

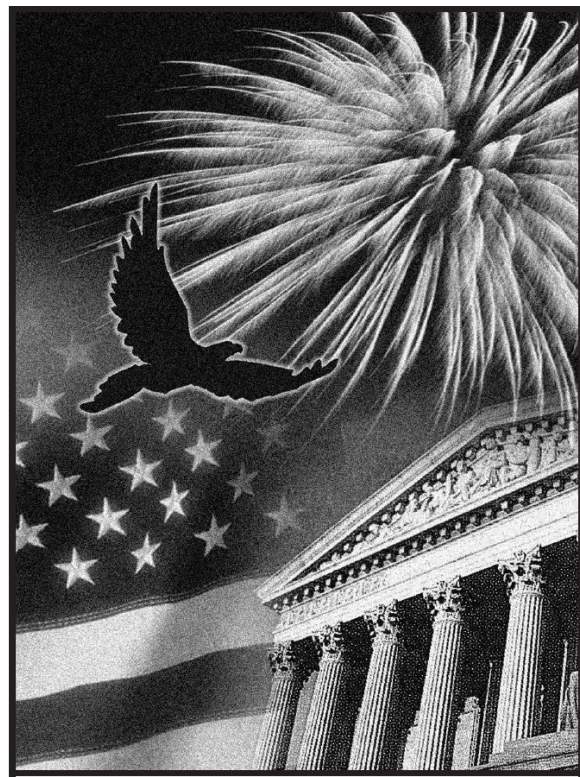
Publication 550

Investment Income and Expenses

(Including Capital Gains and Losses)

For use in preparing **2023** Returns

Volume 4 of 8



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Confidential transaction. A confidential transaction is offered to you under conditions of confidentiality and for which you have paid an advisor a minimum fee. A transaction is offered under conditions of confidentiality if the advisor who is paid the fee places a limit on your disclosure of the tax treatment or tax structure of the transaction and the limit protects the confidentiality of the advisor's tax strategies. The transaction is treated as confidential even if the conditions of confidentiality are not legally binding on you.

Transaction with contractual protection.

Generally, a transaction with contractual protection is one in which you or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences of the transaction are not sustained, or a transaction for which the fees are contingent on realizing the tax benefits from the transaction. For information on exceptions, see Revenue Procedure 2007-20,

2007-7 I.R.B. 517, available at IRS.gov/irb/2007-07_IRB#RP-2007-20.

Loss transaction. For individuals, a loss transaction is one that results in a deductible loss if the gross amount of the loss is at least \$2 million in a single tax year or \$4 million in any combination of tax years. A loss from a foreign currency transaction under section 988 is a loss transaction if the gross amount of the loss is at least \$50,000 in a single tax year, whether or not the loss flows through from an S corporation or partnership.

Certain losses (such as losses from casualties, thefts, and condemnations) are excepted from this category and do not have to be reported on Form 8886. For information on other exceptions, see Revenue Procedure 2013-11, 2013-2 I.R.B. 269, available at IRS.gov/irb/2013-02_IRB#RP-2013-11. See *Updates on reportable transactions*, later, for updates on loss transactions.

Transaction of interest. A transaction of interest is a transaction entered into after November 1, 2006, that is the same as, or substantially similar to, one of the types of transactions that the IRS has identified by notice, regulation, or other published guidance as a transaction of interest. For more information, go to [Abusive Tax Shelters and Transactions](#), where you will find a link to a list of transactions of interest.

Updates on reportable transactions. For updates on all reportable transactions, go to [Abusive Tax Shelters and Transactions](#).

Penalties

Investing in an abusive tax shelter may lead to substantial expenses. First, the promoter generally charges a substantial fee. If your return is examined by the IRS and a tax deficiency is determined, you will have to pay more taxes and interest on the underpayment, possibly a 20%, 30%, or even

40% accuracy-related penalty, or a 75% civil fraud penalty. You may also be subject to the penalty for failure to pay tax. These penalties are explained in the following paragraphs.

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

- Negligence or disregard of rules or regulations,
- Substantial understatement of tax,
- Substantial valuation misstatements (increased to 40% for gross valuation misstatements),
- Transactions lacking economic substance (increased to 40% for nondisclosed noneconomic substance transactions),
- Undisclosed foreign financial asset understatements (40% for tax years beginning after March 18, 2010), or

- Disallowance of a deduction for a qualified conservation contribution by a pass-through entity under section 170(h)(7).

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.

The 20% penalties do not apply to any underpayment attributable to a reportable transaction understatement subject to an accuracy-related penalty (discussed later).

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 due to negligence or disregard of rules or regulations. Generally, the penalty will not be charged if you can show 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. It also includes any failure to keep adequate books and records. A return position that has a reasonable basis is not negligence. See Regulations section 1.6662-3(b)(1).

Disregard includes any careless, reckless, or intentional disregard of rules or regulations.

The penalty for disregard of rules and regulations can be avoided if all the following are true.

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

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

Use Form 8886 to disclose a reportable transaction. See Reportable transaction, earlier.

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

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

For tax years 2018 through 2025, if you claim any deduction allowed under section 199A, an understatement is considered to be substantial if it is more than the greater of:

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

In general, “understatement” means the excess of:

1. The amount of the tax required to be shown on the return for the tax year; over
2. The amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)).

For items other than tax shelters, you can file Form 8275 or Form 8275-R to disclose items that could cause a substantial understatement of income tax. In that way, you can avoid the substantial understatement penalty if you have a reasonable basis for your position on the tax issue. Disclosure of the tax shelter item on a tax return does not reduce the amount of the understatement.

Also, the understatement penalty will not be imposed if you can show 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.

Substantial valuation misstatement. In general, you are liable for a 20% penalty for a substantial valuation misstatement if any the following are true.

- The value or adjusted basis of any property claimed on the return is 150% or more of the correct amount.
- You underpaid your tax by more than \$5,000 because of the misstatement.
- 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 200% or more of the amount determined to be correct, you will be assessed a penalty of 40%, instead of 20%, of the amount you

underpaid because of the gross valuation misstatement. The penalty rate is also 40% if the property's correct value or adjusted basis is zero.

Transaction lacking economic substance.

The economic substance doctrine only applies to an individual that entered into a transaction in connection with a trade or business or an activity engaged in for the production of income. A transaction has economic substance for you as an individual taxpayer only if:

- The transaction changes your economic position in a meaningful way (apart from federal income tax effects), and
- You have a substantial purpose (apart from federal income tax effects) for entering into the transaction.

For purposes of determining whether economic substance exists, a transaction's

profit potential will only be taken into account if the present value of the reasonably expected pre-tax profit from the transaction is substantial compared to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

If any part of your underpayment is due to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance or failing to meet the requirements of any similar rule of law, that part of your underpayment will be subject to the 20% accuracy-related penalty even if you had a reasonable cause and acted in good faith concerning that part.

Additionally, the penalty increases to 40% if you do not adequately disclose, on your return or in a statement attached to your return, the relevant facts affecting the tax treatment of a transaction that lacks economic substance. Relevant facts include

any facts affecting the tax treatment of the transaction.



*You may be subject to a 20% penalty based on the excessive amount of an erroneous claim for an income tax refund or credit. If that excessive amount results from a transaction found to be lacking economic substance, it will **NOT** be treated as due to reasonable cause.*

Undisclosed foreign financial asset understatement. For tax years beginning after March 18, 2010, you may be liable for a 40% penalty for an understatement of your tax liability due to an undisclosed foreign financial asset. An undisclosed foreign financial asset is any asset for which an information return, required to be provided under sections 6038, 6038B, 6038D, 6046A, or 6048 for any tax year, is not provided. The penalty applies to any part of an underpayment related to the following undisclosed foreign financial assets.

- Any foreign business you control, reportable on Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, or Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships.
- Certain transfers of property to a foreign corporation or partnership, reportable on Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation, or certain distributions to a foreign person, reportable on Form 8865.
- Your ownership interest in an otherwise undisclosed foreign financial asset, reportable on Form 8275 or 8275-R. See the Instructions for Form 8275 or Form 8275-R.



Instead of, or in addition to, Form 8275 or 8275-R, you may have to file Form 8938, Statement of Specified

Foreign Financial Assets, with your tax return. See the Instructions for Form 8938 for details.

- Your acquisition, disposition, or substantial change in ownership interest in a foreign partnership, reportable on Form 8865.
- Creation or transfer of money or property to certain foreign trusts, reportable on Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.

Penalty for incorrect appraisals. The person who prepares an appraisal of the value of property may have to pay a penalty if:

- He or she knows, or reasonably should have known, that the appraisal would be used in connection with a return or claim for refund; and

- The claimed value of the property on a return or claim for refund based on that appraisal results in a substantial valuation misstatement or a gross valuation misstatement. See *Substantial valuation misstatement*, earlier.

For details on the penalty amount and exceptions, see Pub. 561.

Penalty for failure to disclose a reportable transaction. If you fail to include any required information regarding a reportable transaction on a return or statement, you may have to pay a penalty of 75% of the decrease in tax shown on your return as a result of such transaction (or that would have resulted if the transaction were respected for federal tax purposes). See *Reportable transaction*, earlier. For an individual, the minimum penalty is \$5,000 and the maximum is \$10,000 (or \$100,000 for a listed transaction). This penalty is in

addition to any other penalty that may be imposed.

The IRS may rescind or abate the penalty for failing to disclose a reportable transaction under certain limited circumstances but cannot rescind the penalty for failing to disclose a listed transaction. See Revenue Procedure 2007-21, as updated by Treasury Decision 9686 and Announcement 2016-1, for information on rescission.

Accuracy-related penalty for a reportable transaction understatement. If you have a reportable transaction understatement, you may have to pay a penalty equal to 20% of the amount of that understatement. This applies to any item due to a listed transaction or other reportable transaction with a significant purpose of avoiding or evading federal income tax. The penalty is 30% rather than 20% for the part of any reportable transaction understatement if the transaction was not properly disclosed.

This penalty does not apply to the part of an understatement on which the fraud penalty, gross valuation misstatement penalty, or penalty for nondisclosure of noneconomic substance transactions is imposed.

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

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

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

Whether To Invest

Take into account the risks, benefits, and the source of every financial transaction before

investing. You may wish to consider professional legal and financial advice for help in evaluating the transaction.

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,
- Nondeductible Interest Expenses,
- How To Report Investment Interest Expenses, and

- When To Report Investment Expenses.

Useful Items

You may want to see:

Publication

☐ **925** Passive Activity and At-Risk Rules

Form (and Instructions)

☐ **Schedule A (Form 1040)** Itemized Deductions

☐ **4952** Investment Interest Expense Deduction

☐ **8615** Tax for Certain Children Who Have Unearned Income

☐ **8814** Parents' Election To Report Child's Interest and Dividends

See chapter 5, *How To Get Tax Help*, 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, or
- The limit on investment expenses.

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

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 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 Pub. 925.

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

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

- More than one-half of the personal services you perform during the year in all trades or businesses are performed in real property trades or

businesses in which you materially participate.

- You perform more than 750 hours of services during the year in real property trades or businesses in which you materially participate.

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

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

Other income (nonpassive income).

Generally, you can use losses from passive activities only to offset income from passive

activities. You 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 other regulated investment companies (RICs)) and real estate investment trusts (REITs).

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

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

- Expenses (other than interest) that are clearly and directly allocable to your portfolio income, or

- 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 Pub. 925.

Interest Expenses

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

For information on business interest, see chapter 8 of Pub. 334, *Tax Guide for Small Business*.

You generally cannot deduct personal interest. However, you can deduct qualified home mortgage interest, as explained in Pub. 936, *Home Mortgage Interest Deduction*, and interest on certain student loans, as explained in Pub. 970, *Tax Benefits for Education*.

Investment Interest

If you borrow money to buy property you hold for investment, the interest you pay is investment interest. You can deduct investment interest subject to the limit discussed later. However, you cannot deduct interest you incurred to produce tax-exempt income. See *Tax-exempt income*, later. You

also cannot deduct interest expenses on straddles discussed under Interest expense and carrying charges on straddles, later.

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

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

Investment property also includes an interest in a trade or business activity in which you did not materially participate (other than a passive activity).

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

Allocation of Interest Expense

If you borrow money for business, personal purposes, or investment, you must allocate the debt among those purposes. Only the interest expense on the part of the debt used for investment purposes is treated as investment expense. The allocation is not affected by the use of property that secures the debt.

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

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

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

Example 2. Assume in *Example 1* that you borrowed the money on March 1 and immediately bought the stock for \$8,000. You did not buy the household items until June

1. You had deposited the \$2,000 in the bank. You had no other transactions on the bank account until June. You did not sell the stock, and you made no principal payments on the debt. You paid interest from another account. The \$8,000 is treated as being used for an

investment purpose. 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, when you spend the \$2,000 for household items, you must begin to allocate 80% of the debt and the interest expense to investment purposes and 20% to personal purposes.

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

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

you received the cash instead of the date you actually made the payment.

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

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

Pass-through entities. If you use borrowed funds to buy an interest in a partnership or S corporation, then the interest on those funds

must be allocated based on the assets of the entity. If you contribute to the capital of the entity, you can make the allocation using any reasonable method.

Additional allocation rules. For more information about allocating interest expense, see chapter 8 of Pub. 334.

When To Deduct Investment Interest

If you use the cash method of accounting, you must pay the interest expense 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, later in this chapter.

Example. You borrowed \$1,000 on August 18, 2023, payable in 90 days at 4% interest. On November 17, 2023, you paid this with a new note for \$1,010, due on February 16, 2024. If you use the cash method of

accounting, you cannot deduct any part of the \$10 interest on your return for 2023 because you did not actually pay it in that year. If you use an accrual method, you may be able to deduct a portion of the interest on the loans through December 31, 2023, on your return for 2023.

Interest paid in advance. Generally, if you pay interest in advance for a period that goes beyond the end of the tax year, you must spread the interest over the tax years to which it belongs under the OID rules discussed in chapter 1. You can deduct in each year only the interest for that year.

Interest on margin accounts. If you are a cash method taxpayer, you can deduct interest on margin accounts to buy taxable securities as investment interest in the year you paid it. You are considered to have paid interest on these accounts only when you actually pay the broker or when payment becomes available to the broker through your

account. Payment may become available to the broker through your account when the broker collects dividends or interest for your account, or sells securities held for you or received from you.

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

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

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

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

Interest not deducted due to limit. In the year you dispose of the bond, you can deduct any interest expense you were not allowed to deduct in earlier years because of the limit.

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

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

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

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

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

- The amount of acquisition discount or OID on the obligation for the tax year, plus
- 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.

Interest not deducted due to limit. 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 any interest expense you were not allowed to deduct for an earlier year because of the limit. Follow the same rules provided in the earlier discussion under Limit on interest deduction for market discount bonds.

Limit on Deduction

Generally, your deduction for investment interest expense is limited to your net investment income.

You can carry over the amount of investment interest you could not deduct because of this limit to the next tax year. The interest carried

over is treated as investment interest paid or accrued in that next year.

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

Net Investment Income

Determine the amount of your net investment income by subtracting your investment expenses (other than interest expense) from your investment income.

Investment income. Generally, investment income 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. It also does not include qualified dividends or net capital gain unless you choose to include them.

Choosing to include qualified dividends.

Investment income generally does not include

qualified dividends, discussed in chapter 1. However, you can choose to include all or part of your qualified dividends in investment income.

You make this choice by completing Form 4952, line 4g, according to its instructions.

If you choose to include any of your qualified dividends in investment income, you must reduce your qualified dividends that are eligible for the lower capital gains tax rates by the same amount.

Choosing to include net capital gain.

Investment income generally does not include net capital gain from disposing of investment property (including capital gain distributions from mutual funds). However, you can choose to include all or part of your net capital gain in investment income.

You make this choice by completing Form 4952, line 4g, according to its instructions.

If you choose to include any of your net capital gain in investment income, you must reduce your net capital gain that is eligible for the lower capital gains tax rates by the same amount.

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



Before making either choice, consider the overall effect on your tax liability. Compare your tax if you make one or both of these choices with your tax if you do not.

Investment income of child reported on parent's return. Investment income includes the part of your child's interest and dividend income you choose to report on your return. If the child does not have qualified dividends, Alaska Permanent Fund dividends, or capital gain distributions, this is the amount on line 6 of Form 8814. Include it on line 4a of Form 4952.

Example. Your 8-year-old child has interest income of \$2,600, which you choose to report on your own return. You enter \$2,600 on Form 8814, lines 1a and 4, and \$100 on lines 6 and 12, and complete Part II. You also enter \$100 on Schedule 1 (Form 1040), line 8z. Your investment income includes this \$100.

Child's qualified dividends. If part of the amount you report is your child's qualified dividends, that part (which is reported on Form 1040, line 3a) generally does not count as investment income. However, you can choose to include all or part of it in investment income, as explained under *Choosing to include qualified dividends*, earlier.

Your investment income also includes the amount on Form 8814, line 12 (or, if applicable, the reduced amount figured next under *Child's Alaska Permanent Fund dividends*).

Child's Alaska Permanent Fund

dividends. If part of the amount you report is your child's Alaska Permanent Fund dividends, that part does not count as investment income. To figure the amount of your child's income that you can consider your investment income, start with the amount on Form 8814, line 6. Multiply that amount by a percentage that is equal to the Alaska Permanent Fund dividends divided by the total amount on Form 8814, line 4. Subtract the result from the amount on Form 8814, line 12.

Example. Your 10-year-old child has taxable interest income of \$4,000 and Alaska Permanent Fund dividends of \$2,000. You choose to report this on your return. You enter \$4,000 on Form 8814, line 1a; \$2,000 on line 2a; and \$6,000 on line 4. You then enter \$3,500 on Form 8814, lines 6 and 12; and Schedule 1 (Form 1040), line 8z. You figure the amount of your child's income that

you can consider your investment income as follows.

$$\$3,500 - (\$3,500 \times (\$2,000 \div \$6,000)) = \$2,333$$

You include the result, \$2,333, on Form 4952, line 4a.

Child's capital gain distributions. If part of the amount you report is your child's capital gain distributions, that part (which is reported on Schedule D (Form 1040), line 13; or Form 1040, line 7) generally does not count as investment income. However, you can choose to include all or part of it in investment income, as explained under Choosing to include net capital gain, earlier.

Your investment income also includes the amount on Form 8814, line 12 (or, if applicable, the reduced amount figured under Child's Alaska Permanent Fund dividends, earlier).

Investment expenses. Investment expenses are your allowed deductions (other than interest expense) directly connected with the production of investment income.

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 Pub. 925 for information about passive activities.

Example. Ted is a partner in a partnership that operates a business. However, he does not materially participate in the partnership's business. Ted's interest in the partnership is considered a passive activity.

Ted's investment income from interest and dividends (other than qualified dividends) is \$10,000. His investment expenses (other than interest) are \$3,200. His investment interest expense is \$8,000. Ted also has income from the partnership of \$2,000.

Ted figures his net investment income and the limit on his investment interest expense deduction in the following way.

Total investment income	\$10,000
Minus: Investment expenses (other than interest)	3,200
Net investment income	<u>\$6,800</u>
Deductible investment interest expense for the year . . .	<u>\$6,800</u>

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

Form 4952

Use Form 4952 to figure your deduction for investment interest. See Form 4952 for more information.

Exception to use of Form 4952. You do not have to complete Form 4952 or attach it to your return if you meet all of the following tests.

- Your investment income from interest and ordinary dividends minus any qualified dividends is more than your investment interest expense.
- You do not have any other deductible investment expenses.
- You have no carryover of investment interest expense from 2022.

If you meet all of these tests, you can deduct all of your investment interest.

Bond Premium Amortization

If you pay a premium to buy a bond, the premium is part of your basis in the bond. If the bond yields taxable interest, you can choose to amortize the premium. This generally means that each year, over the life of the bond, you use a part of the premium to reduce the amount of interest includible in your income. If you make this choice, you must reduce your basis in the bond by the amortization for the year.

If the bond yields tax-exempt interest, you must amortize the premium. This amortized amount is not deductible in determining taxable income. However, each year, you must reduce your basis in the bond (and tax-exempt interest otherwise reportable on your tax return) by the amortization for the year.

If you acquire a security, such as a bond, at a premium, you may receive a Form 1099-INT or Form 1099-OID. See the instructions on

those forms to determine if the amounts of interest reported to you have been reduced by amortizable bond premium for the period.

Bond premium. Bond premium is the amount by which your basis in the bond right after you get it is more than the total of all amounts payable on the bond after you get it (other than payments of qualified stated interest). For example, a bond with a maturity value of \$1,000 generally would have a \$50 premium if you buy it for \$1,050.

Special rules to determine amounts payable on a bond. For special rules that apply to determine the amounts payable on a variable rate bond, an inflation-indexed debt instrument, a bond that provides for certain alternative payment schedules (for example, a bond callable prior to the stated maturity date of the bond), or a bond that provides for remote or incidental contingencies, see Regulations section 1.171-3.

Basis. In general, your basis for figuring bond premium amortization is the same as your basis for figuring any loss on the sale of the bond. However, you may need to use a different basis for:

- Convertible bonds,
- Bonds you got in a trade, and
- Bonds whose basis has to be determined using the basis of the person who transferred the bond to you.

See Regulations section 1.171-1(e).

Dealers. A dealer in taxable bonds (or anyone who holds them mainly for sale to customers in the ordinary course of a trade or business, or who would properly include bonds in inventory at the close of the tax year) cannot claim a deduction for amortizable bond premium.

See section 75 of the Internal Revenue Code for the treatment of bond premium by a dealer in tax-exempt bonds.

How To Figure Amortization

For bonds issued after September 27, 1985, you must amortize bond premium using a constant yield method on the basis of the bond's yield to maturity, determined by using the bond's basis and compounding at the close of each accrual period.

Constant yield method. Figure the bond premium amortization for each accrual period as follows.

Step 1: Determine your yield. Your yield is the discount rate that, when used in figuring the present value of all remaining payments to be made on the bond (including payments of qualified stated interest), produces an amount equal to your basis in the bond. Figure the yield as of the date you got the bond. It must be constant over the term of

the bond and must be figured to at least two decimal places when expressed as a percentage.

If you do not know the yield, consult your broker or tax advisor. Databases available to them are likely to show the yield at the date of purchase.

Step 2: Determine the accrual periods.

You can choose the accrual periods to use. They may be of any length and may vary in length over the term of the bond, but each accrual period can be no longer than 1 year, and each scheduled payment of principal or interest must occur either on the first or the final day of an accrual period. The computation is simplest if accrual periods are the same as the intervals between interest payment dates.

Step 3: Determine the bond premium for the accrual period. To do this, multiply your adjusted acquisition price at the beginning of the accrual period by your yield. Then,

subtract the result from the qualified stated interest for the period.

Your adjusted acquisition price at the beginning of the first accrual period is the same as your basis. After that, it is your basis decreased by the amount of bond premium amortized for earlier periods, and the amount of any payment previously made on the bond other than a payment of qualified stated interest.

Example. On February 1, 2022, you bought a taxable bond for \$110,000. The bond has a stated principal amount of \$100,000, payable at maturity on February 1, 2029, making your premium \$10,000 ($\$110,000 - \$100,000$). The bond pays qualified stated interest of \$10,000 on February 1 of each year. Your yield is

8.07439% compounded annually. You choose to use annual accrual periods ending on February 1 of each year. To find your bond premium amortization for the accrual period

ending on February 1, 2023, you multiply the adjusted acquisition price at the beginning of the period (\$110,000) by your yield. When you subtract the result (\$8,881.83) from the qualified stated interest for the period (\$10,000), you find that your bond premium amortization for the period is \$1,118.17.

Special rules to figure amortization. For special rules to figure the bond premium amortization on a variable rate bond, an inflation-indexed debt instrument, a bond that provides for certain alternative payment schedules (for example, a bond callable prior to the stated maturity date of the bond), or a bond that provides for remote or incidental contingencies, see Regulations section 1.171-3.

Choosing To Amortize

You choose to amortize the premium on taxable bonds by reporting the amortization for the year on your income tax return for the

first tax year you want the choice to apply. You should attach a statement to your return that you are making this choice under section 171. See *How To Report Amortization* next.

This choice is binding for the year you make it and for later tax years. It applies to all taxable bonds you own in the year you make the choice and also to those you acquire in later years.

You can change your decision to amortize bond premium only with the written approval of the IRS. To request approval, use Form 3115. For more information on requesting approval, see section 5 of Revenue Procedure 2023-24 in Internal Revenue Bulletin 2023-26. You can find Revenue Procedure 2023-24 at [IRS.gov/irb/ 2023-28 IRB#REV-PROC-2023-24](https://www.irs.gov/irb/2023-28_IRB#REV-PROC-2023-24).

How To Report Amortization (Taxable Bonds)

Subtract the bond premium amortization from your interest income from these bonds.

Report the bond's interest on Schedule B (Form 1040), line 1. Under your last entry on line 1, put a subtotal of all interest listed on line 1. Below this subtotal, enter the amortizable bond premium allocable to the interest payments for the year and label this amount "ABP Adjustment." Subtract this amount from the subtotal, and enter the result on line 2.

Bond premium amortization more than interest. If the amount of your bond premium amortization for an accrual period is more than the qualified stated interest for the period, you can include the difference in Other Itemized Deductions on Schedule A (Form 1040), line 16.

But your deduction is limited to the amount by which your total interest inclusions on the bond in prior accrual periods is more than your total bond premium deductions on the bond in prior periods. Any amount you cannot deduct because of this limit can be carried forward to the next accrual period.

Pre-1998 election to amortize bond premium. Generally, if you first elected to amortize bond premium before 1998, the above treatment of the premium does not apply to bonds you acquired before 1988.

Bonds acquired before October 23, 1986. The amortization of the premium on these bonds is a miscellaneous itemized deduction not subject to the 2%-of-adjusted-gross-income limit.

Bonds acquired after October 22, 1986, but before 1988. The amortization of the premium on these bonds is investment interest expense subject to the investment interest limit, unless you choose to treat it as an offset to interest income on the bond.

Nondeductible Interest Expenses

Some interest expenses that you incur as an investor are not deductible.

Single-premium life insurance, endowment, and annuity contracts. You cannot deduct interest on money you borrow to buy or carry a single-premium life insurance, endowment, or annuity contract.

Used as collateral. If you use a single-premium annuity contract as collateral to obtain or continue a mortgage loan, you cannot deduct any interest on the loan that is collateralized by the annuity contract. Figure the amount of interest expense disallowed by multiplying the current interest rate on the mortgage loan by the lesser of the amount of the annuity contract used as collateral or the amount of the loan.

Borrowing on insurance. Generally, you cannot deduct interest on money you borrow to buy or carry a life insurance, endowment, or annuity contract if you plan to systematically borrow part or all of the increases in the cash value of the contract. This rule applies to the interest on the total amount borrowed to buy or carry the contract, not just the interest on the borrowed increases in the cash value.

Tax-exempt income. You cannot deduct interest expenses you incur to produce tax-exempt income, such as interest on money you borrow to buy tax-exempt securities or shares in a mutual fund or other regulated investment company that distributes only exempt-interest dividends.

Short-sale expenses. The rule disallowing a deduction for interest expenses on debt proceeds used to purchase 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 under Short Sales in chapter 4.

Expenses for both tax-exempt and taxable income. You may have expenses that are for both tax-exempt and taxable income. If you cannot specifically identify what part of the expenses is for each type of income, you can divide the expenses, using reasonable proportions based on facts and circumstances. You must attach a statement to your return showing how you divided the expenses and stating that each deduction claimed is not based on tax-exempt income.

One accepted method for dividing expenses is to do it in the same proportion that each type

of income is to the total income. If the expenses relate in part to capital gains and losses, include the gains, but not the losses, in figuring this proportion. To find the part of the expenses that is for the tax-exempt income, divide your tax-exempt income by the total income and multiply your expenses by the result.

Example. You received \$6,000 in interest income; \$4,800 was tax exempt and \$1,200 was taxable. In earning this income, you had \$500 of expenses. You cannot specifically identify the amount of each expense item that is for each income item, so you must divide your expenses. 80% (\$4,800 tax-exempt interest divided by \$6,000 total interest) of your expenses is for the tax-exempt income. You cannot deduct \$400 (80% of \$500) of the expenses. You can deduct \$100 (the rest of the expenses) because they are for the taxable interest.

State income taxes. If you itemize your deductions, you can deduct, as taxes, state income taxes on interest income that is exempt from federal income tax. But you cannot deduct, as either taxes or investment expenses, state income taxes on other exempt income.

Interest expense and carrying charges on straddles. You cannot deduct interest and carrying charges 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:

- 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

- The straddle is a hedging transaction.

For information about straddles, including definitions of the terms used in this discussion, see Straddles in 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 under Payments in lieu of dividends 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 Limit on interest deduction for market discount bonds and Limit on interest deduction for short-term obligations, earlier.

Nondeductible amount. Figure the nondeductible interest and carrying charges on straddle property as follows.

1. Add:

- a. Interest on indebtedness incurred or continued to buy or carry the personal property, and
 - b. All other amounts (including charges to insure, store, or transport the personal property) paid or incurred to carry the personal property.
2. Subtract from the amount in (1):
- a. Interest (including OID) includible in gross income for the year on the personal property,
 - b. Any income from the personal property treated as ordinary income on the disposition of short-term government obligations or as ordinary income under the market discount and short-term bond provisions—see Discount on Debt Instruments in chapter 1,

- c. The dividends includible in gross income for the year from the personal property, and
- d. Any payment on a loan of the personal property for use in a short sale that is includible in gross income.

Basis adjustment. Add the nondeductible amount to the basis of your straddle property.

How To Report Investment Interest Expenses

To deduct your investment interest expenses, you must itemize deductions on Schedule A (Form 1040). Enter your deductible investment interest expense on Schedule A (Form 1040), line 9. 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.

Investment expenses from nonpublicly offered mutual fund or real estate mortgage investment conduit (REMIC). If you hold an interest in a nonpublicly offered mutual fund, your investment expenses will be shown in box 6 of Form 1099-DIV. 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 Schedule Q (Form 1066), line 3b. Any expenses relating to your regular interest investment will appear in box 5 of Form 1099-INT or box 9 of Form 1099-OID.

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, is considered to be an indirect deduction through that pass-through entity. You must include in your gross income an amount equal to the expenses allocated to you, whether or not you are able to claim a deduction for those expenses. If you are a shareholder in a nonpublicly offered mutual fund, you must include on your return the full amount of ordinary dividends or other distributions of stock, as shown in box 1a of Form 1099-DIV. 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 Schedule Q (Form 1066), lines 1b and 3b. If you are a REMIC regular interest holder, you must include the amount of any expense allocation you received on Form 1040 or 1040-SR, line 2b.

Publicly offered mutual funds. Most mutual funds are publicly offered. These mutual funds, generally, are traded on an established securities exchange. These funds do not pass investment expenses through to you. Instead, the dividend income they report to you in box 1a of Form 1099-DIV is already reduced by your share of investment expenses. As a result, you cannot deduct the expenses on your return.

Include the amount from box 1a of Form 1099-DIV in your income.



A publicly offered mutual fund is one that:

1. *Is continuously offered pursuant to a public offering,*
2. *Is regularly traded on an established securities market, and*
3. *Is held by or for no fewer than 500 persons at any time during the year.*

Contact your mutual fund if you are not sure whether it is publicly offered.

For information on how to report amortizable bond premium, see *Bond Premium Amortization*, earlier in this chapter.

When To Report Investment Expenses

If you use the cash method to report income and expenses, you generally deduct your expenses, except for certain prepaid interest, in the year you pay them.

If you use an accrual method, you generally deduct your expenses when you incur a liability for them, rather than when you pay them.

See also *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 OID, regardless of when payment is made. This rule also does not apply to loans with below-market interest rates or to certain payments for the use of property and services when the lender or recipient has to include payments periodically in income, even if a payment has not been made.

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4.

Sales and Trades of Investment Property

Introduction

This chapter explains the tax treatment of sales and trades of investment property.

Investment property. This is property that produces investment income. Examples include stocks, bonds, and Treasury bills and notes. Property used in a trade or business is not investment property.

Form 1099-B. If you sold property such as stocks, bonds, mutual funds, or certain commodities through a broker during the year, the broker should send you, for each sale, a Form 1099-B, Proceeds From Broker and Barter Exchange Transactions. You should receive the Form 1099-B for 2023 by February 15, 2024. It will show the gross

proceeds from the sale. The IRS will also get a copy of Form 1099-B from the broker.

Use the Form 1099-B received from your broker to complete Form 8949, Sales and Other Dispositions of Capital Assets. If you sold a covered security in 2023, your broker will send you a Form 1099-B that shows your basis. This will help you complete Form 8949. Generally, a covered security is a security you acquired after 2010, with certain exceptions explained in the Instructions for Form 8949.



For more information on Form 8949 and Schedule D (Form 1040), see Reporting Capital Gains and Losses in this chapter. Also see the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040).

Nominees. If someone receives gross proceeds as a nominee for you, that person will give you a Form 1099-B, which will show gross proceeds received on your behalf.

If you receive a Form 1099-B that includes gross proceeds belonging to another person, see *Nominees*, later, under *Reporting Capital Gains and Losses* for more information.

Other property transactions. Certain transfers of property are discussed in other IRS publications. These include:

- Sale of your main home, discussed in Pub. 523, *Selling Your Home*;
- Installment sales, covered in Pub. 537;
- Various types of transactions involving business property, discussed in Pub. 544, *Sales and Other Dispositions of Assets*;
- Transfers of property at death, covered in Pub. 559; and
- Disposition of an interest in a passive activity, discussed in Pub. 925.

Topics

This chapter discusses:

- What Is a Sale or Trade,
- Basis of Investment Property,
- Adjusted Basis,
- How To Figure Gain or Loss,
- Nontaxable Trades,
- Transfers Between Spouses,
- Related Party Transactions,
- Capital Gains and Losses,
- Reporting Capital Gains and Losses,
and
- Special Rules for Traders in Securities
or Commodities.

Useful Items

You may want to see:

Publication

□ **551** Basis of Assets

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
- ☐ **8949** Sales and Other Dispositions of Capital Assets

See chapter 5, *How To Get Tax Help*, for information about getting these publications and forms.

What Is a Sale or Trade?

Terms you may need to know (see Glossary):

- Equity option
- Futures contract
- Marked-to-market rule

- Nonequity option
- Options dealer
- Regulated futures contract
- Section 1256 contract
- Short sale

This section explains what is a sale or trade. It also explains certain transactions and events that are treated as sales or trades.

A sale is generally a transfer of property for money or a mortgage, note, or other promise to pay money.

A trade is a transfer of property for other property or services, and may be taxed in the same way as a sale.

Sale and purchase. Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. The sale and purchase are two separate transactions. But see Like-

Kind Exchanges under *Nontaxable Trades*, later.

Redemption of stock. A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

Dividend versus sale or trade. Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

- The redemption is not essentially equivalent to a dividend—see Dividends and Other Distributions in chapter 1,
- There is a substantially disproportionate redemption of stock,

- There is a complete redemption of all the stock of the corporation owned by the shareholder, or
- 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 generally treated as a sale or trade. See Stocks, stock rights, and bonds and Discounted Debt Instruments, later.

In addition, a significant modification of a bond is treated as a trade of the original bond for a new bond. For details, see Regulations section 1.1001-3.

Surrender of stock. A surrender of stock by a dominant shareholder who retains ownership of more than half of the corporation's voting shares is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must

reallocate his or her basis in the surrendered shares to the shares he or she retains.

Trade of investment property for an annuity. The transfer of investment property to a corporation, trust, fund, foundation, or other organization, in exchange for a fixed annuity contract that will make guaranteed annual payments to you for life, is a taxable trade. If the present value of the annuity is more than your basis in the property traded, you have a taxable gain in the year of the trade. Figure the present value of the annuity according to factors used by commercial insurance companies issuing annuities.

Transfer by inheritance. The transfer of property of a decedent to the executor or administrator of the estate, or to the heirs or beneficiaries, is not a sale or other disposition. No taxable gain or deductible loss results from the transfer.

Termination of certain rights and obligations. The cancellation, lapse,

expiration, or other termination of a right or obligation (other than a securities futures contract) with respect to property that is a capital asset (or that would be a capital asset if you acquired it) is treated as a sale. Any gain or loss is treated as a capital gain or loss.

This rule does not apply to the retirement of a debt instrument. See Redemption or retirement of bonds, earlier.

Worthless Securities

Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that became completely worthless during the tax year are treated as though they were sold on the last day of the tax year. This affects whether your capital loss is long term or short term. See Holding Period, later.

Worthless securities also include securities that you abandon after March 12, 2008. To abandon a security, you must permanently

surrender and relinquish all rights in the security and receive no consideration in exchange for it. All the facts and circumstances determine whether the transaction is properly characterized as an abandonment or other type of transaction, such as an actual sale or exchange, contribution to capital, dividend, or gift.

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 Form 8949, Part I or Part II, whichever applies.



Report your worthless securities transactions on Form 8949 with the correct box checked for these

transactions. See Form 8949 and the Instructions for Form 8949.

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 1040-X, Amended U.S. Individual Income Tax Return, to amend your return for the year the security became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. (Claims not due to worthless securities or bad debts 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 Publication 556, Examination of Returns, Appeals Rights, and Claims for Refund.

Constructive Sales of Appreciated Financial Positions

You are treated as having made a constructive sale when you enter into certain transactions involving an appreciated financial position (defined later) in stock, a partnership interest, or certain debt instruments. You must recognize gain as if the position were disposed of at its fair market value on the date of the constructive sale. This gives you a new holding period for the position that begins on the date of the constructive sale. Then, when you close the transaction, you reduce your gain (or increase your loss) by the gain recognized on the constructive sale.

Constructive sale. You are treated as having made a constructive sale of an appreciated financial position if you:

- Enter into a short sale of the same or substantially identical property,

- Enter into an offsetting notional principal contract relating to the same or substantially identical property,
- Enter into a futures or forward contract to deliver the same or substantially identical property (including a forward contract that provides for cash settlement), or
- Acquire the same or substantially identical property (if the appreciated financial position is a short sale, an offsetting notional principal contract, or a futures or forward contract).

You are also treated as having made a constructive sale of an appreciated financial position if a person related to you enters into a transaction described above with a view toward avoiding the constructive sale treatment. For this purpose, a related person is any related party described under *Related Party Transactions*, later in this chapter.

Exception for nonmarketable securities.

You are not treated as having made a constructive sale solely because you entered into a contract for sale of any stock, debt instrument, or partnership interest that is not a marketable security if it settles within 1 year of the date you enter into it.

Exception for certain closed transactions.

Do not treat a transaction as a constructive sale if all of the following are true.

1. You closed the transaction on or before the 30th day after the end of your tax year.
2. You held the appreciated financial position throughout the 60-day period beginning on the date you closed the transaction.
3. Your risk of loss was not reduced at any time during that 60-day period by holding certain other positions.

If a closed transaction is reestablished in a substantially similar position during the 60-day period beginning on the date the first transaction was closed, this exception still applies if the reestablished position is closed before the 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.

This exception also applies to successive short sales of an entire appreciated financial position. For more information, see Revenue Ruling 2003-1 in Internal Revenue Bulletin 2003-3. This bulletin is available at [IRS.gov/pub/irsirbs/irb03-03.pdf](https://www.irs.gov/pub/irsirbs/irb03-03.pdf).

Appreciated financial position. This is any interest in stock, a partnership interest, or a debt instrument (including a futures or forward contract, a short sale, or an option) if disposing of the interest would result in a gain.

Exceptions. An appreciated financial position does not include the following.

1. Any position from which all of the appreciation is accounted for under marked-to-market rules, including section 1256 contracts (described later under Section 1256 Contracts Marked to Market).
2. Any position in a debt instrument if:
 - a. The position unconditionally entitles the holder to receive a specified principal amount;
 - b. The interest payments (or other similar amounts) with respect to the position are payable at a fixed rate or a variable rate described in Regulations section 1.860G-1(a)(3); and
 - c. The position is not convertible, either directly or indirectly, into

stock of the issuer (or any related person).

3. Any hedge with respect to a position described in (2).

Certain trust instruments treated as stock. For the constructive sale rules, an interest in an actively traded trust is treated as stock unless substantially all of the value of the property held by the trust is debt that qualifies for the exception to the definition of an appreciated financial position (explained in (2) above).

Sale of appreciated financial position. A transaction treated as a constructive sale of an appreciated financial position is not treated as a constructive sale of any other appreciated financial position, as long as you continue to hold the original position. However, if you hold another appreciated financial position and dispose of the original position before closing the transaction that resulted in the constructive sale, you are

treated as if, at the same time, you constructively sold the other appreciated financial position.

Section 1256 Contracts Marked to Market

If you hold a section 1256 contract at the end of the tax year, you must generally treat it as sold at its fair market value on the last business day of the tax year.

Section 1256 Contract

A section 1256 contract is any:

- Regulated futures contract,
- Foreign currency contract,
- Nonequity option,
- Dealer equity option, or
- Dealer securities futures contract.

Exceptions. A section 1256 contract does not include:

- Interest rate swaps,
- Currency swaps,
- Basis swaps,
- Interest rate caps,
- Interest rate floors,
- Commodity swaps,
- Equity swaps,
- Equity index swaps,
- Credit default swaps, or
- Similar agreements.

For more details, including definitions of these terms, see section 1256.

Regulated futures contract. This is a contract that:

- Provides that amounts which must be deposited to, or can be withdrawn from, your margin account depend on

daily market conditions (a system of marking to market); and

- Is traded on, or subject to the rules of, a qualified board of exchange. A qualified board of exchange is a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, any board of trade or exchange approved by the Secretary of the Treasury, or a national securities exchange registered with the Securities and Exchange Commission (SEC).

Foreign currency contract. This is a contract that:

- 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),

- Is traded in the interbank market, and

- 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 longer than the maturities ordinarily available for regulated futures contracts are considered to meet the definition of a foreign currency contract if the above three conditions are satisfied.

Special rules apply to certain foreign currency transactions. These transactions may result in ordinary gain or loss treatment. For details, see Internal Revenue Code section 988 and Regulations sections 1.988-1(a)(7) and 1.988-3.

Nonequity option. This is any listed option (defined later) that is not an equity option. Nonequity options include debt options, commodity futures options, currency options, and broad-based stock index options. A broad-based stock index is based on the value of a group of diversified stocks or

securities (such as the Standard and Poor's 500 index).

Warrants based on a stock index that are economically substantially identical in all material respects to options based on a stock index are treated as options based on a stock index.

Cash-settled options. Cash-settled options based on a stock index and either traded on or subject to the rules of a qualified board of exchange are nonequity options if the SEC determines that the stock index is broad based.

This rule does not apply to options established before the SEC determines that the stock index is broad based.

Listed option. This is any option traded on, or subject to the rules of, a qualified board or exchange (as discussed earlier under *Regulated futures contract*). A listed option,

however, does not include an option that is a right to acquire stock from the issuer.

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

- Is an equity option,
- Is bought or granted by that dealer in the normal course of the dealer's business activity of dealing in options, and
- Is listed on the qualified board of exchange where that dealer is registered.

An “options dealer” is any person registered with an appropriate national securities exchange as a market maker or specialist in listed options.

Equity option. This is any option:

- To buy or sell stock, or

- That is valued directly or indirectly by reference to any stock or narrow-based security index.

Equity options include options on a group of stocks only if the group is a narrow-based stock index.

Dealer securities futures contract. For any dealer in securities futures contracts or options on those contracts, this is a securities futures contract (or option on such a contract) that:

- Is entered into by the dealer (or, in the case of an option, is purchased or granted by the dealer) in the normal course of the dealer's activity of dealing in this type of contract (or option); and
- Is traded on a qualified board or exchange (as defined under *Regulated futures contract*, earlier).

A securities futures contract that is not a dealer securities futures contract is treated as described later under Securities Futures Contracts.

Marked-to-Market Rules

A section 1256 contract that you hold at the end of the tax year will generally be treated as sold at its fair market value on the last business day of the tax year, and you must recognize any gain or loss that results. That gain or loss is taken into account in figuring your gain or loss when you later dispose of the contract, as shown in the Example under *60/40 rule* below.

Hedging exception. The marked-to-market rules do not apply to hedging transactions. See Hedging Transactions, later.