Publication 550

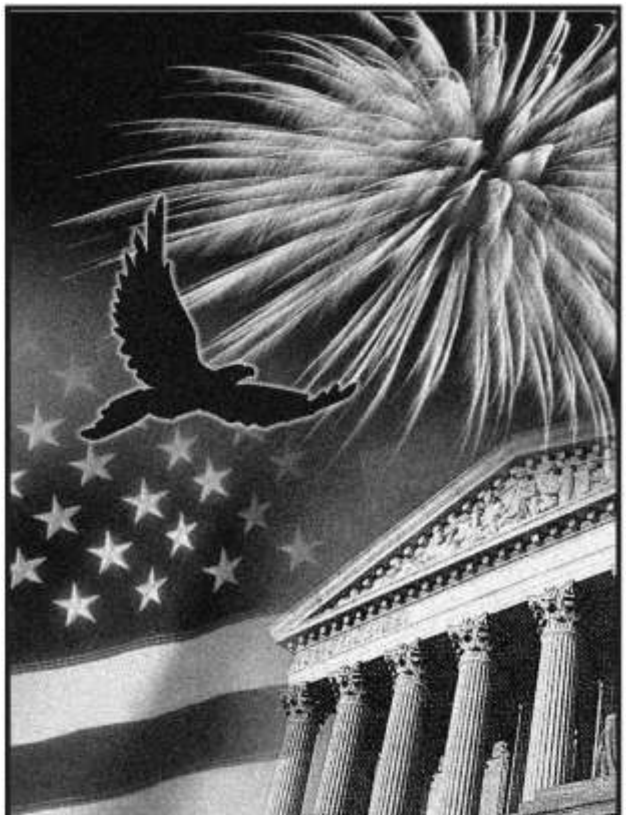
Investment Income and Expenses

(Including Capital Gains and Losses)

For use in preparing

2022 Returns

Volume 7 of 9



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Example. On April 1, 2022, you bought a mutual fund share for $20. On June 17, 2022, the mutual fund paid a capital gain distribution of $2 per share, which is taxed as a long-term capital gain. On July 15, 2022, you sold the share for $17.50. If it were not for the capital gain distribution, your loss would be a short-term loss of $2.50 ($20 − $17.50). However, the part of the loss that is not more than the capital gain distribution ($2) must be reported as a long-term capital loss. The remaining $0.50 of the loss can be reported as a 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. Report the loss as a short-term capital loss. On Form 8949, Part I, line 1, column (d), increase the sales price by the amount of exempt-interest dividends, but do not increase it to more than the cost or other basis shown in column (e).

For more information on Form 8949 and Schedule D (Form 1040), see the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040).

Example. On January 10, 2022, you bought a mutual fund share for $40. On February 7, 2022, the mutual fund paid a $5 dividend from tax-exempt interest, which is not taxable to you. On February 14, 2022, you sold the share for $34. If it were not for the tax-exempt dividend, your loss would be $6 ($40 − $34). However, you must increase the sales price from $34 to $39 (to account for the $5 portion of the loss that is not deductible). You can deduct only $1 as a short-term capital loss.

Loss on stock that paid qualified dividends. Any loss on the sale or trade of stock must be treated as a long-term capital loss to the extent you received, from that stock, qualified dividends (defined in chapter 1) that are extraordinary dividends. This is true regardless of how long you actually held the stock. Generally, an extraordinary dividend is a dividend that equals or exceeds 10% (5% in the case of preferred stock) of your adjusted basis in the stock.

Nonbusiness Bad Debts

If someone owes you money that you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless.

There are two kinds of bad debts—business and nonbusiness. A business bad debt, generally, is one that comes from operating your trade or business and is deductible as a business loss. All other bad debts are nonbusiness bad debts and are deductible as short-term capital losses.

Example. An architect made personal loans to several friends who were not clients. She could not collect on some of these loans. They are deductible only as nonbusiness bad debts because the architect was not in the business of lending money and the loans do not have any relationship to her business.

Business bad debts. For information on business bad debts of an employee, see Pub. 529, Miscellaneous Deductions. For information on other business bad debts, see chapter 10 of Pub. 535.

Deductible nonbusiness bad debts. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partly worthless nonbusiness debt.

Genuine debt required. A debt must be genuine for you to deduct a loss. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money.

Loan or gift. For a bad debt, you must show there was an intention at the time of the transaction to make a loan and not a gift. If you lend money to a relative or friend with the understanding that it may not be repaid, it is considered a gift and not a loan. You cannot take a bad debt deduction for a gift. There cannot be a bad debt unless there is a true creditor-debtor relationship between you and the person or organization that owes you the money.

When minor children borrow from their parents to pay for their basic needs, there is no genuine debt. A bad debt cannot be deducted for such a loan.

Basis in bad debt required. To deduct a bad debt, you must have a basis in it—that is, you must have already included the amount in your income or loaned out your cash. For example, you cannot claim a bad debt deduction for court-ordered child support not paid to you by your former spouse. If you are a cash method taxpayer (most individuals are), you generally cannot take a bad debt deduction for unpaid salaries, wages, rents, fees, interest, dividends, and similar items.

When deductible. You can take a bad debt deduction only in the year the debt becomes worthless. You do not have to wait until a debt is due to determine whether it is worthless. A debt becomes worthless when there is no longer any chance that the amount owed will be paid.

It is not necessary to go to court if you can show that a judgment from the court would be uncollectible. You must only show that you have taken reasonable steps to collect the debt. Bankruptcy of your debtor is generally good evidence of the worthlessness of at least a part of an unsecured and unpreferred debt.

If your bad debt is the loss of a deposit in a financial institution, see *Deposit in Insolvent or Bankrupt Financial Institution*, earlier.

Filing a claim for refund. If you do not deduct a bad debt on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the bad debt. To do this, use Form 1040-X 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 must generally be filed within 3 years from the date a return is filed, or 2 years from the date the tax is paid, whichever is later.) For more information about filing a claim, see Pub. 556.

Loan guarantees. If you guarantee a debt that becomes worthless, you cannot take a bad debt deduction for your payments on the debt unless you can show either that your reason for making the guarantee was to protect your investment or that you entered the guarantee transaction with a profit motive. If you make the guarantee as a favor to friends and do not receive any consideration in return, your payments are considered a gift and you cannot take a deduction.

Example 1. Henry Lloyd, an officer and principal shareholder of the Spruce Corporation, guaranteed payment of a bank loan the corporation received. The corporation defaulted on the loan and Henry made full payment. Because he guaranteed the loan to protect his investment in the corporation, Henry can take a nonbusiness bad debt deduction.

Example 2. Milt and Pat are co-workers. Milt, as a favor to Pat, guarantees a note at their local credit union. Pat does not pay the note and declares bankruptcy. Milt pays off the note. However, since he did not enter into the guarantee agreement to protect an investment or to make a profit, Milt cannot take a bad debt deduction.

Deductible in year paid. Unless you have rights against the borrower, discussed next, a payment you make on a loan you guaranteed is deductible in the year you make the payment.

Rights against the borrower. When you make payment on a loan 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:

- A political party;
- A national, state, or local committee of a political party; or

- A committee, association, or organization that either accepts contributions or spends money to influence elections.

Mechanics' and suppliers' liens. Workers and material suppliers may file liens against property because of debts owed by a builder or contractor. If you pay off the lien to avoid foreclosure and loss of your property, you are entitled to repayment from the builder or contractor. If the debt is uncollectible, you can take a bad debt deduction.

Insolvency of contractor. You can take a bad debt deduction for the amount you deposit with a contractor if the contractor becomes insolvent and you are unable to recover your deposit. If the deposit is for work unrelated to your trade or business, it is a nonbusiness bad debt deduction.

Secondary liability on home mortgage. If the buyer of your home assumes your mortgage, you may remain secondarily liable for repayment of the mortgage loan. If the buyer defaults on the loan and the house is then sold for less than the amount outstanding on the mortgage, you may have to make up the difference.

You can take a bad debt deduction for the amount you pay to satisfy the mortgage if you cannot collect it from the buyer.

Worthless securities. If you own securities that become totally worthless, you can take a deduction for a loss, but not for a bad debt. See *Worthless Securities* under *What Is a Sale or Trade*, earlier in this chapter.

Recovery of a bad debt. If you deducted a bad debt and in a later tax year you recover (collect) all or part of it, you may have to include the amount you recover in your gross income. However, you can exclude from gross income the amount recovered up to the amount of the deduction that did not reduce your tax in the year deducted. See *Recoveries* in Pub. 525.

How to report bad debts. Deduct nonbusiness bad debts as short-term capital losses on Form 8949.

On Form 8949, Part I, line 1, enter the name of the debtor and "bad debt statement attached" in column (a). Enter your basis in the bad debt in column (e) and enter zero in column (d). Use a separate line for each bad debt.

Make sure you report your bad debt(s) (and any other short-term transactions for which you did not receive a Form 1099-B) on Form 8949 with box C checked.

For each bad debt, attach a statement to your return that contains:

- A description of the debt, including the amount, and the date it became due;
- The name of the debtor, and any business or family relationship between you and the debtor;

- The efforts you made to collect the debt; and
- 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.

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.

- You sell short. You borrow property and deliver it to a buyer.
- 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 you held at the time of the sale. Delivery of property borrowed from another

lender does not satisfy this requirement.

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.

The Instructions for Form 1099-B discuss when you should receive a Form 1099-B for short sales. For more information, see the Instructions for Form 1099-B.

Reporting a short sale. Report any short sale on Form 8949 in the year it closes. If a short sale closed in 2022 but you did not get a Form 1099-B for it because you entered into it before 2011, report it on a Form 8949 in Part I or Part II (whichever applies). In column (a), enter (for example) “100 sh. XYZ Co. — 2010 short sale closed.” Fill in the other columns according to their instructions. Report the short sale the same way if you received a 2022 Form 1099-B that does not show proceeds (sales price).

Exception if property becomes worthless.

A different rule applies if the property sold short becomes substantially worthless. In that case, you must recognize gain as if the short sale were closed when the property became substantially worthless.

Exception for constructive sales. Entering into a short sale may cause you to be treated as having made a constructive sale of property. In that case, you will have to recognize gain on the date of the constructive sale. For details, see *Constructive Sales of Appreciated Financial Positions*, earlier.

Example. On May 6, 2022, you bought 100 shares of Baker Corporation stock for $1,000. On September 9, 2022, you sold short 100 shares of similar Baker stock for $1,600. You made no other transactions involving Baker stock for the rest of 2022 and the first 30 days of 2023. Your short sale is treated as a constructive sale of an appreciated financial position because a sale of your Baker stock on the date of the short sale would have resulted in a gain. You recognize a $600 short-term capital gain from the constructive sale and your new holding period in the Baker stock begins on September 9.

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 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 1 day.

Special rules. Special rules may apply to gains and losses from short sales of stocks, securities, and commodity and securities futures (other than certain straddles) if you held or acquired property substantially identical to property that sold short. But if the amount of property you sold short is more than the amount of that substantially identical property, the special rules do not apply to the gain or loss on the excess.

Gains and holding period. If you held the substantially identical property for 1 year or less on the date of the short sale, or if you acquired the substantially identical property after the short sale and by the date of closing the short sale, then:

> ***Rule 1.*** Your gain, if any, when you close the short sale is a short-term capital gain; and

Rule 2. The holding period of the substantially identical property begins on the date of the closing of the short sale or on the date of the sale of this property, whichever comes first.

Losses. If, on the date of the short sale, you held substantially identical property for more than 1 year, any loss you realize on the short sale is a long-term capital loss, even if you held the property used to close the sale for 1 year or less. Certain losses on short sales of stock or securities are also subject to wash sale treatment. For information, see *Wash Sales*, later.

Mixed straddles. Under certain elections, you can avoid the treatment of loss from a short sale as long term under the special rule. These elections are for positions that are part of a mixed straddle. See *Other elections*, 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 Schedule 1 (Form 1040), line 8z.

Substitute payment. A substitute payment means a payment in lieu of:

- Tax-exempt interest (including OID) accrued while the short sale was open; and
- 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.

Payments in lieu of dividends. 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 later) and you itemize your deductions.

You deduct these payments 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 you make to the lender. Instead, you must increase the basis of the stock used to close the short sale by that amount.

To determine how long a short sale is kept open, do not include any period during which you hold, have an option to buy, or are under a contractual obligation to buy substantially identical stock or securities.

If your payment is made for a liquidating distribution or nontaxable stock distribution, or if you buy more shares equal to a stock distribution issued on the borrowed stock during your short position, you have a capital expense. You must add the payment to the cost of the stock sold short.

Exception. If you close the short sale within 45 days, the deduction for amounts you pay in lieu of dividends will be disallowed only to the extent the payments are more than the amount 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 unless the loss was incurred in the ordinary course of your business as a dealer in stock or securities.

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,
3. Acquire a contract or option to buy substantially identical stock or securities, or
4. Acquire substantially identical stock for your individual retirement arrangement (IRA) or Roth IRA.

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 (except in (4) above). The result is your basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities. Your holding period for the new stock or securities includes the holding period of the stock or securities sold.

Example 1. You buy 100 shares of X stock for $1,000. You sell these shares for $750 and within 30 days from the sale you buy 100 shares of the same stock for $800. Because you bought substantially identical stock, you cannot deduct your loss of $250 on the sale.

However, you add the disallowed loss of $250 to the cost of the new stock, $800, to obtain your basis in the new stock, which is $1,050.

Example 2. You are an employee of a corporation with an incentive pay plan. Under this plan, you are given 10 shares of the corporation's stock as a bonus award. You include the fair market value of the stock in your gross income as additional pay. You later sell these shares at a loss. If you receive another bonus award of substantially identical stock within 30 days of the sale, you cannot deduct your loss on the sale.

Options and futures contracts. The wash sale rules apply to losses from sales or trades of contracts and options to acquire or sell stock or securities. They do not apply to losses from sales or trades of commodity futures contracts and foreign currencies. See *Coordination of Loss Deferral Rules and Wash Sale Rules*, later, for information about the tax treatment of losses on the disposition of positions in a straddle.

Securities futures contract to sell. Losses from the sale, exchange, or termination of a securities futures contract to sell are generally treated in the same manner as losses from the closing of a short sale, discussed later in this section under *Short sales*.

Warrants. The wash sale rules apply if you sell common stock at a loss and, at the same time, buy warrants for common stock of the same corporation. But if you sell warrants at a loss and, at the same time, buy common stock in the same corporation, the wash sale rules apply only if the warrants and stock are considered substantially identical, as discussed next.

Substantially identical. In determining whether stock or securities are substantially identical, you must consider all the facts and circumstances in your particular case. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. However, they may be substantially identical in some cases. For example, in a reorganization, the stocks and securities of the predecessor and successor corporations may be substantially identical.

Similarly, bonds or preferred stock of a corporation are not ordinarily considered substantially identical to the common stock of the same corporation. However, where the bonds or preferred stock are convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may make these bonds or preferred stock and the common stock substantially identical. For example, preferred stock is substantially identical to the common stock if the preferred stock: • Is convertible into common stock,

- Has the same voting rights as the common stock,
- Is subject to the same dividend restrictions,
- Trades at prices that do not vary significantly from the conversion ratio, and
- 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 20, 2021, for $5,000. On December 13, 2021, you bought 50 shares of substantially identical stock for $2,750. On December 20, 2021, you bought 25 shares of substantially identical stock for $1,125. On January 3, 2022, 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 before 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 13, 2021, is increased by two-thirds (50 ÷ 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 20, 2021, 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 16, 2021. On January 28, 2022, you sold those shares at a $1,000 loss. On each of the 4 days from February 1, 2022, to February 4, 2022, 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 1. Add the other half ($500) to the basis of the shares bought on February 2.

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 2016, you bought 100 shares of X stock on each of three occasions. You paid $158 per share for the first block of 100 shares, $100 per share for the second block, and $95 per share for the third block. On December 27, 2021, you sold 300 shares of X stock for $125 per share. On January 10, 2022, you bought 250 shares of identical X stock. You cannot deduct the loss of $33 per share on the first block because within 30 days after the date of sale you bought 250 identical shares of X stock. In addition, you cannot reduce the gain realized on the sale of the second and third blocks of stock by this loss.

Dealers. The wash sale rules do not apply to a dealer in stock or securities if the loss is from a transaction made in the ordinary course of business.

Short sales. The wash sale rules apply to a loss realized on a short sale if you sell, or enter into another short sale of, substantially identical stock or securities within a period beginning 30 days before the date the short sale is complete and ending 30 days after that date.

For purposes of the wash sale rules, a short sale is considered complete on the date the short sale is entered into if:

- 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
- 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.

This treatment also applies to losses from the sale, exchange, or termination of a securities futures contract to sell.

Example. On June 4, you buy 100 shares of stock for $1,000. You sell short 100 shares of the stock for $750 on October 15. On October 16, you buy 100 shares of the same stock for $750. You close the short sale on November 19 by delivering the shares bought on June 4. You cannot deduct the $250 loss ($1,000 − $750) because the date of entering into the short sale (October 15) 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 real estate mortgage investment conduit (REMIC). The wash sale rules will generally apply to the sale of your residual interest in a 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.

Nondeductible wash sale loss. If you received a Form 1099-B, box 1g will show the amount of wash sale loss disallowed if:

- The stock or securities sold were covered securities, and
- The substantially identical stock or securities you bought had the same CUSIP numbers as the stock or securities you sold and were bought in the same account as the stock or securities you sold.

However, you cannot deduct a loss from a wash sale even if it is not reported on Form 1099-B.

How to report. Report a wash sale transaction in Part I or Part II of Form 8949 with the appropriate box checked. Complete all columns. Enter “W” in column (f). Enter as a positive number in column (g) the amount of the loss not allowed. See the Instructions for Form 8949.

Securities Futures Contracts

A securities futures contract is a contract of sale for future delivery of a single security or of a narrow-based security index.

Gain or loss from the contract will generally be treated in a manner similar to gain or loss from transactions in the underlying security. This means gain or loss from the sale, exchange, or termination of the contract will generally have the same character as gain or loss from transactions in the property to which the contract relates. Any capital gain or loss on a sale, exchange, or termination of a contract to sell property will be considered short term, regardless of how long you hold the contract. These contracts are not section

1256 contracts (unless they are dealer securities futures contracts).

Options

Options are generally subject to the rules described in this section. If the option is part of a straddle, the *Loss Deferral Rules* covered later under *Straddles* may also apply. For special rules that apply to nonequity options and dealer equity options, see *Section 1256 Contracts* *Marked to Market*, earlier.

Gain or loss from the sale or trade of an option to buy or sell property that is a capital asset in your hands, or would be if you acquired it, is capital gain or loss. If the property is not or would not be a capital asset, the gain or loss is ordinary gain or loss.

Example 1. You purchased an option to buy 100 shares of XYZ Company stock. The stock increases in value, and you sell the option for more than you paid for it. Your gain is capital gain because the stock underlying the option would have been a capital asset in your hands.

Example 2. The facts are the same as in *Example 1*, except the stock decreases in value and you sell the option for less than you paid for it. Your loss is a capital loss.

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

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

If you are not in the business of writing options and an option you write on stocks, securities, commodities, or commodity futures is not exercised (or repurchased), the amount you receive is a short-term capital gain.

If an option requiring you to buy or sell property is exercised, see *Writers of puts and calls*, later.

Section 1256 contract options. Gain or loss is recognized on the exercise of an option on a section 1256 contract. Section 1256 contracts are defined under *Section 1256 Contracts Marked to Market*, earlier.

Cash settlement option. A cash settlement option is treated as an option to buy or sell property. A cash settlement option is any option that on exercise is settled in, or could be settled in, cash or property other than the underlying property.

How to report. Report on Form 8949 gain or loss from the closing or expiration of an option that is not a section 1256 contract but is a capital asset in your hands. If an option you purchased expired, enter the expiration date in column (c) and enter “Expired” in column (d). If an option that was granted (written) expired, enter the expiration date in column (b) and enter “Expired” in column (e). Fill in the other columns as appropriate.

If a call option you sold was exercised and the option premium you received was not reflected in the sales price shown on the Form 1099-B you received, enter the premium as a positive number in column (g) of Form 8949 and enter “E” in column (f).

Puts and Calls

Puts and calls are options on securities and are covered by the rules just discussed for options. The following are specific applications of these rules to holders and writers of options that are bought, sold, or “closed out” in transactions on a national securities exchange, such as the Chicago Board Options Exchange. (But see *Section 1256 Contracts Marked to Market*, earlier, for special rules that may apply to nonequity options and dealer equity options.) These rules are also presented in Table 4-3.

Puts and calls are issued by writers (grantors) to holders for cash premiums. They are ended by exercise, closing transaction, or lapse.

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. Conversely, 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.

Holders of puts and calls. If you buy a put or a call, you may not deduct its cost. It is a capital expenditure.

If you sell the put or the call before you exercise it, the difference between its cost and the amount you receive for it is either a long-term or short-term capital gain or loss, depending on how long you held it.

If the option expires, its cost is either a long-term or short-term capital loss, depending on your holding period, which ends on the expiration date.

If you exercise a call, add its cost to the basis of the stock you bought. If you exercise a put, reduce your amount realized on the sale of the underlying stock by the cost of the put when figuring your gain or loss. Any gain or loss on the sale of the underlying stock is long term or short term depending on your holding period for the underlying stock.

Put option as short sale. Buying a put option is generally treated as a short sale, and the exercise, sale, or expiration of the put is a 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.

Table 4-3. **Puts and Calls**

Puts		
When a put:	**If you are the holder:**	**If you are the writer:**
Is exercised	Reduce your amount realized from the sale of the underlying stock by the cost of the put.	Reduce your basis in the stock you buy by the amount you received for the put.
Expires	Report the cost of the put as a capital loss on the date it expires.*	Report the amount you received for the put as a short-term capital gain.
Is sold by the holder	Report the difference between the cost of the put and the amount you receive for it as a capital gain or loss.*	This does not affect you. (But if you buy back the put, report the difference between the amount you pay and the amount you received for the put as a short-term capital gain or loss.)

Calls		
When a call:	**If you are the holder:**	**If you are the writer:**
Is exercised	Add the cost of the call to your basis in the stock purchased.	Increase your amount realized on sale of the stock by the amount you received for the call.
Expires	Report the cost of the call as a capital loss on the date it expires.*	Report the amount you received for the call as a short-term capital gain.
Is sold by the holder	Report the difference between the cost of the call and the amount you receive for it as a capital gain or loss.*	This does not affect you. (But if you buy back the call, report the difference between the amount you pay and the amount you received for the call as a short-term capital gain or loss.)

* See *Holders of puts and calls* and *Writers of puts and calls* in the accompanying text to find whether your gain or loss is short term or long term.

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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:

- The date you dispose of the stock,
- The date you exercise the put,
- The date you sell the put, or
- The date the put expires.

Writers of puts and calls. If you write (grant) a put or a call, 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:

- Your obligation expires;
- You buy, in the case of a put, or sell, in the case of a call, the underlying stock when the option is exercised; or
- 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 put you write is exercised and you buy the underlying stock, decrease your basis in the stock by the amount you received for the put. Your holding period for the stock begins on the date you buy it, not on the date you wrote the put.

If 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 you enter into a closing transaction by paying an amount equal to the value of the put or call at the time of the payment, the difference between the amount you pay and the amount you receive for the put or call is a short-term capital gain or loss.

Examples of nondealer transactions.

1. ***Expiration.*** Ten JJJ call options were is-sued on April 8, 2022, for $4,000. These equity options expired in December 2022 without being exercised. If you were a holder (buyer) of the options, you would recognize a short-term capital loss of $4,000. If you were a writer of the options, you would recognize a short-term capital gain of $4,000.
2. ***Closing transaction.*** The facts are the same as in (1), except that on May 6, 2022, the options were sold for $6,000. If you were the holder of the options who sold them, you would recognize a short-term capital gain of $2,000. If you were the writer of the options and you bought them back, you would recognize a short-term capital loss of $2,000.

3. ***Exercise.*** The facts are the same as in (1), except that the options were exercised on May 20, 2022. The buyer adds the cost of the options to the basis of the stock bought through the exercise of the op-tions. The writer adds the amount received from writing the options to the amount re-alized from selling the stock to figure gain or loss. The gain or loss is short term or long term depending upon the holding period of the stock.
4. ***Section 1256 contracts.*** The facts are the same as in (1), except the options were nonequity options, subject to the rules for section 1256 contracts. If you were a buyer of the options, you would recognize a short-term capital loss of $1,600, and a long-term capital loss of $2,400. If you were a writer of the options, you would recognize a short-term capital gain of $1,600, and a long-term

capital gain of $2,400. See *Section 1256 Contracts Marked to Market*, earlier, for more information.

Straddles

This section discusses the loss deferral rules that apply to the sale or other disposition of positions in a straddle. These rules do not apply to the straddles described under *Exceptions*, later.

A straddle is any set of offsetting positions on personal property. For example, a straddle may consist of a purchased option to buy and a purchased option to sell on the same number of shares of the security, with the same exercise price and period.

Personal property. This is any actively traded property. 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 of a type that is actively traded, and at least one of the offsetting positions is a position on that stock or substantially similar or related property.
2. The stock is in a corporation formed or availed of to take positions in personal property that offset positions taken by any shareholder.

Note. For positions established before October 22, 2004, condition 1 above does not apply. Instead, personal property includes stock if condition 2 above applies or the stock was part of a straddle in which at least one of the offsetting positions was:

- An option to buy or sell the stock or substantially identical stock or securities,
- A securities futures contract on the stock or substantially identical stock or securities, or
- A position on substantially similar or related property (other than stock).

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 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.

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 later), do not treat it as offsetting to a position that is part of an identified straddle.

Presumed offsetting positions. Two or more positions will be presumed to be offsetting if:

- 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;
- 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;

- The positions are in debt instruments with a similar maturity, and the positions' values vary inversely as described in the first condition;
- The positions are sold or marketed as offsetting positions, whether or not the positions are called a straddle, spread, butterfly, or any similar name; or
- 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 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 flow-through entity, such as a partnership or trust, you are also considered to hold that position.

Loss Deferral Rules

Generally, you can deduct a loss on the disposition of one or more positions only to the extent the loss is more than any unrecognized gain you have on offsetting positions. Unused losses are treated as sustained in the next tax year.

Unrecognized gain. This is:

- 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
- 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 8, 2022, you entered into a straddle. On December 11, 2022, you closed one position of the straddle at a loss of $15,000. On December 30, 2022, the end of your tax year, you have an unrecognized gain of $12,750 in the offsetting open position. On your 2022 return, your deductible loss on the position you closed is limited to $2,250 ($15,000 − $12,750). You must carry forward the unused loss of $12,750.

Note. If you physically settle a position established after October 21, 2004, that is part of a straddle by delivering property to which the position relates (and you would realize a loss on that position if you terminated it), you are treated as having terminated the position for its fair market value immediately before the settlement and as having sold the property used to physically settle the position at its fair market value.

Exceptions. The loss deferral rules do not apply to:

1. Positions established after October 21, 2004, comprising an identified straddle;
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*, later).

Note. For positions established before October 22, 2004, the loss deferral rules also do not apply to a straddle that is an identified straddle at the end of the tax year.

Identified straddle. Any straddle (other than a straddle described in (2) or (3) above) is an identified straddle if all the following conditions exist.

- You clearly identified the straddle on your records before the close of the day on which you acquired it.

- For straddles acquired after December 29, 2007, you identified the positions in the straddle that are offsetting with respect to one another (for example, position A offsets position D, and position B offsets position C).
- The straddle is not part of a larger straddle.

If there is a loss from any position in an identified straddle, you must increase the basis of each of the positions that offset the loss position in the identified straddle. The increase is the loss multiplied by the following fraction:

$$\frac{\text{Unrecognized gain (if any) on the offsetting position}}{\text{The total unrecognized gain on all positions that offset the loss position in the identified straddle}}$$

For this purpose, your unrecognized gain is the excess of the fair market value of the position that is part of an identified straddle at the time you incur a loss on another position in the identified straddle, over the fair market value of that position when you identified it as a position in the straddle.

If the application of the above rule does not result in the increase in basis of any offsetting position in the identified straddle, you must increase the basis of each of the offsetting positions in the straddle in a manner that:

- Is reasonable,
- Is consistently applied by you,
- Is consistent with the purposes of the identified straddle rules, and
- Results in a total increase in the basis of those offsetting positions equal to the loss.

If you adopt an allocation method under this rule, you must describe that method in your books and records.

The identified straddle rules also apply to positions that are or have been a liability or obligation to you (for example, a debt obligation you issued, a written option, or a notional principal contract you entered into).

Neither you nor anyone else can take into account any loss on a position that is part of an identified straddle to the extent the loss increases the basis of any positions that offset the loss position in the identified straddle.

Note. For positions established before October 22, 2004, identified straddles have to meet two additional conditions.

1. All the original positions that you identify were acquired on the same day.
2. All the positions included in condition 1 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.

Also, the losses from positions are deferred until you dispose of all the positions in the straddle. The rule discussed above for increasing the basis of each of the positions does not apply.

Qualified covered call options and optioned stock. A straddle is not subject to the loss deferral rules for straddles if both of the following are true.

- All the offsetting positions consist of one or more qualified covered call options and the stock to be purchased from you under the options.
- The straddle is not part of a larger straddle.

But see *Special year-end rule*, later, for an exception.

A qualified covered call option is any option you grant to purchase stock you hold (or stock you acquire in connection with granting the option), but only if all the following are true.

- The option is traded on a national securities exchange or other market approved by the Secretary of the Treasury.
- The option is granted more than 30 days before its expiration date.

For covered call options entered into after July 28, 2002, the option is granted not more than 12 months before its expiration date or satisfies term limitation and qualified benchmark requirements published in the Internal Revenue Bulletin.

- The option is not a deep-in-the-money option.

- You are not an options dealer who granted the option in connection with your activity of dealing in options.
- 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. Strike prices are listed in the financial sections of many newspapers. The LQB is the highest available strike price that is less than the applicable stock price. However, the LQB for an option with a term of more than 90 days and a strike price of more than $50 is the second-highest available strike price that is less than the applicable stock price.

The availability of strike prices for equity options with flexible terms does not affect the determination of the LQB for an option that is not an equity option with flexible terms.

The applicable stock price for any stock for which an option has been granted is:

1. The closing price of the stock on the most recent day on which that stock was traded before the date on which the option was granted; or
2. The opening price of the stock on the day on which the option was granted, but only if that price is greater than 110% of the price determined in (1).

If the applicable stock price is $25 or less, the LQB will be treated as not less than 85% of the applicable stock price. If the applicable stock price is $150 or less, the LQB will be treated as not less than an amount that is $10 below the applicable stock price.

Example. On May 13, 2022, you held XYZ stock and you wrote an XYZ/September call option with a strike price of $120. The closing price of one share of XYZ stock on May 12, 2022, was $130.25. The strike prices of all XYZ/

September call options offered on May 13, 2022, were as follows: $110, $115, $120, $125, $130, and $135. Because the option has a term of more than 90 days, the LQB is $125, the second-highest strike price that is less than $130.25, the applicable stock price. The call option is a deep-in-the-money option because its strike price is lower than the LQB. As a result, the option is not a qualified covered call option, and the loss deferral rules apply if you closed out the option or the stock at a loss during the year.

Capital loss on qualified covered call options. If you hold stock and you write a qualified covered call option on that stock with a strike price less than the applicable stock price, treat any loss from the option as long-term capital loss if, at the time the loss was realized, gain on the sale or exchange of the stock would be treated as long-term capital gain. The holding period of the stock does not include any period during which you are the writer of the option.

Special year-end rule. The loss deferral rules for straddles apply if all the following are true.

- The qualified covered call options are closed, or the stock is disposed of at a loss during any tax year.
- Gain on disposition of the stock or gain on the options is includible in gross income in a later tax year.
- The stock or options were held less than 30 days after the closing of the options or the disposition of the stock.

How To Report Gains and Losses (Form 6781)

As a general rule, 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.

See the Form 6781 instructions for how to report these gains and losses.

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, 2022, you bought stock in XX Corporation (XX stock) and an offsetting put option. On December 9, 2022, there was $20 of unrealized gain in the put option and you sold the XX stock at a $20 loss. By December 16, 2022, the value of the put option had declined, eliminating all unrealized gain in the position. On December

16, you bought a second XX stock position that is substantially identical to the XX stock you sold on December 9. 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 2022 under Rule 1 because, within a period beginning 30 days before December 9 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 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 any loss disallowed under Rule 1.

- Successor positions.
- Offsetting positions to the loss position.

- 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 the following conditions are met.

- The second position was offsetting to the loss position that was sold.
- The successor position is entered into during a period beginning 30 days before and ending 30 days after the sale of the loss position.

Example 1. On November 4, 2022, you entered into offsetting long and short positions in non-section 1256 contracts. On November 11, 2022, you disposed of the long position at a $10 loss. On November 18, 2022, you entered into a new long position (successor position) that is offsetting to the retained short position, but not substantially identical to the long position disposed of on

November 11. 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 2022 because there is $10 of unrecognized gain in the successor long position.

Example 2. The facts are the same as in *Example 1*, except that at year end you have $4 of unrecognized gain in the successor long position and $6 of unrecognized gain in the offsetting short position. Under these circumstances, the entire $10 loss will be disallowed for 2022 because there is a total of $10 of unrecognized gain in the successor long position and offsetting short position.

Example 3. The facts are the same as in *Example 1*, except that at year end you have $8 of unrecognized gain in the successor long position and $8 of unrecognized loss in the offsetting short position. Under these circumstances, $8 of the total $10 realized loss will be disallowed for 2022 because there is $8 of unrecognized gain in the successor long position.

Loss carryover. If you have a disallowed loss that resulted from applying Rule 1 and Rule 2, you must carry it over to the next tax year and apply Rule 1 and Rule 2 to that carryover loss. For example, a loss disallowed in 2021 under Rule 1 will not be allowed in 2022, unless the substantially identical stock or securities (which caused the loss to be disallowed in 2021) were disposed of during 2022. In addition, the carryover loss will not be allowed in 2022 if Rule 1 or Rule 2 disallows it.

Example. The facts are the same as in the example under *Rule 1*. On December 23, 2023, you sell the second XX stock at a $20 loss and there is $40 of unrecognized gain in the put option. Under these circumstances, you cannot deduct in 2023 either the $20 loss disallowed in 2022 or the $20 loss you incurred for the December 23, 2023, sale of XX stock. Rule 1 does not apply because the substantially identical XX stock was sold during the year and no substantially identical stock or securities were bought within the 61-day period. However, Rule 2 does apply because there is $40 of unrecognized gain in the put option, an offsetting position to the loss positions.

Capital loss carryover. If the sale of a loss position would have resulted in a capital loss, you treat the carryover loss as a capital loss on the date it is allowed, even if you would treat the gain or loss on any successor positions as ordinary income or loss. Likewise, if the sale of a loss position (in the case of section 1256 contracts) would have resulted in a 60% long-term capital loss and a 40% short-term capital loss, you treat the carryover loss under the 60/40 rule, even if you would treat any gain or loss on any successor positions as 100% long-term or short-term capital gain or loss.

Exceptions. The rules for coordinating straddle losses and wash sales do not apply to the following loss situations.

- Loss on the sale of one or more positions in a hedging transaction. (*Hedging transactions* are described under *Section 1256 Contracts Marked to Market*, earlier.)
- Loss on the sale of a loss position in a mixed straddle account. (See *Mixed straddle account (Election C)*, later.)
- Loss on the sale of a position that is part of a straddle consisting only of section 1256 contracts.

Holding Period and Loss Treatment Rules

The holding period of a position in a straddle generally begins no earlier than the date on which the straddle ends (the date you no longer hold an offsetting position). This rule does not apply to any position you held more than 1 year before you established the straddle. But see *Exceptions*, later.

Example. On March 8, 2021, you acquired gold. On January 10, 2022, you entered into an offsetting short gold forward contract (nonregulated futures contract). On April 1, 2022, you disposed of the short gold forward contract at no gain or loss. On April 8, 2022, 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, 2022, the date the straddle ended. Gain recognized on the sale of the gold will be treated as short-term capital gain.

Loss treatment. Treat the loss on the sale of one or more positions (the loss position) of a straddle as a long-term capital loss if both the following are true.

- You held (directly or indirectly) one or more offsetting positions to the loss position on the date you entered into the loss position.
- You would have treated all gain or loss on one or more of the straddle positions as long-term capital gain or loss if you had sold these positions on the day you entered into the loss position.

Mixed straddles. Special rules apply to a loss position that is part of a mixed straddle and that is a non-section 1256 position. A mixed straddle is a straddle:

- That is not part of a larger straddle,
- In which all positions are held as capital assets,

- In which at least one (but not all) of the positions is a section 1256 contract, and
- For which the mixed straddle election (Election A, discussed later) has not been made.

Treat the loss as 60% long-term capital loss and 40% short-term capital loss if all the following conditions apply.

- 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.
- The sale of no position in the straddle, other than a section 1256 contract, would result in a long-term capital gain or loss.
- You have not made a straddle-by-straddle identification election (Election B) or mixed straddle account

election (Election C), both discussed later.

Example. On March 4, 2022, you entered into a long gold forward contract. On July 15, 2022, 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 5, 2022, 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:

- Constitute part of a hedging transaction;

- Are included in a straddle consisting only of section 1256 contracts; or
- Are included in a mixed straddle account (Election C), discussed later.

Mixed Straddle Elections

If you disposed of a position in a mixed straddle and make one of the elections described in the following discussions, report your gain or loss as indicated in those discussions. If you do not make any of the elections, report your gain or loss in Part II of Form 6781. If you disposed of the section 1256 component of the straddle, enter the recognized loss (line 10, column (h)) or your gain (line 12, column (f)) in Part I of Form 6781, on line 1. Do not include it on line 11 or 13 (Part II).

Mixed straddle election (Election A). You can elect out of the marked-to-market rules, discussed under *Section 1256 Contracts Marked to Market*, earlier, for all section 1256 contracts that are part of a mixed straddle. Instead, the gain and loss rules for straddles will apply to these contracts. However, if you make this election for an option on a section 1256 contract, the gain or loss treatment discussed earlier under *Options* will apply, subject to the gain and loss rules for straddles. You can make this election if:

- At least one (but not all) of the positions is a section 1256 contract, and
- Each position forming part of the straddle is clearly identified as being part of that straddle on the day the first section 1256 contract forming part of the straddle is acquired.

If you make this election, it will apply for all later years as well. It cannot be revoked without the consent of the IRS. If you made this election, check box A of Form 6781. Do not report the section 1256 component in Part I.

Other elections. You can avoid the 60% long-term capital loss treatment required for a non-section 1256 loss position that is part of a mixed straddle, described earlier, if you choose either of the two following elections to offset gains and losses for these positions.

- ***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).
- ***Election C.*** Establish a mixed straddle account for a class of activities for which gains and losses will be recognized and offset on a periodic basis.

These two elections are alternatives to the mixed straddle election. You can choose only one of the three elections. Use Form 6781 to indicate your election choice by checking box A, B, or C, whichever applies.

Straddle-by-straddle identification election (Election B). Under this election, you must clearly identify each position that is part of the identified mixed straddle by the earlier of:

- The close of the day the identified mixed straddle is established, or
- 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.

If you make this election, any positions you held on the day before the election are deemed sold for their fair market value at the close of the last business day before the day of the election. For elections made on or before August 18, 2014, take this gain or loss into account when figuring taxable income for the year in which the election was made. For elections made after August 18, 2014, take this gain or loss into account in the year you would have reported the gain or loss if the identified mixed straddle had not been established. In addition, when the gain or loss that accrued prior to the time the identified mixed straddle was established is taken into account, it will have the same character it would have had if the identified mixed straddle had not been established. See Regulations section 1.1092(b)-6 for details.

The basic tax treatment of gain or loss under this election depends on which side of the straddle produced the total net gain or loss. If the net gain or loss from the straddle is due to the section 1256 contracts, gain or loss is treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss. Enter the net gain or loss in Part I of Form

6781 and identify the election by checking box B.

If the net gain or loss is due to the non-section 1256 positions, gain or loss is short-term capital gain or loss. See the Form 6781 instructions for how to report the net gain or loss.

For the specific application of the rules of this election, see Regulations sections 1.1092(b)-3T and 1.1092(b)-6.

Example 1. Straddle established on or before August 18, 2014. On April 2, 2014, 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 9, 2014, 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 was offset against the $800 gain on the section 1256 contract. The net gain of $200 from the straddle was treated as 60% long-term capital gain and 40% short-term capital gain because it was due to the section 1256 contract.

Example 2. Straddle established after August 18, 2014. On December 2, 2021, you entered into a non-section 1256 position for $100. At the end of the day on January 24, 2022, the position had a value of $500. On January 25, 2022, you entered into an offsetting section 1256 position. You elected to treat the straddle as an identified mixed straddle.

On February 10, 2022, you closed out the section 1256 contract at a $500 loss and disposed of the non-section 1256 position for $975. Prior to entering into the identified mixed straddle, you had a $400 unrealized short-term capital gain on the non-section 1256 position. When you disposed of the non-section 1256 position on February 10, 2022, you recognized the $400 gain. This gain is figured as though you had disposed of the position on the day prior to establishing the identified mixed straddle.

You also realized a gain of $475 ($975 proceeds – $500 value before entering into the identified mixed straddle). This gain is offset by the $500 loss on the section 1256 contract for a net loss of $25. This net loss is recognized and treated as 60% long-term capital loss and 40% short-term capital loss attributable to the section 1256 contract.

Mixed straddle account (Election C). You may elect to establish one or more accounts for determining gains and losses from all positions in a mixed straddle. You must establish a separate mixed straddle account for each separate designated class of activities.

Generally, you must determine gain or loss for each position in a mixed straddle account as of the close of each business day of the tax year. You offset the net section 1256 contracts against the net non-section 1256 positions to determine the “daily account net gain or loss.”

If the daily account amount is due to non-section 1256 positions, the amount is treated as short-term capital gain or loss. If the daily account amount is due to section 1256 contracts, the amount is treated as 60% long-term and 40% short-term capital gain or loss.

On the last business day of the tax year, you determine the “annual account net gain or loss” for each account by netting the daily account amounts for that account for the tax year. The “total annual account net gain or loss” is determined by netting the annual account amounts for all mixed straddle accounts that you had established.

The net amounts keep their long-term or short-term classification. However, no more than 50% of the total annual account net gain for the tax year can be treated as long-term capital gain. Any remaining gain is treated as short-term capital gain. Also, no more than 40% of the total annual account net loss can be treated as short-term capital loss. Any remaining loss is treated as long-term capital loss.

The election to establish one or more mixed straddle accounts for each tax year must be made by the due date (without extensions) of your income tax return for the immediately preceding tax year. If you begin trading in a new class of activities during a tax year, you must make the election for the new class of activities by the later of either:

- The due date of your return for the immediately preceding tax year (without extensions), or
- 60 days after you entered into the first mixed straddle in the new class of activities.

You make the election on Form 6781 by checking box C. Attach Form 6781 to your income tax return for the immediately preceding tax year, or file it within 60 days, if that applies. Report the annual account net gain or loss from a mixed straddle account in Part II of Form 6781. In addition, you must attach a statement to Form 6781 specifically designating the class of activities for which a mixed straddle account is established.

For the specific application of the rules of this election, see Regulations section 1.1092(b)-4T.

Interest expense and carrying charges relating to mixed straddle account positions. You cannot deduct interest and carrying charges that are allocable to any positions held in a mixed straddle account. Treat these charges as an adjustment to the annual account net gain or loss and allocate them proportionately between the net short-term and the net long-term capital gains or losses.

To find the amount of interest and carrying charges that is not deductible and that must be added to the annual account net gain or loss, apply the rules described earlier to the positions held in the mixed straddle account. See *Interest expense and carrying charges on straddles* in chapter 3.

For special rules on the deferral of gain related to a straddle where the gain is invested in a Qualified Opportunity Fund, see section 1400Z-2 for more details.

Sales of Stock to Employee Stock Ownership Plans (ESOPs) or Certain Cooperatives

If you sold qualified securities held for at least 3 years to an ESOP or eligible worker-owned cooperative, you may be able to elect to postpone all or part of the gain on the sale if you bought qualified replacement property (certain securities) within the period that began 3 months before the sale and ended 12 months after the sale. If you make the election, you must recognize gain on the sale only to the extent the proceeds from the sale exceed the cost of the qualified replacement property.

You must reduce the basis of the replacement property by any postponed gain. If you dispose of any replacement property, you may have to recognize all of the postponed gain.

Generally, to qualify for the election, the ESOP or cooperative must own at least 30% of the outstanding stock of the corporation that issued the qualified securities. Also, the qualified replacement property must have been issued by a domestic operating corporation.