



**TIP** If you plan to redeem Series EE bonds in the same year that you will pay for higher educational expenses, you should consider using method 1 above. See Education Savings Bond Program, later, for more information.

**Bonds held beyond maturity.** If you hold the bonds beyond the original maturity, and if you have chosen to report the interest each year, you must continue to do so unless you get permission to change your method of reporting. If you have chosen to postpone reporting the interest, do not include the interest in income for the year of original maturity. Report it in the year you redeem or dispose of the bonds or the year in which the extended maturity period ends, whichever is earlier. The original maturity period has been extended on all Series E bonds.

The extended maturity period of Series E bonds issued between May 1941 and No-

ember 1965 ends 40 years from their issue dates. The Department of the Treasury has announced that no further extension will be given to these bonds. If you have postponed reporting interest on Series E bonds purchased in 1957, you must report the interest on your 1997 return, unless you trade your Series E bonds for Series HH bonds.

The maturity period of Series E bonds issued after November 1965 is 30 years. Bonds issued in 1967 stopped accruing interest in 1997. If you have postponed reporting interest on Series E bonds purchased in 1967, you must report the interest on your 1997 return, unless you trade your Series E bonds for Series HH bonds.

**Co-owners.** If you buy a U.S. savings bond issued in your name and another person's name as 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.

**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*, later, under *How To Report Interest Income*, 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 purchase price, interest on the bond 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 must report one-half 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. The interest is income to your child in the later 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 annually 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 another 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

Table 1-2. **Who Pays Tax on U.S. Savings Bond Interest**

How Bond is Purchased	Who Must Pay Tax on Bond Interest
You use your funds to buy a bond in your name and the name of another person as co-owners.	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.	Each of you, in proportion to the amount you and the other co-owner each paid
You and your spouse, who live in a community property state, buy a bond that is community property.	If you file separate returns, each of you generally pays tax on one-half.

**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 EE or Series E 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 are transferred between spouses or incident to divorce.

**Example.** You bought Series E and Series EE bonds entirely with your own funds and had not elected to report the accrued interest each year. 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 issuance 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 EE or Series E 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 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 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 EE or Series E 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 EE or Series E 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 includes 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 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 any of it until the year the bonds are cashed or disposed of or the year they finally mature, whichever is earlier. In the year that person reports the interest, he or she can claim a deduction for any federal estate tax paid that was for the part of the interest included in the decedent's estate.

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

**Example 1.** Your uncle, a cash-basis 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-basis 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% AGI 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. This \$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 and EE bonds you hold, including the \$200 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 use the cash method and did not choose to report the interest on your Series EE or Series E bonds as it accrued, you did not realize taxable income when you traded the bonds for Series HH or Series H bonds, unless you received cash in the trade. Any cash you received is income to the extent 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.** You trade Series E bonds with accrued interest of \$523 and a redemption value of \$2,723 for Series HH bonds. You get \$2,500 in Series HH bonds and \$223 in cash. You must report the \$223 as taxable income in the year of the trade to the extent that you did not previously report interest on the Series E bonds you traded.

**\$500 minimum value.** Series EE or Series E bonds that you want to trade must have a current redemption value of \$500 or more. To figure the current redemption value of the bonds to be traded, you must add the accrued interest to their original purchase price.

**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, see *Change from method 1* under *Series EE 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 but did not use your funds to buy the bond. (See *Co-owners*, earlier in this section, 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.)

You must report your interest income even if you did not get a Form 1099-INT.

For information on including the correct amount of interest on your return, see *U.S. savings bond interest previously reported 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 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 U.S. savings bond **issued after 1989**. The bond must be issued either in your name (sole owner) or in your 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. You can designate any individual (including a child) as a beneficiary of the bond (payable on death).

**Verification by IRS.** Only Series EE U.S. savings bonds issued after 1989 qualify for this exclusion. If you claim the exclusion, IRS will check it by using bond redemption information from Department of the Treasury records.

**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 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 and nonprofit universities and colleges and certain vocational schools that are eligible for federal assistance.

**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.

**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 April 1997, Mark and Joan, a married couple, cashed a qualified Series EE U.S. savings bond they bought in November 1991. They received proceeds of \$6,720, representing principal of \$5,000 and interest of \$1,720. In 1997, they helped pay for their daughter's college tuition. The qualified higher educational expenses they paid during 1997 totaled \$4,000. They can exclude \$1,024 ( $\$1,720 \times (\$4,000 \div \$6,720)$ ) of interest in 1997. They must pay tax on the remaining \$696 ( $\$1,720 - \$1,024$ ) interest.

**Modified adjusted gross income limit.** The interest exclusion is phased out if your modified adjusted gross income (modified AGI) is:

- \$50,850 to \$65,850 for taxpayers filing single or head of household, and
- \$76,250 to \$106,250 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.

**TIP** **Refunds for 1994 and 1995.** In 1996, the modified AGI amounts at which the exclusion phases out were retroactively increased. If that limit reduced or eliminated your exclusion in 1994 or 1995, you may be entitled to a refund.

For 1994, the new modified AGI amounts are:

- \$46,900 to \$61,900 for taxpayers filing single or head of household, and
- \$70,350 to \$100,350 for married taxpayers filing jointly, or for a qualifying widow(er) with dependent child.

For 1995, the new modified AGI amounts are:

- \$48,100 to \$63,100 for taxpayers filing single or head of household, and
- \$72,150 to \$102,150 for married taxpayers filing jointly, or for a qualifying widow(er) with dependent child.

If you are entitled to a refund, complete and file a separate Form 1040X, Amended U.S. Individual Income Tax Return, for each tax year affected. (Generally, an amended return for 1994 must be filed by April 15, 1998.)

Modified AGI, for purposes of this exclusion, is adjusted gross income (line 16 of Form 1040A or line 32 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, and
- 5) Exclusion for adoption benefits received under an employer's adoption assistance program.

Use the worksheet in the instructions for line 9, Form 8815, to figure your modified AGI. If you have any of the exclusion or deduction items listed above, add the amount of the exclusion or deduction to the amount on line 5 of the worksheet, and enter the total on Form 8815, line 9, as your modified AGI.

**Note:** Because the deduction for interest expenses attributable to investments is limited to your net investment income (see *Limit on 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 computation. On this form, include in your net investment income your total interest income for the year from Series EE U.S. savings bonds. 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 Series EE U.S. savings bonds issued after 1989 that you redeem. Your written record must include the serial number, issue date, face value, and redemption proceeds of each bond. You can use Form 8818, *Optional Form To Record Redemption of Series EE U.S. Savings Bonds Issued After 1989*, to keep 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.

**Treasury bills.** These bills generally have a 13-week, 26-week, or 52-week maturity period. They are issued at a discount in denominations of \$10,000 and additional 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.

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. 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 notes and bonds.** Treasury notes have maturity periods ranging from 1 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 par value, you will receive a refund for the difference between the purchase price and the par value. This amount is considered

a “discount.” You can disregard the discount and treat it as zero if it 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. This small discount is called “de minimis” discount. Examples of when you can disregard de minimis discount are shown later in the discussion under *Original Issue Discount (OID)*. 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  
U.S. Department of the Treasury  
Capitol Area Servicing Center  
1300 C Street, S.W.  
Washington, D.C. 20239-0001



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. Each interest payment and the principal are 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 *Nontaxable 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. 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 not usually 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 proceeds from life insurance 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

The interest that you receive on obligations of a state or local government may or may not be taxable, depending on the type of obligation issued and the nature of the activity funded. This part of the chapter provides general information for an investor on how to treat the interest from certain types of state or local government bonds, or other obligations, for income tax purposes. Transfers of these obligations are subject to federal income, estate, gift, and generation-skipping taxes, even if interest on the obligations is exempt for income tax purposes (not subject to income taxes).

The bond issuer should be able to tell you whether the interest from its obligations is taxable or not taxable. The issuer should also provide you with a periodic (or year-end) statement that indicates the tax treatment of your investment. If you invested in state or local government obligations through an arrangement offered by a trust, a fund, or other organization, that organization should provide you with statements, or other information, advising you of the tax treatment of the interest you receive on these obligations.

If you want information about the specific requirements for issuance of state or local government obligations, consult the issuing government agency or refer to section 103 and sections 141 through 150 of the Internal Revenue Code, and their related regulations.

If you receive a Form 1099-INT for tax-exempt interest, see *Reporting tax-exempt interest* under *How To Report Interest Income*, later in this chapter.

**Tax-exempt interest on state or local obligations.** Generally, interest on obligations used to finance government operations is not taxable if the obligations are issued by a state, the District of Columbia, a possession of the United States, or any of their political subdivisions. Political subdivisions can include:

- Port authorities,
- Toll road commissions,
- Utility services authorities,
- Community redevelopment agencies,
- Qualified volunteer fire departments (for certain obligations issued after 1980), and
- Similar bodies created for public functions.

**Registration requirement.** Generally, a bond must be in registered form (if issued after June 30, 1983) for the interest to be tax exempt.

**Interest not on a bond.** The interest is not taxable even if you receive it on a debt evidenced only by an ordinary written agreement of purchase and sale, rather than on a bond. Generally, it is also not taxable if paid by an insurer on default by the state or political subdivision.

**Indian tribal government.** Interest on obligations issued after 1982 by an Indian tribal government, which is treated as a state, is generally exempt from tax. The obligations must be part of an issue of which substantially all of the proceeds are to be used in the exercise of any essential government function. However, except for interest on certain bonds for tribal manufacturing facilities, interest on the tribal government's private activity bonds is taxable. Private activity bonds are discussed later.

**Empowerment zone or enterprise community.** Interest on certain bonds issued to help qualified businesses finance qualified property located in an empowerment zone or enterprise community is tax exempt.

**Information-reporting requirement.** If you are required to file a tax return and you received or accrued any tax-exempt interest income, you must show that interest on your return. This is an information-reporting requirement and does not convert tax-exempt interest to taxable interest. See *Reporting tax-exempt interest* under *How To Report Interest Income*, later in this chapter.

**Taxable interest on state or local obligations.** Interest on some state or local obligations is taxable.

**Federally guaranteed.** Interest on state or local obligations issued after 1983 that are federally guaranteed is generally taxable. This applies to interest on an obligation issued after April 14, 1983, if the obligation is issued as part of an issue and a significant part of the proceeds of the issue is to be directly or indirectly invested in federally insured deposits or accounts. There are exceptions to this rule.

Interest on obligations guaranteed by the following U.S. Government agencies is not taxable.

- Bonneville Power Authority.
- 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 an obligation issued by a state or local government, 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 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).

Interest on a private activity bond that is a **qualified bond** is tax exempt. A qualified bond is an exempt-facility bond, qualified student loan bond, qualified small issue 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.

**Original issue discount on tax-exempt bonds.** The original issue discount (OID) on these bonds is not taxable. Any gain on their sale or redemption that is not more than your part of the OID is treated as nontaxable interest. Do not include this part of the gain in your income.

However, you must accrue OID on a tax-exempt obligation issued after September 3, 1982, that you acquired after March 1, 1984, to determine its basis when you dispose of it. See *Original issue discount (OID) on debt instruments* under *Stocks and Bonds* in chapter 4.

**Stripped tax-exempt bonds or coupons.** You must accrue OID on any stripped tax-exempt bond or coupon that you acquired after October 22, 1986. A portion of this OID may be taxable. See *Stripped Bonds and Coupons*, later, under *Discount on Debt Instruments*.

**Redeemed before maturity.** 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.

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.

**Example.** On July 1, 1981, 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 16 years (July 1, 1997) for its face amount of \$1,000 plus accrued annual interest of \$60. Four-fifths (192 months ÷ 240 months) of the

OID is interest earned during the time you held the bond. This interest, \$160, is not taxable. The \$60 accrued annual interest also is not taxable. However, the balance of the OID, \$40, is not interest earned during the time you held the bond. You must report this unearned part of the OID as a capital gain.

**Market discount on tax-exempt bonds.** Any gain from market discount on tax-exempt bonds is taxable when you dispose of or redeem the bonds. If you bought the tax-exempt bonds after April 30, 1993, the gain from market discount is ordinary income. If you bought the tax-exempt bonds before May 1, 1993, the gain from market discount is capital gain.

For an explanation of market discount, see *Market Discount Bonds* in the following section.

## 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.

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 and Other CDOs*, later, for information about applying the rules discussed in this section to the regular interest holder of a REMIC or other CDO.

### Original Issue Discount (OID)

Original issue discount (OID) is a form of interest. You generally report OID as it accrues, whether or not you receive any payments from the bond issuer.

A long-term debt instrument generally has OID when the instrument is issued for a price that is less than its stated redemption price at maturity (principal amount). The amount of OID is the difference between the principal amount and the issue price of the instrument.

All long-term 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 rules 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 disregard the discount and treat it 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 and having 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, you can disregard the OID.

**Example 2.** Assume the same facts 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 report the OID.

**Debt instrument bought after original issue.** If you buy a debt instrument with de minimis OID at a premium, the OID is not includible 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 for publicly offered, long-term instruments 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, 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 period in 1997 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 1997 but did not receive a Form 1099–OID, see Publication 1212, *List of Original Issue Discount Instruments*. Publication 1212 lists total OID on certain debt instruments and gives information on figuring OID. If your debt instrument is not listed in Publication 1212, consult the issuer for further information about the OID that accrued for 1997.

**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*, later, under *How To Report Interest Income*.

**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 do not have to report any OID as ordinary income. When you sell or redeem an instrument bought at a premium, the difference between the sale or redemption price and your purchase price is a capital gain or loss.

**Qualified stated interest.** 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 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 corporate debt instrument or acquired it from another holder during 1997, 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 if 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:

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

**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.** These 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 the bearer certificate with a Form 1099–INT.

CDs issued after 1982 generally must be in registered form. For more information, see *Bearer obligations under Investment Property* in chapter 4.

## Time deposit open account arrangement.

This is an arrangement with a fixed maturity date in which deposits are made on a schedule arranged between you and your bank. But there is no actual payment 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.

All deposits under such an arrangement are part of a single obligation, but you must figure the OID separately for each deposit. Each year the financial institution must give you 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. See *Penalty on early withdrawal of savings under How To Report Interest Income*, later in this chapter.

**Partial redemption.** If you redeem only a part of a deferred interest account before the maturity date, the adjusted basis of the unredeemed part of the obligation on the date of partial redemption is equal to the adjusted basis of the entire obligation on that date minus the amount paid on the redemption.

## Face-Amount Certificates

These certificates are subject to the OID rules. They are a form of endowment contract 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.

If you paid a lump sum, 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.

If you make periodic payments, you figure the OID for each payment separately.

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 a debt instrument that is adjusted for inflation and deflation, you generally must treat any increase in the inflation-adjusted principal amount as OID. This treatment applies to Treasury Inflation-Indexed Securities and other debt instruments with similar terms issued after January 5, 1997. You should receive Form 1099–OID from the payer showing the amount you must report as OID and the interest paid to you during the year.

## 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 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.

Examples include obligations backed by U.S. Treasury bonds that are offered primarily by brokerage firms (variously called CATS, TIGRs, etc.).

**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 the OID any of the stated redemption price at maturity that is more than the bond's purchase price. If you buy a stripped coupon, treat as the OID any of the amount payable on the due date of the coupon that is more than the coupon's 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 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 *Investment Property* 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 disregard market discount and treat it 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 identical.)

**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 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 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 Investment Property* 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.

For certain short-term obligations, however, you do not have a choice, and you must include the accrued discount and interest in current income. This rule applies to 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*.

**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 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 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 and 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. It cannot be changed 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.

## When To Report Interest Income

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

Accrual method  
Cash method

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

**Cash method.** If you use this method, you generally report your interest income in the year in which you actually or constructively receive it. Most individual taxpayers use this method. 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, 1995, you loaned another individual \$2,000 at 12% a year. The note stated that principal and interest would be due on August 31, 1997. In 1997, you received \$2,480 (\$2,000 principal and \$480 interest). If you use the cash method, you must include in income on your 1997 return the \$480 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.

**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: 1995, \$80; 1996, \$240; and 1997, \$160.

**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 any of the following are true.

- 1) Your interest income is more than \$400.
- 2) You are excluding interest under the Education Savings Bond Program.
- 3) You received interest as a nominee (that is, in your name but the interest actually belongs to someone else).
- 4) You received a Form 1099-INT for U.S. savings bond interest that includes amounts you reported before 1997.

Instead, you must complete the schedules for Form 1040A or Form 1040.

In addition, you cannot use Form 1040EZ or Form 1040A if you must use Form 1040, as described later.

**Form 1040A.** You must complete Part I of Schedule 1 (Form 1040A) if you file Form 1040A and:

- 1) Your taxable interest income totals more than \$400,
- 2) You are claiming the interest exclusion under the Education Savings Bond Program,
- 3) You received a Form 1099-INT for tax-exempt interest,
- 4) You received interest from a seller-financed mortgage and the buyer used the property as a home, or

- 5) You received, as a nominee, interest that actually belongs to someone else.

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.

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

- 1) You are reporting OID in an amount more or less than the amount shown on Form 1099-OID,
- 2) You received or paid accrued interest on securities transferred between interest payment dates,
- 3) 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
- 4) You forfeited interest income because of the early withdrawal of a time deposit.

**Schedule B.** You must complete Part 1 of Schedule B (Form 1040) if 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.
- 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, as a nominee, interest that actually belongs to someone else.
- 6) You received a Form 1099-INT for interest on a bond that you bought between interest payment dates.
- 7) Statement (1) or (3) in the preceding list is true.

If you received more than \$400 in taxable interest, you must also complete Part III of Schedule B.

On line 1, Part I, list each payer's name and the amount received from each.

If you receive 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, write "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.

Interest earned on an individual retirement arrangement (IRA) is tax deferred rather than

tax exempt. Do not include such amount in 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 (early withdrawal penalty). If an amount appears in box 2, file Form 1040 and report this amount on line 29 (penalty on early withdrawal of savings).

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. Include the amount shown in box 3 in your total taxable interest income, unless it includes an amount previously included in interest income. If part of the amount shown in box 3 was previously included in interest income, see *U.S. savings bond interest previously reported*, later. If you redeemed U.S. savings bonds you bought after 1989 and you had qualified educational expenses, see *Interest excluded under the Education Savings Bond Program*, later.

Box 4 of Form 1099-INT (federal income tax withheld) will contain an amount if you were subject to backup withholding. You may have been subject to backup withholding if, for example, you did not furnish your social security number to a payer. Report the amount from box 4 on Form 1040EZ, line 7, on Form 1040A, line 29a, or on Form 1040, line 54 (federal income tax withheld).

If there are entries in boxes 5 and 6 of Form 1099-INT, you must file Form 1040. Report the amount shown in box 5 (foreign tax paid) on **Form 1116, Foreign Tax Credit**, unless you deduct this amount on Schedule A of Form 1040 as "Other taxes." For more information on the credit and deduction, 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. 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. If an amount appears in box 3, file Form 1040 and report this amount on line 29.

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 7, on Form 1040A, line 29a, or on Form 1040, line 54.

**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*, earlier, under *U.S. Savings Bonds*.



CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.		Payer's RTN (optional)	OMB No. 1545-0112	<b>1997</b> <b>Interest Income</b>
PAYER'S Federal identification number		RECIPIENT'S identification number	Form <b>1099-INT</b>	
RECIPIENT'S name	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.	
Street address (including apt. no.)	2 Early withdrawal penalty \$	3 Interest on U.S. Savings Bonds and Treas. obligations \$		
City, state, and ZIP code	4 Federal income tax withheld \$			
Account number (optional)	5 Foreign tax paid \$	6 Foreign country or U.S. possession		

Form **1099-INT**

(Keep for your records.)

Department of the Treasury - Internal Revenue Service

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 make the following adjustment. Several lines above line 2, enter a subtotal of all interest listed on line 1. Below the subtotal write "U.S. Savings Bond Interest Previously Reported" and enter amounts previously reported or interest accrued before receiving the bond. 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 1997, you redeemed one of the bonds — a \$1,000 Series E bond. The bond was originally issued in March 1980. When you redeemed the bond, you received \$1,832.00 for it.

The Form 1099-INT you received shows interest income of \$1,332.00. However, since the interest on your savings bonds was reported yearly, you need only include the \$53.20 interest that accrued from January 1997 to April 1997.

You received no other taxable interest for 1997. You file Form 1040A.

On line 1, Part I of Schedule 1 (Form 1040A), enter your interest income as shown on Form 1099-INT — \$1,332.00. (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, write "U.S. Savings Bond Interest Previously Reported" and enter \$1,278.80 (\$1,332.00 – \$53.20 interest for 1997). Subtract \$1,278.80 from \$1,332.00 and write \$53.20 on line 2. Enter \$53.20 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 ex-

ecutor included in your uncle's final return \$200 of the interest which 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, write "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 1994 from your company's profit-sharing plan.

In April 1997, you redeemed a \$100 Series EE bond that was part of the distribution you received in 1994. You received \$106.56 for the bond. The company told you that the bond was bought in May 1986 for \$50 and that the value of the bond at the time of distribution in 1994 was \$87. (This is the amount you included on your 1994 return.) The bank gave you a Form 1099-INT that shows \$56.56 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 1994, you need include in your 1997 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 write "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 ..... \$106.56
- B. Write the value of the bond at the time of distribution by the plan ..... 87.00
- 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 ..... \$19.56
- D. Write the amount of interest shown on your Form 1099-INT ..... \$56.56
- 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" ..... \$37.00

Subtract \$37 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, *Exclusion of Interest From Series EE U.S. Savings Bonds Issued After 1989*, to figure your interest exclusion when you redeem 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 Series EE U.S. savings bonds issued after 1989 that you cashed during 1997 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 1997, you must exclude these amounts from your gross income. (See *Interest income on frozen deposits*, earlier, under *Interest Income*.) Do not include this income on line 8a of Form 1040A or Form 1040. If you are completing 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 the total interest income you list on line 1, Part I of Schedule B (Form 1040) reflects accrued interest paid on a bond that you bought between interest payment dates, show that amount separately below a subtotal of all interest income listed. Identify the amount as "Accrued Interest" and subtract it from the interest income subtotal. Report 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 the total interest income you list on line 1, Part I of Schedule 1 (Form 1040A) or line 1, Part I of Schedule B (Form 1040) includes any amount that you received as a nominee for the real owner, show that amount separately below a subtotal of all interest income listed. Identify the amount as "Nominee Distribution" and subtract it from the interest income subtotal. Report the result on line 2 and also on line 8a of Form 1040A or 1040.

**Interest on a joint account.** If you receive a Form 1099-INT that shows your taxpayer identification number, and names two or more recipients or includes amounts belonging to another person, you must file a Form 1099-INT with the IRS to show the proper distributions of the amounts shown. Complete a Form 1099-INT and **Form 1096, Annual Summary and Transmittal of U.S. Information Returns**, and file both forms with

your Internal Revenue Service Center. Give the other person(s) Copy B of the Form 1099-INT that you filed as a nominee. On Form 1099-INT and Form 1096, 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 *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 receive a Form 1099-INT for 1997 that shows a total of \$1,500 of interest income earned on a savings account that you hold jointly with your sister. You each have agreed to share the yearly interest income in proportion to the amount that each of you has invested, even though your social security number was given to the bank for its recordkeeping purposes. Your sister deposited 30% of the amount invested in this account. As a result, you received as a nominee the amount of interest income belonging to your sister. For 1997, this amount is \$450, or 30% of the total interest of \$1,500.

You must give your sister a Form 1099-INT by February 2, 1998, showing \$450 of interest income that she earned for 1997. 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, 1998. 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 1997 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 account before maturity, you may be charged a

penalty. You must report the gross amount of interest paid or credited to your account during the year, without subtracting the penalty. You deduct the penalty on line 29, Form 1040. Deduct the entire penalty even if it is more than your interest income. The Form 1099-INT or similar statement given to you by the financial institution will show the gross amount of interest and the penalty.

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## 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.)

You may receive any of the following kinds of distribution.

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

Most distributions that you receive are paid in cash (check). However, you may receive 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 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*, later in this chapter under *How To Report Dividend Income*, 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) in October, November, or December and that dividend is payable to you on a specified date by December 31, you are considered to have received the dividend on December 31 even though the company or trust actually pays the dividend during January of the following calendar year. You report the amount in the year of declaration.

## 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.

**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 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 income the fair market value of the additional stock on the dividend payment date.

You also must report as 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 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 1c 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.

If you receive capital gain distributions on mutual fund or REIT stock you hold 6 months or less and sell at a loss, see *Loss on mutual fund or REIT stock held 6 months or less* under *Holding Period* in chapter 4.

**Undistributed capital gains of mutual funds and REITs.** Some mutual funds 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 actually receive them. However, they are not included on Form 1099-DIV. Instead, your share of the fund's undistributed capital gains and tax paid will be reported to you on **Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains**.

For tax years beginning after August 5, 1997, a REIT can keep its long-term capital gains and pay the tax on them, in the same way as a mutual fund. Your share of these gains and the tax paid on them will also be reported to you on Form 2439.

Report undistributed capital gains as long-term capital gains in column (f) on line 11 of Schedule D (Form 1040). The mutual fund or REIT should tell you how much of the gain is a 28% rate gain and how much is an unrecaptured section 1250 gain. (For information about these terms, see *Holding Period* and *Maximum Tax Rates on Net Capital Gain* in chapter 4.) If it does not, the entire amount is a 28% rate gain.

Enter in column (g) of line 11 of Schedule D the total of the undistributed capital gains reported to you as 28% rate gain. Include on line 25 of Schedule D the total of these amounts reported to you as unrecaptured section 1250 gain.

You take credit for the tax paid by the mutual fund or REIT by including it on line 59, 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 stock, 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. 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 1986 for \$100. In 1988, 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 1997. The first \$20 of this amount reduced your basis to zero. You report the other \$10 as a long-term capital gain for 1997. 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.

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 subscribe to 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 gives 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 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 *Losses on Sales or Trades of Property*, 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, 1990, for \$100. The corporation declared a common stock dividend of 5% on June 30, 1997. 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 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 ÷ \$210) × \$100 .....	\$95.24
Basis (cost) of stock dividend ((\$10 ÷ \$210) × \$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 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 portion 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 in income its fair market value 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. (However, see *Information reporting requirement*, next.) 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.

If you receive exempt-interest dividends on stock you hold 6 months or less and sell at a loss, see *Loss on mutual fund or REIT stock held 6 months or less under Holding Period* in chapter 4.

**Information reporting requirement.** Although these 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 convert tax-exempt interest to taxable interest. See *Reporting tax-exempt interest under How To Report Interest Income*, earlier.

**Alternative minimum tax treatment.** Exempt-interest dividends may be treated as tax-exempt interest on specified private activity bonds, which is a "tax preference item" that 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 *Distributions 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 11b (Form 1040A).

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

**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 12 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. However, you must use Form 1040 if you receive capital gain distributions or return of capital distributions. You cannot use Form 1040EZ if you receive any dividend income.

Report the total of your taxable dividend income on line 9 of Form 1040 or Form 1040A.

**Form 1099-DIV.** If you owned stock on which you received \$10 or more in gross 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 gross dividend income (box 1a of Form 1099-DIV) totals 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 dividend income received from each payer. 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 gross dividends (box 1a of Form 1099-DIV), including capital gain and nontaxable distributions, are more than \$400, or
- 2) You received, as a nominee, dividends that actually belong to someone else.

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

You must report all of your dividend income (box 1a of Form 1099-DIV) on line 5, Part II of Schedule B. You must include on this line all the ordinary dividends, capital gain distributions, and return of capital distributions (other than liquidating distributions) you received. List the name of each payer and the amount of distribution 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.

Enter on line 7 any amount shown on line 5 that is a capital gain distribution. Enter on line 8 any amount from line 5 that is a return of capital.

Add the amounts shown on lines 7 and 8 and enter the total on line 9. Subtract the amount on line 9 from the amount on line 6. The difference, if any, is your taxable ordinary dividends. Enter this amount on line 10, Part II of Schedule B, and 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 Received for Services* in Publication 525, *Taxable and Nontaxable Income*, 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, Part II 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 in gross income the value of restricted stock as pay for services. If you make this choice, the dividends are treated as any other dividends. 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. List the dividends on line 5, Part II of Schedule B, along with your other dividends (if the amount of dividends received from all sources is more than \$400). 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.** Report capital gain distributions (box 1c of Form 1099-DIV) in column (f) of line 13, Part II of Schedule D (Form 1040).

The mutual fund or real estate investment trust (REIT) making the distribution should tell you how much of it is a 28% rate gain and how much is an unrecaptured section 1250 gain. (For information about these terms, see *Holding Period and Maximum Tax Rates on Net Capital Gain* in chapter 4.) If it does not, the entire distribution is a 28% rate gain.

Enter in column (g) of line 13 of Schedule D the total of the capital gain distributions reported to you as 28% rate gain. Include on line 25 of Schedule D the total of these amounts reported to you as unrecaptured section 1250 gain.

**Nontaxable (return of capital) distributions.** Report return of capital distributions (box 1d 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. Write "Dividend R.O.C. Exceeding Basis" in column (a) of Schedule D and the name of the company. Report your gain in column (f) of Schedule D and, if it is a 28% rate gain, in column (g). Your gain is the amount of the distribution that is more than your basis in the stock.

**Nominees.** If you received 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 of Part II.

If you receive a Form 1099-DIV that shows your taxpayer identification number, and names two or more recipients, or includes amounts belonging to another person, you must file a Form 1099-DIV with the IRS to show the proper distributions of the amounts shown. Complete the form and a **Form 1096, Annual Summary and Trans-**

CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.		1a Gross dividends and other distributions on stock (Total of 1b, 1c, 1d, and 1e) \$	OMB No. 1545-0110 <b>1997</b> Form <b>1099-DIV</b>	<b>Dividends and Distributions</b>
		1b Ordinary dividends \$		
PAYER'S Federal identification number	RECIPIENT'S identification number	1c Capital gain distributions \$	2 Federal income tax withheld \$	<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 name		1d Nontaxable distributions \$	3 Foreign tax paid \$	
Street address (including apt. no.)		1e Investment expenses \$	4 Foreign country or U.S. possession	
City, state, and ZIP code		<b>Liquidation Distributions</b>		
Account number (optional)		5 Cash \$	6 Noncash (Fair market value) \$	

Form **1099-DIV**

(Keep for your records.)

Department of the Treasury - Internal Revenue Service

mittal of U.S. Information Returns, and file both forms with your Internal Revenue Service Center. Give the other person Copy B of the Form 1099-DIV that you filed as a nominee. On the forms, you should be listed as the "Payer." On Form 1099-DIV, 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 *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 5 and 6. Generally, a liquidating distribution is treated as the proceeds from a sale or exchange of the stock and should be reported on Schedule D (Form 1040).

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

## 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*, 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.** You are treated as having purchased stripped preferred stock if you:

- 1) Strip the rights to one or more dividends from stock that meets test (2) under *Stripped preferred stock defined*, earlier, and
- 2) Dispose of those dividend rights after April 30, 1993.

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 and Other CDOs

Holders of interests in real estate mortgage investment conduits (REMICs) 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.

Amounts includible in income (or deductible as a loss) by holders of REMIC regular and residual interests are treated as portfolio income (or loss). Such income (or loss) is not taken into account in determining the 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 defined.** 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). Any interest payments must be payable based upon a fixed or variable rate, or they must consist of a specified portion of the interest payments on qualified mortgages. This specified portion cannot vary during the period in which this interest is outstanding. The timing (but not the amount) of principal payments can be contingent on the

extent of prepayments on qualified mortgages and the amount of income from permitted investments of a REMIC.

**Residual interest defined.** 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.

## Tax Treatment of REMIC Regular Interests

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.

**Reporting requirements.** Holders of regular interests must use an accrual method of accounting to report OID and interest income. Because accrual methods are not based on 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.

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.

**Forms 1099-INT and 1099-OID.** You should receive a copy of Form 1099-INT, or Form 1099-OID and an additional written statement, by March 16, 1998 (if you are a calendar year taxpayer), that indicates the amounts you must include in your gross income. The additional written statement should also contain enough information to enable you to figure your accrual of market discount or amortizable bond premium. It should also show your share of deductible investment expenses.

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.

**Persons exempt from Form 1099 reporting.** 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 only available electronically. You can get it from the IRS bulletin board (IRP-BBS). Using your computer and modem, dial 1-304-264-7070 and follow the instructions. This is not a toll-free call. To download the publication from the Internet, connect to the IRS Home Page at [www.irs.ustreas.gov](http://www.irs.ustreas.gov).

If the specified exempt recipient holds the regular interest or CDO through a nominee (rather than directly), they can request the information from their nominee in the manner prescribed in Regulation 1.6049-7(f)(7)(i).

**Allocated investment expenses of a REMIC.** 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 investment expenses as interest income 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 REMIC 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 (Schedule D of Form 1040 for individuals) 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 REMIC 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.

## Tax Treatment of REMIC Residual Interests

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.

**Excess inclusions.** A portion of the REMIC's taxable income allocated to you may be characterized as an excess inclusion. Your taxable income for the calendar year cannot be less than your allocable share of the amount of the excess inclusion for that calendar year.

**Limit on recognition of losses.** You cannot claim your share of the quarterly net loss from a REMIC that is greater than the adjusted basis of your residual interest in the REMIC at the end of the calendar quarter (determined

without regard to your share of the net loss of the REMIC for that quarter). You can treat the amount disallowed as a loss incurred by the REMIC in the next calendar quarter, but only for the purpose of offsetting your share of REMIC taxable income for that quarter.

**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 also *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:

- 1) Your pro rata share of the REMIC's quarterly taxable income (or loss),
- 2) Any "excess inclusion," which is the smallest amount of taxable income you can report for the year,
- 3) Your pro rata share of the REMIC's expenses for the quarter, and
- 4) Other information that is relevant only to certain institutional investors.

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. Generally, you must report REMIC items shown on Schedule Q (and any attached schedules), or similar statement, consistent with the way the REMIC treated the items on the return it filed. If you are treating these REMIC items differently from the REMIC, you must complete **Form 8082**, *Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)*, and attach it to your tax return.

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 on your tax return for certain ordinary and necessary expenses that you paid or incurred, directly or indirectly, in connection with your investment in a REMIC. Indirect 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.

### Tax Treatment of CDOs

If you are the holder of a CDO, that obligation is considered to be 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 chapter under *Discount on Debt Instruments*, also apply to the CDO.

**Reporting requirements.** 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 and an additional written statement, by March 16, 1998, that indicates the amounts you must include in your gross income. The additional written 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.

Persons exempt from Form 1099 reporting and fiscal year taxpayers should see *Persons exempt from Form 1099 reporting*, earlier, under *Tax Treatment of REMIC Regular Interests*.

## S Corporations

For tax years beginning after 1996, some of the requirements for qualifying for S corporation status are less restrictive than before. To qualify for S corporation status in 1997, a

corporation must meet all the following requirements.

- 1) It must be a domestic corporation.
- 2) It must have only one class of stock.
- 3) It must have no more than 75 shareholders. When counting shareholders, a husband and wife and their estates are treated as one shareholder.
- 4) Its shareholders must be only individuals, estates (including estates of individuals in bankruptcy), and certain trusts.
- 5) It cannot have any nonresident alien shareholders.
- 6) It cannot be a financial institution that uses the reserve method of accounting for bad debts. Certain other types of corporations also do not qualify.
- 7) All shareholders must agree to the corporation's decision to be an S corporation.

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**Note:** For tax years beginning after 1997, the types of shareholders allowed in (4) above have been expanded to include certain tax-exempt organizations.

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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.

An S corporation must file a return on **Form 1120S, U.S. Income Tax Return for an S Corporation**. This shows the results of the corporation's operation for its tax year and the items of income, gain, loss, deduction, or credit that affect the shareholders' individual income tax returns.

If you are a 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, see *S corporation stock under Stocks and Bonds* 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.

Dividends of an S corporation generally are paid only from retained earnings from years before 1983 or before it became an S corporation.

**How to report S corporation income, deductions, and credits.** The S corporation should send you a copy of Schedule K-1 (Form 1120S) showing your share of income, credits, and deductions of the S corporation for the tax year. You must report your distributive share of the items of income, gain, loss, deduction, or credit of the S corporation on the appropriate lines and schedules of your Form 1040. You generally treat these items as if you had realized or incurred them personally.

If you are treating S corporation items on your tax return differently from the way the S corporation reported the items on its return,

you must complete **Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)**, and attach it to your tax return. For more information about your treatment of the S corporation tax items, see *Shareholder's Instructions for Schedule K-1 (Form 1120S)*.

**Limit on losses and deductions.** Your 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 your 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 limited or stated amounts of funds 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, exchanges, 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. If your club does not have an EIN, get **Form SS-4, Application for Employer Identification Number**, from your nearest Social Security Administration office or by calling 1-800-TAX-FORM (1-800-829-3676). Mail the completed Form SS-4 to the Internal Revenue Service Center where you file the club's tax return.

**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 to the payer of investment income. (When an investment is held in the names of two or more club members, the social security number 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 to be the owner of the dividend, his or her social security number, 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 1997 and 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 actually 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 and can be deducted by the individual partners if the partners itemize their deductions on Schedule A (Form 1040). These expenses are listed on line 22 of Schedule A along with other miscellaneous deductions subject to the 2% limit. See chapter 3 for more information.

If you are treating partnership items on your tax return differently from the way the partnership reported the items on its return, you must complete **Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR)**, and attach it to your tax return. For more information about reporting your income from a partnership, see the Schedule K-1 instructions.

For more information about the tax treatment of partnership items and a partner's tax return, 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 com-

plete **Form 8582, Passive Activity Loss Limitations**, 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 collecting 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.

For more information on self-employment tax, see Publication 533, *Self-Employment Tax.*

**Choosing not to be treated as a partnership.** An unincorporated club used only for investment purposes, and not for the active conduct of a business, can choose not to be treated as a partnership if all the partners agree. It can choose either:

- 1) To be taxed as a corporation, as explained later, or
- 2) Not to be treated as a separate entity.

To make the choice in (2), above, the club must file a partnership return, Form 1065, for the first year for which it does not want to be treated as a partnership. The return must be filed by the due date, including extensions, for filing the return. This return should show only the name or other identification and the address of the club. A separate statement must be attached to the return showing the following information:

- 1) The names, addresses, and identification numbers of all the members of the club,
- 2) A statement that the club is used for investment purposes only and that its members can figure their income without figuring partnership taxable income,
- 3) A statement that the club is an investing partnership,
- 4) Information about where to obtain the terms of the agreement, written or oral, under which the club operates, and
- 5) A statement that all the members of the club have chosen the exclusion from partnership treatment.

If the investment club makes this choice, Form 1065 need not be filed for later years, but the members must report their share of income, deductions, and credits on their individual returns. The members can deduct their share of investment expenses, as miscellaneous deductions subject to the 2% limit, on Schedule A (Form 1040) if they itemize their deductions. The choice remains in effect as long as the club qualifies, or until the IRS approves the club's application to change the choice.

## Club as a Corporation

An investment club is taxed as a corporation if:

- 1) It is organized under a law that describes or refers to it as incorporated, or as a corporation, body corporate, body politic, joint-stock company, or joint-stock association, or
- 2) 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 Forms 1096 and 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), *Beneficiary's Share of Income, Deductions, Credits, etc.*, 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 mischaracterization 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 income, 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 investors.** Organizers and sellers of any potentially abusive tax shelter must maintain a list identifying each investor. (This rule, however, does not apply to an investor who, as a seller, later transfers an interest in a tax shelter that is a projected income investment, defined later.) 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 the value of property you donate is 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 the production or purchase of inventory goods, to constructed business property, and to noninventory property produced or purchased for sale. Under the uniform capitalization rules, the direct cost and a portion 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 tax shelter that is not expected to reduce the tax liability of any investor. That tax shelter is considered to be a projected income investment. To qualify as a projected income investment, the 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, *Examination of Returns, Appeal Rights, and Claims for Refund*.

**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, would 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 the tax shelter provided to you. (See *Registration of tax shelters*, earlier.) Complete and attach **Form 8271, Investor Reporting of Tax Shelter Registration Number**, 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.

**Exception.** Even if you have an interest in a registration-required tax shelter, you do not have to file Form 8271 if you did not claim any deduction, loss, credit, or other tax benefit, or report any income from that tax shelter.

**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 interest. 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 limited to \$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 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.** A 20% accuracy-related penalty 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, Disclosure Statement**, to make your disclosure, and attach it to your tax return. To disclose a position contrary to a regulation, use **Form 8275-R, Regulation Disclosure Statement**.

**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.

The understatement is considered to be due to a tax shelter if it is the result of a partnership or other entity (such as a corporation or trust), an investment plan, or other arrangement that:

- 1) In the case of transactions entered into before August 6, 1997, has the principal purpose of avoiding or evading federal income tax, or

- 2) In the case of transactions entered into after August 5, 1997, has a significant purpose of avoiding or evading federal income tax.

Two special rules apply in the case of tax shelters.

- 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 to 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.** You may be liable for a penalty if you misstate the value or adjusted basis of property. In general, you are liable for the penalty 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 at least \$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 of tax 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 this underpayment will be added to your tax.

**Joint return.** The fraud penalty on a joint return applies to each spouse only to the extent that 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 it, 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
- 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 *Limit on Investment Interest*. 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 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 more than one-half (and more than 750 hours) of the personal services you perform during the year are performed in real property trades or businesses in which you materially participate. The term **trade or business** includes any activity that involves the conduct of a trade or business and, to the extent provided in regulations, any activity in connection with a trade or business and any activity engaged in for the production of income. 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. Portfolio income does not include Alaska Permanent Fund dividends.

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

- 1) Expenses (other than interest) which 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 the interest expenses you may be able to deduct as an investor.

For information on business interest, see chapter 8 of Publication 535.

You cannot deduct personal interest expense other than qualified home mortgage

interest, as explained in Publication 936. Beginning in 1998, you can also deduct interest on certain student loans. For details, see Publication 553, *Highlights of 1997 Tax Changes*.

## Investment Interest

If you borrow money that is used to acquire 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*, later, under *Nondeductible Expenses*. 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.

## Allocation of Interest Expense

If the money you borrowed is used 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 that debt used for investment purposes is treated as investment interest. The allocation is not affected by the use of property that secures the debt. However, fully deductible home mortgage interest is not treated as investment interest and the debt does not have to be allocated, regardless of how the proceeds are used.

**Example 1.** You borrow \$10,000 and use \$8,000 to purchase stock. The other \$2,000 is used to purchase 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.** Interest you pay on debt proceeds that you received in cash is generally treated as nondeductible personal interest. However, you can treat any payment you make within 30 days before or after you receive the proceeds as made from those proceeds. This applies to any payment (up to the amount of the proceeds) made from any account you own, or from cash. Also, you can treat the payment as made on the date you received the cash instead of on the date you actually made the payment.

**Debt proceeds deposited in account.** If you deposit debt proceeds in an account, that deposit is treated as an investment expenditure. Amounts held in the account are treated as investment property, regardless of whether the account bears interest. Any interest you pay on the deposited proceeds is investment interest. But, if you withdraw the funds and use them for another purpose, you must re-allocate the debt and any interest you pay.

**Example 2.** Assume in Example 1 that you borrowed the money on March 1 and immediately purchased the stock for \$8,000. You did not purchase 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 for investment purposes and 20% for personal purposes.

**Payments on debt require new allocation.** As you repay the debt, you must reallocate the balance. You must first reduce the amount allocated for personal purposes by the repayment. You then reallocate the balance of the debt to find what portion 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 for 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 ÷ \$9,500) of the debt and the interest expense is allocated for investment.

**Pass-through entities.** If you use borrowed funds to purchase an interest in a partnership or S corporation, then the interest on those funds has to 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 8 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, 1997, payable in 90 days at 12% interest. On December 5, 1997, you paid this with a new note for \$1,030, due on March 5, 1998. If you use the cash method of accounting, you cannot deduct any portion of the \$30 interest on your return for 1997 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, 1997, on your return for 1997.

**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. You can deduct in each year only the interest for that year.

**Interest on margin accounts.** If you are a cash-basis taxpayer, you can deduct interest on margin accounts 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.

**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 applies if you do not 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 for an earlier year.

**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 balance 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 purchase 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 Investment Interest

The amount of investment interest you can deduct is limited. This limit applies to interest paid or accrued in 1997 on money that you borrowed that is properly allocable to investment property. It also applies to any disallowed investment interest carried over from 1996.

**Form 4952.** Use Form 4952, *Investment Interest Expense Deduction*, to figure your total deduction for investment interest. However, you do not have to complete Form 4952 or attach it to your return if all of the following apply.

- Your only investment income was from interest or dividends.
- You do not have any other deductible expenses directly connected with the production of that income.
- Your investment interest expense is not more than the total of that income.
- You have no carryover of investment interest expense from 1996.

**Investment interest.** Investment interest generally is the interest you paid or accrued on money you borrowed that is properly allocable to property held for investment.

**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).

## 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.

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

**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 must make this choice by the due date (including extensions) of the tax return on which the capital gain is reported. 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 maximum capital gains tax rates by the same amount. Before making this choice, consider the effect on your total tax liability. Compare your tax if you make this choice with your tax if you do not.

For more information about the maximum capital gains rates, see *Maximum Tax Rates on Net Capital Gain* in chapter 4.

**Investment income of child reported on parent's return.** Investment income includes your child's interest and dividend income that you choose to report on your return. See *Tax on investment income of a child under age 14 under General Information* in chapter 1.

However, 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 5 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 line 3 of Form 8814. Subtract the result from the amount on line 5 of Form 8814.

**Example.** Your 10-year-old child has interest and dividend income of \$4,000, including \$500 in Alaska Permanent Fund dividends. You choose to report this on your return. You enter \$4,000 on line 3 of Form 8814 and \$2,700 on line 5 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:

$$\begin{array}{r} \$2,700 - (\$2,700 \times \frac{\$500}{\$4,000}) = \$2,363 \end{array}$$

**Investment expenses.** Investment expenses include all income-producing expenses (other than interest expense) relating to the 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.

**Example.** Jane Smith's income in 1997 includes \$3,000 in dividends and a net capital gain of \$9,000 on the sale of investment property. Jane's 1997 investment expenses (other than interest), which were directly connected with the production of this income, amounted to \$980 after taking into account the 2% limit on miscellaneous itemized deductions. Jane also incurred \$12,500 of investment interest expense in 1997.

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). She figures her net investment income and the limit on the amount of her investment interest expense deduction in the following way:

Total investment income .....	\$12,000
Minus: Investment expenses (other than interest) .....	980
Net investment income .....	\$11,020
Deductible investment interest expense for 1997 .....	\$11,020

For 1997, Jane's investment interest expense deduction is limited to \$11,020, the amount of her net investment income.

Form 4952 for Jane Smith is illustrated on page 35.

**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. In 1997, Ted's interest in the partnership is considered a passive activity.

For 1997, 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 the amount of his investment interest expense deduction for 1997 in the following way:

Total investment income .....	\$10,000
Minus: Investment expenses (other than interest) .....	3,200
Net investment income .....	\$6,800
Deductible investment interest expense for 1997 .....	\$6,800

The \$2,000 of income from the passive activity is not used in determining Ted's net investment income. His investment interest deduction is limited to \$6,800, the amount of his net investment income.

## 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 means that you deduct a part of the premium each year over the life of the bond. 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 a bond's cost or other basis is more than its face, or maturity, value. For

example, a bond with a face value of \$1,000 would have a \$50 premium if you buy it for \$1,050.

**Callable bond.** A taxable bond that is subject to a call before it matures can be redeemed by the issuer before the scheduled maturity date. The bond premium is determined by reference to the amount the issuer will pay at the earlier call date, rather than at maturity, if using that amount results in a smaller amortizable bond premium for the period ending on the call date.

**Bonds acquired in an exchange after May 6, 1986.** The basis amount used to figure amortizable bond premium is limited if you received the bond after May 6, 1986, in exchange for other property and its basis is determined (in whole or in part) by reference to the basis of the other property. The basis cannot exceed the bond's fair market value immediately after the exchange. This treatment does not apply to an exchange of a bond for another bond if the exchange is part of a corporate reorganization.

**Convertible bond.** If you paid a premium for a convertible bond, you cannot amortize or deduct the amount of the premium based on the conversion feature of the bond.

**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 and who would properly include bonds on hand 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

Figure the amount of bond premium amortization for the year as follows.

**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 amortizable bond premium 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 amortizable bond premium claimed in earlier years). This gives you your amortizable bond premium for the year.

**Revenue Ruling 82-10 method.** Under this method, the amount of your amortizable bond premium increases each month over the life of the bond. This method is explained in Revenue Ruling 82-10.

**Bonds issued after September 27, 1985.** For these bonds, you must amortize bond premium using the 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.

## Choosing To Amortize

You choose to amortize the premium on taxable bonds by deducting the amortization for the year on your income tax return for the first tax year for which you want the choice to apply. You must attach a statement to your return showing how you figured your deduction. 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 similar 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.

## How To Report Amortization

How you deduct your bond premium amortization depends on when you acquired the bond. However, you must file Form 1040 if you amortize bond premium.

**Taxable bonds acquired before October 23, 1986.** For these bonds, deduct bond premium amortization on line 27 of Schedule A (Form 1040) as a miscellaneous itemized deduction not subject to the 2% of adjusted gross income limit.

**Taxable bonds acquired after October 22, 1986, but before 1988.** For these bonds, deduct the bond premium amortization as interest expense on line 13 of Schedule A (Form 1040). If required, use **Form 4952, Investment Interest Expense Deduction**, to figure your allowable deduction and attach the form to your return.

You can choose to deduct the premium by reducing the bond's interest income instead of deducting it on Schedule A. See *Taxable bonds acquired after 1987*, next.

**Taxable bonds acquired after 1987.** For these bonds, deduct the amortizable bond premium by reducing the interest income from the bond. This also applies to taxable bonds acquired after October 22, 1986, and before 1988, for which you choose to deduct the premium by reducing interest income.

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 1. Below this subtotal, write "ABP Adjustment," and the amortization amount. Subtract this amount from the subtotal, and enter the result on line 2.

## Expenses of Producing Income

You deduct investment expenses (other than interest expenses) as **miscellaneous 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.

**Brokerage fees.** 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 on Schedule D*, 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 if the fees relate to 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 investment-related papers and documents. If you use the box to store taxable securities and tax-exempt securities or personal items, you can deduct only a part of the rent. See *Tax-exempt income* later, under *Nondeductible Expenses*, to figure what part you can deduct.

**Sponsored investment plan.** If you are a subscriber to a sponsored investment plan, you pay creation and custody fees.

**Creation fee.** This fee is deducted by the custodian from your deposits. It is paid to the sponsor for its services in developing, selling, and administering the plan. It is a fee paid for the privilege of getting stock through the plan. This fee is a capital expense. You must add it to the cost of the shares you get through the investment plan. You cannot deduct it.

**Custody fee.** This fee is paid for services performed by the custodian for holding the shares you acquired through the plan, collecting and reinvesting cash dividends, maintaining individual records, and providing you with detailed statements of your account. It is a fixed percentage of each deposit. You can deduct this fee.

**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 (mu-



tual 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 1e 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 on a separate statement accompanying the Form 1099 (or equivalent statement).

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 gross dividends or other distributions of stock, as shown in box 1a 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. This type of fund reports to you on Form 1099-DIV, in box 1a, your net dividend income (gross dividends minus investment expenses). Include this net figure 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 though 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.

This includes policies for which almost all the premiums are paid within 4 years from the date of purchase, or for which an amount is deposited with the insurer for the payment of a large number of future premiums.

**Single premium annuity contract as collateral.** If you use a single premium annuity contract as collateral to obtain or continue a mortgage loan, you cannot deduct interest on the loan to the extent it 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.

**Systematic 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 the tax-exempt income and what part is for the taxable income, you can allocate the expenses, using reasonable proportions based on facts and circumstances. You must attach a statement to your return showing the basis of the apportionment and stating that each deduction claimed is not based on tax-exempt income.

One accepted method for allocating 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 relates to 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 prorate 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 the rest of the ex-

penses, \$100, 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 that must be added to the basis of the straddle property as follows.

- 1) Add together:
  - a) Interest on indebtedness incurred or continued to purchase 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 discount 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.

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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 for 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 of reporting 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 deduct your expenses when they accrue 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 though 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 1997. See instructions. . . . .	<b>1</b>	12,500	
2 Disallowed investment interest expense from 1996 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 all or part of the amount on 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 1998. 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 smaller of line 3 or 6. See instructions . . . . .	<b>8</b>	11,020	

## 4.

# Sales and Trades of Investment Property

## Introduction

This chapter explains how you figure your gain or loss when you sell or trade investment property. To determine whether you had a gain or loss on a sale of property, you generally subtract your adjusted basis (defined later) from the amount you realize (defined later).

**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.

If you receive a Form 1099-B or equivalent statement, you must complete Schedule D of Form 1040.

**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,
- 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):

Forward contract  
Futures contract  
Short sale

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 vs. 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 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.

However, if the issuer has merely extended the maturity date of its notes, during which period some of the noteholders have agreed not to redeem their notes until all the other notes are retired or their retirement is provided for, neither a trade nor a closed or completed transaction has occurred. Under these circumstances, you do not figure gain or loss.

**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 contract providing for a fixed annuity to pay you guaranteed annual payments 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 if it takes place after September 4, 1997. Any gain or loss is treated as a capital gain or loss.

In the case of terminations before September 5, 1997, this rule applies only if the right or obligation was with respect to:

- 1) Personal property as defined under *Straddles*, later, or
- 2) Section 1256 contracts (discussed later).

This rule does not apply to the retirement of a debt instrument, regardless of whether that retirement takes place before September 5, 1997, or after September 4, 1997. See *Redemption or retirement of bonds*, earlier.

## Constructive Sales of Appreciated Financial Positions

Beginning in 1997, you are treated as having made a constructive sale when you enter into certain transactions involving an appreciated financial position 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-rec-

ognized on the constructive sale. This new rule generally applies to constructive sales after June 8, 1997.

**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, 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 Transaction*, 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 close the transaction before the end of the 30th day after the end of your tax year.
- 2) You hold the appreciated financial position throughout the 60-day period beginning on the date you close the transaction.
- 3) Your risk of loss is 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 either of the following.

- 1) Any position that is marked to market, including section 1256 contracts (described later under *Capital or Ordinary Gain or Loss*).
- 2) Any position in a debt instrument if:
  - a) The debt unconditionally entitles the holder to receive a specified principal amount,

- b) The interest payments on the debt (or other similar amounts) are payable at a fixed rate or a variable rate described in section 1.860G-1(a)(3) of the Regulations, and
- c) The debt is not convertible, either directly or indirectly, into stock of the issuer (or any related person).



*As this publication was being prepared for print, Congress was considering legislation that would allow a position in a debt instrument to qualify for the exception in (2) above only if the position itself meets the requirements listed or is a hedge of a position that meets those requirements. For information about the status of this legislation, see Publication 553, Highlights of 1997 Tax Changes.*

#### **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 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 constructively sold the other appreciated financial position.

**Transitional rule for position held before June 9, 1997.** A special rule may apply if you entered into a transaction before June 9, 1997, that was a constructive sale of an appreciated financial position. Under this rule, you do not take either the position or the transaction into account to determine whether any other constructive sale has occurred after June 8, 1997. This rule applies only if, before September 4, 1997, you clearly identified the transaction and the position in your records as offsetting. This rule does not apply as of the date you close the transaction or stop holding the position.

**Transitional rule for decedents.** A special rule may apply if there was a constructive sale before June 9, 1997, of an appreciated financial position held by a decedent dying after that date. Under this rule, the position and the transaction that resulted in the constructive sale are treated as property constituting rights to receive an item of income in respect of a decedent. However, gain on the position that accrues after the transaction is closed is not treated as income in respect of a decedent.

This rule applies only if both the following requirements are met.

- 1) The transaction resulting in the constructive sale remains open (with respect to the decedent or any related person)—
  - a) For at least 2 years after the date of the transaction, and
  - b) At any time during the 3-year period ending on the date of the decedent's death.

- 2) The transaction was not closed during the period beginning on August 5, 1997, and ending on September 3, 1997.



*As this publication was being prepared for print, Congress was considering legislation that would change the requirement in (2) above so that the transitional rule for decedents would not apply if the transaction resulting in the constructive sale was closed at any time before September 5, 1997. For information about the status of this legislation, see Publication 553, Highlights of 1997 Tax Changes.*

## **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 figure depreciation, amortization, depletion, and casualty losses, and 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 money you pay and the fair market value of other property or services you give for it.

**Assuming a mortgage.** If you buy property and become liable for an existing mortgage on the property, the cost of the property is the amount you pay plus the unpaid mortgage you assume.

**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.

**Settlement fees.** Include certain closing costs and settlement fees in the basis of property. These include:

- 1) Legal and recording fees,
- 2) Real estate agent's commissions,
- 3) Abstract fees (sometimes called abstract of title fees),
- 4) Charges for installing utility services,
- 5) Surveys,
- 6) Transfer taxes,
- 7) Title insurance,
- 8) Legal fees for perfecting title, and
- 9) Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees,

charges for improvements or repairs, and sales commissions.

Closing costs that you cannot add to your basis include:

- 1) Fire insurance premiums,
- 2) Mortgage insurance premiums,
- 3) The cost of repairs,
- 4) Rent for occupancy before closing,
- 5) Charges for utilities or other services relating to occupancy before closing, and
- 6) Amounts placed in escrow for the future payment of items such as taxes and insurance.

If the seller actually paid for any item for which you are liable, such as your share of the real property taxes for that year, you must reduce your basis by that amount if you are not charged for it at settlement.

**Real estate taxes.** If you buy real property and agree to pay taxes that are owed by the seller, you include the taxes you pay in the cost of the property. You cannot deduct them as taxes you paid.

If you reimburse the seller for taxes the seller paid for you, you ordinarily can deduct those taxes. Do not include them in the cost of the property.

## Basis Other Than Cost

There are times when you must use a basis other than cost. In these cases, the fair market value or the adjusted basis of certain property may be used.

**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 on 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 no longer subject to substantial risk of forfeiture. See *Restricted Property Received for Services* in Publication 525 for more information.

**Bargain purchases.** If you buy investment property from your employer 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 it is more than \$1,200, you have a deductible loss on the trade. The basis of the 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 exchange. See *Nontaxable Trades*, later.

The basis of property you received in a nontaxable or partially nontaxable trade is generally 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, any liability of yours that was assumed, and any liability to which the property you traded was subject.

## Property Received From Your Spouse

If property is transferred to you from your spouse, or (if the transfer is incident to divorce) from your former spouse, your basis is 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 adjusted basis to the donor 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 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.** Assume the same facts 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 1997, 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 .67 (\$60,000 ÷ \$90,000) .....	14,100
Gift tax due to net increase in value .....	\$14,070
Plus: Adjusted basis of property to your mother .....	40,000
<b>Your basis in the property</b> .....	<u><b>\$54,070</b></u>

**Part sale, part gift.** If you get property in a transaction that is partly a sale and partly a gift, your basis is either the basis of the gift, as explained here, or the amount you paid for the property, whichever is greater.

## Inherited Property

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 survivor's or beneficiary's basis in community property, a joint tenancy or tenancy by the entirety, a qualified joint interest, and a farm or business.

## 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 1984 for \$10 a share. In January 1985, you bought another 200 shares for \$11 a share. In July 1985, you gave your son 50 shares. In December 1987,

you bought 100 shares for \$9 a share. In April 1997, 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 ( $50 \times \$10$ ). You figure the basis of the 130 shares of stock you sold in 1997 as follows:

50 shares ( $50 \times \$10$ ) balance of stock bought in 1984 .....	\$500
80 shares ( $80 \times \$11$ ) stock bought in January 1985 .....	880
<b>Total basis of stock sold in 1997</b> .....	<b><u>\$1,380</u></b>

**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, an adequate identification is made 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.

**Mutual fund shares.** Your basis in shares of a regulated investment company (mutual fund) is generally figured in the same way as the basis of other stock. Your cost basis in mutual fund shares you bought often includes a sales fee, also known as a **load charge**. But, in certain cases, you cannot add to your basis the entire amount of a load charge incurred after October 3, 1989, if the load charge gives you a reinvestment right. For more information, see Publication 564.

**Choosing to use average basis.** You can choose to use the average basis of shares you own in a mutual fund if you acquired the shares at various times and prices and left the shares on deposit in an account kept by a custodian or agent who acquires or redeems those shares. The methods you can use to figure average basis and other information on the basis of mutual fund shares are explained in Publication 564.

**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.

In determining your holding period for shares bought by the bank, full shares are considered bought first and any fractional shares are considered bought last. Your holding period starts on 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.

**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.** 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 ( $\$45 \div 3$ ). If you owned two shares before the distribution, one bought for \$30 and the other for \$45, you would have six shares after the distribution—three with a basis of \$10 each and three with a basis of \$15 each.

**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, 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.

**Stock splits.** Figure the basis of stock splits in the same way as stock dividends if identical stock is distributed on the stock held.

**Holding period.** Your holding period for new stock that you receive as a nontaxable stock dividend begins on the same date as the holding period of the old stock.

**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. Your holding period for the new stock begins on the date of distribution.

**Stock rights.** A stock right is a right to subscribe to a new issue of 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. The holding period of the new stock begins on the date you exercised the stock rights.

**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

$(\$3,000 \div \$3,030) \times \$2,200 = \$2,178.22$ , new basis of old stock

$(\$30 \div \$3,030) \times \$2,200 = \$21.78$ , 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.

**Holding period.** The holding period of nontaxable stock rights begins on the same date as the holding period of the original stock.

**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 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*, 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 *Sales of Small Business Stock*, later.

**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 a 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.** If you include OID in your income currently, increase the basis of the debt instrument by this amount. 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 that obligation 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.

## 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**.

**Note.** Certain basis adjustments relating to stocks and bonds were discussed earlier under *Stocks and Bonds*.

### Increases to Basis

You increase the basis or cost of your property by all items that are charged to a capital account. These include:

- The cost of improvements and betterments having a life of more than 1 year,
- OID for the period you held a bond,
- Assessments levied against the property to pay for local benefits,
- Legal fees for getting the assessment reduced, and
- Certain carrying charges.

You cannot increase your basis in property for expenses that are deductible as current expenses. However, you can choose to capitalize certain taxes, interest, commitment fees, carrying charges, etc. If you make this choice, add these items to the basis of the property.

**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 sold short.

See *Short Sales*, later, for information about deducting payments in lieu of dividends.

**Mutual fund stock.** If you own stock in a mutual fund, you must report as capital gains any amounts that the fund allocated to you as capital gain distributions, even though you did not actually receive them. Increase your basis in the stock by 65% of the undistributed capital gain (the difference between the undistributed capital gain included in income and the amount of tax paid for you by the fund). See *Undistributed capital gains of mutual funds and REITs* under *Capital Gain Distributions* in chapter 1.

### Decreases to Basis

You must reduce your original basis by receipts that are a return of capital. Other items that reduce basis include:

- Amortization,
- Depreciation and depletion allowed or allowable,
- Losses recognized on involuntary conversions,
- Deducted casualty losses, and
- Insurance reimbursements.

However, you cannot reduce your basis below zero.

**Easements.** The amount you receive for granting an easement is usually considered to be from the sale of an interest in your real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis to zero and treat the excess as a recognized gain.

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## 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 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.

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 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 for other property and in addition pay cash, 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 which generally do not result in a taxable gain or a deductible loss. For additional 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 must postpone tax on the gain or postpone deducting the 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 business or investment purposes. Neither property may be property used for personal purposes, such as your home or family car.
- 2) The property must not be property held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise. It must be property held for productive use in your trade or business or property held for investment.
- 3) There must be an exchange of like property. The exchange of real estate for real estate and the exchange of personal property for similar personal property are exchanges of like property. The trade of an apartment house for a store building, or a panel truck for a pickup truck, is a like-kind exchange. The exchange of a piece of machinery for a store building is not a like-kind exchange. Real property located in the United States and real property located outside the United States are not like property. In the case of transfers after June 8, 1997, personal property used predominantly within the United States and personal property used predominantly outside the United States are not like property.
- 4) The property must not be stocks, bonds, notes, choses in action, certificates of trust or beneficial interests, or other securities or evidences of indebtedness or interest, including partnership interests. However, you can have a nontaxable

exchange of corporate stocks under a different rule, as discussed later.

- 5) The property to be received must be identified by the day that is 45 days after the date of transfer of the property given up in the exchange.
- 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.

**Partially nontaxable exchange.** If you receive cash or unlike property in addition to the like property, and conditions (1) — (6) are met, you have a partially nontaxable trade. You are taxed on any gain you realize, but only to the extent 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 transferring property in exchange for like property.

**Basis of property received.** You figure your basis in property received in a nontaxable or partially nontaxable trade as explained earlier under *Basis Other Than Cost*.

**How to report.** You must report the exchange of like property on **Form 8824, Like-Kind Exchanges**. 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 5 of Publication 544.

## Corporate Stocks

The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

**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, may be taxed. The rules for figuring the taxable gain generally follow those for a partially nontaxable exchange discussed earlier under *Like-Kind Exchanges*. Any loss is not recognized.

**Nonqualified preferred stock.** For trades after June 8, 1997, nonqualified preferred stock is 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.

**Corporate reorganizations.** In some instances, you can trade common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation without having a recognized gain or loss. These trades must be part of mergers, recapitalizations, transfers to controlled corporations, bankruptcies, corporate divisions, corporate acquisitions, or other corporate reorganizations.

**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 that 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. You presented the bond and \$50 and received one share of XYZ Corporation common stock.

You did not have a recognized gain or loss when you surrendered the bond and \$50 for the share of common stock. 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. Your holding period is split. Your holding period for the part of the share of stock based on your ownership of the bond (\$100 basis) begins on December 2. Your holding period for the part of the share of stock 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. However, if you had a gain from the disposition of depreciable property from this transaction, you may be taxed on part of the gain. See Publication 544 for more information.

If you are in a bankruptcy or a similar proceeding and you transfer assets 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 nonvoting 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 gain in this situation generally follow those for a partially nontaxable exchange discussed earlier under *Like-Kind Exchanges*. No loss is recognized.

For trades after June 8, 1997, 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 exchange. Decrease this amount by any cash you received, the fair market value of any other property you received, and any loss recognized on the exchange.

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 stay the same as under the original contract. 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.

## 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. The Treasury will issue a payment for the final interest, regardless of whether your maturing securities are used to purchase new Treasury securities or are presented for cash payment. However, if you purchased a new issue through the TREASURY DIRECT system, these payments will be credited to your designated account by direct deposit. See the discussion in chapter 1 under *U.S. Treasury Bills, Notes, and Bonds*, for more information about income from these investments.

## 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 carry-over 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 mar-

riage. For more information, see *Property Settlements* in Publication 504, *Divorced or Separated Individuals*.

## 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 2 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 *Nontaxable 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.

The 2-year period does not include the period during which 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), for tax years beginning after August 5, 1997.
- 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 profits 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.** These include sales through a stock exchange. 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.

**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 or Ordinary Gain or Loss

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

Call  
Commodity future  
Conversion transaction  
Equity option  
Extraordinary dividend  
Forward contract  
Limited partner  
Listed option  
Marked to market  
Nonequity option  
Options dealer  
Put  
Regulated futures contract  
Section 1256 contract  
Straddle  
Wash sale

This section discusses the tax treatment of different types of investment transactions. For information about the tax treatment of gains and losses on the sale or exchange of property used in a trade or business, see Publication 544.

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 later) 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.

**Character of gain or loss.** It is important for you to properly distinguish or classify your gains and losses as either ordinary or capital gains or losses. You 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 any unrecaptured section 1250 gain.

The correct classification and identification helps you figure the limit on capital losses and your proper tax on capital gains. For information about determining whether your capital gain or loss is short term or long term and whether your long-term gain or loss is a 28% rate gain or loss, see *Holding Period*, later. For information about unrecaptured section 1250 gain, see *Maximum Tax Rates on Net Capital Gain*, later.

## 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.

The following items are **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, or for services rendered as an employee, or from the sale of any of the properties 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.

**Personal use property.** Property held for personal use is a capital asset. Gain from a sale or exchange of that property is a capital gain. Loss from the sale or exchange of that property is not deductible. You can deduct a loss relating to personal use property only if it results from a casualty, such as a fire or hurricane, or a theft. If you need more information about casualty or theft losses, get Publication 547, *Casualties, Disasters, and Thefts (Business and Nonbusiness)*.

## Investment Property

Investment property is a capital asset. Any gain or loss you have 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 you have 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 Small Business Stock and Losses on Small Business Investment Company Stock*, later.

**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. To determine whether your capital loss is long-term or short-term, or whether it is a 28% rate loss, you are considered to have held the securities until the last day of the year in which they became worthless. 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), write "Worthless." Enter the amount of your loss in parentheses in column (f) and, if it is a 28% rate loss, in column (g).

**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 re-

turn for that year had to be filed, or 2 years later 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*.

**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 the 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. This amount increases your basis in the obligation. 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 the 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. This amount increases your basis. 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 exchange 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.

If you redeem tax-exempt bonds issued before June 9, 1980, before maturity, treat the entire OID on the bonds as tax-exempt interest. If the bonds were issued after June 8, 1980, treat only your part of the OID as tax-exempt interest.

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.

**Long-term debt instruments issued after 1954 and before May 28, 1969 (or before July 2, 1982, if a government instrument).** If you sell, exchange, 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. See *Original Issue Discount (OID)* in chapter 1.

**Example 1.** You bought a 30-year, 6% government bond for \$700 at original issue on April 1, 1982, and sold it for \$800 on April 20, 1997. 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 180 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 180/360 multiplied by the discount of \$300 (\$1,000 – \$700) is equal to \$150. This is your ratable share of OID for the period you owned the bond. You must treat any part of the gain up to \$150 as ordinary income. As a result, your \$100 gain is treated as ordinary income.

**Example 2.** If, in Example 1, you sold the bond for \$900, you would have a gain of \$200. Of that amount, \$150 is ordinary income and \$50 is long-term capital gain.

**Long-term corporate debt instruments issued after May 27, 1969, and government instruments issued after July 1, 1982.** 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 exchange the debt instrument before maturity, your gain on the sale 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 on the sale of the instrument 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, 1995, 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, 1997, you sold the

bond to Susan Green for \$9,040. Assume you have included \$480 of the OID in your gross income and increased your basis in the bond by that amount. This includes the amount accrued for 1997. Your basis is now \$8,080. If at the time of the original issue there was no intention to call the bond before maturity, your gain of \$960 (\$9,040 amount realized minus \$8,080 adjusted basis) is a long-term capital gain.

**Example 2.** If, in Example 1, at the time of original issue there was an intention to call the bond before maturity, you will include the entire gain as 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 .....	480
3) Maximum amount includible by you as ordinary income .....	\$1,920

Because the amount in (3) is more than your gain of \$960, your entire gain is ordinary income.

**Market discount bonds.** If the debt instrument has market discount and 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.

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 of a market discount bond on Schedule D (Form 1040), line 1 or line 8. Then, on the next line, enter "Accrued Market Discount" in column (a) and the amount of the accrued market discount as a loss in column (f). (If you chose to include market discount in income currently, enter only the accrued market discount for the year of sale.) Also report on Schedule B (Form 1040), line 1, the amount of the market discount you did not include in your interest income in earlier years, 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 exchanged 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 ratable share of the OID at that time is ordinary income. The balance 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 that must be in registered form but 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 that must 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.

**Loss on deposits in an insolvent or bankrupt financial institution.** If you can reasonably estimate your loss on a deposit because of the bankruptcy or insolvency of a qualified financial institution, you can choose to treat the amount as either a casualty loss or an ordinary loss in the current year. Either way, you claim the loss as an itemized deduction. Otherwise, you can wait until the year of final determination of the actual loss and treat the amount as a nonbusiness bad debt (discussed next) in that year.

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.

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.

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.

If the actual loss that is finally determined is more than the amount 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.

**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.

## 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 bad debts and nonbusiness bad debts. A business bad debt, generally, is one that comes from operating your trade or business. 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 the architect's 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 14 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.

**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 you 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-basis taxpayer (most individuals are), you cannot take a bad debt deduction for expected income such as unpaid salaries, wages, rents, fees, interest, and dividends unless you have previously included the amount in your income.

**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 *Loss on deposits in an insolvent or bankrupt financial institution*, earlier, under *Investment Property*.

**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. You must use Form 1040X, *Amended U.S. Individual Income Tax Return*, 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 or gift.** If you lend money to a relative or friend with the understanding that it is to be repaid, but you later forgive the debt, 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.

**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 entered into the guarantee 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.

**Right 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 such a 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*, earlier in this chapter, under *Investment Property*.

**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.

**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.

## 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. This does not apply to a short sale of property that became worthless before August 6, 1997.

**Exception for constructive sales.** In some cases, 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.

## 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.

**Figure 4-A.** Figure 4-A shows this general rule and the special rules that follow.

**Special rules.** Special rules may apply to short sales of stocks, securities, and commodity futures (other than certain straddles). These rules limit the circumstances for treating capital gain as long term and capital loss as short term by taking into account certain substantially identical property you held or acquired. 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.

**Special rules for 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 acquire property sub-

stantially identical to the property sold short 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.

**Example 1.** On May 1, 1996, you bought 100 shares of Able Corporation stock for \$1,000. On October 2, 1996, you sold short 100 shares of similar Able stock for \$1,600. On May 2, 1997, you closed the short sale with the 100 shares of Able stock you bought on May 1, 1996. Because you had held substantially identical property for 1 year or less on the date of the short sale, the \$600 gain is a short-term capital gain under Rule 1. It does not matter that the stock used to close the short sale had been held more than 1 year when the sale was closed.

**Example 2.** On May 4, 1996, you bought 100 shares of Able Corporation stock for \$1,000. On October 2, 1996, you sold short 100 shares of similar Able stock for \$1,600. On November 2, 1996, you bought 100 more shares of Able stock for \$1,800, which you used to close the short sale. On this short sale you realized a \$200 short-term capital loss.

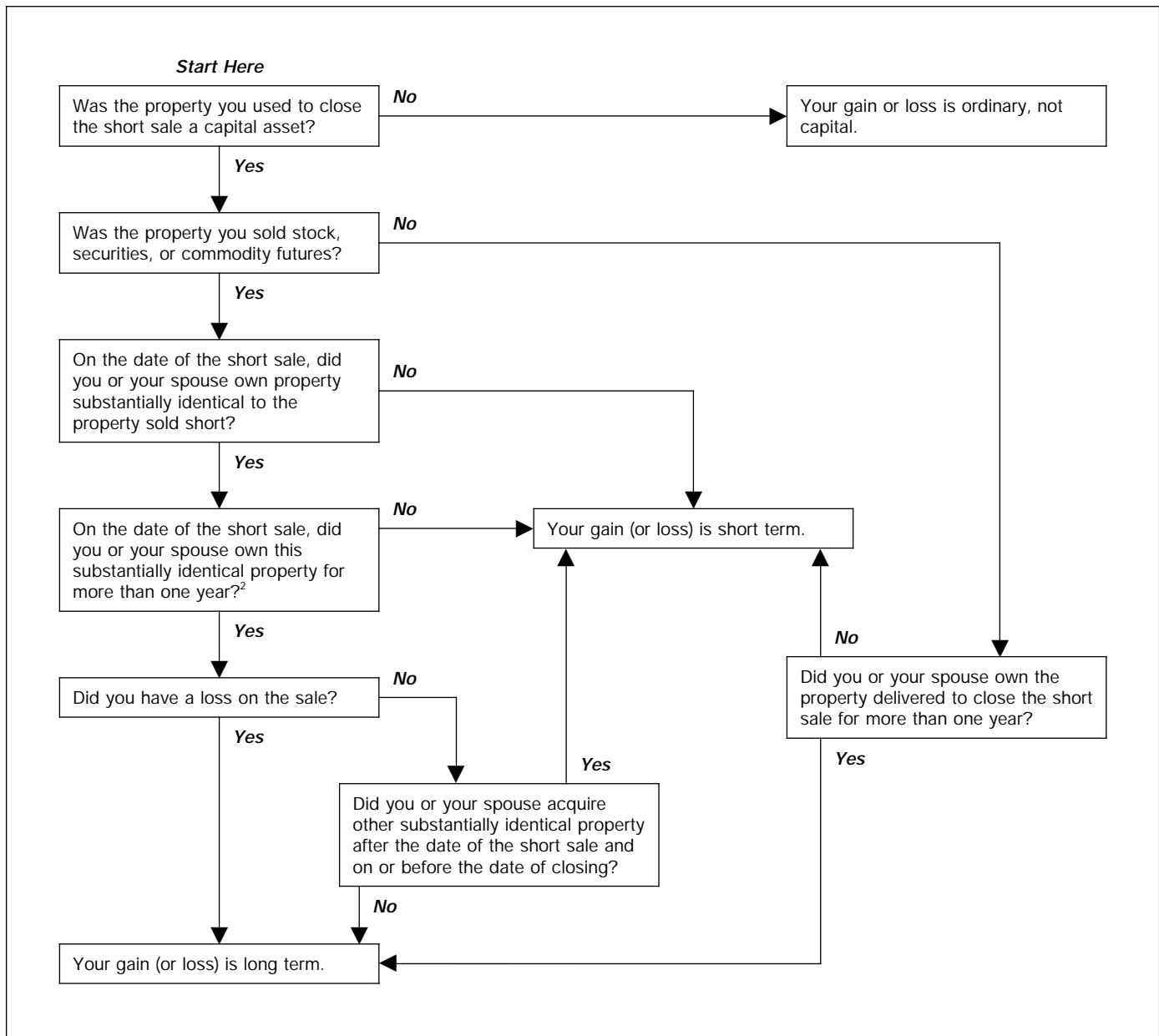
On June 3, 1997, you sold for \$1,800 the stock you originally bought on May 4, 1996. Although you have actually held this stock for more than 1 year, Rule 2 applies because you sold short identical stock on October 2, 1996 (within a year of purchasing this stock). Your holding period began on November 2, 1996, the date on which the short sale closed. The \$800 gain realized on the sale is a short-term capital gain.

**Example 3.** On May 1, 1997, you bought 100 shares of Baker Corporation stock for \$1,000. On September 3, 1997, you sold short 100 shares of similar Baker stock for \$1,600. You made no other transactions involving Baker stock for the rest of 1997 and the first 30 days of 1998. Your short sale is treated as a constructive sale of an appreciated financial position because you entered into it after June 8, 1997, and a sale of your Baker stock on the date of the short sale would have resulted in a gain. You realize a \$600 short-term capital gain from the constructive sale and get a new holding period in your Baker stock that starts on September 3. For details (including exceptions), see *Constructive Sales of Appreciated Financial Positions*, earlier.

**Special rule for treatment of 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.

**28% rate gain or loss.** If, on the date of the short sale, you held substantially identical property for more than 1 year but not more than 18 months, your gain or loss on the short sale is a 28% rate gain or loss (defined later under *Holding Period*).

Figure 4-A. Is Your Short Sale Gain (or Loss) Short Term or Long Term?<sup>1</sup>



<sup>1</sup>This Figure 4-A does not apply to certain put options, straddles, and hedging transactions in commodity futures.

<sup>2</sup>If you or your spouse owned some of this substantially identical property for more than one year and some for one year or less, do not use this Figure 4-A.

**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. In addition, do not include any period during which you are considered to have diminished your risk of loss from the short sale by holding one or more other positions in substantially similar or related properties.



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. Any gain from these sales is taxable as a capital gain.

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. The effect of this adjustment is to postpone the loss deduction until the disposition of the new stock or securities. Your holding period for the new stock or securities includes the holding period for 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 acquire 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 (\$250) to the cost of the new stock (\$800) to obtain your basis of 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.

**Stock or securities.** Under the wash sale rules, stock or securities include contracts or options to acquire or sell stock or securities.

They do not include commodity futures contracts and foreign currencies. See *Coordination of Loss Deferral Rules and Wash Sale Rules*, later under *Straddles*, for information about the tax treatment of losses on the disposition of positions in a straddle.

**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 21, 1996, for \$5,000. On December 21, 1996, you bought 50 shares of substantially identical stock for \$2,750. On December 28, 1996, you bought 25 shares of substantially identical stock for \$1,125. On January 4, 1997, 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, 1996, 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, 1996, is increased by the rest of the loss to \$1,375 ( $\$1,125 + \$250$ ).

**Example 2.** You bought 100 shares of M stock on September 21, 1996. On February 1, 1997, you sold those shares at a \$1,000

loss. On each of the 4 days from February 15, 1997, to February 18, 1997, 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 15. Add the other half (\$500) to the basis of the shares bought on February 16.

**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 1992, 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, 1997, you sold 300 shares of X stock for \$125 a share. On January 6, 1998, 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.

## 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.

**Short sale completed.** 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.

## 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.

**Nondealers.** For sales of stock or securities, the wash sale rules apply to all nondealers.

## 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 column (f), and in column (g) if required. 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), and in column (g) if required.

## 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.

Businesses may enter into commodity futures contracts as either:

- 1) Hedging transactions, or
- 2) Transactions that are not hedging transactions.

Futures transactions are hedging transactions if they are entered into in the normal course of business primarily to reduce 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.)

Futures transactions that are not hedging transactions generally result in capital gain or loss. There is a limit on the amount of capital losses you can deduct each year, as explained under *Capital Losses*, later in this chapter.

The termination of a contract that is part of a hedging transaction generally produces ordinary gain or loss. For instance, ordinary gain or loss generally results from offset or exercise of a futures contract that protects against price changes in a business' inventory. On the other hand, contracts that protect against price changes of noninventory supplies generally do not receive ordinary gain or loss treatment because the sale of noninventory supplies gives rise to capital gain or loss. However, if a business sells only a negligible amount of a noninventory supply, a transaction to hedge the purchase of that supply is treated as a hedging transaction if it occurred after July 17, 1994.

Ordinary gain or loss treatment is also available for certain hedges involving the purchase of noninventory supplies and section 1231 assets that occurred in a taxable year that ended before July 18, 1994, if the tax return was still open for adjustment of tax on September 1, 1994. See Treasury Regulation 1.1221-2(g)(3) for details.

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 hedging transactions entered into after 1993, or hedging transactions entered into before 1994 and remaining in existence on March 31, 1994, you must identify both the hedging transaction and the item, items, or aggregate risk that is being hedged. The identification of the hedged item must be made no more than 35 days after entering into the hedging transaction. The identification must clearly indicate that the hedging transactions are for tax purposes. For more specific requirements concerning identification of hedging transactions and the underlying item, items, or aggregate risk that is being hedged, see Treasury Regulation 1.1221-2(e).

The marked to market rules, described next, generally do not apply to properly identified hedging transactions that meet the three requirements described in the next section under *Hedging Transactions*.

## Section 1256 Contracts Marked to Market

This section discusses the special tax rules that apply to holders of section 1256 contracts.

### Definitions

The following definitions apply in this section.

**Section 1256 contract.** A section 1256 contract is any:

- 1) Regulated futures contract,
- 2) Foreign currency contract,
- 3) Nonequity option, or
- 4) Dealer equity option.

**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 or 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.

By definition, a qualified board or exchange also includes a national securities exchange registered with the Securities and Exchange Commission. However, a regulated futures contract normally is not subject to the rules of, or traded in, a national securities exchange.

**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 section 988 and Regulations sections 1.988-1(a)(7) and 1.988-3.

**Nonequity option.** This is any listed option (defined below) that is not an equity option. Nonequity options include debt options, commodity futures options, currency options, and broad-based stock index options, such as options on the High Technology Index and the Institutional Index. 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 or 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 by November 10, 1994, or 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 in *Regulated futures contract*). A listed option, however, does not include an option that is a right to acquire stock from the issuer.

**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, group of stocks, or stock index.

Equity options include options on certain narrow-based stock indexes, but exclude options on broad-based stock indexes and options on stock index futures.

An equity option, however, does not include an option for any group of stocks or stock index if:

- 1) The Commodities Futures Trading Commission has designated a contract market for a contract based on that group or index, and that designation is in effect, or
- 2) The Secretary of the Treasury determines that that option meets the legal requirements for such a designation.

**Dealer equity option.** This is any listed option that, for an options dealer:

- 1) Is an equity option,
- 2) Is purchased 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 or 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.

## 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. When you later dispose of the contract, any gain or loss you have will be increased or decreased by the gain or loss that you had previously recognized.

**Hedging exception.** The marked to market rules do not apply to certain 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 from property held more than 18 months, 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.

**Limited partners or entrepreneurs.** The 60/40 rule does not apply to dealer equity options 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.

**Example.** On June 22, 1996, you bought a regulated futures contract for \$50,000. On December 31, 1996 (the last business day of your tax year), the fair market value of the regulated futures contract was \$57,000. You have a \$7,000 gain recognized on your 1996 tax return, treated as 60% long-term and 40% short-term capital gain.

On February 1, 1997, you sold the contract for \$56,000. You have a \$1,000 loss recognized on your 1997 tax return, treated as 60% long-term and 40% short-term capital loss.

**Loss carryback election.** An individual or partnership having a net section 1256 contracts loss (defined below) for 1997 can elect to carry this loss back 3 years, instead of carrying it over to the next year. See *How To Report*, later in this section, 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 (defined below) 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 on Schedule D*, 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 hedging purposes if any loss from the contract would be an ordinary loss. The fact that an individual is actively engaged in dealing or trading in section 1256 contracts is not a consideration in determining whether a loss would be ordinary for this purpose.

## How To Report

If you disposed of regulated futures or foreign currency contracts in 1997 (or had unrealized profit or loss on these contracts that were open at the end of 1996 or 1997), 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 amounts shown in box 9 of Form 1099-B, or on the equivalent statement. 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.

For an example of a filled-in Form 6781, see the *Comprehensive Example* at the end of this chapter.

**Loss carryback election.** To carry back your loss under the election procedures described earlier, file an amended Form 6781 for the year to which you are carrying the loss, together with Form 1040X or appropriate amended return. 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 a hedging transaction if all three of the following conditions are met.

- 1) You entered into the transaction in the normal course of your trade or business primarily to reduce the risk of:
  - a) Price changes or currency fluctuations on property you hold (or are about to hold), or
  - b) Interest rate or price changes, or currency fluctuations, on your current or future borrowings, or on your current or future obligations.
- 2) The gain or loss on the transaction is treated as ordinary income or loss.
- 3) 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 any hedging loss that is disallowed because of this limit, you can carry it over to the next tax year as a deduction based on 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. This limit also applies to a corporation if, at any time during the last half of the tax year, more than

50% in value of its outstanding stock is owned by five or fewer individuals.

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 later under *Straddles*.

**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 6 of Publication 535, *Business Expenses*, Publication 560, *Retirement Plans for Small Business*, and Publication 590, *Individual Retirement Arrangements (IRAs)*.

## 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.** Assume the same facts 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.

**Section 1231 transactions.** If you hold an option more than 1 year to buy or sell property that is (or would be) used for business or to produce rents or royalties, the gain or loss on its sale or trade is a section 1231 gain or loss. For information on its treatment, see *Section 1231 Gains and Losses* in chapter 4 of Publication 544.

**Option not exercised.** If you do not exercise an option to buy or sell, and you have a loss, you are considered to have sold or traded the option on the date that it expired.

**Grantor of option.** If you grant (write) an option, how you report your gain or loss depends on whether it was exercised.

If you grant (write) an option on stocks, securities, commodities, or commodity futures and it is not exercised, the amount you re-

ceive, if you are not in the business of granting options, is a short-term capital gain.

If the option is exercised, you add the option payment to other amounts you receive to figure the amount you realize on the sale of the property. Whether your gain or loss is capital or ordinary is determined by the type of property you sell.

**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 earlier under *Section 1256 Contracts Marked to Market*.

**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 a purchased option expired, enter the expiration date in column (c) and write "Expired" in column (d).

If an option that you granted (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 the Chicago Board Options Exchange. (But see *Section 1256 Contracts Marked to Market* 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.

**Short sale.** Buying a put option is generally treated as a short sale, and the exercise, sale, or expiration of the put is a closing 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, rather than 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 XYZ call options were issued on April 8, 1997, for a total premium (cost) of \$4,000. These equity options expired in December 1997, without being exercised. If you were a holder (buyer) of the options, you would recognize a short-term capital loss of \$4,000 on Schedule D of your 1997 return. If you were a writer of the options, you would recognize a short-term capital gain of \$4,000 on Schedule D of your 1997 return.
- 2) **Closing transaction.** The facts are the same as in (1), except that on May 10, 1997, the options were sold for \$6,000. If you were the seller, you would recognize a short-term capital gain of \$2,000 on Schedule D of your 1997 return. If you were the writer of the options and you bought them back, you would recognize a short-term capital loss of \$2,000 on Schedule D of your 1997 return.

- 3) **Exercise.** The options in (1) were exercised on May 27, 1997. The buyer adds the premium (cost) of the options to the basis of the stock bought through the exercise of the options. The writer adds the premium received from the options to the amount realized on the sale of stock through the exercise of the options.
- 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.

## 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.

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 premium you received for the put.
Expires	Report the cost of the put as a capital loss.*	Report the premium you received 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 premium 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 premium you received for the call.
Expires	Report the cost of the call as a capital loss on the date it expires.*	Report the premium you received 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 premium 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.

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. This rate is published by the IRS each calendar quarter in the *Internal Revenue Bulletin*.

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. This rate is published by the IRS each month in the *Internal Revenue Bulletin*. You can contact the IRS to get these rates. See chapter 5 for the number to call.

**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 built-in loss against 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.** Special rules apply to options dealers and commodities traders. See section 1258(d)(5) of the Internal Revenue Code.

**How to report.** See the instructions for lines 11 and 13 of Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles*, for details on how to report any gain from the disposition or other termination of any position you held as part of a conversion transaction.

## 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.

For information on what is meant by a "straddle" and a "position" in a straddle, see *Definition of a Straddle*, later.

**Loss deferral rules.** Generally, you can deduct a loss on the disposition of one or more positions only to the extent that the loss exceeds 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, 1997, you entered into a straddle. On December 16, 1997, you closed one position of the straddle at a loss of \$15,000. On December 31, 1997, the end of your tax year, you have an unrecognized gain of \$12,750 in the offsetting open position. On your 1997 return, you are limited to a loss of \$2,250, which is the amount of the loss minus the unrecognized gain in the open position. You must carry forward to 1998 the unused loss of \$12,750.

## Exceptions

The loss deferral rules just described 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.** An identified straddle is not subject to the loss deferral rules just described. Instead, 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, and
- 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:

- 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, and
- 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:

- 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, and
- 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 that is 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 **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.** An XYZ/September call option was granted on May 13, 1997. The closing price of one share of XYZ stock on May 12, 1997, was \$130<sup>1</sup>/<sub>4</sub>. The strike prices of all the XYZ/September options offered on May 13, 1997, were as follows: \$110, \$115, \$120, \$125, \$130, and \$135. The option was granted more than 90 days before expiration. Therefore, the LQB is the second highest strike price that is less than the applicable stock price. This amount is \$125. On May 13, 1997, you held XYZ stock and you acquired an XYZ/September option granted for a strike price of \$120. The call granted is a deep-in-the-money option because it is lower than the LQB. The option granted is not a qualified covered call option and the loss deferral rules apply if the call or the stock was closed out at a loss during the year.

**Capital loss on qualified covered call options.** If you hold stock and you grant 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. If the long-term capital gain on the sale of the stock would be a 28% rate gain (defined later under *Holding Period*), treat the long-term capital loss from the option as a 28% rate loss. The holding period of the stock does not include any period during which you are the grantor of the option.

**Special year-end rule.** The loss deferral rules for straddles apply if:

- 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 includable in gross income in a later tax year, and
- 3) The stock or options were held less than 30 days after the closing of the options or the disposition of the stock.

## Definition of a Straddle

A straddle is any set of offsetting positions on personal property. For example, a straddle may consist of a call option and a put option written at the same time on the same number of shares of a 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, or
  - b) 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*, earlier, under *Section 1256 Contracts Marked to Market*.

**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 identified straddle (described earlier under *Exceptions*), 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.

## 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, 1997, you bought stock in XX Corporation (XX stock) and an offsetting put option. On December 13, 1997, there was \$20 of unrealized gain in the put option and you sold the XX stock at a \$20 loss. By December 16, 1997, the value of the put option had declined, eliminating all unrealized gain in the position. On December 16, 1997, you bought a second XX stock position that is substantially identical to the XX stock you sold on December 13, 1997. 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 1997 under Rule 1 because, within a period beginning 30 days before December 13, 1997, 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 be-

fore, and ending 30 days after, the sale of the loss position.

**Example 1.** On December 2, 1997, you entered into offsetting long and short positions. On December 9, 1997, you disposed of the short position at an \$11 loss. At year end, you have an unrecognized gain of \$5 in the offsetting long position. Only \$6 of the loss is deductible in 1997. You can carry forward the remaining \$5 into 1998.

**Example 2.** The facts are the same as in Example 1, except that at year end you have \$11 of unrecognized gain in the offsetting long position. Under these circumstances, the entire \$11 loss will be disallowed for 1997 because there is \$11 of unrecognized gain at year end in the offsetting long position.

**Example 3.** On November 1, 1997, you entered into offsetting long and short positions in non-section 1256 contracts. On November 12, 1997, you disposed of the long position at a \$10 loss. On November 14, 1997, 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, 1997. 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 1997 because there is an unrecognized gain in the successor long position.

**Example 4.** The facts are the same as in Example 3, 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 1997 because there is a total of \$10 of unrecognized gain in both the successor long position and offsetting short position.

**Example 5.** The facts are the same as in Example 3, 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 1997 because there is \$8 of unrecognized gain in the successor long position.

**Loss carryover.** If you have an unused 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 1996 under Rule 1 will not be allowed in 1997, unless the substantially identical stock or securities (which caused the loss to be disallowed in 1996) were disposed of during 1997. In addition, the loss carryover will not be allowed in 1997 if Rule 1 and Rule 2 disallow it.

**Example.** The facts are the same as in the example under Rule 1 above, except that on December 31, 1998, 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 1998 either the \$20 loss disallowed in 1997 or the \$20 loss you incurred for the December 31, 1998, 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 \$40 loss position.

**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.
- 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.

For more information about identified straddles, offsetting positions, unrecognized gain, and determining gain or loss on the sale of one or more straddle positions, see the discussions earlier in this section. Hedging transactions are described earlier under *Section 1256 Contracts Marked to Market*.

## 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 applies to any position other than a position you held more than 1 year before you established the straddle. But see *Exceptions*, later.

**Example.** On March 6, 1996, you acquired gold. On January 4, 1997, you entered into an offsetting short gold forward contract (nonregulated futures contract). On April 1, 1997, you disposed of the short gold forward contract at no gain or loss. On April 8, 1997, 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, 1997, the date the straddle was terminated. 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:

- 1) You held (directly or indirectly) one or more offsetting positions to the loss position on the date you entered into the loss position, and
- 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** for this purpose is a straddle that is not part of a larger straddle —

- 1) In which all positions are held as capital assets,
- 2) In which at least one (but not all) of the positions is a section 1256 contract, and
- 3) For which the mixed straddle election governing section 1256 contracts has not been made. (This election is discussed later under *Mixed Straddles*.)

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 or mixed straddle account election. See *Other elections*, under *Mixed Straddles*, later.

**Example.** On March 1, 1997, you entered into a long gold forward contract. On July 15, 1997, 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, 1997, 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. (See *Other elections*, under *Mixed Straddles*, next.)

## Mixed Straddles

A mixed straddle is a straddle in which at least one, but not all, of the positions is a section 1256 contract. Mixed straddles are generally subject to the same rules that apply to other straddles, except that the section 1256 component is also subject to the marked to market rules. (See *Section 1256 Contracts Marked to Market*, earlier.)

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 not to have the marked to market rules for determining gain and loss, discussed earlier under *Section 1256 Contracts Marked to Market*, apply to 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. If you choose this election, you avoid the 60% long-term capital loss treatment required for a non-section 1256 loss position that is part of a mixed straddle. See *Loss treatment under Holding Period and Loss Treatment Rules*, earlier.

Under the election, each position forming part of the straddle must be 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 in addition to the mixed straddle election. If you choose to make an election, only one of the three elections can be made. Use Form 6781 to indicate your election choice by checking box A, B, or C, whichever applies.

**Straddle-by-straddle identification (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 under normal rules for section 1256 contracts, that is, 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 Temporary Regulations section 1.1092(b)-3T.

**Example.** On April 1, 1997, 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, 1997, 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).** A mixed straddle account is an account for determining gains and losses from all positions held as capital assets in a designated class of activities at the time you elected to establish the account. 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 Temporary 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.

## Losses on 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 small business stock. Gain on small business 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 small business stock is a business loss.

### Section 1244 stock (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 exchanges of stocks or securities. If the corporation was in existence more than 1 year, but less than 5 years, the 50% test applies to the period of the corporation's tax years ending before the loss. If the corporation was in existence less than 1 year, the 50% test applies to days 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 small business stock, see section 1244 of the Internal Revenue Code and its regulations.

**Ordinary loss limit.** The loss on small business stock that you can deduct as 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 on a joint return. The remaining \$10,000 is a capital loss.

**The stock must be issued to the person taking the loss.** You must be the original owner of this 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 small business 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 small business 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 small business 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 exchange your small business 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 small business stock if the stock you exchange meets the requirements when the exchange occurs.

If you hold small business 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 small business stock. Only that part based on the small business stock you hold will qualify.

**Example.** Your basis for 100 shares of X common stock is \$1,000. These shares qualify as small business stock. If, as a non-taxable 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 small business stock.

If you also own stock in the corporation that is not small business stock when you receive the stock dividend, you must divide the shares you receive as a dividend between the small business stock and the other stock. Only the shares from the former can be small business stock.

**Contributed property.** To determine ordinary loss on small business stock you receive in exchange 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 exchange, 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. 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 small business 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 small business 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 small business stock has increased, through contributions to capital or otherwise, you must treat this increase as applying to nonqualified stock when you figure an ordinary loss on its sale.

**Example.** You buy 100 shares of qualifying small business 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 ( $\$10,000/\$12,000 \times \$3,000$ ) as an ordinary loss under these rules. The remaining \$500 is a capital loss.

**How to report.** An ordinary loss on small business stock is reported on line 10, Part II of Form 4797, *Sales of Business Property*. However, if you are reporting a loss on an asset used in a passive activity, use Form 8582, *Passive Activity Loss Limitations*, to see how much of the loss is allowed on Form 4797.



**Recordkeeping.** You must keep records sufficient to show your stock qualifies as section 1244 stock (small business stock). Your records must also distinguish your small business 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 are allowed an ordinary loss (business loss), rather than a capital loss, on losses from the sale or exchange of that stock. You are allowed capital gain on gains from the sale or exchange of that stock.

**How to report.** You report these losses in 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.

If you have a gain on the sale of SBIC stock, report it as a capital gain on Schedule D of Form 1040. Do not offset your gains and losses, even if they are on stock of the same company.

**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*, earlier 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. If it is a long-term capital gain or loss, your holding period can also determine whether it is a 28% rate 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 same date of each following month is the beginning of a new month regardless of the number of days in the preceding month. The day you disposed of the property is part of your holding period.

**Example.** If you bought investment property on February 5, 1996, you start counting on February 6. The 6th of each following month is the beginning of a new month. If you sold the property on February 5, 1997, 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, 1997, your holding period is more than 1 year and you have a long-term capital gain or loss.

**28% rate gain or loss.** Your 28% rate gains and losses determine the amount of a net capital gain that is taxed at a maximum rate of 28%. (See *Maximum Tax Rates on Net Capital Gain*, later.) These are your long-term capital gains and losses from:

- 1) Sales or trades (or installment payments received):
  - a) Before May 7, 1997, or
  - b) After July 28, 1997, for assets that you held more than 1 year but not more than 18 months, or
- 2) Sales or trades of collectibles (works of art, rugs, antiques, metals, gems, stamps, coins, and alcoholic beverages).

Collectibles gain includes gain from the sale of an interest in a partnership, S corporation, or trust attributable to unrealized appreciation of collectibles.

**Securities traded on an established market.** For securities traded on an established securities market, your holding period begins the day after the *trading date* you bought the securities, and ends on the trading date you sold them. Ignore the settlement dates for tax purposes.

**Example.** You are a cash method, calendar year taxpayer. You sold stock at a gain on December 27, 1997. 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 2, 1998. You received

payment of the sale price on that same day. Report your gain on your 1997 return, even though you received the payment in 1998. 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 27. If you had sold the stock at a loss, you would also report it on your 1997 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.

**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 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 and your basis for it is:

- 1) Determined by its fair market value at the date of the decedent's death,
- 2) Determined by its fair market value at the alternate valuation date, or
- 3) The decedent's adjusted basis (for appreciated property),

your capital gain or loss on any later disposition of that property is treated as a long-term capital gain or loss from property held more than 18 months. This is true regardless of how long you actually held the property. For more information about determining basis, see *Inherited Property*, earlier in this chapter under *Basis Other Than Cost*.

**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.

**Nontaxable stock dividends.** 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. Your long-term gain or loss is treated as gain or loss from the sale of property held more than 18 months. See *Section 1256 Contracts Marked to Market*, earlier.

**Option property.** 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 includes the period you held the old stock.

**Commodity 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, other than a regulated futures contract subject to Internal Revenue Code section 1256, includes your holding period for the futures contract.

**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. (See *Capital Gain Distributions under Dividends and Other Corporate Distributions* in chapter 1.) 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. (For information on exempt-interest dividends, see *Other Distri-*

*butions under Dividends and Other Corporate Distributions* in chapter 1.)

## Rollover of Gain

This section discusses the tax-free rollover of certain gains from the sale of publicly traded securities. 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 postponed.** 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 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 gain.** If you choose to postpone gain, report the entire gain realized from the sale on line 1 or line 8 of Schedule D (Form 1040), whichever is appropriate. Directly below the line on which you report the gain, enter "SSBIC Rollover" in column (a) and enter the amount of gain postponed in column (f). Enter it as a loss (in parentheses).

Also enter the appropriate amount in column (g) of both lines.

Also attach a schedule showing:

- 1) How you figured the postponed gain,
- 2) The name of the SSBIC in which you purchased common stock or a partnership interest,
- 3) The date of that purchase, and
- 4) Your new basis in that SSBIC stock or partnership interest.

You must make the choice to postpone gain by the due date (including extensions) of the tax return on which you must report the gain. Your choice is revocable with the consent of the IRS.

## Sales of 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. Beginning in 1997, you may qualify for a tax-free **rollover** of the gain. Beginning in 1998, 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) As of the date the stock was issued, the corporation must have been a qualified small business, defined later.
- 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 exchange of qualified small business stock that you held.
- 5) The corporation must have met the **active business test**, defined later, and 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 minimus 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 a significant amount of its stock from anyone.

**Qualified small business.** This is a C corporation with total gross assets of \$50 million or less at all times after August 9, 1993, and before it issued the stock. The corporation's 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-subsidary controlled group as one corporation.

**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 later.
- 2) It used at least 80% (by value) of its assets in the active conduct of at least one **qualified trade or business**, defined later.

**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, 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

This section explains the tax-free rollover of capital gain from the sale after August 5, 1997, of qualified small business stock held more than 6 months. If you buy replacement stock and make the choice described in this section, you postpone part or all of your gain.

You roll over the gain by adjusting the basis of the replacement stock as described in *Basis of replacement stock*, later. This

postpones your gain until the year you dispose of the replacement property.

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.



*As this publication was being prepared for print, Congress was considering legislation that would prohibit a partnership or S corporation from making this choice unless, at all times during the tax year, all of the partners or shareholders are individuals or estates. For information about the status of this legislation, see Publication 553, Highlights of 1997 Tax Changes.*

**Amount of gain postponed.** 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.

**How to report gain.** If you choose to postpone gain, report the entire gain realized from the sale on line 1 or line 8 of Schedule D (Form 1040), whichever is appropriate. Directly below the line on which you report the gain, enter "Section 1045 Rollover" in column (a) and enter the amount of gain postponed in column (f). Enter it as a loss (in parentheses). Also enter the appropriate amount in column (g) of both lines.

## Exclusion of Gain

Beginning in 1998, you will have to pay tax on only one-half of your gain from the sale or exchange of qualified small business stock held by you for more than 5 years.

For information about limits and additional requirements that may apply, see section 1202 of the Internal Revenue Code. Or, you may wish to consult with a tax practitioner.

## Reporting Capital Gains and Losses on Schedule D

This section discusses how to report your capital gains and losses on Schedule D (Form 1040), *Capital Gains and Losses*. 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) on lines 1 and 2 and lines 8 and 9 and enter the totals on lines 3 and 10. Then add the following amounts reported to you for 1997 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 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.** If you will receive any of the proceeds from the sale of your investment property after the year of sale, you may have an installment sale. Generally, you report gain from an installment sale using the installment method. Under this method, you report part of the gain each year that you receive a payment. For information, see Publication 537, *Installment Sales*.

**Stock or securities.** You cannot use the installment method to report gain from the sale of stock or securities traded on an established securities market. You must report the entire gain for 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 exchange 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 of a market discount bond on Schedule D (Form 1040), line 1 or line 8. Then, on the next line, enter "Accrued Market Discount" in column (a) and the amount of the accrued market discount as a loss in column (f). (If you chose to include market discount in income currently, enter only the accrued market discount for the year of sale.) Also report on Schedule B (Form 1040), line 1, the amount of the market discount you did not include in your interest income in earlier years, and identify it as "Accrued Market Discount."

**Form 1099-S transactions.** If you sold or exchanged reportable real estate, you should receive from the real estate reporting person a Form 1099-S, *Proceeds From Real Estate Transactions*, showing the gross proceeds from the sale.

"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 lines 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. Write "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. Report the amount of each gain or loss for the entire year in column (f). If you have 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, and
- 4) Long-term capital loss carryovers.

The result from 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 (defined earlier under *Holding Period*). Enter any loss in parentheses.

**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 38 of Form 1040 is more than zero, see *Maximum Tax Rates on Net Capital Gain*, 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.

**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 1997 that you can carry over to 1998.

**Example.** Bob and Gloria sold securities in 1997. 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 1997 return, they can deduct \$3,000. The unused part of the loss, \$4,000 (\$7,000 - \$3,000), can be carried over to 1998.

If their capital loss had been \$2,000, their capital loss deduction would have been \$2,000. They would have no carryover to 1998.

**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.

**A decedent's capital loss.** A capital loss sustained by a decedent during his or her last tax year can only be deducted 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.

## Maximum Tax Rates on Net Capital Gain

The 31%, 36%, and 39.6% income tax rates for individuals do not apply to a net capital gain. In some cases, the 15% and 28% rates do not apply either. Instead, your net capital gain is taxed at a lower maximum rate.

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 rate may be 10%, 20%, 25%, or 28%, or a combination of those rates, as shown in the following table.

The Maximum Rate is . . .	For . . .
28%	<ul style="list-style-type: none"> <li>Gain on a sale before May 7, 1997, of property held more than 1 year</li> <li>Gain on a sale after July 28, 1997, of property held more than 1 year but not more than 18 months</li> <li>A collectibles gain</li> </ul>
25%	<ul style="list-style-type: none"> <li>Unrecaptured section 1250 gain on a sale after May 6, 1997, and before July 29, 1997, of property held more than 1 year</li> <li>Unrecaptured section 1250 gain on a sale after July 28, 1997, of property held more than 18 months</li> </ul>
20%	<ul style="list-style-type: none"> <li>Gain on a sale after May 6, 1997, and before July 29, 1997, of property held more than 1 year (unless 28%, 25%, or 10% rate applies)</li> <li>Gain on a sale after July 28, 1997, of property held more than 18 months (unless 28%, 25%, or 10% rate applies)</li> </ul>
10%	<ul style="list-style-type: none"> <li>Gain on a sale that would qualify for the 20% maximum rate except that, if there were no maximum capital gains rates, the gain would be taxed at the 15% regular tax rate</li> </ul>

The term "sale" includes a trade, involuntary conversion, and installment payment received.

You also may find *Table 4-2* helpful in finding your maximum capital gains rate for 1997.

**Collectibles gain.** This is gain from the sale of a work of art, rug, antique, metal, gem, stamp, coin, or alcoholic beverage held more than 1 year.

**Unrecaptured section 1250 gain.** Generally, this is the part of any capital gain from selling section 1250 property (real property) that is due to depreciation. For more information about section 1250 property, see Publication 544.

**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 maximum 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. For more informa-

tion, see *Limit on Investment Interest* in chapter 3.

## Using the Maximum Rates

The part of a net capital gain that is subject to each maximum rate is determined under the following rules.

- 1) Long-term capital gains are netted with long-term capital losses in the following groups.
  - a) A 28% group, consisting of gains and losses on the types of transactions described in the table on this page in the section for gains subject to the 28% maximum rate, plus long-term capital loss carryovers.
  - b) A 25% group, consisting of unrecaptured section 1250 gains described in the table on this page in the section for gains subject to the 25% maximum rate.
  - c) A 20% group, consisting of gains and losses on the types of transactions described in the table on this page in the sections for gains subject to the 20% or 10% maximum rate.
- 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 gain from the 25% group.

You apply these rules by using Part IV of Schedule D (Form 1040) to figure your tax. You will need to 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 long-term capital gain or loss combined with any net short-term capital gain or loss.)
- 2) Your taxable income on Form 1040, line 38, is more than zero.

See the *Comprehensive Example*, later, for an example of how to figure your tax using the maximum capital gains rates.

**Alternative minimum tax.** These maximum capital gains rates are also used in figuring alternative minimum tax.

## Changes for Years After 1997

After 1997, there will be some additional changes in these rules.

**1998.** The taxable part of gain from certain sales or trades after August 11, 1998, of qualified small business stock, up to the amount of excluded gain from those sales, will be subject to the maximum capital gains rate of 28%. For information about qualified small business stock and the exclusion, see *Sales of Small Business Stock*, earlier in this chapter.

**2001.** Beginning in the year 2001, the 10% maximum capital gains rate will be lowered to 8% for "qualified 5-year gain."

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

Taxpayers who own certain stock on January 1, 2001, can choose to treat the stock as sold and repurchased on January 2, 2001, if they pay tax for 2001 on any resulting 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% or 20% maximum capital gains rate.

## Comprehensive Example

Emily Jones is single and, in addition to wages from her job, she has income from some stocks and other securities. For the 1997 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 purchased in May. She had an adjusted basis of \$650 in the stock and sold it for \$900, for a gain of \$250. In July, she sold 25 shares of Computer Co. stock that she bought in March. She had an adjusted basis in the stock of \$2,500 and sold it for \$2,000, for a loss 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. Because she sold the stock before May 7, it is a 28% rate loss, so she enters it in both column (f) and column (g) of line 8.

On June 27, she sold 500 shares of Furniture Co. stock for \$5,000. She bought 100 of those shares in 1987, for \$1,000. She bought 100 more shares in 1989 for \$2,200, and an additional 300 shares in 1991 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.

In September, she sold 20 shares of Toy Co. for \$2,600. Her basis is \$1,100, so she has a \$1,500 gain. Because she sold the stock after July 28 and did not hold it more than 18 months, her gain is a 28% rate gain. She enters it in both column (f) and column (g) of line 8.

She received a Form 1099-B (not shown) from her broker for each of these transactions.

**Form 6781.** In January 1997, 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 \$26,000 at the end of 1997. These amounts are shown in boxes 6 and 8 of the Form

Table 4-2. What Is Your Maximum Capital Gains Rate for 1997?

IF the sale* took place . . .	AND the capital asset was held . . .	AND your gain . . .	THEN your maximum capital gains rate is . . .
Before May 7, 1997	More than 1 year	Is from selling any type of capital asset	28%
After May 6, 1997, but before July 29, 1997	More than 1 year	1) Is a collectibles gain	28%
		2) Is an unrecaptured section 1250 gain	25%
		3) Is not a gain that (1), (2), or (4) applies to	20%
		4) Would be taxed, if there were no maximum capital gains rates, at the 15% regular tax rate — and (1) and (2) don't apply	10%
After July 28, 1997	More than 1 year but not more than 18 months	Is from selling any type of capital asset	28%
After July 28, 1997	More than 18 months	1) Is a collectibles gain	28%
		2) Is an unrecaptured section 1250 gain	25%
		3) Is not a gain that (1), (2), or (4) applies to	20%
		4) Would be taxed, if there were no maximum capital gains rates, at the 15% regular tax rate — and (1) and (2) don't apply	10%

\* The term "sale" includes a trade, involuntary conversion, and installment payment received.

1099-B she receives from her broker (not shown). Her combined profit is \$15,000 (\$26,000 – \$11,000). She reports this gain in Part I of Form 6781. She must show the \$11,000 loss in column (c) because she realized it before May 7, 1997. She also shows the short-term part of her gain on line 4 of Schedule D and the long-term part on line 11 of Schedule D.

**Capital loss carryover from 1996.** Emily has a capital loss carryover to 1997 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 1996 Schedule D instructions (not shown), so she could properly report her loss carryover for the 1997 tax year without refiguring it.

**Tax computation using maximum capital gains rates.** Because Emily has gains on both lines 16 and 17 of Schedule D and has taxable income, she uses Part IV of Schedule D to figure her tax. After entering the gain from line 17 on line 13 of her Form 1040, she completes the rest of Form 1040 through line 38. She enters the amount from that line, \$30,000, on line 19 of Schedule D.

After filling out the rest of Part IV, she finds that her tax is \$4,544. This is less than the tax she would have found without using the maximum capital gains rates, \$5,203.

**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 from the sales of investment property is not less than the total of the amounts shown on the Forms 1099-B she received from her broker. For 1997, the total of each is \$12,600.

**SCHEDULE D  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service

**Capital Gains and Losses**

▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).  
▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8.

OMB No. 1545-0074

**1997**

Attachment  
Sequence No. **12**

Name(s) shown on Form 1040

Emily Jones

Your social security number

111 : 00 : 1111

**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-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) FOR ENTIRE YEAR. Subtract (e) from (d)
1 100 sh Trucking Co.	5-12-97	6-12-97	900	650	250
25 sh Computer Co.	3-14-97	7-30-97	2,000	2,500	(500)
<b>2</b> Enter your short-term totals, if any, from Schedule D-1, line 2 . . . . .					
<b>3 Total short-term sales price amounts.</b> Add column (d) of lines 1 and 2 . . . . .			<b>3</b> 2,900		
<b>4</b> Short-term gain from Forms 2119 and 6252, and short-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .					<b>4</b> 6,000
<b>5</b> Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .					<b>5</b>
<b>6</b> Short-term capital loss carryover. Enter the amount, if any, from line 9 of your 1996 Capital Loss Carryover Worksheet . . . . .					<b>6</b> ( 300 )
<b>7 Net short-term capital gain or (loss).</b> Combine lines 1 through 6 in column (f). . . . .					<b>7</b> 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-3)	(e) Cost or other basis (see page D-4)	(f) GAIN or (LOSS) FOR ENTIRE YEAR. Subtract (e) from (d)	(g) 28% RATE GAIN or (LOSS) * (see instr. below)
8 60 sh Car Co.	inherited	2-3-97	2,100	2,500	(400)	(400)
500 sh Furniture Co.	various	6-27-97	5,000	4,700	300	
20 sh Toy Co.	6-28-96	9-15-97	2,600	1,100	1,500	1,500
<b>9</b> Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . .						<b>9</b>
<b>10 Total long-term sales price amounts.</b> Add column (d) of lines 8 and 9 . . . . .			<b>10</b> 9,700			
<b>11</b> Gain from Form 4797, Part I; long-term gain from Forms 2119, 2439, and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .					<b>11</b> 9,000	(6,600)
<b>12</b> Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1. . . . .					<b>12</b>	
<b>13</b> Capital gain distributions . . . . .					<b>13</b>	
<b>14</b> Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 14 of your 1996 Capital Loss Carryover Worksheet . . . . .					<b>14</b> ( 500 )	( 500 )
<b>15</b> Combine lines 8 through 14 in column (g) . . . . .					<b>15</b>	(6,000)
<b>16 Net long-term capital gain or (loss).</b> Combine lines 8 through 14 in column (f). . . . .					<b>16</b> 9,900	

\* **28% Rate Gain or Loss** includes all gains and losses in Part II, column (f) from sales, exchanges, or conversions (including installment payments received) either: • **Before May 7, 1997, or**  
• **After July 28, 1997, for assets held more than 1 year but not more than 18 months.**  
It also includes **ALL** "collectibles gains and losses" (as defined on page D-4).



**Part III Summary of Parts I and II**

<b>17</b>	Combine lines 7 and 16. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13 <b>Next:</b> Complete Form 1040 through line 38. Then, go to <b>Part IV</b> to figure your tax if: <ul style="list-style-type: none"> <li>• Both lines 16 and 17 are gains, <b>and</b></li> <li>• Form 1040, line 38, is more than zero.</li> </ul>	<b>17</b>	15,350
<b>18</b>	If line 17 is a loss, enter here and as a (loss) on Form 1040, line 13, the <b>smaller</b> of these losses: <ul style="list-style-type: none"> <li>• The loss on line 17; <b>or</b></li> <li>• (\$3,000) or, if married filing separately, (\$1,500)</li> </ul> <b>Next:</b> Complete Form 1040 through line 36. Then, complete the <b>Capital Loss Carryover Worksheet</b> on page D-4 if: <ul style="list-style-type: none"> <li>• The loss on line 17 exceeds the loss on line 18, <b>or</b></li> <li>• Form 1040, line 36, is a loss.</li> </ul>	<b>18</b>	( )

**Part IV Tax Computation Using Maximum Capital Gains Rates**

<b>19</b>	Enter your taxable income from Form 1040, line 38	<b>19</b>	30,000
<b>20</b>	Enter the <b>smaller</b> of line 16 or line 17	<b>20</b>	9,900
<b>21</b>	If you are filing Form 4952, enter the amount from Form 4952, line 4e	<b>21</b>	—
<b>22</b>	Subtract line 21 from line 20. If zero or less, enter -0-	<b>22</b>	9,900
<b>23</b>	Combine lines 7 and 15. If zero or less, enter -0-	<b>23</b>	-0-
<b>24</b>	Enter the <b>smaller</b> of line 15 or line 23, but not less than zero	<b>24</b>	-0-
<b>25</b>	Enter your unrecaptured section 1250 gain, if any (see page D-4)	<b>25</b>	-0-
<b>26</b>	Add lines 24 and 25	<b>26</b>	-0-
<b>27</b>	Subtract line 26 from line 22. If zero or less, enter -0-	<b>27</b>	9,900
<b>28</b>	Subtract line 27 from line 19. If zero or less, enter -0-	<b>28</b>	20,100
<b>29</b>	Enter the <b>smaller</b> of line 19 or \$41,200 (\$24,650 if single; \$20,600 if married filing separately; \$33,050 if head of household)	<b>29</b>	24,650
<b>30</b>	Enter the <b>smaller</b> of line 28 or line 29	<b>30</b>	20,100
<b>31</b>	Subtract line 22 from line 19. If zero or less, enter -0-	<b>31</b>	20,100
<b>32</b>	Enter the <b>larger</b> of line 30 or line 31	<b>32</b>	20,100
<b>33</b>	Figure the tax on the amount on line 32. Use the Tax Table or Tax Rate Schedules, whichever applies	<b>33</b>	3,019
<b>34</b>	Enter the amount from line 29	<b>34</b>	24,650
<b>35</b>	Enter the amount from line 28	<b>35</b>	20,100
<b>36</b>	Subtract line 35 from line 34. If zero or less, enter -0-	<b>36</b>	4,550
<b>37</b>	Multiply line 36 by 10% (.10)	<b>37</b>	455
<b>38</b>	Enter the <b>smaller</b> of line 19 or line 27	<b>38</b>	9,900
<b>39</b>	Enter the amount from line 36	<b>39</b>	4,550
<b>40</b>	Subtract line 39 from line 38. If zero or less, enter -0-	<b>40</b>	5,350
<b>41</b>	Multiply line 40 by 20% (.20)	<b>41</b>	1,070
<b>42</b>	Enter the <b>smaller</b> of line 22 or line 25	<b>42</b>	-0-
<b>43</b>	Add lines 22 and 32	<b>43</b>	30,000
<b>44</b>	Enter the amount from line 19	<b>44</b>	30,000
<b>45</b>	Subtract line 44 from line 43. If zero or less, enter -0-	<b>45</b>	-0-
<b>46</b>	Subtract line 45 from line 42. If zero or less, enter -0-	<b>46</b>	-0-
<b>47</b>	Multiply line 46 by 25% (.25)	<b>47</b>	-0-
<b>48</b>	Enter the amount from line 19	<b>48</b>	30,000
<b>49</b>	Add lines 32, 36, 40, and 46	<b>49</b>	30,000
<b>50</b>	Subtract line 49 from line 48	<b>50</b>	-0-
<b>51</b>	Multiply line 50 by 28% (.28)	<b>51</b>	-0-
<b>52</b>	Add lines 33, 37, 41, 47, and 51	<b>52</b>	4,544
<b>53</b>	Figure the tax on the amount on line 19. Use the Tax Table or Tax Rate Schedules, whichever applies	<b>53</b>	5,203
<b>54</b>	<b>Tax.</b> Enter the <b>smaller</b> of line 52 or line 53 here and on Form 1040, line 39	<b>54</b>	4,544

# Gains and Losses From Section 1256 Contracts and Straddles

▶ Attach to your tax return.

Name(s) shown on tax return: Emily Jones Identifying number: 111-00-1111

Check applicable box(es) (see instructions):  
**A**  Mixed straddle election      **C**  Mixed straddle account election  
**B**  Straddle-by-straddle identification election      **D**  Net section 1256 contracts loss election

**Part I Section 1256 Contracts Marked to Market**

(a) Identification of account	(b) GAIN or (LOSS) For ENTIRE YEAR	(c) GAIN or (LOSS) from column (b) BEFORE 5/7/97
1 Form 1099-B XYZ Trading Co.	15,000	(11,000)
2 Net gain or (loss). Combine amounts on line 1 in columns (b) and (c) . . . . .	15,000	(11,000)
3 Form 1099-B adjustments. See instructions and attach schedule . . . . .		
4 Combine lines 2 and 3, column (b) . . . . .	15,000	
5 Combine lines 2 and 3, column (c) . . . . .		(11,000)
<b>Note:</b> If line 4 shows a net gain, skip line 6 and enter the line 4 and 5 amounts on line 7. Partnerships and S corporations, see instructions.		
6 If you have a net section 1256 contracts loss and checked box D, enter the amount to be carried back. Do not enter in column (c) more than any loss on line 5 . . . . .		
7 Subtract line 6, column (b) from line 4, and line 6, column (c) from line 5. . . . .	15,000	(11,000)
8 Short-term capital gain or (loss). Multiply line 7, column (b) by 40%. Enter here and on Schedule D. See instructions. . . . .	6,000	
9 Long-term capital gain or (loss). Multiply line 7, columns (b) and (c) by 60%. Enter here and on Schedule D. See instructions . . . . .	9,000	(6,600)

**Part II Gains and Losses From Straddles.** Attach a separate schedule listing each straddle and its components.

**Section A—Losses From Straddles**

(a) Description of property	(b) Date entered into or acquired	(c) Date closed out or sold	(d) Gross sales price	(e) Cost or other basis plus expense of sale	(f) LOSS. If column (e) is more than (d), enter difference. Otherwise, enter -0-	(g) Unrecognized gain on offsetting positions	(h) RECOGNIZED LOSS For ENTIRE YEAR. If column (f) is more than (g), enter difference. Otherwise, enter -0-	(i) 28% RATE LOSS
10								
11a Enter short-term portion of line 10, column (h), losses here and on Schedule D. See instructions . . . . .							( )	
b Enter long-term portion of line 10, column (h), losses here and on Schedule D. See instructions . . . . .							( )	( )

**Section B—Gains From Straddles**

(a) Description of property	(b) Date entered into or acquired	(c) Date closed out or sold	(d) Gross sales price	(e) Cost or other basis plus expense of sale	(f) GAIN For ENTIRE YEAR. If column (d) is more than (e), enter difference. Otherwise, enter -0-	(g) 28% RATE GAIN
12						
13a Enter short-term portion of line 12, column (f), gains here and on Schedule D. See instructions						
b Enter long-term portion of line 12, column (f), gains here and on Schedule D. See instructions						

**Part III Unrecognized Gains From Positions Held on Last Day of Tax Year.** Memo Entry Only—See instructions.

(a) Description of property	(b) Date acquired	(c) Fair market value on last business day of tax year	(d) Cost or other basis as adjusted	(e) UNRECOGNIZED GAIN. If column (c) is more than (d), enter difference. Otherwise, enter -0-
14				

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## 5.

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# How To Get More Information



You can get help from the IRS in several ways.

**Free publications and forms.** To order free publications and forms, call 1-800-TAX-FORM (1-800-829-3676). You can also write to the IRS Forms Distribution Center nearest you. Check your income tax

package for the address. Your local library or post office also may have the items you need.

For a list of free tax publications, order Publication 910, *Guide to Free Tax Services*. It also contains an index of tax topics and related publications and describes other free tax information services available from the IRS, including tax education and assistance programs.

If you have access to a personal computer and modem, you also can get many forms and publications electronically. See *Quick and Easy Access to Tax Help and Forms* in your income tax package for details.

**Tax questions.** You can call the IRS with your tax questions. Check your income tax package or telephone book for the local number, or you can call 1-800-829-1040.

**TTY/TDD equipment.** If you have access to TTY/TDD equipment, you can call 1-800-829-4059 to ask tax questions or to

order forms and publications. See your income tax package for the hours of operation.

**Evaluating the quality of our telephone services.** To ensure that IRS representatives give accurate, courteous, and professional answers, we evaluate the quality of our "800 number" 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.

## 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 deduct your expenses when you become liable 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:** Usually the cost (money and fair market value of other property or services) of property you acquire.

**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 exceeds 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 which is designated as a contract market by the Commodities Futures Trading Commission.

**Commodity future:** A contract for the sale of a commodity at a future date for a fixed price.

**Conversion transaction:** Any transaction that you entered into after April 30, 1993, and 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, group of stocks, or stock index.

**Extraordinary dividend:** Any dividend you receive on stock which equals or exceeds 5% of your adjusted basis in preferred stock (10% in the case of other stock).

**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 for a substantially fixed price.

**Futures contract:** An 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 which 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 long-term 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 more than one-half (and more than 750 hours) of the personal services you perform during the year are performed 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 the purchase price is more than the stated redemption price of an instrument at maturity.

**Private activity bond:** A state or local bond issue of which:

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

**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:** Nontransferable stock that you get for services you perform and that is subject to a substantial risk of forfeiture.

**Section 1256 contract:** Any:

- 1) Regulated futures contract,
- 2) Foreign currency contract as defined in the discussion under *Section 1256 Contracts Marked to Market*,

- 3) Nonequity option, or
- 4) Dealer equity option.

**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 an option to buy and an option to sell written at the same time

on the same number of shares of a 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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