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If you wish, you can submit comments about draft or final forms, instructions, or publications at IRS.gov/FormsComments. We cannot respond to all comments due to the high volume we receive. Please note that we may not be able to consider many suggestions until the subsequent revision of the product.

Department of the Treasury

Internal Revenue Service

Publication 550
Cat. No. 15093R

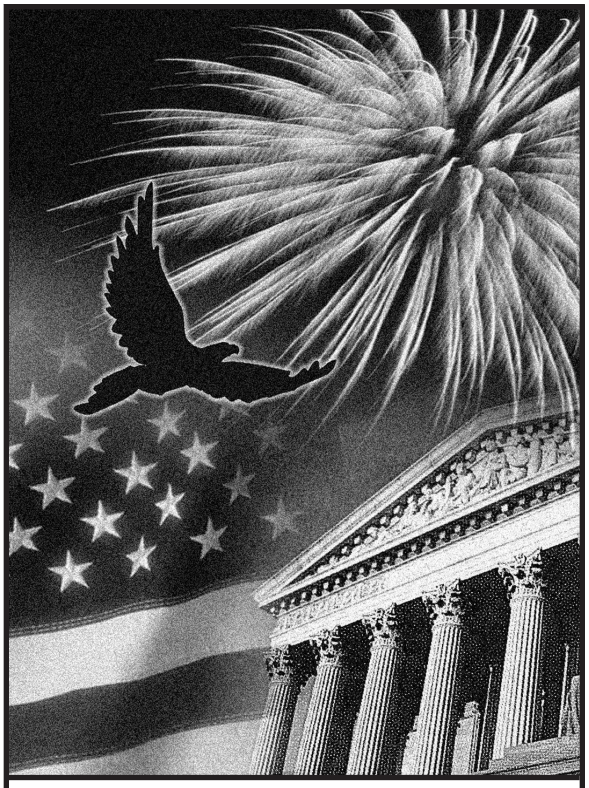
Investment Income and Expenses

(Including Capital Gains and Losses)

For use in preparing

2018 Returns

DRAFT AS OF March 15, 2019



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Future Developments

For the latest information about developments related to Pub. 550, such as legislation enacted after it was published, go to *IRS.gov/Pub550*.

What's New

Form 1040 redesigned. Form 1040 has been redesigned for 2018. See Form 1040 and its instructions for more information.

Forms 1040A and 1040EZ no longer available. Forms 1040A and 1040EZ are not available to file your 2018 taxes. See Form 1040 and its instructions for more information.

Capital gains invested in Qualified Opportunity Funds. You may be able to defer or exclude capital gains that you invest in Qualified Opportunity Funds. See section 1400Z-2, Form 8949 and its instructions, and *IRS.gov/Opportunity-Zones-Frequently-Asked-Questions*.

Like-kind exchanges limited to real property. Section 1031 allows you to defer recognizing gain or loss when you exchange property for like-kind property. Section 1031 was amended to apply only to the exchange of real property for real property of a like kind if both the real property disposed of by you and the real property received by you are held for productive use in a trade or business or for investment. The amendment does not apply if the property was disposed of by you or received by you before 2018. See section 1031.

Exclusion of gain on rollover of empowerment zone assets. The election to rollover gain on an empowerment zone asset has expired for 2018.

Rollovers into specialized small business investment companies (SSBICs). Tax-free rollover of publicly traded securities gain into SSBICs is not available for sales after 2017.

Miscellaneous itemized deductions suspended for tax years 2018 though 2025. Miscellaneous itemized deductions under section 67 are not allowed for tax years beginning after 2017 and before 2026. See section 67(g).

Overall limitation on itemized deductions suspended for tax years 2018 though 2025. The overall limitation on itemized deductions under section 68 does not apply for tax years beginning after 2017 and before 2026. See section 68(f).

Disaster relief. Relief is available for those affected by some disasters. See *IRS.gov/DisasterTaxRelief*.

Reminders

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

Employee stock options. If you received an option to buy or sell stock or other property as payment for your services, see Pub. 525, Taxable and Nontaxable Income, for the special tax rules that apply.

Photographs of missing children. The Internal Revenue Service is a proud partner with the *National Center for Missing & Exploited Children® (NCMEC)*. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling 800-THE-LOST (800-843-5678) if you recognize a child.

Introduction

This publication provides information on the tax treatment of investment income and expenses. It includes information on the tax treatment of investment income and expenses for individual shareholders of mutual funds or other regulated investment companies, such as money market funds. It explains what investment income is taxable and what investment expenses are deductible. It explains when and how to show these items on your tax return. It also explains how to determine and report gains and losses on the disposition of investment property and provides information on property trades and tax shelters.

TIP *The glossary at the end of this publication defines many of the terms used.*

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

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

Qualified retirement plans and IRAs. The rules in this publication do not apply to investments held in individual retirement arrangements (IRAs), section 401(k) plans, and other qualified retirement plans. The tax rules that apply to retirement plan distributions are explained in the following publications.

- Pub. 560, Retirement Plans for Small Business.
- Pub. 571, Tax-Sheltered Annuity Plans.
- Pub. 575, Pension and Annuity Income.
- Pub. 590-A, Contributions to Individual Retirement Arrangements (IRAs).
- Pub. 590-B, Distributions from Individual Retirement Arrangements (IRAs).
- Pub. 721, Tax Guide to U.S. Civil Service Retirement Benefits.

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

You can send us comments through *IRS.gov/FormComments*. Or you can write to:

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Although we can't respond individually to each comment received, we do appreciate your feedback and will consider your comments as we revise our tax forms, instructions, and publications.

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Tax questions. If you have a tax question not answered by this publication, check IRS.gov and *How To Get Tax Help* at the end of this publication.

DRAFT AS OF March 14, 2019

1. Investment Income

Topics

This chapter discusses:

- *Interest Income*,
- *Discount on Debt Instruments*,
- *When To Report Interest Income*,
- *How To Report Interest Income*,
- *Dividends and Other Distributions*,
- *How To Report Dividend Income*,
- *Stripped Preferred Stock*,
- *Real estate mortgage investment conduits (REMICs), financial asset securitization investment trusts (FASITs), and other collateralized debt obligations (CDOs)*,
- *S Corporations*, and
- *Investment Clubs*.

Useful Items

You may want to see:

Publication

- ❑ **525** Taxable and Nontaxable Income
- ❑ **537** Installment Sales
- ❑ **590-B** Distributions from Individual Retirement Arrangements (IRAs)
- ❑ **925** Passive Activity and At-Risk Rules
- ❑ **1212** Guide to Original Issue Discount (OID) Instruments

Form (and Instructions)

- ❑ **Schedule B (Form 1040)** Interest and Ordinary Dividends
- ❑ **Schedule D (Form 1040)** Capital Gains and Losses
- ❑ **1040** U.S. Individual Income Tax Return
- ❑ **1099** General Instructions for Certain Information Returns
- ❑ **2439** Notice to Shareholder of Undistributed Long-Term Capital Gains
- ❑ **3115** Application for Change in Accounting Method

- ❑ **6251** Alternative Minimum Tax — Individuals
- ❑ **8582** Passive Activity Loss Limitations
- ❑ **8615** Tax for Certain Children Who Have Unearned Income
- ❑ **8814** Parents' Election To Report Child's Interest and Dividends
- ❑ **8815** Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989
- ❑ **8818** Optional Form To Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989
- ❑ **8824** Like-Kind Exchanges
- ❑ **8949** Sales and Other Dispositions of Capital Assets
- ❑ **8960** Net Investment Income Tax—Individuals, Estates, and Trusts

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

General Information

A few items of general interest are covered here.

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

Net investment income tax (NIIT). You may be subject to the NIIT. The NIIT is a 3.8% tax on the lesser of your net investment income or the amount of your modified adjusted gross income (MAGI) that is over a threshold amount based on your filing status.

Filing Status	Threshold Amount
Married filing jointly	$250,000
Married filing separately	$125,000
Single	$200,000
Head of household (with qualifying person)	$200,000
Qualifying Widow(er) with dependent child	$250,000

For more information, see Form 8960, Net Investment Income Tax—Individuals, Estates, and Trusts, and the Instructions for Form 8960.

Tax on unearned income of certain children. Part of a child's 2018 unearned income may be taxed at the parent's tax rate. This may happen if all of the following are true.

1. The child had more than $2,100 of unearned income.
2. The child is required to file a tax return.
3. The child either:
   a. Was under age 18 at the end of 2018,
   b. Was age 18 at the end of 2018 and did not have earned income that was more than half of the child's support, or
   c. Was a full-time student at least age 19 and under age 24 at the end of 2018 and did not have earned income that was more than half of the child's support.
4. At least one of the child's parents was alive at the end of 2018.
5. The child does not file a joint return for 2018.

A child born on January 1, 2001, is considered to be age 18 at the end of 2018; a child born on January 1, 2000, is considered to be age 19 at the end of 2018; a child born on January 1, 1995, is considered to be age 24 at the end of 2018.

However, the parent can choose to include the child's interest and dividends on the parent's return if certain requirements are met. Use Form 8814, Parents' Election To Report Child's Interest and Dividends, for this purpose.

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

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

Social security number (SSN). You must give your name and SSN or individual tax identification number (ITIN) to any person required by federal tax law to make a return, statement, or other document that relates to you. This includes payers of interest and dividends. If you do not give your SSN or ITIN to the payer of interest, you may have to pay a penalty.

SSN for joint account. If the funds in a joint account belong to one person, list that person's name first on the account and give that person's SSN to the payer. (For information on who owns the funds in a joint account, see *Joint accounts*, later.) If the joint account contains combined funds, give the SSN of the person whose name is listed first on the account. This is because only one name and SSN can be shown on Form 1099.

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

Custodian account for your child. If your child is the actual owner of an account that is recorded in your name as custodian for the child, give the child's SSN to the payer. For example, you must give your child's SSN to the payer of dividends on stock owned by your child, even though the dividends are paid to you as custodian.

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

- Include your SSN on any return, statement, or other document;
- Give your SSN to another person who must include it on any return, statement, or other document; or
- Include the SSN of another person on any return, statement, or other document.

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

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

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

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

Backup withholding applies if:

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

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

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

- You failed to include any part of a reportable interest or dividend payment required to be shown on your return, or
- You were required to file a return and to include a reportable interest or dividend payment on that return, but you failed to file the return.

How to stop backup withholding due to underreporting. If you have been notified that

DRAFT AS OF March 15, 2019

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

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

Type of Income	If you file Form 1040, report on ...
Tax-exempt interest (Form 1099-INT, box 8)	Line 2a
Taxable interest that totals $1,500 or less	Line 2b (You may need to file Schedule B as well.)
Taxable interest that totals more than $1,500	Line 2b; also use Schedule B, line 1
Savings bond interest you will exclude because of higher education expenses	Schedule B; also use Form 8815
Ordinary dividends that total $1,500 or less	Line 3b (You may need to file Schedule B as well.)
Ordinary dividends that total more than $1,500	Line 3b; also use Schedule B, line 5
Qualified dividends (if you do not have to file Schedule D)	Line 3a; also use the Qualified Dividends and Capital Gain Tax Worksheet, line 2
Qualified dividends (if you have to file Schedule D)	Line 3a; also use the Qualified Dividends and Capital Gain Tax Worksheet or the Schedule D Tax Worksheet, line 2
Capital gain distributions (if you do not have to file Schedule D)	Schedule 1, line 13; also use the Qualified Dividends and Capital Gain Tax Worksheet, line 3
Capital gain distributions (if you have to file Schedule D)	Schedule D, line 13; also use the Qualified Dividends and Capital Gain Tax Worksheet or the Schedule D Tax Worksheet
Section 1250, 1202, or collectibles gain (Form 1099-DIV, box 2b, 2c, or 2d)	Form 8949 and Schedule D
Nondividend distributions (Form 1099-DIV, box 3)	Generally not reported*
Undistributed capital gains (Form 2439, boxes 1a–1d)	Schedule D
Gain or loss from sales of stocks or bonds	Schedule 1, line 13; also use Form 8949, Schedule D, and the Qualified Dividends and Capital Gain Tax Worksheet or the Schedule D Tax Worksheet
Gain or loss from exchanges of like-kind investment property	Schedule 1, line 13; also use Schedule D, Form 8824, and the Qualified Dividends and Capital Gain Tax Worksheet or the Schedule D Tax Worksheet

*Report any amounts in excess of your basis in your mutual fund shares on Form 8949. Use Part II if you held the shares more than 1 year. Use Part I if you held your mutual fund shares 1 year or less. For details on Form 8949, see *Reporting Capital Gains and Losses* in chapter 4, and the Instructions for Form 8949.

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

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

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

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

Reporting backup withholding. If backup withholding is deducted from your interest or dividend income or other reportable payment, the bank or other business must give you an information return for the year (for example, a Form 1099-INT) indicating the amount withheld. The information return will show any backup withholding as "Federal income tax withheld."

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

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

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

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

Community property states. If you are married and receive a distribution that is community income, half of the distribution generally is considered to be received by each spouse. If you file separate returns, you must each report one-half of any taxable distribution. See Pub. 555, Community Property, for more information on community income.

If the distribution is not considered community property and you and your spouse file separate returns, each of you must report your separate taxable distributions.

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

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

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

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

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

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

DRAFT AS OF March 15, 2019

Interest Income

Terms you may need to know (see Glossary):

- Accrual method
- Below-market loan
- Cash method
- Demand loan
- Forgone interest
- Gift loan
- Interest
- Mutual fund
- Nominee
- Original issue discount
- Private activity bond
- Term loan

DRAFT As of March 15, 2019

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

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

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

Report on your tax return the total interest income you receive for the tax year. See the Instructions for Form 1099-INT to see whether you need to adjust any of the amounts reported to you.

Interest not reported on Form 1099-INT. Even if you do not receive a Form 1099-INT, you must still report all of your interest income. For example, you may receive distributive shares of interest from partnerships or S corporations. This interest is reported to you on Schedule K-1 (Form 1065), Partner's Share of Income, Deductions, Credits, etc., and Schedule K-1 (Form 1120S), Shareholder's Share of Income, Deductions, Credits, etc.

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

If you receive a Form 1099-INT that includes amounts belonging to another person, see the discussion on *Nominee distributions*, later.

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

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

Exempt-interest dividends. Exempt-interest dividends you receive from a mutual fund or other regulated investment company, including those received from a qualified fund of funds in any tax year beginning after December 22, 2010, are not included in your taxable income. (However, see *Information reporting requirement*, next.) Exempt-interest dividends should be shown in box 10 of Form 1099-DIV. You do not reduce your basis for distributions that are exempt-interest dividends.

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

Note. Exempt-interest dividends on specified private activity bonds may be subject to the alternative minimum tax. The exempt-interest dividends subject to the alternative minimum tax are shown in box 11 of Form 1099-DIV. See Form 6251 and its instructions for more information about this tax. *Private activity bonds* are discussed later.

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

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

Taxable Interest—General

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

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

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

The "dividends" will be shown as interest income on Form 1099-INT.

Money market funds. Money market funds are offered by nonbank financial institutions such as mutual funds and stock brokerage houses, and pay dividends. Generally, amounts you receive from money market funds should be reported as dividends, not as interest.

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

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

Money borrowed to invest in certificate of deposit. The interest you pay on money borrowed from a bank or savings institution to meet the minimum deposit required for a certificate of deposit from the institution and the interest you earn on the certificate are two separate items. You must report the total interest you earn on the certificate in your income. If you itemize deductions, you can deduct the interest you pay as investment interest, up to the amount of your net investment income. See *Interest Expenses* in chapter 3.

Example. You deposited $5,000 with a bank and borrowed $5,000 from the bank to make up the $10,000 minimum deposit required to buy a 6-month certificate of deposit. The certificate earned $575 at maturity in 2018, but you received only $265, which represented the $575 you earned minus $310 interest charged on your $5,000 loan. The bank gives you a Form 1099-INT for 2018 showing the $575 interest you earned. The bank also gives you a statement showing that you paid $310 interest for 2018. You must include the $575 in your income. If you itemize your deductions on Schedule A (Form 1040), Itemized Deductions, you can deduct $310, subject to the net investment income limit.

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

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

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

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

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

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

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

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

Installment sale payments. If a contract for the sale or exchange of property provides for deferred payments, it also usually provides for interest payable with the deferred payments. Generally, that interest is taxable when you receive it. If little or no interest is provided for in a deferred payment contract, part of each payment may be treated as interest. See *Unstated Interest and Original Issue Discount (OID)* in Pub. 537.

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

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

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

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

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

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

If you receive a Form 1099-INT for interest income on deposits that were frozen at the end of 2018, see *Frozen deposits*, later, for information about reporting this interest income exclusion on your tax return.

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

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

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

Below-Market Loans

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

If you receive a below-market loan, you may be able to deduct the forgone interest as well as any interest you actually paid, but not if it is personal interest.

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

- Gift loans,
- Pay-related loans,
- Corporation-shareholder loans,
- Tax avoidance loans, and
- Certain loans made to qualified continuing care facilities under a continuing care contract.

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

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

Forgone interest. For any period, forgone interest is:

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

Applicable federal rate. Applicable federal rates are published by the IRS each month in the Internal Revenue Bulletin. The Internal Revenue Bulletin is available through *IRS.gov/IRB*. You also can find applicable federal rates in the Index of Applicable Federal Rates (AFR) Rulings at *IRS.gov/FederalRates*.

See chapter 5, *How To Get Tax Help*, for other ways to get this information.

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

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

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

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

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

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

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

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

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

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

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

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

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

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

Exception for loans to continuing care facilities. Loans to qualified continuing care facilities under continuing care contracts are not subject to the rules for below-market loans for the calendar year if the lender or the lender's spouse is age 62 or older at the end of the year. For the definitions of qualified continuing care facility and continuing care contract, see Internal Revenue Code section 7872(h).

Exception for loans without significant tax effect. Loans are excluded from the below-market loan rules if their interest arrangements do not have a significant effect on the federal tax liability of the borrower or the lender. These loans include:

1. Loans made available by the lender to the general public on the same terms and conditions that are consistent with the lender's customary business practice;
2. Loans subsidized by a federal, state, or municipal government that are made available under a program of general application to the public;
3. Certain employee-relocation loans;
4. Certain loans from a foreign person, unless the interest income would be effectively connected with the conduct of a U.S. trade or business and would not be exempt from U.S. tax under an income tax treaty;
5. Gift loans to a charitable organization, contributions to which are deductible, if the total outstanding amount of loans between the organization and lender is $250,000 or less at all times during the tax year; and
6. Other loans on which the interest arrangement can be shown to have no significant effect on the federal tax liability of the lender or the borrower.

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

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

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

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

U.S. Savings Bonds

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

U.S. savings bonds currently offered to individuals include Series EE bonds and Series I bonds.

For information about U.S. savings bonds, go to *www.treasurydirect.gov/indiv/indiv.htm*. Also go to *www.treasurydirect.gov/email.htm* and click on a topic to find answers to your questions by email.

If you prefer, write to:

For Series HH/H:

Series HH and Series H
Treasury Retail Securities Site
P.O. Box 2186
Minneapolis, MN 55480-2186

For Series EE and I paper savings bonds:

Series EE and Series I
Treasury Retail Securities Site
P.O. Box 214
Minneapolis, MN 55480-0214

For Series EE and I electronic bonds:

Series EE and Series I
Treasury Retail Securities Site
P.O. Box 7015
Minneapolis, MN 55480-7015

Accrual method taxpayers. If you use an accrual method of accounting, you must report interest on U.S. savings bonds each year as it accrues. You cannot postpone reporting interest until you receive it or until the bonds mature.

Cash method taxpayers. If you use the cash method of accounting, as most individual taxpayers do, you generally report the interest on U.S. savings bonds when you receive it. But see *Reporting options for cash method taxpayers*, later.

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

Series HH bonds were first offered in 1980 and last offered in August 2004. Before 1980, Series H bonds were issued. Series H bonds are treated the same as Series HH bonds. If you are a cash method taxpayer, you must report the interest when you receive it.

Series H bonds have a maturity period of 30 years. Series HH bonds mature in 20 years. The last Series H bonds matured in 2009. The last Series HH bonds will mature in 2024.

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

Series EE bonds. Series EE bonds were first offered in January 1980 and have a maturity period of 30 years. Before July 1980, Series E bonds were issued. The original 10-year maturity period of Series E bonds has been extended to 40 years for bonds issued before December 1965 and 30 years for bonds issued after November 1965. Paper Series EE bonds are issued at a discount. The face value is payable to you at maturity. Electronic Series EE bonds are issued at their face value. The face value plus accrued interest is payable to you at maturity. As of January 1, 2012, paper savings bonds are no longer sold at financial institutions.

Owners of paper Series EE bonds can convert them to electronic bonds. These converted bonds do not retain the denomination listed on the paper certificate but are posted at their purchase price (with accrued interest).

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

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

1. ***Method 1.*** Postpone reporting the interest until the earlier of the year you cash or dispose of the bonds or the year in which they mature. (However, see *Savings bonds traded*, later.)
   Note. Series EE bonds issued in 1988 matured in 2018. If you have used method 1, you generally must report the interest on these bonds on your 2018 return. The last Series E bonds were issued in 1980 and matured in 2010. If you used method 1, you generally should have reported the interest on these bonds on your 2010 return.
2. ***Method 2.*** Choose to report the increase in redemption value as interest each year.

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

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

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

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

Change from method 1. If you want to change your method of reporting the interest from method 1 to method 2, you can do so without permission from the IRS. In the year of change, you must report all interest accrued to date and not previously reported for all your bonds.

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

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

1. You have typed or printed the following number at the top: "131."
2. It includes your name and social security number under "131."
3. It includes the year of change (both the beginning and ending dates).
4. It identifies the savings bonds for which you are requesting this change.
5. It includes your agreement to:
   a. Report all interest on any bonds acquired during or after the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest; and
   b. Report all interest on the bonds acquired before the year of change when the interest is realized upon disposition, redemption, or final maturity, whichever is earliest, with the exception of the interest reported in prior tax years.

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

You can have an automatic extension of 6 months from the due date of your return for the year of change (excluding extensions) to file the statement with an amended return. On the statement, type or print "Filed pursuant to section 301.9100-2." To get this extension, you must have filed your original return for the year of the change by the due date (including extensions). See also Revenue Procedure 2015-13, Section 6.03(4).

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

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

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

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

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

Table 1-2. These rules are also shown in Table 1-2.

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

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

Unless your child is otherwise required to file a tax return for any year after making this choice, your child does not have to file a return only to report the annual accrual of U.S. savings bond interest under this choice. However, see *Tax on unearned income of certain children*, earlier, under *General Information*. Neither you nor your child can change the way you report the interest unless you request permission from the IRS, as discussed earlier under *Change from method 2*.

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

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

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

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

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

If bonds that you and a co-owner bought jointly are reissued to each of you separately in the same proportion as your contribution to the purchase price, neither you nor your co-owner has to report at that time the interest earned before the bonds were reissued.

Example 1. You and your spouse each spent an equal amount to buy a $1,000 Series EE savings bond. The bond was issued to you and your spouse as co-owners. You both

postpone reporting interest on the bond. You later have the bond reissued as two $500 bonds, one in your name and one in your spouse's name. At that time neither you nor your spouse has to report the interest earned to the date of reissue.

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

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

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

Decedents. The manner of reporting interest income on Series E, Series EE, or Series I bonds, after the death of the owner (decedent), depends on the accounting and income-reporting methods previously used by the decedent.

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

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

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

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

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

You are a cash method taxpayer and do not choose to report the interest each year as it is earned. If you cash the bond when it reaches maturity value of $1,000, you report $500 interest income—the difference between maturity value of $1,000 and the original cost of $500.

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

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

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

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

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

Savings bonds traded. If you postponed reporting the interest on your Series EE or Series E bonds, you did not recognize taxable income when you traded the bonds for Series HH or Series H bonds, unless you received cash in the trade. (You cannot trade Series I bonds for Series HH bonds. After August 31, 2004, you cannot trade any other series of bonds for Series HH bonds.) Any cash you received is income up to the amount of the interest earned on the bonds traded. When your Series HH or Series H bonds mature, or if you dispose of them before maturity, you report as interest the difference between their redemption value and your cost. Your cost is the sum of the amount you paid for the traded Series EE or Series E bonds plus any amount you had to pay at the time of the trade.

Example. You traded Series EE bonds (on which you postponed reporting the interest) for $2,500 in Series HH bonds and $223 in cash. You reported the $223 as taxable income on your tax return. At the time of the trade, the Series EE bonds had accrued interest of $523 and a redemption value of $2,723. You hold the Series HH bonds until maturity, when you receive $2,500. You must report $300 as interest income in the year of maturity. This is the difference between their redemption value, $2,500, and your cost, $2,200 (the amount you paid for the Series EE bonds). (It also is the difference between the accrued interest of $523 on the Series EE bonds and the $223 cash received on the trade.)

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

Form 1099-INT for U.S. savings bond interest. When you cash a bond, the bank or other payer that redeems it must give you a Form 1099-INT if the interest part of the payment you receive is $10 or more. Box 3 of your Form 1099-INT should show the interest as the difference between the amount you received and the amount paid for the bond. However, your Form 1099-INT may show more interest than you have to include on your income tax return. For example, this may happen if any of the following are true.

- You chose to report the increase in the redemption value of the bond each year. The

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interest shown on your Form 1099-INT will not be reduced by amounts previously included in income.

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

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

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

Education Savings Bond Program

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

You do not qualify for this exclusion if your filing status is married filing separately.

Form 8815. Use Form 8815 to figure your exclusion. Attach the form to your Form 1040.

Qualified U.S. savings bonds. A qualified U.S. savings bond is a Series EE bond issued after 1989 or a Series I bond. The bond must be issued either in your name (sole owner) or in your and your spouse's names (co-owners). You must be at least 24 years old before the bond's issue date. For example, a bond bought by a parent and issued in the name of his or her child under age 24 does not qualify for the exclusion by the parent or child.

CAUTION *The issue date of a bond may be earlier than the date the bond is purchased because the issue date assigned to a bond is the first day of the month in which it is purchased.*

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

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

Qualified expenses. Qualified higher educational expenses are tuition and fees required for you, your spouse, or your dependent to attend an eligible educational institution.

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

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

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

Reduction for certain benefits. You must reduce your qualified higher educational expenses by all of the following tax-free benefits.

1. Tax-free part of scholarships and fellowships.
2. Expenses used to figure the tax-free portion of distributions from a Coverdell ESA.
3. Expenses used to figure the tax-free portion of distributions from a qualified tuition program.
4. Any tax-free payments (other than gifts or inheritances) received as educational assistance, such as:
   a. Veterans' educational assistance benefits,
   b. Qualified tuition reductions, or
   c. Employer-provided educational assistance.
5. Any expense used in figuring the American Opportunity and lifetime learning credits.

For information about these benefits, see Pub. 970.

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

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

Example. In February 2018, Mark and Joan, a married couple, cashed qualified Series EE U.S. savings bonds with a total denomination of $10,000 that they bought in April 2002 for $5,000. They received proceeds of $7,244, representing principal of $5,000 and interest of $2,244. In 2018, they paid $4,000 of their daughter's college tuition. They are not claiming an education credit for that amount, and their daughter does not have any tax-free educational assistance. They can exclude $1,239 ($2,244 × ($4,000 ÷ $7,244)) of interest in 2018. They must pay tax on the remaining $1,005 ($2,244 – $1,239) interest.

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

If you previously reported any interest from savings bonds cashed during 2018, use the Alternate Line 6 Worksheet below instead.

Alternate Line 6 Worksheet

1.	Enter the amount from Form 8815, line 5	_____
2.	Enter the face value of all post-1989 paper Series EE bonds cashed in 2018	_____
3.	Multiply line 2 by 50% (0.50)	_____
4.	Enter the face value of all electronic Series EE bonds (including post-1989 Series EE bonds converted from paper to electronic format) and all Series I bonds cashed in 2018	_____
5.	Add lines 3 and 4	_____
6.	Subtract line 5 from line 1	_____
7.	Enter the amount of interest reported as income in previous years	_____
8.	Subtract line 7 from line 6. Enter the result here and on Form 8815, line 6	_____

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

- $119,300 to $149,300 for married taxpayers filing jointly, and
- $79,550 to $94,550 for all other taxpayers.

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

Modified AGI. Modified AGI, for purposes of this exclusion, is adjusted gross income (Form 1040, line 7) figured before the interest exclusion, and modified by adding back any:

1. Foreign earned income exclusion,
2. Foreign housing exclusion and deduction,
3. Exclusion of income for bona fide residents of American Samoa,
4. Exclusion for income from Puerto Rico,
5. Exclusion for adoption benefits received under an employer's adoption assistance program,
6. Deduction for tuition and fees,

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7. Deduction for student loan interest, and
8. Deduction for domestic production activities.

Use the Line 9 Worksheet in the Form 8815 instructions to figure your modified AGI. If you claim any of the exclusion or deduction items listed above (except items 6, 7, and 8), add the amount of the exclusion or deduction (except items 6, 7, and 8) to the amount on line 5 of the worksheet, and enter the total on Form 8815, line 9, as your modified AGI.

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

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

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

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

U.S. Treasury Bills, Notes, and Bonds

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

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

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

Treasury bills. These bills generally have a 4-week, 13-week, 26-week, or 52-week maturity period. They generally are issued at a discount in the amount of $100 and multiples of $100. The difference between the discounted price you pay for the bills and the face value you receive at maturity is interest income. Generally, you report this interest income when the bill is paid at maturity. If you paid a premium for a bill (more than face value), you generally report the premium as a section 171 deduction when the bill is paid at maturity. See *Discount on Short-Term Obligations*, later.

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

Treasury notes and bonds. Treasury notes have maturity periods of more than 1 year, ranging up to 10 years. Maturity periods for Treasury bonds are longer than 10 years. Both generally are issued in denominations of $100 to $1 million and both generally pay interest every 6 months. Generally, you report this interest for the year paid. When the notes or bonds mature, you can redeem these securities for face value or use the proceeds from the maturing note or bond to reinvest in another note or bond of the same type and term. If you do nothing, the proceeds from the maturing note or bond will be deposited in your bank account.

Treasury notes and bonds are sold by auction. Two types of bids are accepted: competitive bids and noncompetitive bids. If you make a competitive bid and a determination is made that the purchase price is less than the face value, you will receive a refund for the difference between the purchase price and the face value. This amount is considered original issue discount. However, the original issue discount rules (discussed later) do not apply if the discount is less than one-fourth of 1% (0.0025) of the face amount, multiplied by the number of full years from the date of original issue to maturity. See *De minimis OID*, later. If the purchase price is determined to be more than the face amount, the difference is a premium. (See *Bond Premium Amortization* in chapter 3.)

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

Treasury Retail Securities Site
P.O. Box 7015
Minneapolis, MN 55480-7015

Or, on the Internet, visit *www.treasurydirect.gov/indiv/indiv.htm*.

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

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

Bonds Sold Between Interest Dates

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

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

Insurance

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

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

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

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

State or Local Government Obligations

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

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

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Tax-Exempt Interest

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

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

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

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

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

Indian tribal government. Bonds issued after 1982 by an Indian tribal government (including tribal economic development bonds issued after February 17, 2009) are treated as issued by a state. Interest on these bonds generally is tax exempt if the bonds are part of an issue of which substantially all proceeds are to be used in the exercise of any essential government function. However, the essential government function requirement does not apply to tribal economic development bonds issued after February 17, 2009, for tax-exempt treatment. Interest on private activity bonds (other than certain bonds for tribal manufacturing facilities) is taxable.

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

For information on the treatment of OID when you dispose of a tax-exempt bond, see *Tax-exempt state and local government bonds*, later.

Stripped bonds or coupons. For special rules that apply to stripped tax-exempt obligations, see *Stripped Bonds and Coupons*, later.

Information reporting requirement. If you must file a tax return, you are required to show any tax-exempt interest you received on your return. This is an information reporting requirement only. It does not change tax-exempt interest to taxable interest. See *Reporting tax-exempt interest*, later in this chapter.

Taxable Interest

Interest on some state or local obligations is taxable.

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

- Bonneville Power Authority (if the guarantee was under the Northwest Power Act as in effect on July 18, 1984).
- Department of Veterans Affairs.
- Federal home loan banks. (The guarantee must be made after July 30, 2008, in connection with the original bond issue during the period beginning on July 30, 2008, and ending on December 31, 2010 (or a renewal or extension of a guarantee so made) and the bank must meet safety and soundness requirements.)
- Federal Home Loan Mortgage Corporation.
- Federal Housing Administration.
- Federal National Mortgage Association.
- Government National Mortgage Corporation.
- Resolution Funding Corporation.
- Student Loan Marketing Association.

Tax credit bonds. Tax credit bonds generally do not pay interest. Instead, the bondholder is allowed an annual tax credit. The credit compensates the holder for lending money to the issuer and functions as interest paid on the bond. Use Form 8912, Credit to Holders of Tax Credit Bonds, to claim the credit for the following tax credit bonds and to figure the amount of the credit to report as interest income.

- Clean renewable energy bond (CREB).
- New clean renewable energy bond (NCREB).
- Qualified energy conservation bond (QECB).
- Qualified zone academy bond (QZAB).
- Qualified school construction bond (QSCB).
- Build America bond (BAB).

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

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

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

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

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

Qualified bond. Interest on a private activity bond that is a qualified bond is tax exempt. A qualified bond is an exempt-facility bond (including an enterprise zone facility bond, a New York Liberty bond, a Midwestern disaster area bond, a Hurricane Ike disaster area bond, a Gulf Opportunity Zone bond treated as an exempt-facility bond, or any recovery zone facility bond issued after February 17, 2009, and before January 1, 2011), qualified student loan bond, qualified small issue bond (including a tribal manufacturing facility bond), qualified redevelopment bond, qualified mortgage bond (including a Gulf Opportunity Zone bond, a Midwestern disaster area bond, or a Hurricane Ike disaster area bond treated as a qualified mortgage bond), qualified veterans' mortgage bond, or qualified 501(c)(3) bond (a bond issued for the benefit of certain tax-exempt organizations).

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

The interest on the following bonds is not a tax preference item and is not subject to the alternative minimum tax.

- Qualified 501(c)(3) bonds.
- New York Liberty bonds.
- Gulf Opportunity Zone bonds.
- Midwestern disaster area bonds.
- Hurricane Ike disaster area bonds.
- Exempt facility bonds issued after July 30, 2008.
- Qualified mortgage bonds issued after July 30, 2008.
- Qualified veterans' mortgage bonds issued after July 30, 2008.

Qualified bonds issued in 2009 or 2010. The interest on any qualified bond issued in 2009 or 2010 is not a tax preference item and is not subject to the alternative minimum tax. For this purpose, a refunding bond (whether a current or advanced refunding) is treated as issued on the date the refunded bond was issued (or on the date the original bond was issued in the case of a series of refundings). However, this rule does not apply to any refunding bond issued to refund any qualified bond issued during 2004 through 2008 or after 2010.

Qualified bonds issued after December 31, 2010. A portion of the interest on specified private activity bonds issued after December 31, 2010, may be a tax preference item subject to the alternative minimum tax. The tax preference status will apply to the portion of the interest that remains after reducing it by deductions

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that would be allowed if the interest were taxable.

Enterprise zone facility bonds. Interest on certain private activity bonds issued by a state or local government to finance a facility used in an empowerment zone or enterprise community is tax exempt.

New York Liberty bonds. New York Liberty bonds are bonds issued after March 9, 2002, to finance the construction and rehabilitation of real property in the designated "Liberty Zone" of New York City. Interest on these bonds issued before 2014 is tax exempt.

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

For more information on the treatment of market discount when you dispose of a tax-exempt bond, see *Discounted Debt Instruments*, later.

Discount on Debt Instruments

Terms you may need to know (see Glossary):

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

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

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

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

Original Issue Discount (OID)

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

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

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

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

For information about the sale of a debt instrument with OID, see *Original issue discount (OID) on debt instruments*, later.

De minimis OID. You can treat the discount as zero if it is less than one-fourth of 1% (0.0025) of the stated redemption price at maturity multiplied by the number of full years from the date of original issue to maturity. This small discount is known as "de minimis" OID. In the case of a debt instrument providing for more than one stated principal payment (an installment obligation), the "de minimis" formula described above is modified. See Regulations section 1.1273-1(d)(3).

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

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

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

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

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

Form 1099-OID

The issuer of the debt instrument (or your broker, if you held the instrument through a broker) should give you Form 1099-OID, or a similar statement, if the total OID for the calendar year is $10 or more. Form 1099-OID will show, in box 1, the amount of OID for the part of the year that you held the bond. It also will show, in box 2, the stated interest you must include in your income. Box 8 shows OID on a U.S. Treasury obligation for the part of the year you owned it and is not included in box 1. Box 10 shows bond premium amortization. A copy of Form 1099-OID will be sent to the IRS. Do not file your copy with your return. Keep it for your records.

In most cases, you must report the entire amount in boxes 1, 2, and 8 of Form 1099-OID as interest income. But see *Refiguring OID shown on Form 1099-OID*, later in this discussion, and also *Original issue discount (OID) adjustment*, later in this chapter, for more information.

Form 1099-OID not received. If you had OID for the year but did not receive a Form 1099-OID, you may have to figure the correct amount of OID to report on your return. See Pub. 1212 for details on how to figure the correct OID.

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

If you receive a Form 1099-OID that includes amounts belonging to another person, see *Nominee distributions*, later.

Refiguring OID shown on Form 1099-OID. You may need to refigure the OID shown in box 1 or box 8 of Form 1099-OID if either of the following apply.

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

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See *Original issue discount (OID) adjustment*, later in this chapter, for information about reporting the correct amount of OID.

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

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

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

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

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

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

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

Applying the OID Rules

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

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

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

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

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

Certificates of Deposit (CDs)

If you buy a CD with a maturity of more than 1 year, you must include in income each year a part of the total interest due and report it in the same manner as other OID.

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

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

Bearer CDs. CDs issued after 1982 generally must be in registered form. Bearer CDs are CDs not in registered form. They are not issued in the depositor's name and are transferable from one individual to another.

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

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

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

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

Face-Amount Certificates

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

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

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

Inflation-Indexed Debt Instruments

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

Stripped Bonds and Coupons

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

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

Stripped bonds and stripped coupons include:

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

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

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

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

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

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

You must refigure OID shown on the Form 1099-OID you receive for a stripped bond or coupon. For information about figuring the correct amount of OID on these instruments to include in your income, see *Figuring OID on Stripped Bonds and Coupons* in Pub. 1212. Owners of stripped bonds and coupons should not rely on the OID shown in Section II of the OID tables (available by going to *IRS.gov* and searching for "OID Tables") because the amounts listed in Section II for stripped bonds or coupons are figured without reference to the date or price at which you acquired them.

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

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

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

Market Discount Bonds

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

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

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

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

- You must treat any gain when you dispose of the bond as ordinary interest income, up to the amount of the accrued market discount. See *Discounted Debt Instruments*, later.
- You must treat any partial payment of principal on the bond as ordinary interest income, up to the amount of the accrued market discount. See *Partial principal payments*, later in this discussion.
- If you borrow money to buy or carry the bond, your deduction for interest paid on the debt is limited. See *Limit on interest deduction for market discount bonds*, later.

Market discount. Market discount is the amount of the stated redemption price of a bond at maturity that is more than your basis in the bond immediately after you acquire it. You treat market discount as zero if it is less than one-fourth of 1% (0.0025) of the stated redemption price of the bond multiplied by the number of full years to maturity (after you acquire the bond).

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

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

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

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

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

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

Constant yield method. Instead of using the ratable accrual method, you can choose to figure the accrued discount using a constant interest rate (the constant yield method). Make this choice by attaching to your timely filed return a statement identifying the bond and stating that you are making a constant interest rate election. The choice takes effect on the date you acquired the bond. If you choose to use this method for any bond, you cannot change your choice for that bond.

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

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

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

Once you make this choice, it will apply to all market discount bonds you acquire during the tax year and in later tax years. You cannot revoke your choice without the consent of the IRS. For information on how to revoke your choice, see section 30 of Revenue Procedure 2018-31 in Internal Revenue Bulletin 2018-22. You can find this revenue procedure at *IRS.gov/irb/2018-31_IRB*.

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

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

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

There are three methods you can use to figure accrued market discount for this purpose.

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

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

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

Discount on Short-Term Obligations

When you buy a short-term obligation (one with a fixed maturity date of 1 year or less from the date of issue), other than a tax-exempt

obligation, you generally can choose to include any discount and interest payable on the obligation in income currently. If you do not make this choice, the following rules generally apply.

- You must treat any gain when you sell, exchange, or redeem the obligation as ordinary income, up to the amount of the ratable share of the discount. See *Discounted Debt Instruments*, later.
- If you borrow money to buy or carry the obligation, your deduction for interest paid on the debt is limited. See *Limit on interest deduction for short-term obligations*, later.

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

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

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

Figuring the accrued discount. Figure the accrued discount by using either the ratable accrual method or the constant yield method discussed in *Accrued market discount*, earlier.

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

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

Nongovernment obligations. For an obligation listed above that is not a government obligation, the amount you include in your income for the current year is the accrued OID, if any, plus any other accrued interest payable. If you choose the constant yield method to figure accrued OID, apply it by using the obligation's issue price.

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

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

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

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

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

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

Election To Report All Interest as OID

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

When To Report Interest Income

Terms you may need to know (see Glossary):

Accrual method
Cash method

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

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

Example. On September 1, 2016, you loaned another individual $2,000 at 4% compounded annually. You are not in the business of lending money. The note stated that principal and interest would be due on August 31, 2018. In 2018, you received $2,163.20 ($2,000 principal and $163.20 interest). If you use the cash method, you must include in income on your 2018 return the $163.20 in interest you received in that year.

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

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

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

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

Example. If, in the previous example, you use an accrual method, you must include the interest in your income as you earn it. You would report the interest as follows: 2016, $26.67; 2017, $81.06; and 2018, $55.47.

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

How To Report Interest Income

Terms you may need to know (see Glossary):

Nominee
Original issue discount (OID)

Generally, you report all your taxable interest income on Form 1040, line 2b.

If your taxable interest income is more than $1,500, you must use Form 1040.

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Form 1040. You must use Form 1040 instead if:

1. You forfeited interest income because of the early withdrawal of a time deposit;
2. You acquired taxable bonds after 1987, you choose to reduce interest income from the bonds by any amortizable bond premium, and you are deducting the excess of bond premium amortization for the accrual period over the qualified stated interest for the period (discussed in chapter 3 under *Bond Premium Amortization*); or
3. You received tax-exempt interest from private activity bonds issued after August 7, 1986.

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

1. Your taxable interest income is more than $1,500.
2. You are claiming the interest exclusion under the *Education Savings Bond Program* (discussed earlier).
3. You received interest from a seller-financed mortgage, and the buyer used the property as a home.
4. You received a Form 1099-INT for U.S. savings bond interest that includes amounts you reported in a previous tax year.
5. You received, as a nominee, interest that actually belongs to someone else.
6. You received a Form 1099-INT for interest on frozen deposits.
7. You received a Form 1099-INT for interest on a bond you bought between interest payment dates.
8. You are reporting OID in an amount less than the amount shown on Form 1099-OID.
9. Statement (2) in the preceding list is true.

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

Reporting tax-exempt interest. Total your tax-exempt interest (such as interest or accrued OID on certain state and municipal bonds, including zero coupon municipal bonds) reported on Form 1099-INT, box 8, and exempt-interest dividends from a mutual fund or other regulated investment company reported on Form 1099-DIV, box 10. Add these amounts to any other tax-exempt interest you received. Report the total on line 2a of Form 1040.

Form 1099-INT, box 9, and Form 1099-DIV, box 11, show the tax-exempt interest subject to the alternative minimum tax on Form 6251. These amounts already are included in the amounts on Form 1099-INT, box 8, and Form 1099-DIV, box 10. Do not add the amounts in Form 1099-INT, box 9, and Form 1099-DIV, box 11, to, or subtract them from, the amounts on Form 1099-INT, box 8, and Form 1099-DIV, box 10.

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

Form 1099-INT. Your taxable interest income, except for interest from U.S. savings bonds and Treasury obligations, is shown in box 1 of Form 1099-INT. Add this amount to any other taxable interest income you received. See the Instructions for Form 1099-INT if you have interest from a security acquired at a premium. You must report all your taxable interest income even if you do not receive a Form 1099-INT. Contact your financial institution if you do not receive a Form 1099-INT by February 15. Your identifying number may be truncated on any paper Form 1099-INT you receive.

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

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

Box 4 of Form 1099-INT will contain an amount if you were subject to backup withholding. Include the amount from box 4 on Form 1040, line 16.

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

If there are entries in boxes 6 and 7 of Form 1099-INT, you must file Form 1040. You may be able to take a credit for the amount shown in box 6 unless you deduct this amount on line 8 of Schedule A (Form 1040). To take the credit, you may have to file Form 1116, Foreign Tax Credit. For more information, see Pub. 514, Foreign Tax Credit for Individuals.

For a covered security, if you made an election under section 1278(b) to include market discount in income as it accrues and you notified your payer of the election, box 10 shows the market discount that accrued on the debt instrument during the year while held by you. Report this amount on your income tax return as directed in the Instructions for Form 1040.

For a covered security, box 11 shows the amount of premium amortization for the year, unless you notified the payer in writing in accordance with Regulations section 1.6045-1(n)(5) that you did not want to amortize bond premium under section 171. If an amount is reported in this box, see the Instructions for Schedule B (Form 1040). If an amount is not reported in this box for a covered security acquired at a premium, the payer has reported a net amount of interest in box 1, 3, 8, or 9, whichever is applicable. If the amount in this box is greater than the amount of interest paid on the covered security, see Regulations section 1.171-2(a)(4).

Form 1099-OID. The taxable OID on a discounted obligation for the part of the year you owned it is shown in box 1 of Form 1099-OID. Include this amount in your total taxable interest income. But see *Refiguring OID shown on Form 1099-OID*, earlier. Your identifying number may be truncated on any paper Form 1099-OID you receive.

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

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

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

Box 4 of Form 1099-OID will contain an amount if you were subject to backup withholding. Report the amount from box 4 on Form 1040, line 16.

Box 9 of Form 1099-OID shows investment expenses you may be able to deduct as an itemized deduction. Chapter 3 discusses investment expenses.

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

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

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

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

In March 2018, you redeemed one of the bonds — a $1,000 Series EE bond. The bond was originally issued in March 1999. When you redeemed the bond, you received $1,027.20 for it.

The Form 1099-INT you received shows interest income of $527.20. However, since the interest on your savings bonds was reported yearly, you need only include the $4.00 interest that accrued from January 2018 to March 2018.

On Schedule B (Form 1040), Part I, line 1, enter your interest income as shown on Form 1099-INT — $527.20. (If you had other taxable interest income, you would enter it next and then enter a subtotal, as described earlier, before going to the next step.) Several lines above line 2, enter "U.S. Savings Bond Interest Previously Reported" and enter $523.20 ($527.20 – $4.00). Subtract $523.20 from $527.20 and enter $4.00 on line 2. Enter $4.00 on Schedule B (Form 1040), line 4.

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

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

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

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

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

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

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

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

Example. You received a distribution of Series EE U.S. savings bonds in December 2015 from your company's profit-sharing plan.

In March 2018, you redeemed a $100 Series EE bond that was part of the distribution you received in 2015. You received $74.72 for the bond the company bought in May 2001. The value of the bond at the time of distribution in 2015 was $72.40. (This is the amount you included on your 2015 return.) The bank gave you a Form 1099-INT that shows $24.72 interest (the total interest from the date the bond was purchased to the date of redemption). Since a part of the interest was included in your income in 2015, you need to include in your 2018 income only the interest that accrued after the bond was distributed to you.

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

A.	Enter the amount of cash received upon redemption of the bond	$74.72
B.	Enter the value of the bond at the time of distribution by the plan	$72.40
C.	Subtract the amount on line B from the amount on line A. This is the amount of interest accrued on the bond since it was distributed by the plan	$2.32
D.	Enter the amount of interest shown on your Form 1099-INT	$24.72
E.	Subtract the amount on line C from the amount on line D. This is the amount you include in "U.S. Savings Bond Interest Previously Reported"	$22.40

Subtract $22.40 from the subtotal and enter the result on Schedule B (Form 1040), line 2. You then complete the rest of the form.

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

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

You must show your total interest from qualified savings bonds you cashed during 2018 on Form 8815, line 6, and on Schedule B (Form 1040). After completing Form 8815, enter the result from line 14 (Form 8815) on Schedule B (Form 1040), line 3.

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

You also must give your name, address, and SSN (or EIN) to the buyer. If you do not, you may have to pay a $50 penalty.

Frozen deposits. Even if you receive a Form 1099-INT for interest on deposits that you could not withdraw at the end of 2018, you must exclude these amounts from your gross income. (See *Interest income on frozen deposits*, earlier.) Do not include this income on line 2b of Form 1040. On Schedule B (Form 1040), Part I, include the full amount of interest shown on your Form 1099-INT on line 1. Several lines above line 2, put a subtotal of all interest income. Below this subtotal, enter "Frozen Deposits" and show the amount of interest that you are excluding. Subtract this amount from the subtotal and enter the result on line 2.

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

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

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

File Form 1099-INT with the IRS. If you received interest as a nominee in 2018, you must file a Form 1099-INT for that interest with the IRS. Send Copy A of Form 1099-INT with a Form 1096, Annual Summary and Transmittal of U.S. Information Returns, to your Internal Revenue Service Center by February 28, 2019 (April 1, 2019, if you file Form 1099-INT electronically). Give the actual owner of the interest Copy B of the Form 1099-INT by January 31, 2019. On Form 1099-INT, you should be listed as the "Payer." Prepare one Form 1099-INT for each other owner and show that person as the "Recipient." However, you do not have to file Form 1099-INT to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see the General Instructions for Certain Information Returns.

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

Example. You and your sister have a joint savings account that paid $1,500 interest for 2018. Your sister deposited 30% of the funds in this account, and you and she have agreed to share the yearly interest income in proportion to the amount each of you has invested. Because your SSN was given to the bank, you received a Form 1099-INT for 2018 that includes the interest income earned belonging to your sister. This amount is $450, or 30% of the total interest of $1,500.

You must give your sister a Form 1099-INT by January 31, 2019, showing $450 of interest income she earned for 2018. You also must send a copy of the nominee Form 1099-INT, along with Form 1096, to the Internal Revenue Service Center by February 28, 2019 (April 2, 2019, if you file Form 1099-INT electronically). Show your own name, address, and SSN as that of the "Payer" on the Form 1099-INT. Show your sister's name, address, and SSN in the

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blocks provided for identification of the "Recipient."

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

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

Penalty on early withdrawal of savings. If you withdraw funds from a certificate of deposit or other deferred interest account before maturity, you may be charged a penalty. The Form 1099-INT or similar statement given to you by the financial institution will show the total amount of interest in box 1 and will show the penalty separately in box 2. You must include in income all interest shown in box 1. You can deduct the penalty on Form 1040, line 7. Deduct the entire penalty even if it is more than your interest income.

Dividends and Other Distributions

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

The most common kinds of distributions are:

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

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

Form 1099-DIV. Most corporations use Form 1099-DIV to show you the distributions you received from them during the year. Keep this form with your records. You do not have to attach it to your tax return. Your identifying number may be truncated on any paper Form 1099-DIV you receive.

Dividends not reported on Form 1099-DIV. Even if you do not receive a Form 1099-DIV, you must still report all your taxable dividend income. For example, you may receive distributive shares of dividends from partnerships or S corporations. These dividends are reported to you on Schedule K-1 (Form 1065) and Schedule K-1 (Form 1120S).

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

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

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

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

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

Dividends received in January. If a mutual fund (or other regulated investment company) or real estate investment trust (REIT) declares a dividend (including any exempt-interest dividend or capital gain distribution) in October, November, or December, payable to shareholders of record on a date in one of those months but actually pays the dividend during January of the next calendar year, you are considered to have received the dividend on December 31. You report the dividend in the year it was declared.

Ordinary Dividends

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

Qualified Dividends

Qualified dividends are the ordinary dividends subject to the same 0%, 15%, or 20% maximum tax rate that applies to net capital gain. They should be shown in box 1b of the Form 1099-DIV you receive.

The maximum rate of tax on qualified dividends is:

- 0% on any amount that otherwise would be taxed at a 10% or 15% rate,
- 15% on any amount that otherwise would be taxed at rates greater than 15% but less than 37%, and
- 20% on any amount that otherwise would be taxed at a 37% rate.

To qualify for the maximum rate, all of the following requirements must be met.

- The dividends must have been paid by a U.S. corporation or a qualified foreign corporation. (See *Qualified foreign corporation*, later.)
- The dividends are not of the type listed later under *Dividends that are not qualified dividends*.
- You meet the holding period (discussed next).

Holding period. You must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date. The ex-dividend date is the first date following the declaration of a dividend on which the buyer of a stock is not entitled to receive the next dividend payment. When counting the number of days you held the stock, include the day you disposed of the stock, but not the day you acquired it. See the examples below.

Exception for preferred stock. In the case of preferred stock, you must have held the stock more than 90 days during the 181-day period that begins 90 days before the ex-dividend date if the dividends are due to periods totaling more than 366 days. If the preferred dividends are due to periods totaling less than 367 days, the holding period in the preceding paragraph applies.

Example 1. You bought 5,000 shares of XYZ Corp. common stock on July 5, 2018. XYZ Corp. paid a cash dividend of 10 cents per share. The ex-dividend date was July 12, 2018. Your Form 1099-DIV from XYZ Corp. shows $500 in box 1a (ordinary dividends) and in box 1b (qualified dividends). However, you sold the 5,000 shares on August 8, 2018. You held your shares of XYZ Corp. for only 34 days of the 121-day period (from July 6, 2018, through August 8, 2018). The 121-day period began on May 13, 2018 (60 days before the ex-dividend date), and ended on September 10, 2018. You have no qualified dividends from XYZ Corp. because you held the XYZ stock for less than 61 days.

Example 2. Assume the same facts as in *Example 1* except that you bought the stock on July 11, 2018 (the day before the ex-dividend date), and you sold the stock on September 13, 2018. You held the stock for 63 days (from July 12, 2018, through September 13, 2018). The $500 of qualified dividends shown in box 1b of your Form 1099-DIV are all qualified dividends because you held the stock for 61 days of the 121-day period (from July 12, 2018, through September 13, 2018).

Example 3. You bought 10,000 shares of ABC Mutual Fund common stock on July 5, 2018. ABC Mutual Fund paid a cash dividend of 10 cents per share. The ex-dividend date was July 12, 2018. The ABC Mutual Fund advises you that the portion of the dividend eligible to be treated as qualified dividends equals 2 cents

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per share. Your Form 1099-DIV from ABC Mutual Fund shows total ordinary dividends of $1,000 and qualified dividends of $200. However, you sold the 10,000 shares on August 8, 2018. You have no qualified dividends from ABC Mutual Fund because you held the ABC Mutual Fund stock for less than 61 days.

Holding period reduced where risk of loss is diminished. When determining whether you met the minimum holding period discussed earlier, you cannot count any day during which you meet any of the following conditions.

1. You had an option to sell, were under a contractual obligation to sell, or had made (and not closed) a short sale of substantially identical stock or securities.
2. You were grantor (writer) of an option to buy substantially identical stock or securities.
3. Your risk of loss is diminished by holding one or more other positions in substantially similar or related property.

For information about how to apply condition (3), see Regulations section 1.246-5.

Qualified foreign corporation. A foreign corporation is a qualified foreign corporation if it meets any of the following conditions.

1. The corporation is incorporated in a U.S. possession.
2. The corporation is eligible for the benefits of a comprehensive income tax treaty with the United States that the Department of the Treasury determines is satisfactory for this purpose and that includes an exchange of information program. For a list of those treaties, see Table 1-3.
3. The corporation does not meet (1) or (2) above, but the stock for which the dividend is paid is readily tradable on an established securities market in the United States. See *Readily tradable stock*, later.

Exception. A corporation is not a qualified foreign corporation if it is a passive foreign investment company during its tax year in which the dividends are paid or during its previous tax year.

Controlled foreign corporation (CFC). Dividends paid out of a CFC's earnings and profits that were not previously taxed are qualified dividends if the CFC is otherwise a qualified foreign corporation and the other requirements in this discussion are met. Certain dividends paid by a CFC that would be treated as a passive foreign investment company but for section 1297(d) of the Internal Revenue Code may be treated as qualified dividends. For more information, see Notice 2004-70, which can be found at *IRS.gov/irb/2004-44_IRB/ar09.html*.

Readily tradable stock. Any stock or American depositary receipt in respect of that stock is considered to satisfy requirement (3) under *Qualified foreign corporation*, if it is listed on a national securities exchange that is registered under section 6 of the Securities Exchange Act of 1934 or on the Nasdaq Stock Market. For a list of the exchanges that meet these requirements, see *www.sec.gov/divisions/marketreg/mrexchanges.shtml*.

Table 1-3. **Income Tax Treaties**

Income tax treaties that the United States has with the following countries satisfy requirement (2) under *Qualified foreign corporation*.

Armenia	Ireland	Slovenia
Australia	Israel	South Africa
Austria	Italy	Spain
Azerbaijan	Jamaica	Sri Lanka
Bangladesh	Japan	Sweden
Barbados	Kazakhstan	Switzerland
Belarus	Korea	Tajikistan
Belgium	Kyrgyzstan	Thailand
Bulgaria	Latvia	Trinidad and Tobago
Canada	Lithuania	Tunisia
China	Luxembourg	Turkey
Cyprus	Malta	Turkmenistan
Czech Republic	Mexico	Ukraine
Denmark	Moldova	Union of Soviet Socialist Republics (USSR)
Egypt	Morocco	United Kingdom
Estonia	Netherlands	United States Model
Finland	New Zealand	Uzbekistan
France	Norway	Venezuela
Georgia	Pakistan	
Germany	Philippines	
Greece	Poland	
Hungary	Portugal	
Iceland	Romania	
India	Russia	
Indonesia	Slovak Republic	

Dividends that are not qualified dividends. The following dividends are not qualified dividends. They are not qualified dividends even if they are shown in box 1b of Form 1099-DIV.

- Capital gain distributions.
- Dividends paid on deposits with mutual savings banks, cooperative banks, credit unions, U.S. building and loan associations, U.S. savings and loan associations, federal savings and loan associations, and similar financial institutions. Report these amounts as interest income.
- Dividends from a corporation that is a tax-exempt organization or farmer's cooperative during the corporation's tax year in which the dividends were paid or during the corporation's previous tax year.
- Dividends paid by a corporation on employer securities held on the date of record by an employee stock ownership plan (ESOP) maintained by that corporation.
- Dividends on any share of stock to the extent you are obligated (whether under a short sale or otherwise) to make related payments for positions in substantially similar or related property.
- Payments in lieu of dividends, but only if you know or have reason to know the payments are not qualified dividends.
- Payments shown on Form 1099-DIV, box 1b, from a foreign corporation to the extent you know or have reason to know the payments are not qualified dividends.

Dividends Used To Buy More Stock

The corporation in which you own stock may have a dividend reinvestment plan. This plan lets you choose to use your dividends to buy (through an agent) more shares of stock in the corporation instead of receiving the dividends in cash. Most mutual funds also permit shareholders to automatically reinvest distributions in more shares in the fund, instead of receiving cash. If you use your dividends to buy more stock at a price equal to its fair market value, you must still report the dividends as income.

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

You also must report as dividend income any service charge subtracted from your cash dividends before the dividends are used to buy the additional stock. But you may be able to deduct the service charge.

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

Money Market Funds

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

Capital Gain Distributions

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

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

Qualified Opportunity Fund. Effective December 22, 2017, IRC 1400Z-2 provides a temporary deferral of inclusion in gross income for capital gains invested in Qualified Opportunity Funds, and permanent exclusion of capital gains from the sale or exchange of an investment in the Qualified Opportunity Fund if the investment is held for at least 10 years. See

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Form 8949 instructions on how to report your election to defer eligible gains invested in a Qualified Opportunity Fund. For additional information, please see Opportunity Zones Frequently Asked Questions available at www.irs.gov/newsroom/opportunity-zones-frequently-asked-questions.

Undistributed capital gains of mutual funds and REITs. Some mutual funds and REITs keep their long-term capital gains and pay tax on them. You must treat your share of these gains as distributions, even though you did not actually receive them. However, they are not included on Form 1099-DIV. Instead, they are reported to you in box 1a of Form 2439.

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

- Unrecaptured section 1250 gain (box 1b),
- Gain from qualified small business stock (section 1202 gain, box 1c), or
- Collectibles (28%) gain (box 1d).

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

The tax paid on these gains by the mutual fund or REIT is shown in box 2 of Form 2439.

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

Nondividend Distributions

A nondividend distribution is a distribution that is not paid out of the earnings and profits of a corporation or a mutual fund. You should receive a Form 1099-DIV or other statement showing you the nondividend distribution. On Form 1099-DIV, a nondividend distribution will be shown in box 3. If you do not receive such a statement, you report the distribution as an ordinary dividend.

Basis adjustment. A nondividend distribution reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. This nontaxable portion also is called a return of capital; it is a return of your investment in the stock of the company. If you buy stock in a corporation in different lots at different times, and you cannot definitely identify the shares subject to the nondividend distribution, reduce the basis of your earliest purchases first.

When the basis of your stock has been reduced to zero, report any additional nondividend distribution you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period* in chapter 4.

Example 1. You bought stock in 2005 for $100. In 2008, you received a nondividend distribution of $80. You did not include this amount in your income, but you reduced the basis of your stock to $20. You received a nondividend distribution of $30 in 2018. The first $20 of this amount reduced your basis to zero. You report the other $10 as a long-term capital gain for 2018. You must report as a long-term capital gain any nondividend distribution you receive on this stock in later years.

Example 2. You bought shares in XYZ Mutual Fund in 2014 for $12 per share. In 2015, you received a nondividend distribution of $5 per share. You reduced your basis in each share by $5 to an adjusted basis of $7. In 2016, you received a nondividend distribution of $1 per share and further reduced your basis in each share to $6. In 2017, you received a nondividend distribution of $2 per share. Your basis was reduced to $4 per share. In 2018, the nondividend distribution from the mutual fund was $5 per share. You reduce your basis in each share to zero and report $1 of gain. See the Instructions for Form 8949 for details and more information.

TIP *For more information on Form 8949 and Schedule D (Form 1040), see Reporting Capital Gains and Losses in chapter 4. Also, see the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040).*

Liquidating Distributions

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

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

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

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

Distributions of Stock and Stock Rights

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

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

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

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

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

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

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

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

For stock issued before October 10, 1990, you include the redemption premium in your income ratably over the period during which the stock cannot be redeemed. For stock issued after October 9, 1990, you include the redemption premium on the basis of its economic accrual

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over the period during which the stock cannot be redeemed, as if it were original issue discount on a debt instrument. See *Original Issue Discount (OID)*, earlier in this chapter.

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

1. The stock was issued before October 10, 1990 (before December 20, 1995, if redeemable solely at the option of the issuer), and the redemption premium is "reasonable." (For stock issued before October 10, 1990, only the part of the redemption premium that is not "reasonable" is a constructive distribution.) The redemption premium is reasonable if it is not more than 10% of the issue price on stock not redeemable for 5 years from the issue date or is in the nature of a penalty for making a premature redemption.
2. The stock was issued after October 9, 1990 (after December 19, 1995, if redeemable solely at the option of the issuer), and the redemption premium is de minimis. The redemption premium is de minimis if it is less than one-fourth of 1% (0.0025) of the redemption price multiplied by the number of full years from the date of issue to the date redeemable.
3. The stock was issued after October 9, 1990, and must be redeemed at a specified time or is redeemable at your option, but the redemption is unlikely because it is subject to a contingency outside your control (not including the possibility of default, insolvency, etc.).
4. The stock was issued after December 19, 1995, and is redeemable solely at the option of the issuer, but the redemption premium is in the nature of a penalty for premature redemption or redemption is not more likely than not to occur. The redemption will be treated under a "safe harbor" as not more likely than not to occur if all of the following are true.
   a. You and the issuer are not related under the rules discussed in chapter 4 under *Losses on Sales or Trades of Property*, substituting "20%" for "50%."
   b. There are no plans, arrangements, or agreements that effectively require or are intended to compel the issuer to redeem the stock.
   c. The redemption would not reduce the stock's yield.

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

Fractional shares. You may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which fractional shares are not issued but instead are sold, and the cash proceeds are given to the shareholders. Any cash you receive for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. Report this transaction on Form 8949. Enter your gain or loss, the difference between the cash you receive and the basis of the fractional shares sold, in column (h) of Schedule D (Form 1040) in Part I or Part II, whichever is appropriate.

CAUTION *Report these transactions on Form 8949 with the correct box checked.*

For more information on Form 8949 and Schedule D (Form 1040), see *Reporting Capital Gains and Losses* in chapter 4. Also see the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040).

Example. You own one share of common stock that you bought on January 3, 2009, for $100. The corporation declared a common stock dividend of 5% on June 30, 2018. The fair market value of the stock at the time the stock dividend was declared was $200. You were paid $10 for the fractional-share stock dividend under a plan described in the discussion above. You figure your gain or loss as follows.

Fair market value of old stock	$200.00
Fair market value of stock dividend (cash received)	+ 10.00
Fair market value of old stock and stock dividend	$210.00
Basis (cost) of old stock after the stock dividend (($200 ÷ $210) × $100)	$95.24
Basis (cost) of stock dividend (($10 ÷ $210) × $100)	+ 4.76
Total	$100.00
Cash received	$10.00
Basis (cost) of stock dividend	– 4.76
Gain	$5.24

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

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

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

Other Distributions

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

Exempt-interest dividends. Exempt-interest dividends you receive from a mutual fund or other regulated investment company, including those received from a qualified fund of funds in any tax year beginning after December 22, 2010, are not included in your taxable income. (However, see *Information reporting requirement*, next.) Exempt-interest dividends should be shown in box 10 of Form 1099-DIV.

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

Alternative minimum tax treatment. Exempt-interest dividends paid from specified private activity bonds may be subject to the alternative minimum tax. The exempt-interest dividends subject to the alternative minimum tax should be shown in box 11 of Form 1099-DIV. See Form 6251 and its instructions for more information.

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

If dividends on an insurance contract (other than a modified endowment contract) are distributed to you, they are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract. (For information on the treatment of a distribution from a modified endowment contract, see *Distribution Before Annuity Starting Date From a Nonqualified Plan* under *Taxation of Nonperiodic Payments* in Pub. 575.) Report any taxable distributions on insurance policies on Form 1040, line 6.

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

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

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

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

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

Alaska Permanent Fund dividends. Do not report these amounts as dividends. Instead, include these amounts on Form 1040, line 6.

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How To Report Dividend Income

Terms you may need to know (see Glossary):

Nominee
Restricted stock

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Generally, you can use Form 1040 to report your dividend income. Report the total of your ordinary dividends on line 3b of Form 1040. Report qualified dividends on line 3a.

If you receive capital gain distributions, you may have to use Form 1040. See *Capital gain distributions*, later. If you receive nondividend distributions required to be reported as capital gains, you must use Form 1040.

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

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

Form 1040. You must complete Schedule B (Form 1040), Part II, and attach it to your Form 1040, if:

- Your ordinary dividends (Form 1099-DIV, box 1a) are more than $1,500, or
- You received, as a nominee, dividends that actually belong to someone else.

If your ordinary dividends are more than $1,500, you also must complete Schedule B (Form 1040), Part III.

List on Schedule B (Form 1040), Part II, line 5, each payer's name and the ordinary dividends you received. If your securities are held by a brokerage firm (in "street name"), list the name of the brokerage firm shown on Form 1099-DIV as the payer. If your stock is held by a nominee who is the owner of record, and the nominee credited or paid you dividends on the stock, show the name of the nominee and the dividends you received or for which you were credited.

Enter on line 6 the total of the amounts listed on line 5. (However, if you hold stock as a nominee, see *Nominees*, later.) Also enter this total on line 3b of Form 1040.

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

Your employer should include these dividends in the wages shown on your Form W-2, Wage and Tax Statement. If you also get a Form 1099-DIV for these dividends, list them on Schedule B (Form 1040), line 5, with the other dividends you received. Enter a subtotal of all your dividend income several lines above line 6. Below the subtotal, enter "Dividends on restricted stock reported as wages on Form 1040, line 1," and enter the dividends included in your wages on line 1 of Form 1040. Subtract this amount from the subtotal and enter the result on line 6.

Election. You can choose to include the value of restricted stock in gross income as pay for services. If you make this choice, report the dividends on the stock like any other dividends. List them on Part II, line 5, of Schedule B (Form 1040), along with your other dividends (if the amount of ordinary dividends received from all sources is more than $1,500). If you receive both a Form 1099-DIV and a Form W-2 showing these dividends, do not include the dividends in your wages reported on line 1 of Form 1040. Attach a statement to your Form 1040 explaining why the amount shown on line 1 of your Form 1040 is different from the amount shown on your Form W-2.

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

Qualified dividends. Report qualified dividends (Form 1099-DIV, box 1b) on line 3a of Form 1040. The amount in box 1b is already included in box 1a. Do not add the amount in box 1b to, or subtract it from, the amount in box 1a. Do not include any of the following on line 3a.

- Qualified dividends you received as a nominee. See *Nominees*, later.
- Dividends on stock for which you did not meet the holding period. See *Holding period*, earlier, under *Qualified Dividends*.
- Dividends on any share of stock to the extent you are obligated (whether under a short sale or otherwise) to make related payments for positions in substantially similar or related property.
- Payments in lieu of dividends, but only if you know or have reason to know the payments are not qualified dividends.
- Payments shown on Form 1099-DIV, box 1b, from a foreign corporation to the extent you know or have reason to know the payments are not qualified dividends.

If you have qualified dividends, you must figure your tax by completing the Qualified Dividends and Capital Gain Tax Worksheet in the Form 1040 instructions or the Schedule D Tax Worksheet in the Schedule D (Form 1040) instructions, whichever applies. Enter qualified dividends on line 2 of the worksheet.

Investment interest deducted. If you claim a deduction for investment interest, you may have to reduce the amount of your qualified dividends that are eligible for the 0%, 15%, or 20% tax rate. Reduce it by the qualified dividends you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on the Qualified Dividends and Capital Gain Tax Worksheet or the Schedule D Tax Worksheet. For more information about the limit on investment interest, see *Interest Expenses* in chapter 3.

Capital gain distributions. If you received capital gain distributions, you report them directly on Form 1040, line 6; or on Schedule D (Form 1040), line 13, depending on your situation. If you received capital gain distributions from a mutual fund or real estate investment trust (REIT), the distributions of net realized short-term capital gains are not treated as capital gains. Instead, they are included on Form 1099-DIV as ordinary dividends. Report them on your tax return as ordinary dividends.

Exceptions to filing Form 8949 and Schedule D (Form 1040). There are certain situations where you may not have to file Form 8949 and/or Schedule D (Form 1040).

Exception 1. You do not have to file Form 8949 or Schedule D (Form 1040) if you have no capital losses and your only capital gains are capital gain distributions from Form(s) 1099-DIV, box 2a. (If any Form(s) 1099-DIV you receive have an amount in box 2b (unrecaptured section 1250 gain), box 2c (section 1202 gain), or box 2d (collectibles (28%) gain), you do not qualify for this exception.) If you qualify for this exception, report your capital gain distributions directly on line 6 of Form 1040 (and check the box on line 13). Also use the Qualified Dividends and Capital Gain Tax Worksheet in the Form 1040 instructions to figure your tax.

Exception 2. You must file Schedule D (Form 1040), but generally do not have to file Form 8949, if *Exception 1* does not apply and your only capital gains and losses are:

- Capital gain distributions;
- A capital loss carryover;
- A gain from Form 2439, Form 6252, Installment Sale Income, or Part I of Form 4797, Sales of Business Property;
- A gain or loss from Form 4684, Casualties and Thefts, Form 6781, Gains and Losses From Section 1256 Contracts and Straddles, or Form 8824;
- A gain or loss from a partnership, S corporation, estate, or trust; or
- Gains and losses from transactions for which you received a Form 1099-B that shows basis was reported to the IRS and for which you do not need to make any adjustments in column (g) of Form 8949 or enter any codes in column (f) of Form 8949.

Undistributed capital gains. To report undistributed capital gains, you must complete Schedule D (Form 1040) and attach it to your return. Report these gains on Schedule D (Form 1040), line 11, column (h), and attach Copy B of Form 2439 to your return. Report the tax paid by the mutual fund on these gains on Form 1040, line 17, and check box a on that line.

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

- Unrecaptured section 1250 gain (Form 1099-DIV, box 2b), or

- Section 1202 gain (Form 1099-DIV, box 2c).

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

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

Nondividend distributions. Report nondividend distributions (box 3 of Form 1099-DIV) only after your basis in the stock has been reduced to zero. After the basis of your stock has been reduced to zero, you must show this excess amount in Form 8949, Part I, if you held the stock 1 year or less. Show it in Form 8949, Part II, if you held the stock for more than 1 year. Enter the name of the company in column (a) of Form 8949. Report the amount of the excess distribution in column (d) and your zero basis in column (e) of Form 8949.

Report these transactions on Form 8949 with the correct box checked.

For more information on Form 8949 and Schedule D (Form 1040), see *Reporting Capital Gains and Losses* in chapter 4. Also see the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040).

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

If you received a capital gain distribution or were allocated an undistributed capital gain as a nominee, report only the amount that belongs to you on Form 1040, line 6; or Schedule D (Form 1040), line 13, whichever is appropriate. Attach a statement to your return showing the full amount you received or were allocated and the amount you received or were allocated as a nominee.

File Form 1099-DIV with the IRS. If you received dividends as a nominee in 2018, you must file a Form 1099-DIV (or Form 2439) for those dividends with the IRS. Send the Form 1099-DIV with a Form 1096 to your Internal Revenue Service Center by February 28, 2019 (April 1, 2019, if you file Form 1099-DIV electronically). Give the actual owner of the dividends Copy B of the Form 1099-DIV by January 31, 2019. On Form 1099-DIV, you should be listed as the "Payer." The other owner should be listed as the "Recipient." You do not, however, have to file a Form 1099-DIV to show payments for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see the General Instructions for Certain Information Returns and the Instructions for Form 2439.

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

Stripped Preferred Stock

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

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

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

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

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

Report these amounts as other income on Form 1040, line 6. For information about OID, see *Original Issue Discount (OID)*, earlier.

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

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

REMICs, FASITs, and Other CDOs

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

REMICs

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

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

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

Regular Interest

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

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

Generally, you report your income from a regular interest on line 2b of Form 1040. For more information on how to report interest and OID, see *How To Report Interest Income*, earlier.

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

Forms 1099-INT and 1099-OID. You should receive a copy of Form 1099-INT or Form 1099-OID from the REMIC. See the General Instructions for Certain Information Returns for information on when you should receive your copy of Form 1099-INT or Form 1099-OID and a written statement providing additional information. The statement should contain enough information to enable you to figure your accrual of market discount or amortizable bond premium.

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

Form 1099-OID shows OID and interest, if any, that accrued to you for the period you held

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the regular interest. You will not need to make any adjustments to the amounts reported even if you held the regular interest for only a part of the calendar year. However, if you bought the regular interest at a premium or acquisition premium, see *Refiguring OID shown on Form 1099-OID*, earlier.

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

Pub. 938 is available only on the Internet at *IRS.gov/FormsPubs/*.

If you hold a regular interest or CDO through a nominee (rather than directly), you can request the information from the nominee.

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

The single-class REMIC will report your share of its investment expenses in box 5 of Form 1099-INT or box 9 of Form 1099-OID.

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

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

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

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

Residual Interest

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

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

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

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

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

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

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

Collateralized Debt Obligations (CDOs)

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

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

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

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

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

Generally, you report your income from a CDO on line 2b of Form 1040. For more information about reporting these amounts on your return, see *How To Report Interest Income*, earlier.

Forms 1099-INT and 1099-OID. You should receive a copy of Form 1099-INT or Form 1099-OID. See the General Instructions for Certain Information Returns for information on when you should receive your copy of Form 1099-INT or Form 1099-OID and a written statement providing additional information. The statement should contain enough information about the CDO to enable you to figure your accrual of market discount or amortizable bond premium.

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

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

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

FASITs

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

A regular interest in a FASIT is treated as a debt instrument. The rules described under *Collateralized Debt Obligations (CDOs)*, earlier, apply to a regular interest in a FASIT, except that a holder of a regular interest in a FASIT must use an accrual method of accounting to report OID and interest income.

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

CAUTION *Beginning January 1, 2005, the special rules for FASITs are repealed. However, the special rules still apply to any FASIT in existence on October 22, 2004, to the extent that regular interests issued by the FASIT before that date continue to remain outstanding in accordance with the original terms of issuance.*

S Corporations

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

If you are an S corporation shareholder, your share of the corporation's current year income or loss and other tax items are taxed to you whether or not you receive any amount.

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Generally, those items increase or decrease the basis of your S corporation stock as appropriate. For more information on basis adjustments for S corporation stock, see *Stocks and Bonds*, later.

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

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

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

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

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

Passive activity losses. Rules apply that limit losses from passive activities. Your copy of Schedule K-1 (Form 1120S) and its instructions will explain the limits and tell you where on your return to report your share of S corporation items from passive activities.

Form 8582. If you have a passive activity loss from an S corporation, you must complete Form 8582 to figure the allowable loss to enter on your return. See Pub. 925 for more information.

Investment Clubs

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

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

Identifying number. Each club must have an EIN to use when filing its return. The club's EIN also may have to be given to the payer of dividends or other income from investments recorded in the club's name. To obtain an EIN, apply online at *IRS.gov/Businesses/Small-Businesses-&-Self-Employed/Apply-for-an-Employer-Identification-Number-(EIN)-Online* or file Form SS-4, Application for Employer Identification Number. See chapter 5, *How To Get Tax Help*, for more information about how to get this form.

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

Tax Treatment of the Club

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

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

Club as a Partnership

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

Filing requirement. If your investment club is treated as a partnership, it must file Form 1065, U.S. Return of Partnership Income. However, as a partner in the club, you must report on your individual return your share of the club's income, gains, losses, deductions, and credits for the club's tax year. (Its tax year generally must be the same tax year as that of the partners owning a majority interest.) You must report these items whether or not you actually receive any distribution from the partnership.

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

The club's expenses for producing or collecting income, for managing investment property, or for determining any tax are listed separately on Schedule K-1 (Form 1065).

For more information about reporting your income from a partnership, see the Schedule K-1 (Form 1065) instructions. Also see Pub. 541, Partnerships.

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

No social security coverage for investment club earnings. If an investment club partnership's activities are limited to investing in savings certificates, stock, or securities, and collecting interest or dividends for its members' accounts, a member's share of income is not earnings from self-employment. You cannot voluntarily pay the self-employment tax to increase your social security coverage and ultimate benefits.

Club as a Corporation

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

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

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

Filing requirement. If your club is taxed as a corporation, it must file Form 1120, U.S. Corporation Income Tax Return. In that case, you do not report any of its income or expenses on your individual return. All ordinary income and expenses and capital gains and losses must be reported on the Form 1120. Any distribution the club makes that qualifies as a dividend must be reported on Form 1099-DIV if total distributions to the shareholder are $10 or more for the year.

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

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

For more information about corporations, see Pub. 542, Corporations.

Club as a Trust

In a few cases, an investment club is taxed as a trust. In general, a trust is an arrangement through which trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. An arrangement is

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treated as a trust for tax purposes if its purpose is to vest in trustees responsibility for protecting and conserving property for beneficiaries who cannot share in that responsibility and so are not associates in a joint enterprise for the conduct of business for profit. If you need more information about trusts, see Regulations section 301.7701-4.

Filing requirement. If your club is taxed as a trust, it must file Form 1041, U.S. Income Tax Return for Estates and Trusts. You should receive a copy of Schedule K-1 (Form 1041) from the trust. Report the amounts shown on Schedule K-1 (Form 1041) on the appropriate lines and schedules of your income tax return.

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2. Tax Shelters and Other Reportable Transactions

Introduction

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

Topics

This chapter discusses:

- *Abusive Tax Shelters*,
- *Rules To Curb Abusive Tax Shelters*,
- *Investor Reporting*,
- *Penalties*, and
- *Whether To Invest*.

Useful Items

You may want to see:

Publication

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

Form (and Instructions)

- ❑ **8275** Disclosure Statement
- ❑ **8275-R** Regulation Disclosure Statement
- ❑ **Section B (Form 8283)** Information on Donated Property Over $5,000
- ❑ **8886** Reportable Transaction Disclosure Statement

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

Abusive Tax Shelters

Abusive tax shelters are marketing schemes involving artificial transactions with little or no economic reality. They often make use of unrealistic allocations, inflated appraisals, losses in connection with nonrecourse loans, mismatching of income and deductions, financing techniques that do not conform to standard commercial business practices, or mischaracterization of the substance of the transaction. Despite appearances to the contrary, the taxpayer generally risks little.

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

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

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

Rules To Curb Abusive Tax Shelters

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

Disclosure of reportable transactions. You must disclose information for each reportable transaction in which you participate. See *Reportable Transaction Disclosure Statement*, later.

Material advisors with respect to any reportable transaction must disclose information about the transaction on Form 8918, Material Advisor Disclosure Statement. To determine whether you are a material advisor to a transaction, see the Instructions for Form 8918.

Material advisors will receive a reportable transaction number for the disclosed reportable transaction. They must provide this number to all persons to whom they acted as a material advisor. They must provide the number at the time the transaction is entered into. If they do not have the number at that time, they must provide it within 60 days from the date the number is mailed to them. For information on penalties for failure to disclose and failure to maintain lists, see Internal Revenue Code sections 6707, 6707A, and 6708.

Requirement to maintain list. Material advisors must maintain a list of persons to whom they provide material aid, assistance, or advice on any reportable transaction. The list must be available for inspection by the IRS, and the information required to be included on the list generally must be kept for 7 years. See Regulations section 301.6112-1 for more information (including what information is required to be included on the list).

Confidentiality privilege. The confidentiality privilege between you and a federally authorized tax practitioner does not apply to written communications made after October 21, 2004, regarding the promotion of your direct or indirect participation in any tax shelter.

Appraisal requirement for donated property. If you claim a deduction of more than $5,000 for an item or group of similar items of donated property, you generally must get a qualified appraisal from a qualified appraiser and complete and attach Section B (Form 8283) to your return. If you claim a deduction of more than $500,000 for the donated property, you generally must attach the qualified appraisal to your return. See Pub. 561 for information about appraisals.

Passive activity loss and credit limits. The passive activity loss and credit rules limit the amount of losses and credits that can be claimed from passive activities and limit the amount that can offset nonpassive income, such as certain portfolio income from

investments. See Pub. 925 for information about income, losses, and credits from passive activities.

Interest on penalties. If you are assessed an accuracy-related or civil fraud penalty (as discussed under *Penalties*, later), interest will be imposed on the amount of the penalty from the due date of the return (including any extensions) to the date you pay the penalty.

Accounting method restriction. Tax shelters generally cannot use the cash method of accounting.

Uniform capitalization rules. The uniform capitalization rules generally apply to producing property or acquiring it for resale. Under those rules, the direct cost and part of the indirect cost of the property must be capitalized or included in inventory. See Pub. 538 for uniform capitalization rules.

Denial of deduction for interest on an underpayment due to a reportable transaction. You cannot deduct any interest you paid or accrued on any part of an underpayment of tax due to an understatement arising from a reportable transaction (discussed later) if the relevant facts affecting the tax treatment of the item are not adequately disclosed. This rule applies to reportable transactions entered into in tax years beginning after October 22, 2004.

Authority for Disallowance of Tax Benefits

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

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

Investor Reporting

You may be required to file a reportable transaction disclosure statement.

Reportable Transaction Disclosure Statement

Use Form 8886 to disclose information for each reportable transaction (discussed later) in which you participated. Generally, you must attach Form 8886 to your return for each tax year in which you participated in the transaction. Under certain circumstances, a transaction must be disclosed within 90 days of the transaction being identified as a listed transaction or a transaction of interest (discussed later). In addition, for the first year Form 8886 is attached to your return, you must send a copy of the form to:

Internal Revenue Service
OTSA Mail Stop 4915
1973 Rulon White Blvd.
Ogden, UT 84201

If you file your return electronically, the copy sent to The Office of Tax Shelter Analysis (OTSA) must show exactly the same information, word for word, provided with the electronically filed return and it must be provided on the official IRS Form 8886 or an exact copy of the form. If you use a computer-generated or substitute Form 8886, it must be an exact copy of the official IRS form.

If you fail to file Form 8886 as required or fail to include any required information on the form, you may have to pay a penalty. See *Penalty for failure to disclose a reportable transaction*, later.

The following discussion briefly describes reportable transactions. For more details, see the Instructions for Form 8886.

Reportable transaction. A reportable transaction is any of the following.

- A listed transaction.
- A confidential transaction.
- A transaction with contractual protection.
- A loss transaction.
- A transaction of interest entered into after November 1, 2006.

Note. Transactions with a brief asset holding period were removed from the definition of reportable transaction for transactions entered into after August 2, 2007.

Listed transaction. A listed transaction is the same as, or substantially similar to, one of the types of transactions the IRS has determined to be a tax-avoidance transaction. These transactions have been identified in notices, regulations, and other published guidance issued by the IRS. For a list of existing guidance, see Notice 2009-59 in Internal Revenue Bulletin 2009-31, available at *IRS.gov/irb/2009-31_IRB/ar07.html*. See *Updates on reportable transactions*, later, for updates on listed transactions.

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 your realizing the tax benefits from the transaction. For information on exceptions, see Revenue Procedure 2007-20 in Internal Revenue Bulletin 2007-7, available at *IRS.gov/irb/2007-07_IRB/ar15.html*.

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 Internal Revenue Code 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 in Internal Revenue Bulletin 2013-2, available at *IRS.gov/irb/2013-02_IRB/ar09.html*. 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 form of published guidance as a transaction of interest. The IRS has identified the following transactions of interest.

- "Toggling" grantor trusts as described in Notice 2007-73, 2007-36 I.R.B. 545, available at *IRS.gov/irb/2007-36_IRB/ar20.html*.
- Certain transactions involving contributions of a successor member interest in a limited liability company as described in Notice 2007-72, 2007-36 I.R.B. 544, available at *IRS.gov/irb/2007-36_IRB/ar19.html*.
- Certain transactions involving the sale or other disposition of all interests in a charitable remainder trust and claiming little or no taxable gain as described in Notice 2008-99, 2008-47 I.R.B. 1194, available at *IRS.gov/irb/2008-47_IRB/ar11.html*.
- Certain transactions involving a U.S. taxpayer owning controlled foreign corporations (CFCs) that hold stock of a lower-tier CFC through a domestic partnership to avoid reporting income as described in Notice 2009-7, 2009-3 I.R.B. 312, available at *IRS.gov/irb/2009-03_IRB/ar10.html*.
- Certain transactions denominated as an option, notional principal contract, forward contract, or other derivative contract ("basket contracts") to receive a return based on the performance of a basket of referenced assets in an attempt to deliver income recognition and/or convert short-term capital gain and ordinary income to long-term capital gain as described in Notice 2015-74, 2015-46 I.R.B. 663, available at *IRS.gov/irb/2015-46_IRB/ar10.html*.
- Transactions in which a taxpayer attempts to reduce aggregate taxable income of the taxpayer or related parties using contracts that the parties treat as insurance contracts and a related company the parties

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treat as a captive insurance company ("section 831(b) micro-captive") as described in Notice 2016-66, 2016-47 I.R.B. 745, available at IRS.gov/irb/2016-47_IRB/ar07.html, as modified by Notice 2017-8, 2017-3 I.R.B. 423, available at IRS.gov/irb/2017-03_IRB/ar12.html.

Updates on reportable transactions. For updates on listed transactions, loss transactions, and transactions of interest, go to IRS.gov/Businesses/Corporations/Abusive-Tax-Shelters-and-Transactions.

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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 be faced with payment of more tax, 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 misstatement (increased to 40% for gross valuation misstatement),
- Transaction lacking economic substance (increased to 40% for undisclosed transaction lacking economic substance), or
- Undisclosed foreign financial asset understatement (40% in all cases).

Except for a transaction lacking economic substance, this penalty will not be imposed if you can show you had reasonable cause for any understatement of tax and that you acted in good faith. Your failure to disclose a reportable transaction is a strong indication that you failed to act in good faith.

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

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. 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.

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 (discussed 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.

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

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 all 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.

CAUTION *Any excessive amount of an erroneous claim for an income tax refund or credit that results from a transaction found to be lacking economic substance will not be treated as having a reasonable cause and could be subject to a 20% penalty.*

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 Internal Revenue Code section 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.

CAUTION *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 as discussed 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 (discussed earlier) 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). 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. You may not have to pay the 20% penalty if you meet the strengthened reasonable cause and good faith exception. The reasonable cause and good faith exception does not apply to any part of a reportable transaction understatement attributable to one or more transactions that lack economic substance.

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, an investor can be penalized with up to a 25% addition to tax if the failure to pay continues.

Whether To Invest

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

3. Investment Expenses

Terms you may need to know (see Glossary):

At-risk rules
Passive activity
Portfolio income

Topics

This chapter discusses:

- *Limits on Deductions*,
- *Interest Expenses*,
- *Bond Premium Amortization*,
- *Nondeductible Interest Expenses*,
- *How To Report Investment Interest Expenses*, and
- *When To Report Investment Expenses*.

Useful Items

You may want to see:

Publication

❑ **535** Business Expenses

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

❑ **929** Tax Rules for Children and Dependents

Form (and Instructions)

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

❑ **4952** Investment Interest Expense Deduction

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 interest.

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

- 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.

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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) and real estate investment trusts.

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

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

- 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 4 of Pub. 535.

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

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

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

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

Example 2. Assume in *Example 1* that you borrowed the money on March 1 and immediately bought the stock for $8,000. You did not buy the household items until June 1. You had deposited the $2,000 in the bank. You had no other transactions on the bank account 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 ÷ $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 4 of Pub. 535.

When To Deduct Investment Interest

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

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

Example. You borrowed $1,000 on August 22, 2018, payable in 90 days at 4% interest. On November 21, 2018, you paid this with a new note for $1,010, due on February 20, 2019. If you use the cash method of accounting, you cannot deduct any part of the $10 interest on your return for 2018 because you did not actually pay it. If you use an accrual method, you may be able to deduct a portion of the interest on the loans through December 31, 2018, on your return for 2018.

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

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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*, earlier.

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. This generally includes your gross income from property held for investment (such as interest, dividends, annuities, and royalties). Investment income does not include Alaska Permanent Fund dividends. 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.

TIP *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 son has interest income of $2,200, which you choose to report on your own return. You enter $2,200 on Form 8814, lines 1a and 4, and $100 on lines 6 and 12, and complete Part II. Also enter $100 on Schedule 1 (Form 1040), line 21. 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 $3,900 on Form 8814, lines 6 and 12, and Schedule 1 (Form 1040), line 21. You figure the amount of your child's income that you can consider your investment income as follows.

$$\$3{,}900 - (\$3{,}900 \times (\$2{,}000 \div \$6{,}000)) = \$2{,}600$$

You include the result, $2,600, 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 Schedule 1 (Form 1040), line 13) generally does not count as investment income. However, you can choose to include all or part of it in investment income, as explained in *Choosing to include net capital gain*, earlier.

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

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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	$6,800
Deductible investment interest expense for the year	$6,800

The $2,000 of income from the passive activity is not used in determining Ted's net investment income. His investment interest deduction 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 2017.

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, 2017, you bought a taxable bond for $110,000. The bond has a stated principal amount of $100,000, payable at maturity on February 1, 2024, 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, 2018, 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.

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Bonds Issued Before September 28, 1985

For these bonds, you can amortize bond premium using any reasonable method. Reasonable methods include:

- The straight-line method, and
- The Revenue Ruling 82-10 method.

Straight-line method. Under this method, the amount of your bond premium amortization is the same each month. Divide the number of months you held the bond during the year by the number of months from the beginning of the tax year (or, if later, the date of acquisition) to the date of maturity or earlier call date. Then multiply the result by the bond premium (reduced by any bond premium amortization claimed in earlier years). This gives you your bond premium amortization for the year.

Revenue Ruling 82-10 method. Under this method, the amount of your bond premium amortization increases each month over the life of the bond. This method is explained in Revenue Ruling 82-10, 1982-1 C.B. 46.

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 2017-30 in Internal Revenue Bulletin 2017-18. You can find Revenue Procedure 2017-30 at *IRS.gov/irb/2017-18_IRB/ar04.html*.

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

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

Interest expense and carrying charges on straddles. You cannot deduct interest and carrying charges 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 in *Payments in lieu of dividends*, later.

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.

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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, are considered to be indirect deductions 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, 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.

TIP *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 2018 by February 15, 2019. 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 Assests. If you sold a covered security in 2018, 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.

TIP *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.

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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 generally is 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.

CAUTION *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 1040X, Amended U.S. Individual Income Tax Return, to amend your return for the year the security became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. (Claims not due to worthless securities or bad debts generally must be filed within 3

years from the date a return is filed, or 2 years from the date the tax is paid, whichever is later.) For more information about filing a claim, see Pub. 556.

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/irs-irbs/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 generally must treat it as sold at its fair market value on the last business day of the tax year.

Section 1256 Contract

A section 1256 contract is any:

- 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).

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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.

60/40 rule. Under the marked-to-market system, 60% of your capital gain or loss will be treated as a long-term capital gain or loss, and 40% will be treated as a short-term capital gain or loss. This is true regardless of how long you actually held the property.

Example. On June 16, 2017, you bought a regulated futures contract for $50,000. On December 29, 2017 (the last business day of your tax year), the fair market value of the contract was $57,000. You recognized a $7,000 gain on your 2017 tax return. You treated 60% of the gain as long-term capital gain and 40% as short-term capital gain.

On February 2, 2018, you sold the contract for $56,000. Because you recognized a $7,000 gain on your 2017 return, you recognize a $1,000 loss ($57,000 – $56,000) on your 2018 tax return, treated as 60% long-term and 40% short-term capital loss.

Limited partners or entrepreneurs. The 60/40 rule does not apply to dealer equity options or dealer securities futures contracts that result in capital gain or loss allocable to limited partners or limited entrepreneurs (defined later under *Hedging Transactions*). Instead, these gains or losses are treated as short term.

Terminations and transfers. The marked-to-market rules also apply if your obligation or rights under section 1256 contracts are terminated or transferred during the tax year. In this case, use the fair market value of each section 1256 contract at the time of termination or transfer to determine the gain or loss. Terminations or transfers may result from any offsetting, delivery, exercise, assignment, or lapse of your obligation or rights under section 1256 contracts.

Loss carryback election. An individual having a net section 1256 contracts loss (defined later), generally can elect to carry this loss back 3 years instead of carrying it over to the next year. See *How To Report*, later, for information about reporting this election on your return.

The loss carried back to any year under this election cannot be more than the net section 1256 contracts gain in that year. In addition, the amount of loss carried back to an earlier tax year cannot increase or produce a net operating loss for that year.

The loss is carried to the earliest carryback year first, and any unabsorbed loss amount can then be carried to each of the next 2 tax years. In each carryback year, treat 60% of the carryback amount as a long-term capital loss and 40% as a short-term capital loss from section 1256 contracts.

If only a portion of the net section 1256 contracts loss is absorbed by carrying the loss back, the unabsorbed portion can be carried forward, under the capital loss carryover rules, to the year following the loss. For more information, see *Capital Losses*, later. Figure your capital loss carryover as if, for the loss year, you had an additional short-term capital gain of 40% of the amount of net section 1256 contracts loss absorbed in the carryback years and an additional long-term capital gain of 60% of the absorbed loss. In the carryover year, treat any capital loss carryover from losses on section 1256 contracts as if it were a loss from section 1256 contracts for that year.

Net section 1256 contracts loss. This loss is the lesser of:

- The net capital loss for your tax year determined by taking into account only the gains and losses from section 1256 contracts, or
- The capital loss carryover to the next tax year determined without this election.

Net section 1256 contracts gain. This gain is the lesser of:

- The capital gain net income for the carryback year determined by taking into account only gains and losses from section 1256 contracts, or
- The capital gain net income for that year.

Figure your net section 1256 contracts gain for any carryback year without regard to the net section 1256 contracts loss for the loss year or any later tax year.

Traders in section 1256 contracts. Gain or loss from the trading of section 1256 contracts is capital gain or loss subject to the marked-to-market rules. However, this does not apply to contracts held for purposes of hedging property if any loss from the property would be an ordinary loss.

Treatment of underlying property. The determination of whether an individual's gain or loss from any property is ordinary or capital gain or loss is made without regard to the fact that the individual is actively engaged in dealing in or trading section 1256 contracts related to that property.

Deferral of net gain from section 1256 contracts due to investment in Qualified Opportunity Fund. For special rules relating to the deferral of net gain from section 1256 contracts, see section 1400Z-2. See the Form 8949 instructions for how to report.

How To Report

If you disposed of regulated futures or foreign currency contracts in 2018 (or had unrealized profit or loss on these contracts that were open at the end of 2017 or 2018), you should receive Form 1099-B from your broker.

Form 6781. Use Part I of Form 6781 to report your gains and losses from all section 1256 contracts that are open at the end of the year or that were closed out during the year. This includes the amount shown in box 11 of Form 1099-B. Then enter the net amount of these gains and losses on Schedule D (Form 1040), line 4 or line 11, as appropriate. Include a copy of Form 6781 with your income tax return.

If the Form 1099-B you receive includes a straddle or hedging transaction, defined later, it may be necessary to show certain adjustments on Form 6781. Follow the Form 6781 instructions for completing Part I.

Loss carryback election. To carry back your loss under the election procedures described earlier, file Form 1040X or Form 1045, Application for Tentative Refund, for the year to which you are carrying the loss with an amended

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Form 6781 and an amended Schedule D (Form 1040) attached. Follow the instructions for completing Form 6781 for the loss year to make this election.

Hedging Transactions

The marked-to-market rules, described earlier, do not apply to hedging transactions. A transaction is a hedging transaction if both of the following conditions are met.

1. You entered into the transaction in the normal course of your trade or business primarily to manage the risk of:
   a. Price changes or currency fluctuations on ordinary property you hold (or will hold); or
   b. Interest rate or price changes, or currency fluctuations, on your current or future borrowings or ordinary obligations.
2. You clearly identified the transaction as being a hedging transaction before the close of the day on which you entered into it.

This hedging transaction exception does not apply to transactions entered into by or for any syndicate. A syndicate is a partnership, S corporation, or other entity (other than a regular corporation) that allocates more than 35% of its losses to limited partners or limited entrepreneurs. A limited entrepreneur is a person who has an interest in an enterprise (but not as a limited partner) and who does not actively participate in its management. However, an interest is not considered held by a limited partner or entrepreneur if the interest holder actively participates (or did so for at least 5 full years) in the management of the entity, or is the spouse, child (including a legally adopted child), grandchild, or parent of an individual who actively participates in the management of the entity.

Hedging loss limit. If you are a limited partner or entrepreneur in a syndicate, the amount of a hedging loss you can claim is limited. A "hedging loss" is the amount by which the allowable deductions in a tax year that resulted from a hedging transaction (determined without regard to the limit) are more than the income received or accrued during the tax year from this transaction.

Any hedging loss allocated to you for the tax year is limited to your taxable income for that year from the trade or business in which the hedging transaction occurred. Ignore any hedging transaction items in determining this taxable income. If you have a hedging loss that is disallowed because of this limit, you can carry it over to the next tax year as a deduction resulting from a hedging transaction.

If the hedging transaction relates to property other than stock or securities, the limit on hedging losses applies if the limited partner or entrepreneur is an individual.

The limit on hedging losses does not apply to any hedging loss to the extent that it is more than all your unrecognized gains from hedging transactions at the end of the tax year that are from the trade or business in which the hedging transaction occurred. The term "unrecognized gain" has the same meaning as defined under *Loss Deferral Rules*, later.

Sale of property used in a hedge. Once you identify personal property as being part of a hedging transaction, you must treat gain from its sale or exchange as ordinary income, not capital gain.

Self-Employment Income

Gains and losses derived in the ordinary course of a commodity or option dealer's trading in section 1256 contracts and property related to these contracts are included in net earnings from self-employment. See the Instructions for Schedule SE (Form 1040). In addition, the rules relating to contributions to self-employment retirement plans apply. For information on retirement plan contributions, see Pub. 560 and Pub. 590-A.

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Basis of Investment Property

Terms you may need to know (see Glossary):

Basis
Fair market value
Original issue discount (OID)

Basis is a way of measuring your investment in property for tax purposes. You must know the basis of your property to determine whether you have a gain or loss on its sale or other disposition.

Investment property you buy normally has an original basis equal to its cost. If you get property in some way other than buying it, such as by gift or inheritance, its fair market value may be important in figuring the basis.

Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations, or other property or services.

Unstated interest. If you buy property on a time-payment plan that charges little or no interest, the basis of your property is your stated purchase price, minus the amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable federal rate. For more information, see *Unstated Interest and Original Issue Discount (OID)* in Pub. 537.

Basis Other Than Cost

There are times when you must use a basis other than cost. In these cases, you may need to know the property's fair market value or the adjusted basis of the previous owner.

Fair market value. This is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts. Sales of similar property, around the same date, may be helpful in figuring fair market value.

Property Received for Services

If you receive investment property for services, you must include the property's fair market value in income. The amount you include in income then becomes your basis in the property. If the services were performed for a price that was agreed to beforehand, this price will be accepted as the fair market value of the property if there is no evidence to the contrary.

Restricted property. If you receive, as payment for services, property that is subject to certain restrictions, your basis in the property generally is its fair market value when it becomes substantially vested. Property becomes substantially vested when it is transferable or is no longer subject to substantial risk of forfeiture, whichever happens first. See *Restricted Property* in Pub. 525 for more information.

Bargain purchases. If you buy investment property at less than fair market value, as payment for services, you must include the difference in income. Your basis in the property is the price you pay plus the amount you include in income.

Property Received in Taxable Trades

If you received investment property in trade for other property, the basis of the new property is its fair market value at the time of the trade unless you received the property in a nontaxable trade.

Example. You trade A Company stock for B Company stock having a fair market value of $1,200. If the adjusted basis of the A Company stock is less than $1,200, you have a taxable gain on the trade. If the adjusted basis of the A Company stock is more than $1,200, you have a deductible loss on the trade. The basis of your B Company stock is $1,200. If you later sell the B Company stock for $1,300, you will have a gain of $100.

Property Received in Nontaxable Trades

If you have a nontaxable trade, you do not recognize gain or loss until you dispose of the real property you received in the trade. See *Nontaxable Trades*, later.

The basis of property you received in a nontaxable or partly nontaxable trade is generally the same as the adjusted basis of the property you gave up. Increase this amount by any cash you paid, additional costs you had, and any gain recognized. Reduce this amount by any cash or unlike property you received, any loss recognized, and any liability of yours that was assumed or treated as assumed.

Property Received From Your Spouse

If property is transferred to you from your spouse (or former spouse, if the transfer is incident to your divorce), your basis is the same as your spouse's or former spouse's adjusted basis just before the transfer. See *Transfers Between Spouses*, later.

Recordkeeping. The transferor must give you the records necessary to determine the adjusted basis and holding period of the property as of the date of the transfer.

Property Received as a Gift

To figure your basis in property that you received as a gift, you must know its adjusted basis to the donor just before it was given to you, its fair market value at the time it was given to you, the amount of any gift tax paid on it, and the date it was given to you.

Fair market value less than donor's adjusted basis. If the fair market value of the property at the time of the gift was less than the donor's adjusted basis just before the gift, your basis for gain on its sale or other disposition is the same as the donor's adjusted basis plus or minus any required adjustments to basis during the period you hold the property. Your basis for loss is its fair market value at the time of the gift plus or minus any required adjustments to basis during the period you hold the property.

No gain or loss. If you use the basis for figuring a gain and the result is a loss, and then use the basis for figuring a loss and the result is a gain, you will have neither a gain nor a loss.

Example. You receive a gift of investment property having an adjusted basis of $10,000 at the time of the gift. The fair market value at the time of the gift is $9,000. You later sell the property for $9,500. Your basis for figuring gain is $10,000, and $9,500 minus $10,000 results in a $500 loss. Your basis for figuring loss is $9,000, and $9,500 minus $9,000 results in a $500 gain. You have neither gain nor loss.

Fair market value equal to or more than donor's adjusted basis. If the fair market value of the property at the time of the gift was equal to or more than the donor's adjusted basis just before the gift, your basis for gain or loss on its sale or other disposition is the donor's adjusted basis plus or minus any required adjustments to basis during the period you hold the property. Also, you may be allowed to add to the donor's adjusted basis all or part of any gift tax paid, depending on the date of the gift.

Gift received after 1976. If you received property as a gift after 1976, your basis is the donor's adjusted basis increased by the part of the gift tax paid that was for the net increase in value of the gift. You figure this part by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) is the net increase in value of the gift and the denominator (bottom part) is the amount of the gift.

The net increase in value of the gift is the fair market value of the gift minus the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift.

Example. In 2018, you received a gift of property from your mother. At the time of the gift, the property had a fair market value of $101,000 and an adjusted basis to her of $40,000. The amount of the gift for gift tax purposes was $86,000 ($101,000 minus the $15,000 annual exclusion), and your mother paid a gift tax of $20,160. You figure your basis in the following way:

Fair market value	$101,000
Minus: Adjusted basis	40,000
Net increase in value of gift	$ 61,000
Gift tax paid	$ 20,160
Multiplied by 0.709 ($61,000 ÷ $86,000)	0.709
Gift tax due to net increase in value	$ 14,293
Plus: Adjusted basis of property to your mother	40,000
Your basis in the property	$ 54,293

Part sale, part gift. If you get property in a transfer that is partly a sale and partly a gift, your basis is the larger of the amount you paid for the property or the transferor's adjusted basis in the property at the time of the transfer. Add to that amount the amount of any gift tax paid on the gift, as described in the preceding discussion. For figuring loss, your basis is limited to the property's fair market value at the time of the transfer.

Gift tax information. For information on gift tax, see Pub. 559. For information on figuring the amount of gift tax to add to your basis, see *Property Received as a Gift* in Pub. 551.

Property Received as Inheritance

Before or after 2010. If you inherited property from a decedent who died before or after 2010, or who died in 2010 and the executor of the decedent's estate elected not to file Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, your basis in that property generally is its fair market value (its appraised value on Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return) on:

- The date of the decedent's death; or
- The later alternate valuation date if the estate qualifies for, and elects to use, alternate valuation.

In certain circumstances, the executor of an estate (or other person) required to file Form 706 after July 15, 2015, will be required to provide a Schedule A (Form 8971) to you as a beneficiary who receives or is to receive property from the estate. If you receive Schedule A (Form 8971), use the final estate tax value of the property reported on the Schedule A to determine your basis in the property.

If no Form 706 was filed, or the executor was not required to provide you Schedule A (Form 8971), use the appraised value on the date of death for state inheritance or transmission taxes. For stocks and bonds, if no Form 706 was filed and there are no state inheritance or transmission taxes, see the Form 706 instructions for figuring the fair market value of the stocks and bonds on the date of the decedent's death.

Appreciated property you gave the decedent. Your basis in certain appreciated property that you inherited is the decedent's adjusted basis in the property immediately before death rather than its fair market value. This applies to appreciated property that you or your spouse gave the decedent as a gift during the 1-year period ending on the date of death. Appreciated property is any property whose fair market value on the day you gave it to the decedent was more than its adjusted basis.

More information. See Pub. 551 for more information on the basis of inherited property, including community property, property held by a surviving tenant in a joint tenancy or tenancy by the entirety, a qualified joint interest, and a farm or closely held business.

Inherited in 2010 and executor elected to file Form 8939. If you inherited property from a decedent who died in 2010 and the executor made the election to file Form 8939, see Pub. 4895 to figure your basis. Pub. 4895 is available at *IRS.gov/Pub4895*.

Adjusted Basis

Before you can figure any gain or loss on a sale, exchange, or other disposition of property or figure allowable depreciation, depletion, or amortization, you usually must make certain adjustments (increases and decreases) to the basis of the property. The result of these adjustments to the basis is the adjusted basis.

Adjustments to the basis of stocks and bonds are explained in the following discussion. For information about other adjustments to basis, see Pub. 551.

Stocks and Bonds

The basis of stocks or bonds you own generally is the purchase price plus the costs of purchase, such as commissions and recording or transfer fees. If you acquired stock or bonds other than by purchase, your basis is usually determined by fair market value or the previous owner's adjusted basis as discussed earlier under *Basis Other Than Cost*.

The basis of stock must be adjusted for certain events that occur after purchase. For example, if you receive more stock from nontaxable stock dividends or stock splits, you must reduce the basis of your original stock. You must also reduce your basis when you receive nondividend distributions (discussed in chapter 1). These distributions, up to the amount of your basis, are a nontaxable return of capital.

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TIP *The IRS partners with companies that offer Form 8949 and Schedule D (Form 1040) software that can import trades from many brokerage firms and accounting software to help you keep track of your adjusted basis in securities. To find out more, go to IRS.gov/Filing/Filing-Options.*

Identifying stock or bonds sold. If you can adequately identify the shares of stock or the bonds you sold, their basis is the cost or other basis of the particular shares of stock or bonds.

Adequate identification. You will make an adequate identification if you show that certificates representing shares of stock from a lot that you bought on a certain date or for a certain price were delivered to your broker or other agent.

Broker holds stock. If you have left the stock certificates with your broker or other agent, you will make an adequate identification if you:

- Tell your broker or other agent the particular stock to be sold or transferred at the time of the sale or transfer, and
- Receive a written confirmation of this from your broker or other agent within a reasonable time.

Stock identified this way is the stock sold or transferred even if stock certificates from a different lot are delivered to the broker or other agent.

Single stock certificate. If you bought stock in different lots at different times and you hold a single stock certificate for this stock, you will make an adequate identification if you:

- Tell your broker or other agent the particular stock to be sold or transferred when you deliver the certificate to your broker or other agent, and
- Receive a written confirmation of this from your broker or other agent within a reasonable time.

If you sell part of the stock represented by a single certificate directly to the buyer instead of through a broker, you will make an adequate identification if you keep a written record of the particular stock that you intend to sell.

Bonds. These methods of identification also apply to bonds sold or transferred.

Identification not possible. If you buy and sell securities at various times in varying quantities and you cannot adequately identify the shares you sell, the basis of the securities you sell is the basis of the securities you acquired first. Except for certain mutual fund shares, discussed later, you cannot use the average price per share to figure gain or loss on the sale of the shares.

Example. You bought 100 shares of stock of XYZ Corporation in 2003 for $10 per share. In January 2004, you bought another 200 shares for $11 per share. In July 2004, you gave your son 50 shares. In December 2006, you bought 100 shares for $9 per share. In April 2018, you sold 130 shares. You cannot identify the shares you disposed of, so you must use the stock you acquired first to figure the basis. The shares of stock you gave your son had a basis of $500 (50 × $10). You figure the basis of the 130 shares of stock you sold in April 2018 as follows:

50 shares (50 × $10) balance of stock bought in 2003	$ 500
80 shares (80 × $11) stock bought in January 2004	880
Total basis of stock sold in 2018	$1,380

Shares in a mutual fund or real estate investment trust (REIT). The basis of shares in a mutual fund (or other regulated investment company) or a REIT is generally figured in the same way as the basis of other stock and usually includes any commissions or load charges paid for the purchase.

Example. You bought 100 shares of Fund A for $10 per share. You paid a $50 commission to the broker for the purchase. Your cost basis for each share is $10.50 ($1,050 ÷ 100).

Commissions and load charges. The fees and charges you pay to acquire or redeem shares of a mutual fund are not deductible. You can usually add acquisition fees and charges to your cost of the shares and thereby increase your basis. A fee paid to redeem the shares is usually a reduction in the redemption price (sales price).

You cannot add your entire acquisition fee or load charge to the cost of the mutual fund shares acquired if all of the following conditions apply.

1. You get a reinvestment right because of the purchase of the shares or the payment of the fee or charge.
2. You dispose of the shares within 90 days of the purchase date.
3. You acquire new shares in the same mutual fund or another mutual fund, for which the fee or charge is reduced or waived because of the reinvestment right you got when you acquired the original shares.

The amount of the original fee or charge in excess of the reduction in (3) is added to the cost of the original shares. The rest of the original fee or charge is added to the cost basis of the new shares (unless all three conditions above also apply to the purchase of the new shares).

Choosing average basis for mutual fund shares. You can choose to use the average basis of mutual fund shares if you acquired the identical shares at various times and prices, or you acquired the shares after 2011 in connection with a dividend reinvestment plan (DRP), and left them on deposit in an account kept by a custodian or agent. The methods you can use to figure average basis are explained later.

Undistributed capital gains. If you had to include in your income any undistributed capital gains of the mutual fund or REIT, increase your basis in the stock by the difference between the amount you included and the amount of tax paid for you by the fund or REIT. See *Undistributed capital gains of mutual funds and REITs* in chapter 1.

Reinvestment right. This is the right to acquire mutual fund shares in the same or another mutual fund without paying a fee or load charge, or by paying a reduced fee or load charge.

The original cost basis of mutual fund shares you acquire by reinvesting your distributions is the amount of the distributions used to purchase each full or fractional share. This rule applies even if the distribution is an exempt-interest dividend that you do not report as income.

RECORDS **Table 4-1**. This is a worksheet you can use to keep track of the adjusted basis of your mutual fund shares. Enter the cost per share when you acquire new shares and any adjustments to their basis when the adjustment occurs. This worksheet will help you figure the adjusted basis when you sell or redeem shares.

Automatic investment service. If you participate in an automatic investment service, your basis for each share of stock, including fractional shares, bought by the bank or other agent is the purchase price plus a share of the broker's commission.

DRPs. If you participate in a DRP and receive stock from the corporation at a discount, your basis is the full fair market value of the stock on the dividend payment date. You must include the amount of the discount in your income.

Public utilities. If, before 1986, you excluded from income the value of stock you had received under a qualified public utility reinvestment plan, your basis in that stock is zero.

Stock dividends. Stock dividends are distributions made by a corporation of its own stock. Generally, stock dividends are not taxable to you. However, see *Distributions of Stock and Stock Rights* in chapter 1 for some exceptions. If the stock dividends are not taxable, you must divide your basis for the old stock between the old and new stock.

New and old stock identical. If the new stock you received as a nontaxable dividend is identical to the old stock on which the dividend was declared, divide the adjusted basis of the old stock by the number of shares of old and new stock. The result is your basis for each share of stock.

Example 1. You owned one share of common stock that you bought for $45. The corporation distributed two new shares of common stock for each share held. You then had three shares of common stock. Your basis in each share is $15 ($45 ÷ 3).

Example 2. You owned two shares of common stock. You bought one for $30 and the other for $45. The corporation distributed two new shares of common stock for each share held. You had six shares after the distribution—three with a basis of $10 each ($30 ÷ 3) and three with a basis of $15 each ($45 ÷ 3).

New and old stock not identical. If the new stock you received as a nontaxable

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Table 4-1. **Mutual Fund Record**

Mutual Fund	Acquired[1]			Adjustment to Basis per Share					Adjusted[2] Basis per Share	Sold or Redeemed	
	Date	Number of Shares	Cost per Share							Date	Number of Shares

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[1] Include share received from reinvestment of distributions.
[2] Cost plus or minus adjustments.

dividend is not identical to the old stock on which it was declared, the basis of the new stock is figured differently. Divide the adjusted basis of the old stock between the old and the new stock in the ratio of the fair market value of each lot of stock to the total fair market value of both lots on the date of distribution of the new stock.

Example. You bought a share of common stock for $100. Later, the corporation distributed a share of preferred stock for each share of common stock held. At the date of distribution, your common stock had a fair market value of $150 and the preferred stock had a fair market value of $50. You figure the basis of the old and new stock by dividing your $100 basis between them. The basis of your common stock is $75 (($150 ÷ $200) × $100), and the basis of the new preferred stock is $25 (($50 ÷ $200) × $100).

Stock bought at various times. Figure the basis of stock dividends received on stock you bought at various times and at different prices by allocating to each lot of stock the share of the stock dividends due to it.

Taxable stock dividends. If your stock dividend is taxable when you receive it, the basis of your new stock is its fair market value on the date of distribution. The basis of your old stock does not change.

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

Stock rights. A stock right is a right to acquire a corporation's stock. It may be exercised, it may be sold if it has a market value, or it may expire. Stock rights are rarely taxable when you receive them. See *Distributions of Stock and Stock Rights* in chapter 1.

Taxable stock rights. If you receive stock rights that are taxable, the basis of the rights is their fair market value at the time of distribution. The basis of the old stock does not change.

Nontaxable stock rights. If you receive nontaxable stock rights and allow them to expire, they have no basis.

If you exercise or sell the nontaxable stock rights and if, at the time of distribution, the stock rights had a fair market value of 15% or more of the fair market value of the old stock, you must divide the adjusted basis of the old stock between the old stock and the stock rights. Use a ratio of the fair market value of each to the total fair market value of both at the time of distribution.

If the fair market value of the stock rights was less than 15%, their basis is zero. However, you can choose to divide the basis of the old stock between the old stock and the stock rights. To make the choice, attach a statement to your return for the year in which you received the rights, stating that you choose to divide the basis of the stock.

Basis of new stock. If you exercise the stock rights, the basis of the new stock is its cost plus the basis of the stock rights exercised.

Example. You own 100 shares of ABC Company stock, which cost you $22 per share. The ABC Company gave you 10 nontaxable stock rights that would allow you to buy 10 more shares at $26 per share. At the time the stock rights were distributed, the stock had a market value of $30, not including the stock rights. Each stock right had a market value of $3. The market value of the stock rights was less than 15% of the market value of the stock, but you chose to divide the basis of your stock between the stock and the rights. You figure the basis of the rights and the basis of the old stock as follows:

100 shares × $22 = $2,200, basis of old stock

100 shares × $30 = $3,000, market value of old stock

10 rights × $3 = $30, market value of rights

($3,000 ÷ $3,030) × $2,200 = $2,178.22, new basis of old stock

($30 ÷ $3,030) × $2,200 = $21.78, basis of rights

If you sell the rights, the basis for figuring gain or loss is $2.18 ($21.78 ÷ 10) per right. If you exercise the rights, the basis of the stock you acquire is the price you pay ($26) plus the basis of the right exercised ($2.18), or $28.18 per share. The remaining basis of the old stock is $21.78 per share.

Investment property received in liquidation. In general, if you receive investment property as a distribution in partial or complete liquidation of

a corporation and if you recognize gain or loss when you acquire the property, your basis in the property is its fair market value at the time of the distribution.

S corporation stock. You must increase your basis in stock of an S corporation by your pro rata share of the following items.

- All income items of the S corporation, including tax-exempt income, that are separately stated and passed through to you as a shareholder.
- The nonseparately stated income of the S corporation.
- The amount of the deduction for depletion (other than oil and gas depletion) that is more than the basis of the property being depleted.

You must decrease your basis in stock of an S corporation by your pro rata share of the following items.

- Distributions by the S corporation that were not included in your income.
- All loss and deduction items of the S corporation that are separately stated and passed through to you.
- Any nonseparately stated loss of the S corporation.
- Any expense of the S corporation that is not deductible in figuring its taxable income and not properly chargeable to a capital account.
- The amount of your deduction for depletion of oil and gas wells to the extent the deduction is not more than your share of the adjusted basis of the wells.

However, your basis in the stock cannot be reduced below zero.

Qualified small business stock. If you bought this stock as replacement property for other qualified small business stock you sold at a gain, you must reduce the basis of this replacement stock by the amount of any postponed gain on the earlier sale. See *Gains on Qualified Small Business Stock*, later.

Short sales. If you cannot deduct payments you make to a lender in lieu of dividends on stock used in a short sale, the amount you pay to the lender is a capital expense, and you must add it to the basis of the stock used to close the short sale.

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

Premiums on bonds. If you buy a bond at a premium, the premium is treated as part of your basis in the bond. If you choose to amortize the premium paid on a taxable bond, you must reduce the basis of the bond by the amortized part of the premium each year over the life of the bond.

For a taxable bond acquired at a premium that is a covered security, unless you instruct your broker that you do not want to amortize premium, your broker will report income on the bond and your basis in the bond by amortizing premium. Your broker may report the amount of premium amortization for a tax year separately from the amount of gross interest income in boxes 11 and 12 of Form 1099-INT or box 10 of Form 1099-OID, or may report net interest in boxes 1 and 3 of Form 1099-INT or box 2 of Form 1099-OID.

Although you cannot deduct the premium on a tax-exempt bond, you must amortize it to determine your adjusted basis in the bond. You must reduce the basis of the bond by the premium you amortized for the period you held the bond. For a tax-exempt covered security acquired at a premium, box 13 of Form 1099-INT or box 10 of Form 1099-OID shows the amount of bond premium amortization allocable to the interest paid during the tax year. If a net amount of interest appears in box 8 or 9 of Form 1099-INT, whichever is applicable, box 13 of Form 1099-INT should be blank. If a net amount of interest appears in box 2 of Form 1099-OID, box 10 of Form 1099-OID should be blank.

See *Bond Premium Amortization* in chapter 3 for more information.

Market discount on bonds. If you include market discount on a bond in income currently, increase the basis of your bond by the amount of market discount you include in your income. See *Market Discount Bonds* in chapter 1 for more information.

Bonds purchased at par value. A bond purchased at par value (face amount) has no premium or discount. When you sell or otherwise dispose of the bond, you figure the gain or loss by comparing the bond proceeds to the purchase price of the bond.

Example. You purchased a bond several years ago for its par value of $10,000. You sold the bond this year for $10,100. You have a gain of $100. However, if you had sold the bond for $9,900, you would have a loss of $100.

Acquisition discount on short-term obligations. If you include acquisition discount on a short-term obligation in your income currently, increase the basis of the obligation by the amount of acquisition discount you include in your income. See *Discount on Short-Term Obligations* in chapter 1 for more information.

Original issue discount (OID) on debt instruments. Increase the basis of a debt instrument by the OID you include in your income. See *Original Issue Discount (OID)* in chapter 1.

If your debt instrument is a covered security, your broker will report a basis amount that is adjusted for OID included in income.

Discounted tax-exempt obligations. OID on tax-exempt obligations is generally not taxable. However, when you dispose of a tax-exempt obligation issued after September 3, 1982, that you acquired after March 1, 1984, you must accrue OID on the obligation to determine its adjusted basis. The accrued OID is added to the basis of the obligation to determine your gain or loss. If your tax-exempt obligation is a covered security, your broker will report a basis amount that is adjusted for tax-exempt OID.

For information on determining OID on a long-term obligation, see *Debt Instruments Issued After July 1, 1982, and Before 1985* or *Debt Instruments Issued After 1984*, whichever applies, in Pub. 1212 under *Figuring OID on Long-Term Debt Instruments*.

If the tax-exempt obligation has a maturity of 1 year or less, accrue OID under the rules for acquisition discount on short-term obligations. See *Discount on Short-Term Obligations* in chapter 1.

Stripped tax-exempt obligation. If you acquired a stripped tax-exempt bond or coupon after October 22, 1986, you must accrue OID on it to determine its adjusted basis when you dispose of it. For stripped tax-exempt bonds or coupons acquired after June 10, 1987, part of this OID may be taxable. You accrue the OID on these obligations in the manner described in chapter 1 under *Stripped Bonds and Coupons*.

Increase your basis in the stripped tax-exempt bond or coupon by the taxable and nontaxable accrued OID. Also increase your basis by the interest that accrued (but was not paid and was not previously reflected in your basis) before the date you sold the bond or coupon. In addition, for bonds acquired after June 10, 1987, add to your basis any accrued market discount not previously reflected in basis.

How To Figure Gain or Loss

You figure gain or loss on a sale or trade of property by subtracting the adjusted basis of the property from the amount you realize on the sale or trade.

Gain. If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain.

Loss. If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

Amount realized. The amount you realize from a sale or trade of property is everything you receive for the property minus your expenses related to the sale (such as redemption fees, sales commissions, sales charges, or exit fees). Amount realized includes the money you receive plus the fair market value of any property or services you receive.

If you finance the buyer's purchase of your property and the debt instrument does not provide for adequate stated interest, the unstated interest that you must report as ordinary income will reduce the amount realized from the sale. For more information, see Pub. 537.

If a buyer of property issues a debt instrument to the seller of the property, the amount realized is determined by reference to the issue price of the debt instrument, which may or may not be the fair market value of the debt instrument. See Regulations section 1.1001-1(g). However, if the debt instrument was previously issued by a third party (one not part of the sale transaction), the fair market value of the debt instrument is used to determine the amount realized.

Fair market value. Fair market value is the price at which property would change hands between a buyer and a seller, neither being

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forced to buy or sell and both having reasonable knowledge of all the relevant facts.

Example. You trade A Company stock with an adjusted basis of $7,000 for B Company stock with a fair market value of $10,000, which is your amount realized. Your gain is $3,000 ($10,000 – $7,000). If you also receive a note for $6,000 that has an issue price of $6,000, your gain is $9,000 ($10,000 + $6,000 – $7,000).

Debt paid off. A debt against the property, or against you, that is paid off as a part of the transaction or that is assumed by the buyer must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize generally includes the full amount of the note assumed by the buyer even if the amount of the note is more than the fair market value of the property.

Example. You sell stock that you had pledged as security for a bank loan of $8,000. Your basis in the stock is $6,000. The buyer pays off your bank loan and pays you $20,000 in cash. The amount realized is $28,000 ($20,000 + $8,000). Your gain is $22,000 ($28,000 – $6,000).

Payment of cash. If you trade property and cash for other property, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting the cash you pay and the adjusted basis of the property you trade in from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

No gain or loss. You may have to use a basis for figuring gain that is different from the basis used for figuring loss. In this case, you may have neither a gain nor a loss. See *No gain or loss* in the discussion on the basis of property you received as a gift under *Basis Other Than Cost*, earlier.

Special Rules for Mutual Funds

To figure your gain or loss when you dispose of mutual fund shares, you need to determine which shares were sold and the basis of those shares. If your shares in a mutual fund were acquired all on the same day and for the same price, figuring their basis is not difficult. However, shares are generally acquired at various times, in various quantities, and at various prices. Therefore, figuring your basis can be more difficult. You can choose to use either a cost basis or an average basis to figure your gain or loss.

Cost Basis

You can figure your gain or loss using a cost basis only if you did not previously use an average basis for a sale, exchange, or redemption of other shares in the same mutual fund.

To figure cost basis, you can choose one of the following methods.

- Specific share identification.
- First-in first-out (FIFO).

Specific share identification. If you adequately identify the shares you sold, you can use the adjusted basis of those particular shares to figure your gain or loss.

You will adequately identify your mutual fund shares, even if you bought the shares in different lots at various prices and times, if you:

1. Specify to your broker or other agent the particular shares to be sold or transferred at the time of the sale or transfer, and
2. Receive confirmation in writing from your broker or other agent within a reasonable time of your specification of the particular shares sold or transferred.

You continue to have the burden of proving your basis in the specified shares at the time of sale or transfer.

FIFO. If your shares were acquired at different times or at different prices and you cannot identify which shares you sold, use the basis of the shares you acquired first as the basis of the shares sold. In other words, the oldest shares you own are considered sold first. You should keep a separate record of each purchase and any dispositions of the shares until all shares purchased at the same time have been disposed of completely.

Table 4-2 illustrates the use of the FIFO method to figure the cost basis of shares sold, compared with the use of the average basis method (discussed next).

Average Basis

You can use the average basis method to determine the basis of shares of stock if the shares are identical to each other, you acquired them at different times and different prices and left them in an account with a custodian or agent, and either:

- They are shares in a mutual fund (or other regulated investment company);
- They are shares you hold in connection with a DRP, and all the shares you hold in connection with the DRP are treated as covered securities (defined later); or
- You acquired them after 2011 in connection with a DRP.

Average basis is determined by averaging the basis of all shares of identical stock in an account regardless of how long you have held the stock. However, shares of stock in a DRP are not identical to shares of stock with the same CUSIP number that are not in a DRP. The basis of each share of identical stock in the account is the aggregate basis of all shares of that stock in the account divided by the aggregate number of shares.

Transition rule from double-category method. You may no longer use the double-category method for figuring your average basis. If you were using the double-category method for stock you acquired before April 1, 2011, and you sell, exchange, or otherwise dispose of that stock on or after April 1, 2011, you must figure the average basis of this stock by averaging together all identical shares of stock in the account on April 1, 2011, regardless of the holding period.

Election of average basis method for covered securities. To make the election to use the average basis method for your covered securities, you must send written notice to the custodian or agent who keeps the account. The written notice can be made electronically. You must also notify your broker that you have made the election. Generally, a covered security is a security you acquired after 2010, with certain exceptions explained in the Instructions for Form 8949.

You can make the election to use the average basis method at any time. The election will be effective for sales or other dispositions of stocks that occur after you notify the custodian or agent of your election. Your election must identify each account with that custodian or agent and each stock in that account to which the election applies. The election can also indicate that it applies to all accounts with a custodian or agent, including accounts you later establish with the custodian or agent.

Election of average basis method for noncovered securities. For noncovered securities, you elect to use the average basis method on your income tax return for the first tax year that the election applies. You make the election by showing on your return that you used the average basis method in reporting gain or loss on the sale or other disposition.

Revoking the average basis method election. You can revoke an election to use the average basis method for your covered securities by sending written notice to the custodian or agent holding the stock for which you want to revoke the election. The election must generally be revoked by the earlier of 1 year after you make the election or the date of the first sale, transfer, or disposition of the stock following the election. The revocation applies to all the stock you hold in an account that is identical to the shares of stock for which you are revoking the election. After revoking your election, your basis in the shares of stock to which the revocation applies is the basis before averaging.

TIP *You may be able to find the average basis of your shares from information provided by the fund.*

Average basis method illustrated. Table 4-2 illustrates the average basis method of shares sold, compared with the use of the FIFO method to figure cost basis (discussed earlier).

Even though you include all unsold shares of identical stock in an account to figure average basis, you may have both short-term and long-term gains or losses when you sell these shares. To determine your holding period, the shares disposed of are considered to be those acquired first.

Example. You bought 400 identical shares in the LJO Mutual Fund: 200 shares on May 11, 2017, and 200 shares on May 16, 2018. On November 16, 2018, you sold 300 shares. The

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Table 4-2. **Example of How To Figure Basis of Shares Sold**

This is an example showing two different ways to figure basis. It compares the cost basis using the FIFO method with the average basis method.

Date	Action	Share Price	No. of Shares	Total Shares Owned
2/10/2016	Invest $4,000	$25	160	160
8/11/2016	Invest $4,800	$20	240	400
12/15/2016	Reinvest $300 dividend	$30	10	410
10/3/2018	Sell 210 shares for $6,720	$32	210	200

COST BASIS (FIFO)

To figure the basis of the 210 shares sold on 10/3/2018, use the share price of the first 210 shares you bought, namely the 160 shares you purchased on 2/10/2016 and 50 of those purchased on 8/11/2016.

$4,000 (cost of 160 shares on 2/10/2016)
+ $1,000 (cost of 50 shares on 8/11/2016)
Basis = $5,000

AVERAGE BASIS

To figure the basis of the 210 shares sold on 10/3/2018, use the average basis of all 410 shares owned on 10/3/2018.

$9,100 (cost of 410 shares)
÷ 410 (number of shares)
$22.20 (average basis per share)

$22.20
× 210
Basis = $4,662

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basis of all 300 shares sold is the same, but you held 200 shares for more than 1 year, so your gain or loss on those shares is long term. You held 100 shares for 1 year or less, so your gain or loss on those shares is short term.

How to figure the basis of shares sold. To figure the basis of shares you sell, use the steps in the following worksheet.

1. Enter the total adjusted basis of all the shares you owned in the fund just before the sale. (If you made an earlier sale of shares in this fund, add the adjusted basis of any shares you still owned after the last sale and the adjusted basis of any shares you acquired after that sale.) . . . . . $ _____
2. Enter the total number of shares you owned in the fund just before the sale . . . . . _____
3. Divide the amount on line 1 by the amount on line 2. This is your ***average basis per share*** . . . . . $ _____
4. Enter the number of shares you sold . . . _____
5. Multiply the amount on line 3 by the amount on line 4. This is the ***basis of the shares you sold*** . . . . . $ _____

Example 1. You bought 300 identical shares in the LJP Mutual Fund: 100 shares in 2014 for $1,000 ($10 per share); 100 shares in 2015 for $1,200 ($12 per share); and 100 shares in 2016 for $2,600 ($26 per share). Thus, the total cost of your shares was $4,800 ($1,000 + $1,200 + $2,600). On May 9, 2018, you sold 150 shares. The basis of the shares you sold is $2,400 ($16 per share), figured as follows.

1. Enter the total adjusted basis of all the shares you owned in the fund just before the sale. (If you made an earlier sale of shares in this fund, add the adjusted basis of any shares you still owned after the last sale and the adjusted basis of any shares you acquired after that sale.) $4,800
2. Enter the total number of shares you owned in the fund just before the sale 300
3. Divide the amount on line 1 by the amount on line 2. This is your ***average basis per share*** . . . . . $ 16
4. Enter the number of shares you sold 150
5. Multiply the amount on line 3 by the amount on line 4. This is the ***basis of the shares you sold*** $2,400

Remaining shares. The average basis of the shares you still hold after a sale of some of your shares is the same as the average basis of the shares sold. The next time you make a sale, your average basis will still be the same, unless you have acquired additional shares (or have made a subsequent adjustment to basis).

Example 2. The facts are the same as in *Example 1*, except that you sold an additional 50 shares on December 12, 2018. You do not need to refigure the average basis of the 150 shares you owned at that time because you acquired or sold no shares, and had no other adjustments to basis, since the last sale. Your basis is the $16 per share figured earlier.

Example 3. The facts are the same as in *Example 1*, except that you bought an additional 150 identical shares at $14 per share on September 12, 2018, and then sold 50 shares on December 12, 2018. The total adjusted basis of all the shares you owned just before the sale is $4,500, figured as follows.

1. Basis of remaining shares ($16 x 150) $2,400
2. Cost of shares acquired 9/12/2018 ($14 x 150) $2,100
3. Total adjusted basis of all shares owned ($2,400 + $2,100) $4,500

The basis of the shares sold is $750 ($15 per share), figured as follows.

1. Enter the total adjusted basis of all the shares you owned in the fund just before the sale. (If you made an earlier sale of shares in this fund, add the adjusted basis of any shares you still owned after the last sale and the adjusted basis of any shares you acquired after that sale.) $4,500
2. Enter the total number of shares you owned in the fund just before the sale 300
3. Divide the amount on line 1 by the amount on line 2. This is your ***average basis per share*** . . . . . $ 15
4. Enter the number of shares you sold 50
5. Multiply the amount on line 3 by the amount on line 4. This is the ***basis of the shares you sold*** . . . . . $ 750

Shares received as gift. If your account includes shares that you received by gift, and the fair market value of the shares at the time of the gift was not more than the donor's basis, special rules apply. You cannot choose to use the average basis for the account unless you state in writing that you will treat the basis of the gift shares as the fair market value at the time you acquire the shares. You must provide this written statement when you make the election to use the average basis method, as described under *Election of average basis method for covered securities* and *Election for average basis method for noncovered securities*, earlier, or when you transfer the gift shares to an account for which you have made the average basis method election, whichever is later. The statement must be effective for any gift shares identical to the gift shares to which the average basis method election applies that you acquire at any time and must remain in effect as long as the election remains in effect.

RECORDS When there is a sale, exchange, or redemption of your shares in a fund, keep the confirmation statement you receive. The statement shows the price you received for the shares and other information you need to report gain or loss on your return.

Nontaxable Trades

This section discusses trades that generally do not result in a taxable gain or a deductible loss. For more information on nontaxable trades, see chapter 1 of Pub. 544, Sales and Other Dispositions of Assets.

Like-Kind Exchanges

If you trade business or investment real property solely for other business or investment real property of a like kind, you do not pay tax on any gain or deduct any loss from the trade. To be nontaxable, a trade must meet all six of the following conditions.

1. The property must be business or investment property. You must hold both the property you trade and the property you receive for productive use in your trade or business or for investment. Neither property may be property used for personal purposes, such as your home or family car.
2. The property you trade and the property you receive must be real property.
3. There must be a trade of like-kind property. The trade of real estate for real estate is a trade of like-kind property. The trade of an apartment house for a store building is a trade of like-kind property. Real property located in the United States and real property located outside the United States are not like-kind property.
4. The property must not be held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise.
5. The property to be received must be identified in writing within 45 days after the date you transfer the property given up in the trade. If you received the replacement property before the end of the 45-day period, you automatically are treated as having met the 45-day written notice requirement.
6. The property to be received must be received by the earlier of:
   a. The 180th day after the date on which you transfer the property given up in the trade; or
   b. The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

If you trade property with a related party in a like-kind exchange, a special rule may apply. See *Related Party Transactions*, later in this chapter. Also, see chapter 1 of Pub. 544 for more information on exchanges of business property and special rules for exchanges using qualified intermediaries or involving multiple properties.

Exchanges started in 2017 and completed in 2018. Under the Tax Cuts and Jobs Act, section 1031 only applies to exchanges of real property, other than real property held primarily for sale. Before enactment of the new tax law, section 1031 also applied to certain exchanges of personal or intangible property. A transition rule in the new law provides that section 1031 will still apply to a qualifying exchange of personal or intangible property if the taxpayer disposed of the exchanged property on or before December 31, 2017, or received replacement property on or before that date.

Partly nontaxable exchange. If you receive money or property that is not like-kind property in addition to the like-kind property, and the preceding six conditions are met, you have a partly nontaxable trade. You are taxed on any gain you realize, but only up to the amount of the money and the fair market value of the property that is not like-kind you receive. You cannot deduct a loss.

Like property and unlike property transferred. If you give up unlike property in addition to the like-kind property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and its fair market value.

Like property and money transferred. If conditions (1)–(6) above are met, you have a nontaxable trade even if you pay money in addition to the like property.

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

How to report. You must report the trade of like-kind property on Form 8824. If you figure a recognized gain or loss on Form 8824, report it on Schedule D (Form 1040) or on Form 4797, whichever applies.

For information on using Form 4797, see chapter 4 of Pub. 544.

Corporate Stocks

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

Corporate reorganizations. In some instances, a company will give you common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation. If this is a result of a merger, recapitalization, transfer to a controlled corporation, bankruptcy, corporate division, corporate acquisition, or other corporate reorganization, you do not recognize gain or loss.

Example 1. On April 11, 2018, KP1 Corporation was acquired by KP2 Corporation. You held 100 shares of KP1 stock with a basis of $3,500. As a result of the acquisition, you received 70 shares of KP2 stock in exchange for your KP1 stock. You do not recognize gain or loss on the transaction. Your basis in the 70 shares of the new stock is still $3,500.

Example 2. On July 18, 2018, RGB Corporation divests itself of SFH Corporation. You hold 75 shares of RGB stock with a basis of $5,400. You receive 25 shares of SFH stock as a result of the spin-off. You do not recognize any gain or loss on the transaction. You receive information from RGB Corporation that your basis in SFH stock is equal to 10.9624% of your basis in RGB stock ($5,400). Thus, your basis in SFH stock is $592. Your basis in RGB stock (after the spin-off) is $4,808 ($5,400 – $592).

Note. In the case of a spin-off, the divesting corporation should send you information that includes details on how to allocate basis between the old and new stock. Keep this information until the period of limitations expires for the year in which you dispose of the stock in a taxable disposition. Usually, this is 3 years from the date the return was due or filed, or 2 years from the date the tax was paid, whichever is later.

Stock for stock of the same corporation. You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two stockholders as well as a trade between a stockholder and the corporation.

If you receive cash for fractional shares, see *Fractional shares* in chapter 1.

Money or other property received. If in an otherwise nontaxable trade you receive money or other property in addition to stock, then your gain on the trade, if any, is taxed, but only up to the amount of the money or other property. Any loss is not recognized.

If you received cash for fractional shares, see *Fractional shares* in chapter 1.

Nonqualified preferred stock. Nonqualified preferred stock is generally treated as property other than stock. Generally, this applies to preferred stock with one or more of the following features.

- The holder has the right to require the issuer or a related person to redeem or purchase the stock.
- The issuer or a related person is required to redeem or purchase the stock.
- The issuer or a related person has the right to redeem the stock, and on the issue date, it is more likely than not that the right will be exercised.
- The dividend rate on the stock varies with reference to interest rates, commodity prices, or similar indices.

For a detailed definition of nonqualified preferred stock, see section 351(g)(2) of the Internal Revenue Code.

Convertible stocks and bonds. You generally will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate.

Example. In November, you bought for $1 a right issued by XYZ Corporation entitling you, on payment of $99, to subscribe to a bond issued by that corporation.

On December 5, you subscribed to the bond, which was issued on December 12. The bond contained a clause stating that you would receive one share of XYZ Corporation common stock on surrender of one bond and the payment of $50.

Later, you presented the bond and $50 and received one share of XYZ Corporation common stock. You did not have a recognized gain or loss. This is true whether the fair market value of the stock was more or less than $150 on the date of the conversion.

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The basis of your share of stock is $150 ($1 + $99 + $50). Your holding period is split. Your holding period for the part based on your ownership of the bond ($100 basis) begins on December 5. Your holding period for the part based on your cash investment ($50 basis) begins on the day after you acquired the share of stock.

Bonds for stock of another corporation. Generally, if you convert the bonds of one corporation into common stock of another corporation, according to the terms of the bond issue, you must recognize gain or loss up to the difference between the fair market value of the stock received and the adjusted basis of the bonds exchanged. In some instances, however, such as trades that are part of mergers or other corporate reorganizations, you will have no recognized gain or loss if certain requirements are met. For more information about the tax consequences of converting securities of one corporation into common stock of another corporation, under circumstances such as those just described, consult the respective corporations and the terms of the bond issue. This information is also available on the prospectus of the bond issue.

Property for stock of a controlled corporation. If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

If you are in a bankruptcy or a similar proceeding and you transfer property to a controlled corporation under a plan, other than a reorganization, you must recognize gain to the extent the stock you receive in the exchange is used to pay off your debts.

For this purpose, to be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of nonvoting stock of the corporation.

If this provision applies to you, you may have to attach to your return a complete statement of all facts pertinent to the exchange. For details, see Regulations section 1.351-3.

Money or other property received. If, in an otherwise nontaxable trade of property for corporate stock, you also receive money or property other than stock, you may have a taxable gain. However, you are taxed only up to the amount of money plus the fair market value of the other property you receive. The rules for figuring taxable gain in this situation generally follow those for a partly nontaxable exchange discussed earlier under *Like-Kind Exchanges*. If the property you give up includes depreciable property, the taxable gain may have to be reported as ordinary income because of depreciation. (See chapter 3 of Pub. 544.) No loss is recognized.

Nonqualified preferred stock (described earlier under *Stock for stock of the same corporation*) received is generally treated as property other than stock.

Basis of stock or other property received. The basis of the stock you receive is generally the adjusted basis of the property you transfer. Increase this amount by any amount that was treated as a dividend, plus any gain recognized on the trade. Decrease this amount by any cash you received and the fair market value of any other property you received.

The basis of any other property you receive is its fair market value on the date of the trade.

Exchange of Shares in One Mutual Fund For Shares in Another Mutual Fund

Any exchange of shares in one fund for shares in another fund is a taxable exchange. This is true even if you exchange shares in one fund for shares in another fund within the same family of funds. Report any gain or loss on the shares you gave up as a capital gain or loss in the year in which the exchange occurs. Usually, you can add any service charge or fee paid in connection with an exchange to the cost of the shares acquired. For an exception, see *Commissions and load charges*, earlier.

Insurance Policies and Annuities

You will not have a recognized gain or loss if the insured or annuitant is the same under both contracts and you trade:

- A life insurance contract for another life insurance contract or for an endowment or annuity contract or for a qualified long-term care insurance contract,
- An endowment contract for another endowment contract that provides for regular payments beginning at a date no later than the beginning date under the old contract or for annuity contract or for a qualified long-term insurance contract,
- An annuity contract for annuity contract or for a qualified long-term care insurance contract, or
- A qualified long-term care insurance contract for a qualified long-term care insurance contract.

You also may not have to recognize gain or loss from an exchange of a portion of an annuity contract for another annuity contract. For transfers completed before October 24, 2011, see Revenue Ruling 2003-76 and Revenue Procedure 2008-24 in Internal Revenue Bulletin 2008-13. Revenue Ruling 2003-76 is available at *IRS.gov/irb/2003-33_IRB#RR-2003-76*. Revenue Procedure 2008-24 is available at *IRS.gov/irb/2008-13_IRB#RP-2008-24*. For transfers completed on or after October 24, 2011, see Revenue Ruling 2003-76, above, and Revenue Procedure 2011-38 in Internal Revenue Bulletin 2011-30. Revenue Procedure 2011-38 is available at *IRS.gov/irb/2011-30_IRB#RP-2011-38*. For tax years beginning after 2010, amounts received as an annuity for a period of 10 years or more, or for the lives of one or more individuals, under any portion of an annuity, endowment, or life insurance contract, are treated as a separate contract and are considered partial annuities. A portion of an annuity, endowment, or life insurance contract may be annuitized, provided that the annuitization period is for 10 years or more or for the lives of one or more individuals. The investment in the contract is allocated between the part of the contract from which amounts are received as an annuity and the part of the contract from which amounts are not received as an annuity.

Exchanges of contracts not included in this list, such as an annuity contract for an endowment contract, or an annuity or endowment contract for a life insurance contract, are taxable.

Demutualization of Life Insurance Companies

A life insurance company may change from a mutual company to a stock company. This is commonly called demutualization. If you were a policyholder or annuitant of the mutual company, you may have received either stock in the stock company or cash in exchange for your equity interest in the mutual company.

If the demutualization transaction qualifies as a tax-free reorganization under section 368(a)(1) of the Internal Revenue Code, no gain or loss is recognized on the exchange. Your holding period for the new stock includes the period you held an equity interest in the mutual company as a policyholder or annuitant.

If the demutualization transaction does not qualify as a tax-free reorganization under section 368(a)(1) of the Internal Revenue Code, you must recognize a capital gain or loss. Your holding period for the stock does not include the period you held an equity interest in the mutual company.

If you received cash in exchange for your equity interest, you must recognize a capital gain. If you held an equity interest for more than 1 year, your gain is long term.

U.S. Treasury Notes or Bonds

You can trade certain issues of U.S. Treasury obligations for other issues, designated by the Secretary of the Treasury, with no gain or loss recognized on the trade.

See the discussion in chapter 1 under *U.S. Treasury Bills, Notes, and Bonds* for information about income from these investments.

Transfers Between Spouses

Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse or, if incident to a divorce, a former spouse. This nonrecognition rule does not apply in the following situations.

- The recipient spouse or former spouse is a nonresident alien.

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- Property is transferred in trust and liability exceeds basis. Gain must be recognized to the extent the amount of the liabilities assumed by the trust, plus any liabilities on the property, exceed the adjusted basis of the property.
- An installment obligation is transferred in trust. For information on the disposition of an installment obligation, see Pub. 537.
- Certain stock redemptions, which are taxable to a spouse under the tax law, a divorce or separation instrument, or a valid written agreement, discussed in Regulations section 1.1041-2.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the recipient as a gift and is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within 1 year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage. For more information, see *Property Settlements* in Pub. 504, Divorced or Separated Individuals.

Related Party Transactions

Special rules apply to the sale or trade of property between related parties.

Gain on Sale or Trade of Depreciable Property

Your gain from the sale or trade of property to a related party may be ordinary income, rather than capital gain, if the property can be depreciated by the party receiving it. See chapter 2 in Pub. 544 for more information.

Like-Kind Exchanges

Generally, if you trade business or investment real property for other business or investment real property of a like kind, no gain or loss is recognized. See *Like-Kind Exchanges* under *Nontaxable Trades*, earlier.

This rule also applies to trades of real property between related parties, defined next under *Losses on Sales or Trades of Property*. However, if either you or the related party disposes of the like property within 2 years after the trade, you both must report any gain or loss not recognized on the original trade on your return for the year in which the later disposition occurs.

This rule generally does not apply to:
- Dispositions due to the death of either related party,
- Involuntary conversions (see chapter 1 of Pub. 544), or
- Trades and later dispositions whose main purpose is not the avoidance of federal income tax.

If a property holder's risk of loss on the property is substantially diminished during any period, that period is not counted in determining whether the property was disposed of within 2 years. The property holder's risk of loss is substantially diminished by:
- The holding of a put on the property,
- The holding by another person of a right to acquire the property, or
- A short sale or any other transaction.

Losses on Sales or Trades of Property

You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following related parties.
- Members of your family. This includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- A partnership in which you directly or indirectly own more than 50% of the capital interest or the profits interest.
- A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock (see *Constructive ownership of stock*, later).
- A tax-exempt charitable or educational organization directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between the following related parties.
- A grantor and fiduciary, or the fiduciary and beneficiary, of any trust.
- Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust.
- A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest or the profits interest in the partnership.
- Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
- Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- An executor and a beneficiary of an estate (except in the case of a sale or trade to satisfy a monetary bequest).
- Two corporations that are members of the same controlled group (under certain conditions, however, these losses are not disallowed but must be deferred).
- Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital interests or the profit interests in both partnerships.

Multiple property sales or trades. If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

Indirect transactions. You cannot deduct your loss on the sale of stock through your broker if, under a prearranged plan, a related party buys the same stock you had owned. This does not apply to a trade between related parties through an exchange that is purely coincidental and is not prearranged.

Constructive ownership of stock. In determining whether a person directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

Rule 1. Stock directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered to own the stock directly or indirectly owned by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning, other than by applying rule 2, any stock in a corporation is considered to own the stock directly or indirectly owned by or for his or her partner.

Rule 4. When applying rule 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rule 2 or rule 3 is not treated as owned by that individual for again applying either rule 2 or rule 3 to make another person the constructive owner of the stock.

Property received from a related party. If you sell or trade at a gain property you acquired from a related party, you recognize the gain only to the extent that it is more than the loss previously disallowed to the related party. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the related party's loss was disallowed because of the wash sale rules, described later under *Wash Sales*.

If you sell or trade at a loss property you acquired from a related party, you cannot recognize the loss that was not allowed to the related party.

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Example 1. Your brother sells you stock for $7,600. His cost basis is $10,000. Your brother cannot deduct the loss of $2,400. Later, you sell the same stock to an unrelated party for $10,500, realizing a gain of $2,900. Your reportable gain is $500 (the $2,900 gain minus the $2,400 loss not allowed to your brother).

Example 2. If, in *Example 1*, you sold the stock for $6,900 instead of $10,500, your recognized loss is only $700 (your $7,600 basis minus $6,900). You cannot deduct the loss that was not allowed to your brother.

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Capital Gains and Losses

Terms you may need to know (see Glossary):

- Call
- Commodity future
- Conversion transaction
- Forward contract
- Limited partner
- Listed option
- Nonequity option
- Options dealer
- Put
- Regulated futures contract
- Section 1256 contract
- Straddle
- Wash sale

This section discusses the tax treatment of gains and losses from different types of investment transactions.

Character of gain or loss. You need to classify your gains and losses as either ordinary or capital gains or losses. You then need to classify your capital gains and losses as either short term or long term. If you have long-term gains and losses, you must identify your 28% rate gains and losses. If you have a net capital gain, you must also identify any unrecaptured section 1250 gain.

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

Capital or Ordinary Gain or Loss

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. Generally, a sale or trade of a capital asset (defined next) results in a capital gain or loss. A sale or trade of a noncapital asset generally results in ordinary gain or loss. Depending on the circumstances, a gain or loss on a sale or trade of property used in a trade or business may be treated as either capital or ordinary, as explained in Pub. 544. In some situations, part of your gain or loss may be a capital gain or loss, and part may be an ordinary gain or loss.

Capital Assets and Noncapital Assets

For the most part, everything you own and use for personal purposes, pleasure, or investment is a capital asset. Some examples are:

- Stocks or bonds held in your personal account;
- A house owned and used by you and your family;
- Household furnishings;
- A car used for pleasure or commuting;
- Coin or stamp collections;
- Gems and jewelry; and
- Gold, silver, or any other metal.

Any property you own is a capital asset, except the following noncapital assets.

1. Property held mainly for sale to customers or property that will physically become a part of the merchandise for sale to customers. For an exception, see *Capital asset treatment for self-created musical works*, later.
2. Depreciable property used in your trade or business, even if fully depreciated.
3. Real property used in your trade or business.
4. A patent; invention, model, or design (whether or not patented); a secret formula or process; a copyright; a literary, musical, or artistic composition; a letter or memorandum; or similar property, held by:
   a. A person whose personal efforts created such property;
   b. In the case of a letter, memorandum, or similar property, a person for whom such property was prepared or produced; or
   c. Acquired under circumstances (for example, by gift) entitling you to the basis of the person who created the property or for whom it was prepared or produced.

   Effective for dispositions of such property after 2017.

   For an exception to this rule, see *Capital asset treatment for self-created musical works*, later.
5. Accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of property described in (1).
6. U.S. government publications that you received from the government free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications free or for less than the normal sales price.
7. Certain commodities derivative financial instruments held by commodities derivatives dealers. For more information, see section 1221 of the Internal Revenue Code.
8. Hedging transactions, but only if the transaction is clearly identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into. For more information, see the definition of hedging transaction, earlier, and the discussion of hedging transactions under *Commodity Futures*, later.
9. Supplies of a type you regularly use or consume in the ordinary course of your trade or business.

Investment property. Investment property is a capital asset. Any gain or loss from its sale or trade generally is a capital gain or loss.

Gold, silver, stamps, coins, gems, etc. These are capital assets except when they are held for sale by a dealer. Any gain or loss from their sale or trade generally is a capital gain or loss.

Stocks, stock rights, and bonds. All of these, including stock received as a dividend, are capital assets except when they are held for sale by a securities dealer. However, see *Losses on Section 1244 (Small Business) Stock* and *Losses on Small Business Investment Company Stock*, later.

Personal use property. Property held for personal use only, rather than for investment, is a capital asset, and you must report a gain from its sale as a capital gain. However, you cannot deduct a loss from selling personal use property.

Capital asset treatment for self-created musical works. You can elect to treat musical compositions and copyrights in musical works as capital assets when you sell or exchange them if:

- Your personal efforts created the property, or
- You acquired the property under circumstances (for example, by gift) entitling you to the basis of the person who created the property or for whom it was prepared or produced.

You must make a separate election for each musical composition (or copyright in a musical work) sold or exchanged during the tax year. Make the election by the due date (including extensions) of the income tax return for the tax year of the sale or exchange. Make the election on Form 8949 and Schedule D (Form 1040) by treating the sale or exchange as the sale or exchange of a capital asset, according to Form 8949 and Schedule D (Form 1040) and their separate instructions.

You can revoke the election if you have IRS approval. To get IRS approval, you must submit a request for a letter ruling under the appropriate IRS revenue procedure. See, for example, Revenue Procedure 2019-1, available at *IRS.gov/irb/2019-01_IRB#RP-2019-1*. Alternatively, you are granted an automatic 6-month extension from the due date of your income tax return (excluding extensions) to revoke the election, provided you timely file your income tax return, and within this 6-month extension

period, you file Form 1040X that treats the sale or exchange as the sale or exchange of property that is not a capital asset.

Discounted Debt Instruments

Treat your gain or loss on the sale, redemption, or retirement of a bond or other debt instrument originally issued at a discount or bought at a discount as capital gain or loss, except as explained in the following discussions.

Short-term government obligations. Treat gains on short-term federal, state, or local government obligations (other than tax-exempt obligations) as ordinary income up to your ratable share of the acquisition discount. This treatment applies to obligations with a fixed maturity date of not more than 1 year from the date of issue. Acquisition discount is the stated redemption price at maturity minus your basis in the obligation.

However, do not treat these gains as income to the extent you previously included the discount in income. See *Discount on Short-Term Obligations* in chapter 1 for more information.

Short-term nongovernment obligations. Treat gains on short-term nongovernment obligations as ordinary income up to your ratable share of OID. This treatment applies to obligations with a fixed maturity date of not more than 1 year from the date of issue.

However, to the extent you previously included the discount in income, you do not have to include it in income again. See *Discount on Short-Term Obligations* in chapter 1 for more information.

Tax-exempt state and local government bonds. If these bonds were originally issued at a discount before September 4, 1982, or you acquired them before March 2, 1984, treat your part of OID as tax-exempt interest. To figure your gain or loss on the sale or trade of these bonds, reduce the amount realized by your part of OID.

If the bonds were issued after September 3, 1982, and acquired after March 1, 1984, increase the adjusted basis by your part of OID to figure gain or loss. For more information on the basis of these bonds, see *Discounted tax-exempt obligations*, earlier in this chapter.

Any gain from market discount is usually taxable on disposition or redemption of tax-exempt bonds. If you bought the bonds before May 1, 1993, the gain from market discount is capital gain. If you bought the bonds after April 30, 1993, the gain from market discount is ordinary income.

You figure market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders. For more information, see *Market Discount Bonds* in chapter 1.

A loss on the sale or other disposition of a tax-exempt state or local government bond is deductible as a capital loss.

Redeemed before maturity. If a state or local bond issued before June 9, 1980, is redeemed before it matures, the OID is not taxable to you.

If a state or local bond issued after June 8, 1980, is redeemed before it matures, the part of OID earned while you hold the bond is not taxable to you. However, you must report the unearned part of OID as a capital gain.

Example. On July 5, 2007, the date of issue, you bought a 20-year, 6% municipal bond for $800. The face amount of the bond was $1,000. The $200 discount was OID. At the time the bond was issued, the issuer had no intention of redeeming it before it matured. The bond was callable at its face amount beginning 10 years after the issue date.

The issuer redeemed the bond at the end of 11 years (July 5, 2018) for its face amount of $1,000 plus accrued annual interest of $60. The OID earned during the time you held the bond, $73, is not taxable. The $60 accrued annual interest also is not taxable. However, you must report the unearned part of OID, $127 ($200 – $73), as a capital gain.

Long-term debt instruments issued after 1954 and before May 28, 1969 (or before July 2, 1982, if a government instrument). If you sell, trade, or redeem for a gain one of these debt instruments, the part of your gain that is not more than your ratable share of OID at the time of sale or redemption is ordinary income. The rest of the gain is capital gain. If, however, there was an intention to call the debt instrument before maturity, all of your gain that is not more than the entire OID is treated as ordinary income at the time of the sale. This treatment of taxable gain also applies to corporate instruments issued after May 27, 1969, under a written commitment that was binding on May 27, 1969, and at all times thereafter.

Long-term debt instruments issued after May 27, 1969 (or after July 1, 1982, if a government instrument). If you hold one of these debt instruments, you must include a part of OID in your gross income each year you own the instrument. Your basis in that debt instrument is increased by the amount of OID that you have included in your gross income. See *Original Issue Discount (OID)* in chapter 1.

If you sell or trade the debt instrument before maturity, your gain is a capital gain. However, if at the time the instrument was originally issued there was an intention to call it before its maturity, your gain generally is ordinary income to the extent of the entire OID reduced by any amounts of OID previously includible in your income. In this case, the rest of the gain is capital gain.

An intention to call a debt instrument before maturity means there is a written or oral agreement or understanding not provided for in the debt instrument between the issuer and original holder that the issuer will redeem the debt instrument before maturity. In the case of debt instruments that are part of an issue, the agreement or understanding must be between the issuer and the original holders of a substantial amount of the debt instruments in the issue.

Example 1. On February 10, 2016, you bought at original issue for $7,600, Jones Corporation's 10-year, 5% bond which has a stated redemption price at maturity of $10,000. On February 13, 2018, you sold the bond for $9,040. Assume you have included $334 of OID in your gross income (including the amount accrued for 2018) and increased your basis in the bond by that amount. Your basis is now $7,934. If at the time of the original issue there was no intention to call the bond before maturity, your gain of $1,106 ($9,040 amount realized minus $7,934 adjusted basis) is capital gain.

Example 2. If, in *Example 1*, at the time of original issue there was an intention to call the bond before maturity, your entire gain is ordinary income. You figure this as follows:

1. Entire OID ($10,000 stated redemption price at maturity minus $7,600 issue price)	$2,400
2. Minus: Amount previously included in income	334
3. Maximum amount of ordinary income	$2,066

Because the amount in (3) is more than your gain of $1,106, your entire gain is ordinary income.

Market discount bonds. If the debt instrument has market discount and you chose to include the discount in income as it accrued, increase your basis in the debt instrument by the accrued discount to figure capital gain or loss on its disposition. If you did not choose to include the discount in income as it accrued, you must report gain as ordinary interest income up to the instrument's accrued market discount. See *Market Discount Bonds* in chapter 1. The rest of the gain is capital gain.

However, a different rule applies if you dispose of a market discount bond that was:

- Issued before July 19, 1984; and
- Purchased by you before May 1, 1993.

In that case, any gain is treated as interest income up to the amount of your deferred interest deduction for the year you dispose of the bond. The rest of the gain is capital gain. (The limit on the interest deduction for market discount bonds is discussed in chapter 3 under *When To Deduct Investment Interest*.)

Report the sale or trade of a market discount bond in Form 8949, Part I or Part II, whichever is appropriate. Use the table How To Complete Form 8949, Columns (f) and (g) in the Instructions for Form 8949 to help you figure the amounts to report for a sale or trade of a market discount bond. Also report the amount of accrued market discount in column (g) as interest income on Schedule B (Form 1040), line 1, and identify it as "Accrued Market Discount."

TIP *Report your sales or trades of a market discount bond on Form 8949 with the correct box checked for these transactions. See Form 8949 and the Instructions for Form 8949.*

Retirement of debt instrument. Any amount you receive on the retirement of a debt instrument is treated in the same way as if you had sold or traded that instrument.

Notes of individuals. If you hold an obligation of an individual issued with OID after March 1,

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1984, you generally must include the OID in your income currently, and your gain or loss on its sale or retirement is generally capital gain or loss. An exception to this treatment applies if the obligation is a loan between individuals and all the following requirements are met.

- The lender is not in the business of lending money.
- The amount of the loan, plus the amount of any outstanding prior loans, is $10,000 or less.
- Avoiding federal tax is not one of the principal purposes of the loan.

If the exception applies, or the obligation was issued before March 2, 1984, you do not include the OID in your income currently. When you sell or redeem the obligation, the part of your gain that is not more than your accrued share of OID at that time is ordinary income. The rest of the gain, if any, is capital gain. Any loss on the sale or redemption is capital loss.

Bearer Obligations

You cannot deduct any loss on an obligation required to be in registered form that is instead held in bearer form. In addition, any gain on the sale or other disposition of the obligation is ordinary income. However, if the issuer was subject to a tax when the obligation was issued, then you can deduct any loss, and any gain may qualify for capital gain treatment.

Obligations required to be in registered form. Any obligation must be in registered form unless:

- It is issued by a natural person,
- It is not of a type offered to the public,
- It has a maturity at the date of issue of not more than 1 year, or
- It was issued before 1983.

Deposit in Insolvent or Bankrupt Financial Institution

If you lose money you have on deposit in a bank, credit union, or other financial institution that becomes insolvent or bankrupt, you may be able to deduct your loss in one of two ways.

- Casualty loss.
- Nonbusiness bad debt (short-term capital loss).

CAUTION *You can no longer claim any miscellaneous itemized deductions, including the deduction for an ordinary loss on deposits in insolvent or bankrupt financial institutions.*

Casualty loss. If you can reasonably estimate your loss, you can treat the estimated loss as a casualty loss in the current year.

If you claim a casualty loss, attach Form 4684 to your return. Each loss must be reduced by $100. The amount of your casualty loss may be limited. See Pub. 547.

You cannot choose this method if:

- You own at least 1% of the financial institution,
- You are an officer of the institution, or
- You are related to such an owner or officer. You are related if you and the owner or officer are "related parties," as defined earlier under *Related Party Transactions*, or if you are the aunt, uncle, nephew, or niece of the owner or officer.

If the actual loss that is finally determined is more than the amount you deducted as an estimated loss, you can claim the excess loss as a nonbusiness bad debt. If the actual loss is less than the amount deducted as an estimated loss, you must include in income (in the final determination year) the excess loss claimed. See *Recoveries* in Pub. 525.

Nonbusiness bad debt. If you do not choose to deduct your estimated loss as a casualty loss or an ordinary loss, you wait until the year the amount of the actual loss is determined and deduct it as a nonbusiness bad debt in that year. Report it as a short-term capital loss on Form 8949, Part I, line 1, as explained under *How to report bad debts*, later.

Sale of Annuity

The part of any gain on the sale of an annuity contract before its maturity date that is based on interest accumulated on the contract is ordinary income.

Conversion Transactions

Generally, all or part of a gain on a conversion transaction is treated as ordinary income. This applies to gain on the disposition or other termination of any position you held as part of a conversion transaction you entered into after April 30, 1993.

A conversion transaction is any transaction that meets both of these tests.

1. Substantially all of your expected return from the transaction is due to the time value of your net investment. In other words, the return on your investment is, in substance, like interest on a loan.
2. The transaction is one of the following.
   a. A straddle as defined under *Straddles*, later, but including any set of offsetting positions on stock established before October 22, 2004.
   b. Any transaction in which you acquire property (whether or not actively traded) at substantially the same time that you contract to sell the same property, or substantially identical property, at a price set in the contract.
   c. Any other transaction that is marketed or sold as producing capital gains from a transaction described in (1).

Amount treated as ordinary income. The amount of gain treated as ordinary income is the smaller of:

- The gain recognized on the disposition or other termination of the position, or
- The "applicable imputed income amount."

Applicable imputed income amount. Figure this amount as follows.

1. Figure the amount of interest that would have accrued on your net investment in the conversion transaction for the period ending on the earlier of:
   a. The date you dispose of the position, or
   b. The date the transaction stops being a conversion transaction.

   To figure this amount, use an interest rate equal to 120% of the "applicable rate," defined later.
2. Subtract from (1) the amount treated as ordinary income from any earlier disposition or other termination of a position held as part of the same conversion transaction.

Applicable rate. If the term of the conversion transaction is indefinite, the applicable rate is the federal short-term rate in effect under section 6621(b) of the Internal Revenue Code during the period of the conversion transaction, compounded daily.

In all other cases, the applicable rate is the "applicable federal rate" determined as if the conversion transaction were a debt instrument and compounded semiannually.

The rates discussed above are published by the IRS in the Internal Revenue Bulletin. The Internal Revenue Bulletin is available through IRS.gov. You can also find applicable federal rates in the Index of Applicable Federal Rates (AFR) Rulings at *https://apps.IRS.gov/app/picklist/list/federalRates.html*.

See chapter 5, *How To Get Tax Help*, for information on contacting the IRS.

Net investment. To determine your net investment in a conversion transaction, include the fair market value of any position at the time it becomes part of the transaction. This means your net investment generally will be the total amount you invested, less any amount you received for entering into the position (for example, a premium you received for writing a call).

Position with built-in loss. A special rule applies when a position with a built-in loss becomes part of a conversion transaction. A built-in loss is any loss you would have realized if you had disposed of or otherwise terminated the position at its fair market value at the time it became part of the conversion transaction.

When applying the conversion transaction rules to a position with a built-in loss, use the position's fair market value at the time it became part of the transaction. But, when you dispose of or otherwise terminate the position in a transaction in which you recognize gain or loss, you must recognize the built-in loss. The conversion transaction rules do not affect whether the built-in loss is treated as an ordinary or capital loss.

Netting rule for certain conversion transactions. Before determining the amount of gain treated as ordinary income, you can net certain gains and losses from positions of the same conversion transaction. To do this, you have to dispose of all the positions within a 14-day period that is within a single tax year. You cannot net the built-in loss against the gain.

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You can net gains and losses only if you identify the conversion transaction as an identified netting transaction on your books and records. Each position of the conversion transaction must be identified before the end of the day on which the position becomes part of the conversion transaction. For conversion transactions entered into before February 20, 1996, this requirement is met if the identification was made by that date.

Options dealers and commodities traders. These rules do not apply to options dealers and commodities traders.

How to report. Use Form 6781 to report conversion transactions. See the instructions for lines 11 and 13 of Form 6781.

Commodity Futures

A commodity futures contract is a standardized, exchange-traded contract for the sale or purchase of a fixed amount of a commodity at a future date for a fixed price.

If the contract is a regulated futures contract, the rules described earlier under *Section 1256 Contracts Marked to Market* apply to it.

The termination of a commodity futures contract generally results in capital gain or loss unless the contract is a hedging transaction.

Hedging transaction. A futures contract that is a hedging transaction generally produces ordinary gain or loss. A futures contract is a hedging transaction if you enter into the contract in the ordinary course of your business primarily to manage the risk of interest rate or price changes or currency fluctuations on borrowings, ordinary property, or ordinary obligations. (Generally, ordinary property or obligations are those that cannot produce capital gain or loss under any circumstances.) For example, the offset or exercise of a futures contract that protects against price changes in your business inventory results in an ordinary gain or loss.

For more information about hedging transactions, see Regulations section 1.1221-2. Also, see *Hedging Transactions* under *Section 1256 Contracts Marked to Market*, earlier.

If you have multiple transactions in the commodity futures market during the year, the burden of proof is on you to show which transactions are hedging transactions. Clearly identify any hedging transactions on your books and records before the end of the day you entered into the transaction. It may be helpful to have separate brokerage accounts for your hedging and nonhedging transactions. For specific requirements concerning identification of hedging transactions and the underlying item, items, or aggregate risk being hedged, see Regulations section 1.1221-2(f).

Gains From Certain Constructive Ownership Transactions

If you have a gain from a constructive ownership transaction entered into after July 11, 1999, involving a financial asset (discussed later) and the gain normally would be treated as long-term capital gain, all or part of the gain may be treated instead as ordinary income. In addition, if any gain is treated as ordinary income, your tax is increased by an interest charge.

Constructive ownership transactions. The following are constructive ownership transactions.

- A notional principal contract in which you have the right to receive all or substantially all of the investment yield on a financial asset and you are obligated to reimburse all or substantially all of any decline in value of the financial asset.
- A forward or futures contract to acquire a financial asset.
- The holding of a call option and writing of a put option on a financial asset at substantially the same strike price and maturity date.

This provision does not apply if all the positions are marked to market. Marked-to-market rules for section 1256 contracts are discussed in detail under *Section 1256 Contracts Marked to Market*, earlier.

Financial asset. A financial asset, for this purpose, is any equity interest in a pass-through entity. Pass-through entities include partnerships, S corporations, trusts, regulated investment companies, and REITs.

Amount of ordinary income. Long-term capital gain is treated as ordinary income to the extent it is more than the net underlying long-term capital gain. The net underlying long-term capital gain is the net capital gain you would have realized if you acquired the asset for its fair market value on the date the constructive ownership transaction was opened and sold the asset for its fair market value on the date the transaction was closed. If you do not establish the amount of net underlying long-term capital gain by clear and convincing evidence, it is treated as zero.

More information. For more information about constructive ownership transactions, see section 1260 of the Internal Revenue Code.

Losses on Section 1244 (Small Business) Stock

Subject to the limitations discussed under *Ordinary loss limit*, later, you can deduct as an ordinary loss, rather than as a capital loss, a loss on the sale, trade, or worthlessness of section 1244 stock. Report the loss on Form 4797, line 10. Any loss in excess of the amounts described in *Ordinary loss limit*, later, should be reported on Form 8949.

Any gain on section 1244 stock is a capital gain if the stock is a capital asset in your hands. Do not offset gains against losses that are within the ordinary loss limit, explained later in this discussion, even if the transactions are in stock of the same company. Report the gain on Form 8949.

If you must figure a net operating loss, any ordinary loss from the sale of section 1244 stock is a business loss.

Ordinary loss limit. The amount you can deduct as an ordinary loss is limited to $50,000 each year. On a joint return, the limit is $100,000, even if only one spouse has this type of loss. If your loss is $110,000 and your spouse has no loss, you can deduct $100,000 as an ordinary loss on a joint return. The remaining $10,000 is a capital loss.

Section 1244 (small business) stock. This is stock issued for money or property (other than stock and securities) in a domestic small business corporation. During its 5 most recent tax years before the loss, this corporation must have derived more than 50% of its gross receipts from other than royalties, rents, dividends, interest, annuities, and gains from sales and trades of stocks or securities. If the corporation was in existence for at least 1 year, but less than 5 years, the 50% test applies to the tax years ending before the loss. If the corporation was in existence less than 1 year, the 50% test applies to the entire period the corporation was in existence before the day of the loss. However, if the corporation's deductions (other than the net operating loss and dividends received deductions) were more than its gross income during this period, this 50% test does not apply.

The corporation must have been largely an operating company for ordinary loss treatment to apply.

If the stock was issued before July 19, 1984, the stock must be common stock. If issued after July 18, 1984, the stock may be either common or preferred. For more information about the requirements of a small business corporation or the qualifications of section 1244 stock, see section 1244 of the Internal Revenue Code and its regulations.

The stock must be issued to the person taking the loss. You must be the original owner of the stock to be allowed ordinary loss treatment. To claim a deductible loss on stock issued to your partnership, you must have been a partner when the stock was issued and have remained so until the time of the loss. You add your distributive share of the partnership loss to any individual section 1244 stock loss you may have before applying the ordinary loss limit.

Stock distributed by partnership. If your partnership distributes the stock to you, you cannot treat any later loss on that stock as an ordinary loss.

Stock sold through underwriter. Stock sold through an underwriter is not section 1244 stock unless the underwriter only acted as a selling agent for the corporation.

Stock dividends and reorganizations. Stock you receive as a stock dividend qualifies as section 1244 stock if:

- You receive it from a small business corporation in which you own stock, and
- The stock you own meets the requirements when the stock dividend is distributed.

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If you trade your section 1244 stock for new stock in the same corporation in a reorganization that qualifies as a recapitalization or that is only a change in identity, form, or place of organization, the new stock is section 1244 stock if the stock you trade meets the requirements when the trade occurs.

If you hold section 1244 stock and other stock in the same corporation, not all of the stock you receive as a stock dividend or in a reorganization will qualify as section 1244 stock. Only that part based on the section 1244 stock you hold will qualify.

Example. Your basis for 100 shares of X common stock is $1,000. These shares qualify as section 1244 stock. If, as a nontaxable stock dividend, you receive 50 more shares of common stock, the basis of which is determined from the 100 shares you own, the 50 shares are also section 1244 stock.

If you also own stock in the corporation that is not section 1244 stock when you receive the stock dividend, you must divide the shares you receive as a dividend between the section 1244 stock and the other stock. Only the shares from the former can be section 1244 stock.

Contributed property. To determine ordinary loss on section 1244 stock you receive in a trade for property, you have to reduce the basis of the stock if:

- The adjusted basis (for figuring loss) of the property, immediately before the trade, was more than its fair market value; and
- The basis of the stock is determined by the basis of the property.

Reduce the basis of the stock by the difference between the adjusted basis of the property and its fair market value at the time of the trade. You reduce the basis only to figure the ordinary loss. Do not reduce the basis of the stock for any other purpose.

Example. You transfer property with an adjusted basis of $1,000 and a fair market value of $250 to a corporation for its section 1244 stock. The basis of your stock is $1,000, but to figure the ordinary loss under these rules, the basis of your stock is $250 ($1,000 – $750). If you later sell the section 1244 stock for $200, your $800 loss is an ordinary loss of $50 and a capital loss of $750.

Contributions to capital. If the basis of your section 1244 stock has increased, through contributions to capital or otherwise, you must treat this increase as applying to stock that is not section 1244 stock when you figure an ordinary loss on its sale.

Example. You buy 100 shares of section 1244 stock for $10,000. You are the original owner. You later make a $2,000 contribution to capital that increases the total basis of the 100 shares to $12,000. You then sell the 100 shares for $9,000 and have a loss of $3,000. You can deduct only $2,500 ($3,000 × $10,000/$12,000) as an ordinary loss under these rules. The remaining $500 is a capital loss.

Recordkeeping. You must keep records sufficient to show your stock qualifies as section 1244 stock. Your records must also distinguish your section 1244 stock from any other stock you own in the corporation.

Losses on Small Business Investment Company Stock

A small business investment company (SBIC) is one that is licensed and operated under the Small Business Investment Act of 1958.

If you are an investor in SBIC stock, you can deduct as an ordinary loss, rather than a capital loss, a loss from the sale, trade, or worthlessness of that stock. A gain from the sale or trade of that stock is a capital gain. Do not offset your gains and losses, even if they are on stock of the same company.

How to report. You report this type of ordinary loss on Form 4797, Part II, line 10. In addition to the information required by the form, you must include the name and address of the company that issued the stock. If applicable, also include the reason the stock is worthless and the approximate date it became worthless. Report a capital gain from the sale of SBIC stock on Form 8949.

Short sale. If you close a short sale of SBIC stock with other SBIC stock you bought only for that purpose, any loss you have on the sale is a capital loss. See *Short Sales*, later in this chapter, for more information.

Holding Period

If you sold or traded investment property, you must determine your holding period for the property. Your holding period determines whether any capital gain or loss was a short-term or a long-term capital gain or loss.

Long-term or short-term. If you hold investment property more than 1 year, any capital gain or loss is a long-term capital gain or loss. If you hold the property 1 year or less, any capital gain or loss is a short-term capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The day you disposed of the property is part of your holding period.

Example. If you bought investment property on February 3, 2017, and sold it on February 2, 2018, your holding period is not more than 1 year and you have a short-term capital gain or loss. If you sold it on February 6, 2018, your holding period is more than 1 year and you have a long-term capital gain or loss.

Securities traded on an established market. For securities traded on an established securities market, your holding period begins the day after the trade date you bought the securities, and ends on the trade date you sold them.

Do not confuse the trade date with the settlement date, which is the date by which the stock must be delivered and payment must be made.

Example. You are a cash method, calendar year taxpayer. You sold stock on December 31, 2018. According to the rules of the stock exchange, the sale was closed by delivery of the stock and payment of the sale price in January 2019. You received payment of the sale price on that same day. Report your gain or loss on your 2018 return, even though you received the payment in 2019. The gain or loss is long term or short term depending on whether you held the stock more than 1 year. Your holding period ended on December 31.

U.S. Treasury notes and bonds. The holding period of U.S. Treasury notes and bonds sold at auction on the basis of yield starts the day after the Secretary of the Treasury, through news releases, gives notification of acceptance to successful bidders. The holding period of U.S. Treasury notes and bonds sold through an offering on a subscription basis at a specified yield starts the day after the subscription is submitted.

Automatic investment service. In determining your holding period for shares bought by the bank or other agent, full shares are considered bought first and any fractional shares are considered bought last. Your holding period starts on the day after the bank's purchase date. If a share was bought over more than one purchase date, your holding period for that share is a split holding period. A part of the share is considered to have been bought on each date that stock was bought by the bank with the proceeds of available funds.

Nontaxable trades. If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period for the new property begins on the day following the date you acquired the old property.

Property received as a gift. If you receive a gift of property and your basis is determined by the donor's adjusted basis, your holding period is considered to have started on the same day the donor's holding period started.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

Inherited property. If you inherited property from someone who died before or after 2010, or from someone who died in 2010 and the executor of the decedent's estate did not elect to file Form 8939, your capital gain or loss on any later disposition of that property is treated as long-term gain or loss, regardless of how long you held the property. If you acquired the property from someone who died in 2010 and the executor made the election to file Form 8939, see Pub. 4895 to determine your holding period. Pub. 4895 to determine is available at *IRS.gov/pub/irs-prior/P4895-2011.pdf*.

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Real property bought. To figure how long you have held real property bought under an unconditional contract, begin counting on the day after you received title to it or on the day after you took possession of it and assumed the burdens and privileges of ownership, whichever happened first. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Real property repossessed. If you sell real property but keep a security interest in it, and then later repossess the property under the terms of the sales contract, your holding period for a later sale includes the period you held the property before the original sale and the period after the repossession. Your holding period does not include the time between the original sale and the repossession. That is, it does not include the period during which the first buyer held the property. However, the holding period for any improvements made by the first buyer begins at the time of repossession.

Stock dividends. The holding period for stock you received as a taxable stock dividend begins on the date of distribution.

The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a spin-off, which is a distribution of stock or securities in a controlled corporation.

Nontaxable stock rights. Your holding period for nontaxable stock rights includes the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

Section 1256 contracts. Gains or losses on section 1256 contracts open at the end of the year, or terminated during the year, are treated as 60% long term and 40% short term, regardless of how long the contracts were held. See *Section 1256 Contracts Marked to Market*, earlier.

Option exercised. Your holding period for property you acquire when you exercise an option begins the day after you exercise the option.

Wash sales. Your holding period for substantially identical stock or securities you acquire in a wash sale includes the period you held the old stock or securities.

Qualified small business stock. Your holding period for stock you acquired in a tax-free rollover of gain from a sale of qualified small business stock, described later under *Gains on Qualified Small Business Stock*, includes the period you held the old stock.

Commodity futures. Your holding period for a commodity received in satisfaction of a commodity futures contract, other than a regulated futures contract subject to Internal Revenue Code section 1256, includes your holding period for the futures contract if you held the contract as a capital asset.

Securities futures contract. Your holding period for a security received in satisfaction of a securities futures contract, other than one that is a section 1256 contract, includes your holding period for the futures contract if you held the contract as a capital asset.

Your holding period for a security received in satisfaction of a securities futures contract to sell, other than one that is a section 1256 contract, is determined by the rules that apply to short sales, discussed later under *Short Sales*.

Loss on mutual fund or REIT stock held 6 months or less. If you hold stock in a mutual fund (or other regulated investment company) or REIT for 6 months or less and then sell it at a loss (other than under a periodic liquidation plan), special rules may apply.

Capital gain distributions received. The loss (after reduction for any exempt-interest dividends you received, as explained later) is treated as a long-term capital loss up to the total of any capital gain distributions you received and your share of any undistributed capital gains. Any remaining loss is short-term capital loss.

Reinvested distributions. If your dividends and capital gain distributions are reinvested in new shares, the holding period of each new share begins the day after that share was purchased. Therefore, if you sell both the new shares and the original shares, you might have both short-term and long-term gains and losses.

Example. On April 4, 2018, you bought a mutual fund share for $20. On June 20, 2018, the mutual fund paid a capital gain distribution of $2 per share, which is taxed as a long-term capital gain. On July 18, 2018, 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).

TIP *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 11, 2018, you bought a mutual fund share for $40. On February 8, 2018, the mutual fund paid a $5 dividend from tax-exempt interest, which is not taxable to you. On February 16, 2018, 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.

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

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

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

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

Filing a claim for refund. If you do not deduct a bad debt on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the bad debt. To do this, use Form 1040X to amend your return for the year the debt became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. (Claims not due to bad debts or worthless securities generally must be filed within 3 years from the date a return is filed, or 2 years from the date the tax is paid, 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 John are co-workers. Milt, as a favor to John, guarantees a note at their local credit union. John does not pay the note and declares bankruptcy. Milt pays off the note. However, since he did not enter into the guarantee agreement to protect an investment or to make a profit, Milt cannot take a bad debt deduction.

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

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

CAUTION *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 2018 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 2018 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 9, 2018, you bought 100 shares of Baker Corporation stock for $1,000.

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On September 12, 2018, you sold short 100 shares of similar Baker stock for $1,600. You made no other transactions involving Baker stock for the rest of 2018 and the first 30 days of 2019. 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 12.

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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 21.

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 generally are 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 21, 2017, for $5,000. On December 14, 2017, you bought 50 shares of substantially identical stock for $2,750. On December 21, 2017, you bought 25 shares of substantially identical stock for $1,125. On January 4, 2018, 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 14, 2017, 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 21, 2017, is increased by the rest of the loss to $1,375 ($1,125 + $250).

Example 2. You bought 100 shares of M stock on September 21, 2017. On February 2, 2018, you sold those shares at a $1,000 loss. On each of the 4 days from February 6, 2018, to February 9, 2018, 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 6. Add the other half ($500) to the basis of the shares bought on February 7.

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 2012, 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 28, 2017, you sold 300 shares of X stock for $125 per share. On January 11, 2018, 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 generally will 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 generally will be treated in a manner similar to gain or loss from transactions in the underlying security. This means gain or loss from the sale, 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

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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 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.

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. 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

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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 issued on April 11, 2018, for $4,000. These equity options expired in December 2018 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 9, 2018, 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 23, 2018. The buyer adds the cost of the options to the basis of the stock bought through the exercise of the options. The writer adds the amount received from writing the options to the amount realized from selling the stock 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 which 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 earlier 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 11, 2018, you entered into a straddle. On December 12, 2018, you closed one position of the straddle at a loss of $15,000. On December 31, 2018, the end of your tax year, you have an unrecognized gain of $12,750 in the offsetting open position. On your 2018 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.

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- 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 17, 2018, 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 16, 2018, was $130.25. The strike prices of all XYZ/September call options offered on May 17, 2018, 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 5, 2018, you bought

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stock in XX Corporation (XX stock) and an offsetting put option. On December 12, 2018, there was $20 of unrealized gain in the put option and you sold the XX stock at a $20 loss. By December 19, 2018, the value of the put option had declined, eliminating all unrealized gain in the position. On December 19, you bought a second XX stock position that is substantially identical to the XX stock you sold on December 12. 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 2018 under Rule 1 because, within a period beginning 30 days before December 12, 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 7, 2018, you entered into offsetting long and short positions in non-section 1256 contracts. On November 14, 2018, you disposed of the long position at a $10 loss. On November 21, 2018, 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 14. 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 2018 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 2018 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 2018 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 2017 under Rule 1 will not be allowed in 2018, unless the substantially identical stock or securities (which caused the loss to be disallowed in 2017) were disposed of during 2018. In addition, the carryover loss will not be allowed in 2018 if Rule 1 or Rule 2 disallows it.

Example. The facts are the same as in the example under Rule 1. On December 23, 2019, 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 2019 either the $20 loss disallowed in 2018 or the $20 loss you incurred for the December 23, 2019, 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 9, 2017, you acquired gold. On January 11, 2018, you entered into an offsetting short gold forward contract (nonregulated futures contract). On April 4, 2018, you disposed of the short gold forward contract at no gain or loss. On April 11, 2018, 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 4, 2018, 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 7, 2018, you entered into a long gold forward contract. On July 18, 2018, 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 8, 2018, 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.

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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 will be offset against the $800 gain on the section 1256 contract. The net gain of $200 from the straddle will be treated as 60% long-term capital gain and 40% short-term capital gain because it is due to the section 1256 contract.

Example 2. Straddle established after August 18, 2014. On December 1, 2017, you entered into a non-section 1256 position for $100. At the end of the day on January 25, 2018, the position had a value of $500. On January 26, 2018, you entered into an offsetting section 1256 position. You elected to treat the straddle as an identified mixed straddle.

On February 10, 2018, 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, 2018, 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

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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.

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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.

How to make the election. You must make the election no later than the due date (including extensions) for filing your tax return for the year in which you sold the stock. If your original return was filed on time, you may make the election on an amended return filed no later than 6 months after the due date of your return (excluding extensions). Enter "Filed pursuant to section 301.9100-2" at the top of the amended return and file it at the same address you used for your original return.

How to report and postpone gain. Report the sale in Part II of Form 8949 as you would if you were not making the election. Then enter "R" in column (f). Enter the amount of the postponed gain as a negative number in column (g). Put it in parentheses to show it is negative. Complete all remaining columns. If the actual postponed gain is different from the amount you report, file an amended return.

CAUTION *Report your sales of stock to ESOPs or certain cooperatives on Form 8949 with the correct box checked for these transactions. See Form 8949 and the Instructions for Form 8949.*

Also attach the following statements.

1. A "statement of election" that indicates you are making an election under section 1042(a) of the Internal Revenue Code and that includes the following information.
   a. A description of the securities sold, including the type and number of shares, the date of the sale, the amount realized on the sale, and the adjusted basis of the securities.
   b. The name of the ESOP or cooperative to which the qualified securities were sold.
   c. For a sale that was part of a single, interrelated transaction under a prearranged agreement between taxpayers involving other sales of qualified securities, the names and identifying numbers of the other taxpayers under the agreement and the number of shares sold by the other taxpayers.
2. A notarized "statement of purchase" describing the qualified replacement property, date of purchase, and the cost of the property and declaring the property to be qualified replacement property for the qualified stock you sold. The statement must have been notarized no later than 30 days after the purchase. If you have not yet purchased the qualified replacement property, you must attach the notarized "statement of purchase" to your income tax return for the year following the election year (or the election will not be valid).
3. A verified written statement of the domestic corporation whose employees are covered by the ESOP acquiring the securities, or of any authorized officer of the cooperative, consenting to the taxes under sections 4978 and 4979A of the Internal Revenue Code on certain dispositions, and prohibited allocations of the stock purchased by the ESOP or cooperative.

More information. For details, see section 1042 of the Internal Revenue Code and Regulations section 1.1042-1T.

Gains on Qualified Small Business Stock

This section discusses two provisions of the law that may apply to gain from the sale or trade of qualified small business stock. You may qualify for a tax-free rollover of all or part of the gain. You may be able to exclude gain from your income.

Qualified small business stock. This is stock that meets all the following tests.

1. It must be stock in a C corporation.
2. It must have been originally issued after August 10, 1993.
3. The corporation must have total gross assets of $50 million or less at all times after August 9, 1993, and before it issued the stock. Its total gross assets immediately after it issued the stock must also be $50 million or less.

   When figuring the corporation's total gross assets, you must also count the assets of any predecessor of the corporation. In addition, you must treat all corporations that are members of the same parent-subsidiary controlled group as one corporation.
4. You must have acquired the stock at its original issue, directly or through an underwriter, in exchange for money or other property (not including stock), or as pay for services provided to the corporation (other than services performed as an underwriter of the stock). In certain cases, your stock may also meet this test if you acquired it from another person who met this test, or through a conversion or trade of qualified small business stock that you held.
5. The corporation must have met the active business test, defined next, and must have been a C corporation during substantially all the time you held the stock.
6. Within the period beginning 2 years before and ending 2 years after the stock was issued, the corporation cannot have bought more than a de minimis amount of its stock from you or a related party.
7. Within the period beginning 1 year before and ending 1 year after the stock was issued, the corporation cannot have bought more than a de minimis amount of its stock from anyone, unless the total value of the stock it bought is 5% or less of the total value of all its stock.

For more information about tests 6 and 7, see the regulations under section 1202 of the Internal Revenue Code.

Active business test. A corporation meets this test for any period of time if, during that period, both the following are true.

- It was an eligible corporation, defined below.
- It used at least 80% (by value) of its assets in the active conduct of at least one qualified trade or business, defined below.

Exception for Specialized Small Business Investment Company (SSBIC). Any SSBIC is treated as meeting the active business test. An SSBIC is an eligible corporation licensed to operate under section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993.

Eligible corporation. This is any U.S. corporation other than:

- A Domestic International Sales Corporation (DISC) or a former DISC;
- A corporation that has made, or whose subsidiary has made, an election under section 936 of the Internal Revenue Code;
- A regulated investment company;
- A REIT;
- A REMIC;
- Certain financial asset securitization investment trusts (FASITs); or
- A cooperative.

Qualified trade or business. This is any trade or business other than:

- One involving services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services;
- One whose principal asset is the reputation or skill of one or more employees;
- Any banking, insurance, financing, leasing, investing, or similar business;
- Any farming business (including the business of raising or harvesting trees);
- Any business involving the production or extraction of products for which percentage depletion can be claimed; or
- Any business of operating a hotel, motel, restaurant, or similar business.

Rollover of Gain

You may qualify for a tax-free rollover of capital gain from the sale of qualified small business stock held more than 6 months. This means that, if you buy certain replacement stock and make the choice described in this section, you postpone part or all of your gain.

You postpone the gain by adjusting the basis of the replacement stock as described in *Basis of replacement stock*, later. This postpones your gain until the year you dispose of the replacement stock.

You can make this choice if you meet all the following tests.

- You buy replacement stock during the 60-day period beginning on the date of the sale.
- The replacement stock is qualified small business stock.
- The replacement stock continues to meet the active business requirement for small business stock for at least the first 6 months after you buy it.

Amount of gain recognized. If you make the choice described in this section, you must recognize the capital gain only up to the following amount.

- The amount realized on the sale, minus
- The cost of any qualified small business stock you bought during the 60-day period beginning on the date of sale (and did not previously take into account on an earlier sale of qualified small business stock).

If this amount is less than the amount of your capital gain, you can postpone the rest of that gain. If this amount equals or is more than the amount of your capital gain, you must recognize the full amount of your gain.

Basis of replacement stock. You must subtract the amount of postponed gain from the basis of your replacement stock.

Holding period of replacement stock. Your holding period for the replacement stock includes your holding period for the stock sold, except for the purpose of applying the 6-month holding period requirement for choosing to roll over the gain on its sale.

Pass-through entity. A pass-through entity (a partnership, S corporation, or mutual fund or other regulated investment company) also may make the choice to postpone gain. The benefit of the postponed gain applies to your share of the entity's postponed gain if you held an interest in the entity for the entire period the entity held the stock.

If a pass-through entity sold qualified small business stock held for more than 6 months and you held an interest in the entity for the entire period the entity held the stock, you also may choose to postpone gain if you, rather than the pass-through entity, buy the replacement stock within the 60-day period.

How to report gain. Report the entire gain realized from the sale in Part I or Part II of Form 8949. To make the election to postpone gain, report the gain as you would if you were not making the election. Enter "R" in column (f). Enter the amount of the postponed gain as a negative number in column (g). Put it in parentheses to show it is negative. Complete all remaining columns.

CAUTION *Report these transactions on Form 8949 with the correct box checked. See Form 8949 and the Instructions for Form 8949.*

You must make the choice to postpone gain no later than the due date (including extensions) for filing your tax return for the year in which you sold the stock. If your original return was filed on time, you may make the choice on an amended return filed no later than 6 months after the due date of your return (excluding extensions). Enter "Filed pursuant to section 301.9100-2" at the top of the amended return and file it at the same address you used for your original return.

Section 1202 Exclusion

You generally can exclude from your income up to 50% of your gain from the sale or trade of qualified small business stock held by you for more than 5 years. The exclusion can be up to 75% for stock acquired after February 17, 2009, and no later than September 27, 2010, and up to 100% for stock acquired after September 27, 2010. The exclusion can be up to 60% for certain empowerment zone business stock. See *Empowerment zone business stock*, later. The eligible gain minus your section 1202 exclusion is a 28% rate gain. See *Capital Gain Tax Rates*, later.

SSBIC stock. If the stock is SSBIC stock you bought as replacement property for publicly traded securities you sold at a gain before 2018, you must reduce the basis of the stock by the amount of any postponed gain on that earlier sale. But do not reduce your basis by that amount when figuring your section 1202 exclusion.

Limit on eligible gain. The amount of your gain from the stock of any one issuer that is eligible for the exclusion in 2018 is limited to the greater of:

- Ten times your basis in all qualified stock of the issuer you sold or exchanged during the year; or
- $10 million ($5 million for married individuals filing separately), minus the amount of gain from the stock of the same issuer you used to figure your exclusion in earlier years.

How to report gain. Report the sale or exchange on Form 8949, Part II, with the appropriate box checked, as you would if you were not taking the exclusion. Then enter "Q" in column (f) and enter the amount of the excluded gain as a negative number in column (g). Put it in parentheses to show it is negative. Complete all remaining columns. If you are completing line 18 of Schedule D (Form 1040), enter as a positive number the amount of the exclusion on line 2 of the 28% Rate Gain Worksheet in the Schedule D (Form 1040) instructions. But if you exclude 60% of the gain, enter 2/3 of the exclusion. If you exclude 75% of the gain, enter 1/3 of the exclusion. If you exclude 100% of the gain, do not enter an amount.

CAUTION *Report these transactions on Form 8949 with the correct box checked. See Form 8949 and the Instructions for Form 8949.*

More information. For information about additional requirements that may apply, see section 1202 of the Internal Revenue Code.

Empowerment zone business stock. You can exclude up to 60% of your gain if you meet all the following additional requirements.

1. You sell or trade stock in a corporation that qualifies as an empowerment zone business during substantially all of the time you held the stock.
2. You acquired the stock after December 21, 2000.

Condition 1 will still be met if the corporation ceased to qualify after the 5-year period that begins on the date you acquired the stock. However, the gain that qualifies for the 60% exclusion cannot be more than the gain you would have had if you had sold the stock on the date the corporation ceased to qualify.

Note. If either the 75% or 100% exclusion applies, then the 60% exclusion does not apply.

Exclusion of Gain From DC Zone Assets

If you sold or exchanged a District of Columbia Enterprise Zone (DC Zone) asset that you acquired after 1997 but before 2012 and held for more than 5 years, you may be able to exclude a portion of your capital gain attributable to periods after 1997 but before 2017 that you would otherwise include in income. The exclusion applies to an interest in, or property of, certain businesses operating in the District of Columbia before March 24, 2018. See section 1400B for more details.

How to report. Report the sale or exchange on Form 8949, Part II, as you would if you were not taking the exclusion. Enter "X" in column (f) and enter the amount of the exclusion as a negative number in column (g). Put the amount in

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parentheses to show it is negative. See the instructions for Form 8949, columns (f), (g), and (h). Complete all remaining columns.

Reporting Capital Gains and Losses

Generally, report capital gains and losses on Form 8949. Complete Form 8949 before you complete line 1b, 2, 3, 8b, 9, or 10 of Schedule D (Form 1040).

Use Form 8949 to report:

- The sale or exchange of a capital asset not reported on another form or schedule,
- Gains from involuntary conversions (other than from casualty or theft) of capital assets not held for business or profit,
- Nonbusiness bad debts, and
- Worthlessness of a security.

Use Schedule D (Form 1040) to report:

- Overall gain or loss from transactions reported on Form 8949;
- Certain transactions you do not have to report on Form 8949;
- Gain from Form 2439 or 6252 or Part I of Form 4797;
- Gain or loss from Form 4684, 6781, or 8824;
- Gain or loss from a partnership, S corporation, estate, or trust;
- Capital gain distributions not reported directly on your Form 1040; and
- Capital loss carryover from the previous year to the current year.

On Form 8949, enter all sales and exchanges of capital assets, including stocks, bonds, etc., and real estate (if not reported on Form 4684, 4797, 6252, 6781, 8824, or line 1a or 8a of Schedule D (Form 1040)). Include these transactions even if you did not receive a Form 1099-B or Form 1099-S, Proceeds From Real Estate Transactions, for the transaction. Report short-term gains or losses in Part I. Report long-term gains or losses in Part II. Use as many Forms 8949 as you need.

Exceptions to filing Form 8949 and Schedule D (Form 1040). There are certain situations where you may not have to file Form 8949 and/or Schedule D (Form 1040).

Exception 1. You do not have to file Form 8949 or Schedule D (Form 1040) if you have no capital losses and your only capital gains are capital gain distributions from Form(s) 1099-DIV, box 2a. If any Form 1099-DIV you receive has an amount in box 2b (unrecaptured section 1250 gain), box 2c (section 1202 gain), or box 2d (collectibles (28%) gain), you do not qualify for this exception.

If you qualify for this exception, report your capital gain distributions directly on Schedule 1 (Form 1040), line 13, and check the box on that line. Also use the Qualified Dividends and Capital Gain Tax Worksheet in the Form 1040 instructions to figure your tax.

Exception 2. You must file Schedule D (Form 1040), but generally do not have to file Form 8949, if *Exception 1* above does not apply and your only capital gains and losses are:

- Capital gain distributions;
- A capital loss carryover;
- A gain from Form 2439 or 6252 or Part I of Form 4797;
- A gain or loss from Form 4684, 6781, or 8824;
- A gain or loss from a partnership, S corporation, estate, or trust; or
- Gains and losses from transactions for which you received a Form 1099-B that shows basis was reported to the IRS, for which the Ordinary box in box 2 is not checked, and for which you do not need to make any adjustments in column (g) of Form 8949 or enter any codes in column (f) of Form 8949.

Installment sales. You cannot use the installment method to report a gain from the sale of stock or securities traded on an established securities market. You must report the entire gain in the year of sale (the year in which the trade date occurs).

At-risk rules. Special at-risk rules apply to most income-producing activities. These rules limit the amount of loss you can deduct to the amount you risk losing in the activity. The at-risk rules also apply to a loss from the sale or trade of an asset used in an activity to which the at-risk rules apply. For more information, see Pub. 925. Use Form 6198, At-Risk Limitations, to figure the amount of loss you can deduct.

Passive activity gains and losses. If you have gains or losses from a passive activity, you may also have to report them on Form 8582. In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its instructions for more information about reporting capital gains and losses from a passive activity.

Form 1099-B transactions. If you sold property, such as stocks, bonds, or certain commodities, through a broker, you should receive Form 1099-B from the broker. Use the Form 1099-B to complete Form 8949 and/or Schedule D (Form 1040).

If you received a Form 1099-B for a transaction, you usually report the transaction on Form 8949. Report the proceeds shown in box 1d of Form 1099-B in column (d) of either Part I or Part II of Form 8949, whichever applies.

Include in column (g) any selling expenses or option premiums not reflected in Form 1099-B, box 1d or box 1e. If you include a selling expense in column (g), enter "E" in column (f).

Enter the basis shown in box 1e in column (e). If the basis shown on Form 1099-B is not correct, see the table How To Complete Form 8949, Columns (f) and (g), in the Instructions for Form 8949 for the adjustment you must make. If no basis is shown on Form 1099-B, enter the correct basis of the property in column (e). See the instructions for Form 1099-B, Form 8949, and Schedule D (Form 1040) for more information.

Example 1. You sold 100 shares of Fund HIJ for $2,500. You paid a $75 commission to the broker for handling the sale. Your Form 1099-B shows that the net sales proceeds, $2,425 ($2,500 – $75), were reported to the IRS. Report $2,425 in column (d) of Form 8949. Complete columns (a), (b), (c), and (e).

Example 2. You sold 200 shares of Fund KLM for $10,000. You paid a $100 commission at the time of the sale. The broker reported the gross proceeds to the IRS on Form 1099-B, so on Form 8949, you enter "E" in column (f), $10,000 in column (d), and $100 as a negative adjustment in column (g). Complete all remaining columns.

Section 1256 contracts and straddles. Use Form 6781 to report gains and losses from section 1256 contracts and straddles before entering these amounts on Schedule D (Form 1040). Include a copy of Form 6781 with your income tax return.

Market discount bonds. Report the sale or trade of a market discount bond on Part I or Part II of Form 8949, whichever is appropriate. See the table How To Complete Form 8949, Columns (f) and (g), in the Instructions for Form 8949 to help you figure the amounts to report for a sale or trade of a market discount bond. Use the Worksheet for Accrued Market Discount Adjustment in Column (g) in those instructions to figure the adjusted accrued market discount. Also report the amount of accrued market discount as interest income on Schedule B (Form 1040), line 1, and identify it as "Accrued Market Discount." See the Instructions for Form 8949 for more information.

Form 1099-CAP transactions. If a corporation in which you own stock has had a change in control or a substantial change in capital structure, you should receive Form 1099-CAP, Changes in Corporate Control and Capital Structure, from the corporation. Use the Form 1099-CAP to fill in Form 8949. If your computations show that you would have a loss because of the change, do not enter any amounts on Form 8949 or Schedule D (Form 1040) as a result of this transaction.

Report the aggregate amount received shown in box 2 of Form 1099-CAP as the sales price in column (d) of either Part I or Part II of Form 8949, whichever applies.

Form 1099-S transactions. If you sold or traded reportable real estate, you generally should receive from the real estate reporting person a Form 1099-S showing the gross proceeds.

"Reportable real estate" is defined as any present or future ownership interest in any of the following.

- Improved or unimproved land, including air space.
- Inherently permanent structures, including any residential, commercial, or industrial building.
- A condominium unit and its accessory fixtures and common elements, including land.
- Stock in a cooperative housing corporation (as defined in section 216 of the Internal Revenue Code).
- Any noncontingent interest in standing timber.

A "real estate reporting person" could include the buyer's attorney, your attorney, the title or escrow company, a mortgage lender, your

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Worksheet 4-1. **Capital Loss Carryover Worksheet** *Keep for Your Records*

Use this worksheet to figure your capital loss carryovers from 2018 to 2019 if Schedule D (Form 1040), line 21, is a loss and (a) that loss is a smaller loss than the loss on Schedule D (Form 1040), line 16, or (b) Form 1040, line 10, is less than zero. Otherwise, you do not have any carryovers.

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1.	Enter the amount from Form 1040, line 10. If a loss, enclose the amount in parentheses		**1.** _____
2.	Enter the loss from Schedule D (Form 1040), line 21, as a positive amount		**2.** _____
3.	Combine lines 1 and 2. If zero or less, enter -0-		**3.** _____
4.	Enter the smaller of line 2 or line 3		**4.** _____
	If line 7 of Schedule D is a loss, go to line 5; otherwise, enter -0- on line 5 and go to line 9.		
5.	Enter the loss from Schedule D (Form 1040), line 7, as a positive amount		**5.** _____
6.	Enter any gain from Schedule D (Form 1040), line 15. If a loss, enter -0-	**6.** _____	
7.	Add lines 4 and 6		**7.** _____
8.	**Short-term capital loss carryover to 2019.** Subtract line 7 from line 5. If zero or less, enter -0-		**8.** _____
	If line 15 of Schedule D is a loss, go to line 9; otherwise, skip lines 9 through 13.		
9.	Enter the loss from Schedule D (Form 1040), line 15, as a positive amount		**9.** _____
10.	Enter any gain from Schedule D (Form 1040), line 7	**10.** _____	
11.	Subtract line 5 from line 4. If zero or less, enter -0-	**11.** _____	
12.	Add lines 10 and 11		**12.** _____
13.	**Long-term capital loss carryover to 2019.** Subtract line 12 from line 9. If zero or less, enter -0-		**13.** _____

broker, the buyer's broker, or the person acquiring the biggest interest in the property.

Your Form 1099-S will show the gross proceeds from the sale or exchange in box 2. See the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040) for how to report these transactions and include them in Part I or Part II of Form 8949, as appropriate. However, report like-kind exchanges on Form 8824 instead.

It is unlawful for any real estate reporting person to separately charge you for complying with the requirement to file Form 1099-S.

Nominees. If you receive gross proceeds as a nominee (that is, the gross proceeds are in your name but actually belong to someone else), see the Instructions for Form 8949 for how to report these amounts on Form 8949.

File Form 1099-B or Form 1099-S with the IRS. If you received gross proceeds as a nominee in 2018, you must file a Form 1099-B or Form 1099-S for those proceeds with the IRS. Send the Form 1099-B or Form 1099-S with a Form 1096 to your Internal Revenue Service Center by February 28, 2019 (April 2, 2019, if you file Form 1099-B or Form 1099-S electronically). Give the actual owner of the proceeds Copy B of the Form 1099-B or Form 1099-S by February 15, 2019. On Form 1099-B, you should be listed as the "Payer." The actual owner should be listed as the "Recipient." On Form 1099-S, you should be listed as the "Filer." The actual owner should be listed as the "Transferor." You do not have to file a Form 1099-B or Form 1099-S to show proceeds for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see the General Instructions for Certain Information Returns.

Sale of property bought at various times. If you sell a block of stock or other property that you bought at various times, report the short-term gain or loss from the sale on one row in Part I of Form 8949 and the long-term gain or loss on one row in Part II of Form 8949. Enter "Various" in column (b) for the "Date acquired."

Sale expenses. On Form 8949, include in column (g) any expense of sale, such as broker's fees, commissions, state and local transfer taxes, and option premiums, unless you reported the net sales price in column (d). If you include an expense of sale in column (g), enter "E" in column (f).

Short-term gains and losses. Capital gain or loss on the sale or trade of investment property held 1 year or less is a short-term capital gain or loss. You report it in Part I of Form 8949.

You combine your share of short-term capital gain or loss from partnerships, S corporations, and fiduciaries, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on line 7 of Schedule D (Form 1040).

Long-term gains and losses. A capital gain or loss on the sale or trade of investment property held more than 1 year is a long-term capital gain or loss. You report it in Part II of Form 8949.

You also report the following in Part II of Schedule D (Form 1040).

- Undistributed long-term capital gains from a mutual fund (or other regulated investment company) or REIT.
- Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries.
- All capital gain distributions from mutual funds and REITs not reported directly on Schedule 1 (Form 1040), line 13.
- Long-term capital loss carryovers.

The result after combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss (line 15 of Schedule D (Form 1040)).

Total net gain or loss. To figure your total net gain or loss, combine your net short-term capital gain or loss (Schedule D (Form 1040), line 7) with your net long-term capital gain or loss (Schedule D (Form 1040), line 15). Enter the result on Schedule D (Form 1040), Part III, line 16. If your losses are more than your gains, see *Capital Losses* next. If both lines 15 and 16 of your Schedule D (Form 1040) are gains and your taxable income on your Form 1040 is greater than zero, see *Capital Gain Tax Rates*, later.

Capital Losses

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on Schedule 1 (Form 1040), line 13, enclosed in parentheses.

Limit on deduction. Your allowable capital loss deduction, figured on Schedule D (Form 1040), is the lesser of:

- $3,000 ($1,500 if you are married and file a separate return), or
- Your total net loss as shown on line 16 of Schedule D (Form 1040).

You can use your total net loss to reduce your income dollar for dollar, up to the $3,000 limit.

Capital loss carryover. If you have a total net loss on line 16 of Schedule D (Form 1040) that is more than the yearly limit on capital loss

Table 4-4. **What Is Your Maximum Capital Gain Rate?**

IF your net capital gain is from...	THEN your maximum capital gain rate is...
collectibles gain	**28%**
eligible gain on qualified small business stock minus the section 1202 exclusion	**28%**
unrecaptured section 1250 gain	**25%**
other gain[1] and the regular tax rate that would apply is 37%	**20%**
other gain[1] and the regular tax rate that would apply is 22%, 24%, 32%, or 35%	**15%**
other gain[1] and the regular tax rate that would apply is 10% or 12%	**0%**

[1] "Other gain" means any gain that is not collectibles gain, gain on small business stock, or unrecaptured section 1250 gain.

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deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

When you figure the amount of any capital loss carryover to the next year, you must take the current year's allowable deduction into account, whether or not you claimed it and whether or not you filed a return for the current year.

When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains.

Figuring your carryover. The amount of your capital loss carryover is the amount of your total net loss that is more than the lesser of:

1. Your allowable capital loss deduction for the year, or
2. Your taxable income increased by your allowable capital loss deduction for the year.

If your deductions are more than your gross income for the tax year, use your negative taxable income in figuring the amount in (2) above.

Complete Worksheet 4-1 to determine the part of your capital loss that you can carry over.

Example. Bob and Gloria sold securities in 2018. The sales resulted in a capital loss of $7,000. They had no other capital transactions. Their taxable income was $26,000. On their joint 2018 return, they can deduct $3,000. The unused part of the loss, $4,000 ($7,000 – $3,000), can be carried over to 2019.

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

Use short-term losses first. When you figure your capital loss carryover, use your short-term capital losses first, even if you incurred them after a long-term capital loss. If you have not reached the limit on the capital loss deduction after using the short-term capital losses, use the long-term capital losses until you reach the limit.

Decedent's capital loss. A capital loss sustained by a decedent during his or her last tax year (or carried over to that year from an earlier year) can be deducted only on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. The decedent's estate cannot deduct any of the loss or carry it over to following years.

Joint and separate returns. If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your spouse once filed a joint return and are now filing separate returns, any capital loss carryover from the joint return can be deducted only on the return of the spouse who actually had the loss.

Capital Gain Tax Rates

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gain rates.

The term "net capital gain" means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

For 2018, the maximum capital gain rates are 0%, 15%, 20%, 25%, and 28%. See Table 4-4 for details.

TIP *If you figure your tax using the maximum capital gain rate and the regular tax computation results in a lower tax, the regular tax computation applies.*

Example. All of your net capital gain is from selling collectibles, so the capital gain rate would be 28%. If you are otherwise subject to a rate lower than 28%, the 28% rate does not apply.

Investment interest deducted. If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the capital gain tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on the Schedule D Tax Worksheet or the Qualified Dividends and Capital Gain Tax Worksheet. For more information about the limit on investment interest, see *Interest Expenses* in chapter 3.

28% rate gain. This gain includes gain or loss from the sale of collectibles and the eligible gain from the sale of qualified small business stock minus the section 1202 exclusion.

Collectibles gain or loss. This is gain or loss from the sale or trade of a work of art, rug, antique, metal (such as gold, silver, and platinum bullion), gem, stamp, coin, or alcoholic beverage held more than 1 year.

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

Gain on qualified small business stock. If you realized a gain from qualified small business stock that you held more than 5 years, you generally can exclude some or all of your gain under section 1202. The eligible gain minus your section 1202 exclusion is a 28% rate gain. See *Gains on Qualified Small Business Stock*, earlier in this chapter.

Unrecaptured section 1250 gain. Generally, this is any part of your capital gain from selling section 1250 property (real property) that is due to depreciation (but not more than your net section 1231 gain), reduced by any net loss in the 28% group. Use the Unrecaptured Section 1250 Gain Worksheet in the Schedule D (Form 1040) instructions to figure your unrecaptured section 1250 gain. For more information about section 1250 property and section 1231 gain, see chapter 3 of Pub. 544.

Tax computation using maximum capital gain rates. Use the Qualified Dividends and Capital Gain Tax Worksheet or the Schedule D Tax Worksheet (whichever applies) to figure your tax if you have qualified dividends or net capital gain. You have net capital gain if Schedule D (Form 1040), lines 15 and 16, are both gains.

Schedule D Tax Worksheet. Use the Schedule D Tax Worksheet in the Schedule D (Form 1040) instructions to figure your tax if:

- You have to file Schedule D (Form 1040); and
- Schedule D (Form 1040), line 18 (28% rate gain) or line 19 (unrecaptured section 1250 gain), is more than zero.

Qualified Dividends and Capital Gain Tax Worksheet. If you do not have to use the Schedule D Tax Worksheet (as explained above) and any of the following apply, use the Qualified Dividends and Capital Gain Tax Worksheet in the Instructions for Form 1040 to figure your tax.

- You received qualified dividends. (See *Qualified Dividends* in chapter 1.)
- You do not have to file Schedule D (Form 1040) and you received capital gain distributions. (See *Exceptions to filing Form 8949 and Schedule D (Form 1040)*, earlier.)

- Schedule D (Form 1040), lines 15 and 16, are both more than zero.

Alternative minimum tax. These capital gain rates are also used in figuring alternative minimum tax.

Special Rules for Traders in Securities or Commodities

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Special rules apply if you are a trader in securities or commodities in the business of buying and selling securities or commodities for your own account. To be engaged in business as a trader in securities or commodities, you must meet all the following conditions.

- You must seek to profit from daily market movements in the prices of securities or commodities and not from dividends, interest, or capital appreciation.
- Your activity must be substantial.
- You must carry on the activity with continuity and regularity.

The following facts and circumstances should be considered in determining if your activity is a securities or commodities trading business.

- Typical holding periods for securities or commodities bought and sold.
- The frequency and dollar amount of your trades during the year.
- The extent to which you pursue the activity to produce income for a livelihood.
- The amount of time you devote to the activity.

If your trading activities do not meet the above definition of a business, you are considered an investor, and not a trader. It does not matter whether you call yourself a trader or a "day trader."

How To Report

Transactions from trading activities result in capital gains and losses (unless a section 475(f) election has been made) and must be reported on Form 8949 and Schedule D (Form 1040), as appropriate. Losses from these transactions are subject to the limit on capital losses explained earlier in this chapter.

Mark-to-market election made. If you made the section 475(f) mark-to-market election, you should report all gains and losses from trading as ordinary gains and losses in Part II of Form 4797, instead of as capital gains and losses on Form 8949 and Schedule D (Form 1040). In that case, securities or commodities (depending upon which election was made) held at the end of the year in your business as a trader are marked to market by treating them as if they were sold for fair market value on the last business day of the year and gain or loss is recognized. But do not mark to market any securities or commodities you held for investment. Report sales from those securities or commodities on Form 8949 and Schedule D (Form 1040), as appropriate, not Form 4797. See the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040).

Note. You may be a trader in some securities or commodities and have some securities or commodities that are not held in connection with your activities as a trader, such as those held for investment. The special rules for marking to market discussed here do not apply to the securities or commodities held for investment. You must keep detailed records to distinguish those securities or commodities. The securities or commodities held for investment must be identified as such in your records on the day you acquired them (for example, by holding them in a separate brokerage account) specifically identified under section 475.

Expenses. Interest expense and other investment expenses that an investor would deduct on Schedule A (Form 1040) are deducted by a trader on Schedule C (Form 1040), Profit or Loss From Business, if the expenses are from the trading business. Commissions and other costs of acquiring or disposing of securities or commodities (depending upon which election was made) are not deductible but must be used to figure gain or loss. The limit on investment interest expense, which applies to investors, does not apply to interest paid or incurred in a trading business.

Self-employment tax. Gains and losses from selling securities or commodities as a trader are not subject to self-employment tax. This is true whether the election is made or not. For an exception that applies to section 1256 contracts, see *Self-Employment Income*, earlier.

How To Make the Mark-to-Market Election

To make the mark-to-market election for 2019, you must have filed an election statement no later than the due date for your 2017 return (without regard to extensions). The statement must be attached to that return or with a properly filed request for extension of time to file that 2017 return (Form 4868, Application for Automatic Extension of Time To File U.S. Individual Income Tax Return). The statement must have included the following information.

- That you are making an election under section 475(f)(1) or (f)(2) of the Internal Revenue Code.
- The first tax year for which the election is effective.
- The trade or business for which you are making the election.

If you are a new taxpayer and not required to file a 2018 income tax return, you make the election for 2018 by placing the above statement in your books and records no later than March 15, 2019. Attach a copy of the statement to your 2019 return.

If your method of accounting for 2018 is inconsistent with the mark-to-market election, you must change your method of accounting for securities under Revenue Procedure 2018-31 (or its successor), available at *IRS.gov/irb/2018-22_IRB#RP-2018-31*. Revenue Procedure 2018-31 requires you to file Form 3115, Application for Change in Accounting Method. Follow its instructions. Enter "64" on line 1a of the Form 3115.

Once you make the election, it will apply to 2019 and all later tax years, unless you get permission from the IRS to revoke it. The effect of making the election is described under *Mark-to-market election made*, earlier.

For more information on this election, see Revenue Procedure 99-17, on page 52 of Internal Revenue Bulletin 1999-7 at *IRS.gov/pub/irs-irbs/irb99-07.pdf*.

5. How To Get Tax Help

If you have questions about a tax issue, need help preparing your tax return, or want to download free publications, forms, or instructions, go to IRS.gov and find resources that can help you right away.

Tax reform. Major tax reform legislation impacting individuals, businesses, and tax-exempt entities was approved by Congress in the Tax Cuts and Jobs Act on December 22, 2017. Go to *IRS.gov/TaxReform* for information and updates on how this legislation affects your taxes.

Preparing and filing your tax return. Find free options to prepare and file your return on IRS.gov or in your local community if you qualify.

The Volunteer Income Tax Assistance (VITA) program offers free tax help to people who generally make $55,000 or less, persons with disabilities, and limited-English-speaking taxpayers who need help preparing their own tax returns. The Tax Counseling for the Elderly (TCE) program offers free tax help for all taxpayers, particularly those who are 60 years of age and older. TCE volunteers specialize in answering questions about pensions and retirement-related issues unique to seniors.

You can go to IRS.gov to see your options for preparing and filing your return which include the following.

- **Free File.** Go to *IRS.gov/FreeFile*, to see if you qualify to use brand-name software to prepare and *e-file* your federal tax return for free.
- **VITA.** Go to *IRS.gov/VITA*, download the free IRS2Go app, or call 800-906-9887 to find the nearest VITA location for free tax preparation.
- **TCE.** Go to *IRS.gov/TCE*, download the free IRS2Go app, or call 888-227-7669 to find the nearest TCE location for free tax preparation.

Getting answers to your tax questions. On IRS.gov get answers to your tax questions anytime, anywhere.

- Go to *IRS.gov/Help* for a variety of tools that will help you get answers to some of the most common tax questions.
- Go to *IRS.gov/ITA* for the Interactive Tax Assistant, a tool that will ask you questions on a number of tax law topics and provide answers. You can print the entire interview and the final response for your records.
- Go to *IRS.gov/Pub17* to get Pub. 17, Your Federal Income Tax for Individuals, which features details on tax-saving opportunities, 2018 tax changes, and thousands of interactive links to help you find answers to your questions. View it online in HTML, as a PDF, or download it to your mobile device as an eBook.
- You may also be able to access tax law information in your electronic filing software.

Getting tax forms and publications. Go to *IRS.gov/Forms* to view, download, or print all of the forms and publications you may need. You can also download and view popular tax publications and instructions (including the 1040 instructions) on mobile devices as an eBook at no charge. Or, you can go to *IRS.gov/OrderForms* to place an order and have forms mailed to you within 10 business days.

Access your online account (Individual taxpayers only). Go to *IRS.gov/Account* to securely access information about your federal tax account.

- View the amount you owe, pay online or set up an online payment agreement.
- Access your tax records online.
- Review the past 24 months of your payment history.
- Go to *IRS.gov/SecureAccess* to review the required identity authentication process.

Using direct deposit. The fastest way to receive a tax refund is to combine direct deposit and IRS *e-file*. Direct deposit securely and electronically transfers your refund directly into your financial account. Eight in 10 taxpayers use direct deposit to receive their refund. The IRS issues more than 90% of refunds in less than 21 days.

Refund timing for returns claiming certain credits. The IRS can't issue refunds before mid-February 2019 for returns that claimed the earned income credit (EIC) or the additional child tax credit (ACTC). This applies to the entire refund, not just the portion associated with these credits.

Getting a transcript or copy of a return. The quickest way to get a copy of your tax transcript is to go to *IRS.gov/Transcripts*. Click on either "Get Transcript Online" or "Get Transcript by Mail" to order a copy of your transcript. If you prefer, you can:

- Order your transcript by calling 800-908-9946.
- Mail Form 4506-T or Form 4506T-EZ (both available on IRS.gov).

Using online tools to help prepare your return. Go to *IRS.gov/Tools* for the following.

- The *Earned Income Tax Credit Assistant* (*IRS.gov/EIC*) determines if you're eligible for the EIC.
- The *Online EIN Application* (*IRS.gov/EIN*) helps you get an employer identification number.
- The *IRS Withholding Calculator* (*IRS.gov/W4App*) estimates the amount you should have withheld from your paycheck for federal income tax purposes and can help you perform a "paycheck checkup."
- The *First Time Homebuyer Credit Account Look-up* (*IRS.gov/HomeBuyer*) tool provides information on your repayments and account balance.
- The *Sales Tax Deduction Calculator* (*IRS.gov/SalesTax*) figures the amount you can claim if you itemize deductions on Schedule A (Form 1040), choose not to claim state and local income taxes, and you didn't save your receipts showing the sales tax you paid.

Resolving tax-related identity theft issues.

- The IRS doesn't initiate contact with taxpayers by email or telephone to request personal or financial information. This includes any type of electronic communication, such as text messages and social media channels.
- Go to *IRS.gov/IDProtection* for information.
- If your SSN has been lost or stolen or you suspect you're a victim of tax-related identity theft, visit *IRS.gov/IdentityTheft* to learn what steps you should take.

Checking on the status of your refund.

- Go to *IRS.gov/Refunds*.
- The IRS can't issue refunds before mid-February 2019 for returns that claimed the EIC or the ACTC. This applies to the entire refund, not just the portion associated with these credits.
- Download the official IRS2Go app to your mobile device to check your refund status.
- Call the automated refund hotline at 800-829-1954.

Making a tax payment. The IRS uses the latest encryption technology to ensure your electronic payments are safe and secure. You can make electronic payments online, by phone, and from a mobile device using the IRS2Go app. Paying electronically is quick, easy, and faster than mailing in a check or money order. Go to *IRS.gov/Payments* to make a payment using any of the following options.

- *IRS Direct Pay*: Pay your individual tax bill or estimated tax payment directly from your checking or savings account at no cost to you.
- **Debit or credit card:** Choose an approved payment processor to pay online, by phone, and by mobile device.
- **Electronic Funds Withdrawal:** Offered only when filing your federal taxes using tax preparation software or through a tax professional.
- **Electronic Federal Tax Payment System:** Best option for businesses. Enrollment is required.
- **Check or money order:** Mail your payment to the address listed on the notice or instructions.
- **Cash:** You may be able to pay your taxes with cash at a participating retail store.

What if I can't pay now? Go to *IRS.gov/Payments* for more information about your options.

- Apply for an *online payment agreement* (*IRS.gov/OPA*) to meet your tax obligation in monthly installments if you can't pay your taxes in full today. Once you complete the online process, you will receive immediate notification of whether your agreement has been approved.
- Use the *Offer in Compromise Pre-Qualifier* (*IRS.gov/OIC*) to see if you can settle your tax debt for less than the full amount you owe.

Checking the status of an amended return. Go to *IRS.gov/WMAR* to track the status of Form 1040X amended returns. Please note that it can take up to 3 weeks from the date you mailed your amended return for it to show up in our system and processing it can take up to 16 weeks.

Understanding an IRS notice or letter. Go to *IRS.gov/Notices* to find additional information about responding to an IRS notice or letter.

Contacting your local IRS office. Keep in mind, many questions can be answered on IRS.gov without visiting an IRS Tax Assistance Center (TAC). Go to *IRS.gov/LetUsHelp* for the topics people ask about most. If you still need help, IRS TACs provide tax help when a tax issue can't be handled online or by phone. All TACs now provide service by appointment so you'll know in advance that you can get the service you need without long wait times. Before you visit, go to *IRS.gov/TACLocator* to find the nearest TAC, check hours, available services, and appointment options. Or, on the IRS2Go app, under the Stay Connected tab, choose the Contact Us option and click on "Local Offices."

Watching IRS videos. The IRS Video portal (*IRSvideos.gov*) contains video and audio presentations for individuals, small businesses, and tax professionals.

Getting tax information in other languages. For taxpayers whose native language isn't English, we have the following resources available. Taxpayers can find information on IRS.gov in the following languages.

- *Spanish* (*IRS.gov/Spanish*).
- *Chinese* (*IRS.gov/Chinese*).
- *Vietnamese* (*IRS.gov/Vietnamese*).
- *Korean* (*IRS.gov/Korean*).
- *Russian* (*IRS.gov/Russian*).

The IRS TACs provide over-the-phone interpreter service in over 170 languages, and the service is available free to taxpayers.

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The Taxpayer Advocate Service (TAS) Is Here To Help You

What is TAS? TAS is an ***independent*** organization within the IRS that helps taxpayers and protects taxpayer rights. Their job is to ensure that every taxpayer is treated fairly and that you know and understand your rights under the *Taxpayer Bill of Rights*.

How Can You Learn About Your Taxpayer Rights? The Taxpayer Bill of Rights describes 10 basic rights that all taxpayers have when dealing with the IRS. Go to *TaxpayerAdvocate.IRS.gov* to help you understand *what these rights mean to you* and how they apply. These are ***your*** rights. Know them. Use them.

What Can TAS Do For You? TAS can help you resolve problems that you can't resolve with the IRS. And their service is free. If you qualify for their assistance, you will be assigned to one advocate who will work with you throughout the process and will do everything possible to resolve your issue. TAS can help you if:

- Your problem is causing financial difficulty for you, your family, or your business;
- You face (or your business is facing) an immediate threat of adverse action; or
- You've tried repeatedly to contact the IRS but no one has responded, or the IRS hasn't responded by the date promised.

How Can You Reach TAS? TAS has offices *in every state, the District of Columbia, and Puerto Rico*. Your local advocate's number is in your local directory and at *TaxpayerAdvocate.IRS.gov/Contact-Us*. You can also call them at 877-777-4778.

How Else Does TAS Help Taxpayers? TAS works to resolve large-scale problems that affect many taxpayers. If you know of one of these broad issues, please report it to us at *IRS.gov/SAMS*.

TAS also has a website, *Tax Reform Changes*, which shows you how the new tax law may change your future tax filings and helps you plan for these changes. The information is categorized by tax topic in the order of the IRS Form 1040. Go to *TaxChanges.us* for more information.

Low Income Taxpayer Clinics (LITCs)

LITCs are independent from the IRS. LITCs represent individuals whose income is below a certain level and need to resolve tax problems with the IRS, such as audits, appeals, and tax collection disputes. In addition, clinics can provide information about taxpayer rights and responsibilities in different languages for individuals who speak English as a second language. Services are offered for free or a small fee. To find a clinic near you, visit *TaxpayerAdvocate.IRS.gov/LITCmap* or see IRS Publication 4134, *Low Income Taxpayer Clinic List*.

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Glossary

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Accrual method: An accounting method under which you report your income when you earn it, whether or not you have received it. You generally deduct your expenses when you incur a liability for them, rather than when you pay them.

At-risk rules: Rules that limit the amount of loss you may deduct to the amount you risk losing in the activity.

Basis: Basis is the amount of your investment in property for tax purposes. The basis of property you buy is usually the cost. Basis is used to figure gain or loss on the sale or disposition of investment property.

Below-market loan: A demand loan (defined later) on which interest is payable at a rate below the applicable federal rate, or a term loan where the amount loaned is more than the present value of all payments due under the loan.

Call: An option that entitles the purchaser to buy, at any time before a specified future date, property such as a stated number of shares of stock at a specified price.

Cash method: An accounting method under which you report your income in the year in which you actually or constructively receive it. You generally deduct your expenses in the year you pay them.

Commodities trader: A person who is actively engaged in trading section 1256 contracts and is registered with a domestic board of trade designated as a contract market by the Commodities Futures Trading Commission.

Commodity future: A contract made on a commodity exchange, calling for the sale or purchase of a fixed amount of a commodity at a future date for a fixed price.

Covered security: Covered securities are certain securities subject to added reporting by your broker on any Form 1099-B you may receive. See the Instructions for Form 1099-B for more details.

Conversion transaction: Any transaction that you entered into after April 30, 1993, that meets both of these tests:

1. Substantially all of your expected return from the transaction is due to the time value of your net investment.
2. The transaction is one of the following:
   a. A straddle, including any set of offsetting positions on stock.
   b. Any transaction in which you acquire property (whether or not actively traded) at substantially the same time that you contract to sell the same property or substantially identical property at a price set in the contract.
   c. Any other transaction that is marketed or sold as producing capital gains from a transaction described in (1).

Demand loan: A loan payable in full at any time upon demand by the lender.

Dividend: A distribution of money or other property made by a corporation to its shareholders out of its earnings and profits.

Equity option: Any option:
- To buy or sell stock, or
- That is valued directly or indirectly by reference to any stock or narrow-based security index.

Fair market value: The price at which property would change hands between a willing buyer and a willing seller, both having reasonable knowledge of the relevant facts.

Forgone interest: The amount of interest that would be payable for any period if interest accrued at the applicable federal rate and was payable annually on December 31, minus any interest payable on the loan for that period.

Forward contract: A contract to deliver a substantially fixed amount of property (including cash) for a substantially fixed price.

Futures contract: An exchange-traded contract to buy or sell a specified commodity or financial instrument at a specified price at a specified future date. See also *Commodity future.*

Gift loan: Any below-market loan where the forgone interest is in the nature of a gift.

Interest: Compensation for the use or forbearance of money.

Investment interest: The interest you paid or accrued on money you borrowed that is allocable to property held for investment.

Limited partner: A partner whose participation in partnership activities is restricted, and whose personal liability for partnership debts is limited to the amount of money or other property that he or she contributed or may have to contribute.

Listed option: Any option (other than a right to acquire stock from the issuer) which is traded on (or subject to the rules of) a qualified board or exchange.

Marked-to-market rule: The treatment of each section 1256 contract (defined later) held by a taxpayer at the close of the year as if it were sold for its fair market value on the last business day of the year.

Market discount: The stated redemption price of a bond at maturity minus your basis in the bond immediately after you acquire it. Market discount arises when the value of a debt obligation decreases after its issue date.

Market discount bond: Any bond having market discount except:
- Short-term obligations with fixed maturity dates of up to 1 year from the date of issue,
- Tax-exempt obligations that you bought before May 1, 1993,
- U.S. savings bonds, and
- Certain installment obligations.

Mutual fund: A mutual fund is a regulated investment company generally created by "pooling" funds of investors to allow them to take advantage of diversity of investments and professional management.

Nominee: A person who receives, in his or her name, income that actually belongs to someone else.

Noncovered security: Noncovered securities are securities that are not subject to added reporting by your broker on any Form 1099-B you may receive. See the Instructions for Form 1099-B for more details.

Nonequity option: Any listed option that is not an equity option, such as debt options, commodity futures options, currency options, and broad-based stock index options.

Options dealer: Any person registered with an appropriate national securities exchange as a market maker or specialist in listed options.

Original issue discount (OID): The amount by which the stated redemption price at maturity of a debt instrument is more than its issue price.

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

Portfolio income: Gross income from interest, dividends, annuities, or royalties that is not derived in the ordinary course of a trade or business. It includes gains from the sale or trade of property (other than an interest in a passive activity) producing portfolio income or held for investment.

Premium: The amount by which your cost or other basis in a bond right after you get it is more than the total of all amounts payable on the bond after you get it (other than payments of qualified stated interest).

Private activity bond: A bond that is part of a state or local government bond issue of which:

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

money) used for a private business use.

Put: An option that entitles the purchaser to sell, at any time before a specified future date, property such as a stated number of shares of stock at a specified price.

Real estate mortgage investment conduit (REMIC): An entity that is formed for the purpose of holding a fixed pool of mortgages secured by interests in real property, with multiple classes of interests held by investors. These interests may be either regular or residual.

Regulated futures contract: A section 1256 contract that:

- Provides that amounts that must be deposited to, or may be withdrawn from, your margin account depend on daily market conditions (a system of marking to market); and
- Is traded on, or subject to the rules of, a qualified board of exchange, such as a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission or any board of trade or exchange approved by the Secretary of the Treasury.

Restricted stock: Stock you get for services you perform that is nontransferable and is subject to a substantial risk of forfeiture.

Section 1256 contract: Any:

- Regulated futures contract,
- Foreign currency contract as defined in chapter 4 under *Foreign currency contract*,
- Nonequity option,
- Dealer equity option, or
- Dealer securities futures contract.

A section 1256 contract does not include certain swaps as listed in *Exceptions* under *Section 1256 Contracts Marked to Market* in chapter 4.

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

Short sale: The sale of property that you generally do not own. You borrow the property to deliver to a buyer and, at a later date, you buy substantially identical property and deliver it to the lender.

Straddle: Generally, a set of offsetting positions on personal property. A straddle may consist of a 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.

Stripped preferred stock: Stock that meets the following tests:

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

Term loan: Any loan that is not a demand loan.

Wash sale: A sale of stock or securities at a loss within 30 days before or after you buy or acquire in a fully taxable trade, or acquire a contract or option to buy, substantially identical stock or securities.

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Index

To help us develop a more useful index, please let us know if you have ideas for index entries. See "Comments and Suggestions" in the "Introduction" for the ways you can reach us.

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