



## INVESTMENTS

### I. PUTS AND CALLS

#### A. GENERAL INFORMATION

Puts and calls are **options** (so-called equity options) on securities and are issued by writers (sellers) to holders (buyers) for cash premiums. They terminate by exercise, closing the transaction, or lapse.

A **call option is the right to buy** from the writer of the option, at any time before a specified future date, a stated number of shares of stock at a specified price. Conversely, a **put option is the right to sell** to the writer, at any time before a specified future date, a stated number of shares at a specified price.

#### B. BUYERS OF PUTS AND CALLS

A buyer (holder) of a call or a put may not deduct its cost. It is a capital expenditure. If the holder sells the call or the put instead of exercising it, the difference between its cost and the amount received for it is either a long-term or short-term capital gain or loss, depending on the holding period, which ends on the date of sale.

If the holder exercises a call, its cost is added to the basis of the stock. If the holder exercises a put, the amount realized on the sale of the underlying stock is reduced by the cost of the put when figuring the gain or loss. Any gain or loss on the sale of the underlying stock is long term or short term depending on the holding period for the underlying stock.

If the holder lets the option expire, the cost of the option is a long-term or short-term capital loss, depending on the holding period. The holding period begins the day after the option was purchased and ends on the expiration date.

**Example 1.** On June 8, 2000, Bill bought two Bestco call options with a strike price of \$50. They gave Bill the right to buy 200 shares of Bestco stock at \$50 a share on or before the option expiration date. In Bill's case, that expiration date was the third Friday in December, 2000. Bill paid \$275 per option contract plus commission to acquire the two call option contracts. His total purchase price including commission was \$610. Bill expected the price on the underlying Bestco stock to rise, and if it did, Bill would exercise his option.

Example 1, Scenario 1. The price of Bestco stock declined and Bill let his call option expire on the expiration date (December 15, 2000). Bill has a short-term capital loss. He is considered to have sold the option on the date it expired. This is a capital loss because Bill is not a dealer in securities. An expired option is reported by entering the expiration date in column (c), Schedule D and writing "expired" in column (d). See the completed 2000 Schedule D.

# 2000 Workbook

**SCHEDULE D  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)

Name(s) shown on Form 1040

## Capital Gains and Losses

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

OMB No. 1545-0074

**2000**

Attachment  
Sequence No. **12**

Your social security number

### Bill - Example 1, Scenario 1

**Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less**

| (a) Description of property<br>(Example: 100 sh. XYZ Co.) | (b) Date<br>acquired<br>(Mo., day, yr.) | (c) Date sold<br>(Mo., day, yr.) | (d) Sales price<br>(see page D-5) | (e) Cost or<br>other basis<br>(see page D-5) | (f) GAIN or (LOSS)<br>Subtract (e) from (d) |
|---|---|----------------------------------|-----------------------------------|--|---|
| 1<br><b>2 Bestco</b>                                      | <b>6 - 8 - 00</b>                       | <b>12 - 15 - 99</b>              | <b>Expired</b>                    | <b>610</b>                                   | <b>&lt;610&gt;</b>                          |
| <b>12/00 call options</b>                                 |   |                                  |                                   |  |   |

Example 1, Scenario 2. The price of Bestco stock increased as Bill expected. He exercised his call options on October 13, 2000, and acquired the 200 shares at the agreed-upon price (called strike price or exercise price) of \$50 per shares. He must add the \$610 cost of the option to the \$10,000 (200 shares @ \$50) cost of the shares acquired, resulting in a total basis in the 200 shares of \$10,610.

**Observation.** The **holding period** for property that is acquired under an option to buy begins on the day **after** the taxpayer **acquired the property**, not the day after the taxpayer **acquired the option**. Therefore, Bill's holding period for the 200 shares **begins** on October 14, 2000.

Example 1, Scenario 3. The price of Bestco stock increased as Bill expected. He sold the call option on October 13, 2000, for \$1,230 (after commission).

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

OMB No. 1545-0074

**2000**

Attachment  
Sequence No. **12**

Your social security number

### Bill - Example 1, Scenario 3

**Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less**

| (a) Description of property<br>(Example: 100 sh. XYZ Co.) | (b) Date<br>acquired<br>(Mo., day, yr.) | (c) Date sold<br>(Mo., day, yr.) | (d) Sales price<br>(see page D-5) | (e) Cost or<br>other basis<br>(see page D-5) | (f) GAIN or (LOSS)<br>Subtract (e) from (d) |
|---|---|----------------------------------|-----------------------------------|--|---|
| 1<br><b>2 Bestco</b>                                      | <b>6 - 8 - 00</b>                       | <b>10 - 13 - 00</b>              | <b>1230</b>                       | <b>610</b>                                   | <b>620</b>                                  |
| <b>12/ 00 call options</b>                                |   |                                  |                                   |  |   |

**Example 2.** On June 8, 2000, Annette bought (she was a **buyer**, not a **seller**) three December, 2000 put options of Worstco, Inc. with a strike price of \$10. She read reports that the company would announce the filing of bankruptcy soon and she anticipated that the price of the stock of Worstco would decline **dramatically**. The put options gave Annette the right to **sell** to the **writer** of the put 300 shares of Worstco stock at \$10 a share on or before the option expiration date. That date was December 18, 2000. She paid \$225 per option contract plus commission to acquire the three put option contracts. Her total purchase price including commission was \$710.

Example 2, Scenario 1. The price of Worstco, Inc. increased and Annette let her put options expire on the expiration date (December 18, 2000). She had a short-term capital loss of \$710. Her 2000 Schedule D is prepared in the same manner as explained for Bill in Scenario 1 for Example 9.

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Example 2, Scenario 2. The price of Worstco stock decreased as Annette expected. On December 8, 2000, she bought 300 shares of Worstco Inc. at the market price of \$1.25 per share. She paid \$440 including commission. On December 15, 2000, she exercised her put options. Consequently, the writer of the put options (which Annette bought on June 8, 2000) was obligated to buy her 300 shares for the agreed-upon option price of \$10 per share. Annette sold her 300 shares to the writer on December 15, 2000. This stock sale should be reported via Form 1099-B.

When a put is exercised by a **buyer** of the put, the sales price of the underlying acquired stock must be **reduced** by the cost of the put option when computing gain or loss. See the completed 2000 Schedule D.

| <b>SCHEDULE D</b><br><b>(Form 1040)</b><br><small>Department of the Treasury<br/>Internal Revenue Service (99)</small> |                                      | <b>Capital Gains and Losses</b><br>▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).<br>▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8. |                                   |   |   | OMB No. 1545-0074<br><b>2000</b><br>Attachment<br>Sequence No. <b>12</b> |  |
|--|--------------------------------------|---|-----------------------------------|---|---|--|--|
| Name(s) shown on Form 1040<br><b>Annette - Example 2, Scenario 2</b>   |                                      |   |                                   |   |   | Your social security number<br>: : :                                     |  |
| <b>Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less</b>   |                                      |   |                                   |   |   |  |  |
| (a) Description of property<br>(Example: 100 sh. XYZ Co.)  | (b) Date acquired<br>(Mo., day, yr.) | (c) Date sold<br>(Mo., day, yr.)  | (d) Sales price<br>(see page D-5) | (e) Cost or other basis<br>(see page D-5) | (f) GAIN or (LOSS)<br>Subtract (e) from (d) |  |  |
| <sup>1</sup> 300 sh. Worstco   | 12 -8- 00                            | 12 -15- 00  | *2290                             | 440                                       | 1,850                                       |  |  |

\*\$3,000 received from Writer – \$710 cost of the three puts = \$2,290

Example 2, Scenario 3. The price of Worstco, Inc. stock declines as Annette expected. She sells the put options on November 17, 2000, for \$1,450 (after commission). See the completed 2000 Schedule D.

| <b>SCHEDULE D</b><br><b>(Form 1040)</b><br><small>Department of the Treasury<br/>Internal Revenue Service (99)</small> |                                      | <b>Capital Gains and Losses</b><br>▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).<br>▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8. |                                   |   |   | OMB No. 1545-0074<br><b>2000</b><br>Attachment<br>Sequence No. <b>12</b> |  |
|--|--------------------------------------|---|-----------------------------------|---|---|--|--|
| Name(s) shown on Form 1040<br><b>Annette - Example 2, Scenario 3</b>   |                                      |   |                                   |   |   | Your social security number<br>: : :                                     |  |
| <b>Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less</b>   |                                      |   |                                   |   |   |  |  |
| (a) Description of property<br>(Example: 100 sh. XYZ Co.)  | (b) Date acquired<br>(Mo., day, yr.) | (c) Date sold<br>(Mo., day, yr.)  | (d) Sales price<br>(see page D-5) | (e) Cost or other basis<br>(see page D-5) | (f) GAIN or (LOSS)<br>Subtract (e) from (d) |  |  |
| <sup>1</sup> 3 Worstco   | 6 - 8 - 00                           | 11 -17- 00  | 1450                              | 710                                       |   |  |  |
| 12/00 Put options  |                                      |   |                                   |   |   |  |  |

## C. SELLERS OF PUTS AND CALLS

If a taxpayer writes (sells) a call or a put, the amount received for writing (selling) it is not included in income at the time of receipt. It is carried in a deferred account until:

1. The obligation expires,
2. The writer sells, in the case of a call, or buys, in the case of a put, the underlying stock when the holder exercises the option
3. The writer engages in a closing transaction.

If the writer's obligation expires, the amount he or she receives for writing the call or put is short-term capital gain.

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If a **call** is exercised and the writer sells the underlying stock, the amount the writer realized on the sale of the stock is increased by the amount the writer received for the call when figuring gain or loss. The gain or loss is long term or short term depending on the holding period of the stock.

**Example 3.** Brenda bought 100 shares of IBM on March 10, 2000 at \$110 per share. Her total cost including commissions was \$11,140. On June 28, 2000, she sold a **covered call** on IBM. Following are the details regarding her sale of the call option:

|  |                    |
|--|--------------------|
| Number of Shares                                   | 100                |
| Strike Price                                       | \$130              |
| Option expiration date (3rd Friday of the month)   | September 15, 2000 |
| Amount of premium Brenda received after commission | \$1,775            |

Example 3, Scenario 1. Assume that the price of IBM stock **declined** after Brenda sold her call on June 28, 2000. Consequently, the buyer of Brenda's call **did not** exercise the call option and it **expired worthless**. Brenda has a short-term capital **gain** of \$1,775 as shown below in the completed 2000 Schedule D.

| <b>SCHEDULE D</b><br><b>(Form 1040)</b><br><small>Department of the Treasury<br/>Internal Revenue Service (99)</small> |                                      | <b>Capital Gains and Losses</b><br>▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).<br>▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8. |                                   |   | OMB No. 1545-0074<br><b>2000</b><br>Attachment<br>Sequence No. <b>12</b> |  |
|--|--------------------------------------|---|-----------------------------------|---|--|--|
| Name(s) shown on Form 1040   |                                      |   |                                   |   | Your social security number  |  |
| <b>Brenda - Example 3, Scenario 1</b>  |                                      |   |                                   |   |  |  |
| <b>Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less</b>   |                                      |   |                                   |   |  |  |
| (a) Description of property<br>(Example: 100 sh. XYZ Co.)  | (b) Date acquired<br>(Mo., day, yr.) | (c) Date sold<br>(Mo., day, yr.)  | (d) Sales price<br>(see page D-5) | (e) Cost or other basis<br>(see page D-5) | (f) GAIN or (LOSS)<br>Subtract (e) from (d)                              |  |
| <b>1 IBM 9/00</b>  | <b>9-15-00</b>                       | <b>6-28-00</b>  | <b>1775</b>                       | <b>(expired)</b>                          | <b>1775</b>  |  |
| <b>Call Option</b>   |                                      |   |                                   |   |  |  |

Example 3, Scenario 2. Assume that the price of IBM stock closed at \$135 per share on the option expiration date of September 15, 2000. The buyer of Brenda's call **exercised** the option and bought Brenda's 100 shares for the strike price of \$130 per share. Brenda's **sales price** of the 100 shares consists of **two** elements.

|   |                 |
|---|-----------------|
| 1. Amount of the call option premium received on 6-28-00                                    | \$ 1,775        |
| 2. Amount received when call was exercised by buyer on<br>Sept. 15, 2000 (130 × 100 shares) | 13,000          |
| <b>Brenda's Sales Price</b>   | <b>\$14,775</b> |

Brenda has a short-term capital gain of \$3,635 as shown below in the completed Schedule D.

| <b>SCHEDULE D</b><br><b>(Form 1040)</b><br><small>Department of the Treasury<br/>Internal Revenue Service (99)</small> |                                      | <b>Capital Gains and Losses</b><br>▶ Attach to Form 1040. ▶ See Instructions for Schedule D (Form 1040).<br>▶ Use Schedule D-1 for more space to list transactions for lines 1 and 8. |                                   |   | OMB No. 1545-0074<br><b>2000</b><br>Attachment<br>Sequence No. <b>12</b> |  |
|--|--------------------------------------|---|-----------------------------------|---|--|--|
| Name(s) shown on Form 1040   |                                      |   |                                   |   | Your social security number  |  |
| <b>Brenda - Example 3, Scenario 2</b>  |                                      |   |                                   |   |  |  |
| <b>Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less</b>   |                                      |   |                                   |   |  |  |
| (a) Description of property<br>(Example: 100 sh. XYZ Co.)  | (b) Date acquired<br>(Mo., day, yr.) | (c) Date sold<br>(Mo., day, yr.)  | (d) Sales price<br>(see page D-5) | (e) Cost or other basis<br>(see page D-5) | (f) GAIN or (LOSS)<br>Subtract (e) from (d)                              |  |
| <b>1 100 sh. IBM</b>   | <b>3-10-00</b>                       | <b>9-15-00</b>  | <b>14,775</b>                     | <b>11,140</b>                             | <b>3,635</b>   |  |
|  |                                      |   |                                   |   |  |  |

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**Observation.** Selling **covered calls** is a widespread conservative investing technique to increase yield on stocks. If the call expires worthless, the seller of the call keeps the call option premium.

If a **put** is exercised and the writer buys the underlying stock, basis in the stock is decreased by the amount the writer received for the put. The holding period for the stock begins on the date the writer buys it, not on the date the put was sold.

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

The following table from IRS Publication 550, *Investment Income and Expenses* (1999, p. 54) summarizes the tax treatment of puts and calls.

## Puts and Calls

### Puts

**When a put:**

Is exercised

**If you are the holder (buyer):**

Reduce your amount realized from sale of the underlying stock by the cost of the put.

**If you are the writer (seller):**

Reduce your basis in the stock you buy by the amount you received for the put.

Expires

Report the cost of the put as a capital loss.

Report the amount you received for the put as a short-term capital gain.

Is sold by the holder

Report the difference between the cost of the put and the amount you receive for it as a capital gain or loss.

This does not affect you. (But if you buy back the put, report the difference between the amount you pay and the amount you received for the put as a short-term capital gain or loss.)

### Calls

**When a call:**

Is exercised

**If you are the holder (buyer):**

Add the cost of the call to your basis in the stock purchased.

**If you are the writer (seller):**

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.)

## II. HEDGING VERSUS SPECULATION

### A. SPECULATIVE CONTRACTS AND MARKED-TO-MARKET RULES

If a commodity market transaction is treated as a speculative contract, it is an I.R.C. §1256 contract and subject to the marked-to-market rules. Those rules require the taxpayer to report the increase or decrease in the value of the contract at the end of each year.

1. Forty percent of the gain or loss is treated as short-term capital gain or loss, and sixty percent of the gain or loss for the year is treated as long-term capital gain or loss.
2. Gains or losses from §1256 contracts are first offset by other capital gains or losses from the same tax year.
3. If the capital losses from §1256 contracts exceed the gains from other capital transactions for the year, the taxpayer can elect to carry the excess back three years to offset gain reported from §1256 contract in those years.
4. Any capital loss not used in the carryback years is carried forward indefinitely (for individuals) to succeeding tax years and retains its character as a §1256 loss.
5. Losses from §1256 contracts are included with other capital losses for purposes of applying the limit of deducting \$3,000 of capital losses from ordinary income each year.

### B. HEDGING TRANSACTIONS

If a commodity market transaction is treated as a hedge, the gain or loss on the commodity transaction is treated as ordinary income or deduction and is reported on a business schedule (Schedule F for a farmer).

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

1. The taxpayer entered into the transaction in the normal course of a trade or business primarily to reduce the risk of:
  - a. Price changes or currency fluctuations on property the taxpayer holds (or will hold), or
  - b. Interest rate or price changes, or currency fluctuations, on the taxpayer's current or future borrowings or obligations.
2. The gain or loss on the transaction is treated as ordinary income or loss.
3. The taxpayer clearly identified the transaction as being a hedging transaction before the close of the day on which the taxpayer entered into it.

**Practitioner Note.** What constitutes adequate identification of a hedging transaction is discussed in Treas. Reg. §1.1221-2(e)(2) and (3) and Treas. Reg. §1.1221-2(f). The hedge must be identified on and retained as part of the taxpayer's books and records and must specify the hedging transaction and what is being hedged. A taxpayer can identify a particular transaction as a hedge or identify all transactions in a particular account as hedges.

### C. KEY ELEMENTS IN IDENTIFYING A HEDGE

1. An opposite and equal position in futures market offsets a position in cash market. Examples include a corn producer who sells corn futures. The cattle feeder who buys corn futures would generally be speculating unless futures were used to lock-in feed prices for use in cattle feeding operations.
2. The quantity traded should not exceed anticipated production (or expected usage by a feeder). Trading outside that range is speculation.

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3. Timing should correspond to activities in cash market. Failure to lift a hedge after a transaction in the cash market causes the futures contract to become speculative.

## D. EXAMPLE REPORTING OF A HEDGING TRANSACTION

Example 4, Scenario 1. Ben Plowen, a grain farmer, hedged the risk of the price he would receive for his 2000 soybean crop by selling four October futures contracts (20,000 bushels) short in February at a price of \$5.30 per bushel and identified them as a hedge. Ben harvested and sold 21,000 bushels of soybeans for \$4.60 per bushel ( $\$4.60 \times 21,000 = \$96,600$ ) in late September, 2000. He closed out the four October futures contracts at a purchase price of \$4.80 per bushel.

Ben realizes a hedging gain of \$10,000 ( $\$5.30 - \$4.80 = \$0.50 \times 20,000$  bushels) on the futures contracts. Ben reports the hedging gain of \$10,000 on line 10 of Schedule F and the sale of the soybeans on line 4 of Schedule F. **The hedging gain is treated as ordinary income.**

**Observation.** If the above futures transaction had been treated as speculative, the gain would have been a **capital gain** (40% short term, 60% long term).

|   |  |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
|---|--|---|---|--|---------|--|---|---|---|--|--|--|---|---------------------------------------|--|--|--|--|---|--|--|--|--|--------|----|---|----|--|--|--|----|--------------------------|--|--|--|--|----|--|----|--|--|--|----|--------------------------|--|--|--|--|---|--|--|--|--|--|---|---|--|--|--|--|---|-------------------------------|----|--|--|--|----|--------------------------|--|--|--|--|---|---|--|--|--|--|---|-----------------------------------|----|--|--|--|---|--------------------------|--|--|--|--|---|---|--|--|--|--|----|-------------------------------------|--|--|--|--|---|---|--|--|--|--|----|---|--|--|--|--------|----|--|--|--|--|---------|--|
| <b>SCHEDULE F</b><br><b>(Form 1040)</b><br><br><small>Department of the Treasury<br/>Internal Revenue Service (99)</small>  | <b>Profit or Loss From Farming</b><br><br>▶ Attach to Form 1040, Form 1041, Form 1065, or Form 1065-B.<br><br>▶ See Instructions for Schedule F (Form 1040). | OMB No. 1545-0074<br><br><div style="font-size: 2em; font-weight: bold;">2000</div><br>Attachment<br>Sequence No. <b>14</b> |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| Name of proprietor<br><div style="font-size: 1.2em; font-weight: bold;">Ben Plowen - Example 4, Scenario 1</div>  |  | Social security number (SSN)<br>.....   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| A Principal product. Describe in one or two words your principal crop or activity for the current tax year.<br><div style="font-size: 1.2em; font-weight: bold;">Grain</div>  |  | B Enter code from Part IV<br><div style="font-size: 1.2em; font-weight: bold;">▶ 1 1 1 1 0 0</div>                          |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| C Accounting method:                      (1) <input checked="" type="checkbox"/> Cash                      (2) <input type="checkbox"/> Accrual  |  | D Employer ID number (EIN), if any<br>.....   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| E Did you "materially participate" in the operation of this business during 2000? If "No," see page F-2 for limit on passive losses. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No  |  |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| <div style="background-color: #f0f0f0; padding: 2px;"><b>Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method taxpayers complete Parts II and III, and line 11 of Part I.)</b></div> Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797.  |  |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 5%;">1</td> <td style="width: 45%;">Sales of livestock and other items you bought for resale . . . . .</td> <td style="width: 10%; border: 1px solid black;">1</td> <td style="width: 10%; border: 1px solid black;"></td> <td style="width: 10%; border: 1px solid black;"></td> <td style="width: 10%; border: 1px solid black;"></td> </tr> <tr> <td>2</td> <td>Cost or other basis of livestock and other items reported on line 1 . . . . .</td> <td style="border: 1px solid black;">2</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>3</td> <td>Subtract line 2 from line 1 . . . . .</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>4</td> <td>Sales of livestock, produce, grains, and other products you raised . . . . .</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black; text-align: right; font-weight: bold;">96,600</td> </tr> <tr> <td>5a</td> <td>Total cooperative distributions (Form(s) 1099-PATR) . . . . .</td> <td style="border: 1px solid black;">5a</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>5b</td> <td>Taxable amount . . . . .</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>6a</td> <td>Agricultural program payments (see page F-2) . . . . .</td> <td style="border: 1px solid black;">6a</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>6b</td> <td>Taxable amount . . . . .</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>7</td> <td>Commodity Credit Corporation (CCC) loans (see page F-3):</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>a</td> <td>CCC loans reported under election . . . . .</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>b</td> <td>CCC loans forfeited . . . . .</td> <td style="border: 1px solid black;">7b</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>7c</td> <td>Taxable amount . . . . .</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>8</td> <td>Crop insurance proceeds and certain disaster payments (see page F-3):</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>a</td> <td>Amount received in 2000 . . . . .</td> <td style="border: 1px solid black;">8a</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>b</td> <td>Taxable amount . . . . .</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>c</td> <td>If election to defer to 2001 is attached, check here ▶ <input type="checkbox"/> . . . . .</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>8d</td> <td>Amount deferred from 1999 . . . . .</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>9</td> <td>Custom hire (machine work) income . . . . .</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> </tr> <tr> <td>10</td> <td>Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3) <b>Hedging</b> . . . . .</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black; text-align: right; font-weight: bold;">10,000</td> </tr> <tr> <td>11</td> <td><b>Gross income.</b> Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 . . . . . ▶</td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black;"></td> <td style="border: 1px solid black; text-align: right; font-weight: bold;">106,600</td> </tr> </table> | 1  | Sales of livestock and other items you bought for resale . . . . .  | 1 |  |         |  | 2 | Cost or other basis of livestock and other items reported on line 1 . . . . . | 2 |  |  |  | 3 | Subtract line 2 from line 1 . . . . . |  |  |  |  | 4 | Sales of livestock, produce, grains, and other products you raised . . . . . |  |  |  | 96,600 | 5a | Total cooperative distributions (Form(s) 1099-PATR) . . . . . | 5a |  |  |  | 5b | Taxable amount . . . . . |  |  |  |  | 6a | Agricultural program payments (see page F-2) . . . . . | 6a |  |  |  | 6b | Taxable amount . . . . . |  |  |  |  | 7 | Commodity Credit Corporation (CCC) loans (see page F-3): |  |  |  |  | a | CCC loans reported under election . . . . . |  |  |  |  | b | CCC loans forfeited . . . . . | 7b |  |  |  | 7c | Taxable amount . . . . . |  |  |  |  | 8 | Crop insurance proceeds and certain disaster payments (see page F-3): |  |  |  |  | a | Amount received in 2000 . . . . . | 8a |  |  |  | b | Taxable amount . . . . . |  |  |  |  | c | If election to defer to 2001 is attached, check here ▶ <input type="checkbox"/> . . . . . |  |  |  |  | 8d | Amount deferred from 1999 . . . . . |  |  |  |  | 9 | Custom hire (machine work) income . . . . . |  |  |  |  | 10 | Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3) <b>Hedging</b> . . . . . |  |  |  | 10,000 | 11 | <b>Gross income.</b> Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 . . . . . ▶ |  |  |  | 106,600 |  |
| 1   | Sales of livestock and other items you bought for resale . . . . .   | 1   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 2   | Cost or other basis of livestock and other items reported on line 1 . . . . .  | 2   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 3   | Subtract line 2 from line 1 . . . . .  |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 4   | Sales of livestock, produce, grains, and other products you raised . . . . .   |   |   |  | 96,600  |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 5a  | Total cooperative distributions (Form(s) 1099-PATR) . . . . .  | 5a  |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 5b  | Taxable amount . . . . .   |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 6a  | Agricultural program payments (see page F-2) . . . . .   | 6a  |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 6b  | Taxable amount . . . . .   |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 7   | Commodity Credit Corporation (CCC) loans (see page F-3):   |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| a   | CCC loans reported under election . . . . .  |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| b   | CCC loans forfeited . . . . .  | 7b  |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 7c  | Taxable amount . . . . .   |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 8   | Crop insurance proceeds and certain disaster payments (see page F-3):  |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| a   | Amount received in 2000 . . . . .  | 8a  |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| b   | Taxable amount . . . . .   |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| c   | If election to defer to 2001 is attached, check here ▶ <input type="checkbox"/> . . . . .  |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 8d  | Amount deferred from 1999 . . . . .  |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 9   | Custom hire (machine work) income . . . . .  |   |   |  |         |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 10  | Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3) <b>Hedging</b> . . . . .                                      |   |   |  | 10,000  |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |
| 11  | <b>Gross income.</b> Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 . . . . . ▶   |   |   |  | 106,600 |  |   |   |   |  |  |  |   |                                       |  |  |  |  |   |  |  |  |  |        |    |   |    |  |  |  |    |                          |  |  |  |  |    |  |    |  |  |  |    |                          |  |  |  |  |   |  |  |  |  |  |   |   |  |  |  |  |   |                               |    |  |  |  |    |                          |  |  |  |  |   |   |  |  |  |  |   |                                   |    |  |  |  |   |                          |  |  |  |  |   |   |  |  |  |  |    |                                     |  |  |  |  |   |   |  |  |  |  |    |   |  |  |  |        |    |  |  |  |  |         |  |

Example 4, Scenario 2. Assume Ben produced the same amount of soybeans, but that he sold four October futures contracts (20,000 bushels) short in February at a price of \$4.90 per bushel and identified them as a hedge. Ben harvested and sold 21,000 bushels of soybeans for \$5.10 per bushel ( $\$5.10 \times 21,000 = \$107,100$ ) in late September 2000. He closed out the four October futures contracts at a purchase price of \$5.30 per bushel.

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Ben now realizes a hedging loss of \$8,000 ( $\$4.90 - 5.30 = -\$0.40 \times 20,000$  bushels) on the future contracts. Ben reports the hedging loss on line 10 of Schedule F and the sale of the soybeans on line 4 of Schedule F. **The hedging loss is treated as an ordinary loss.**

**Observation.** If the above futures transaction had been treated as speculative, the loss would have been a **capital loss** (40% short term, 60% long term).

|   |   |  |
|---|---|--|
| <p><b>SCHEDULE F</b><br/><b>(Form 1040)</b></p> <p>Department of the Treasury<br/>Internal Revenue Service (99)</p>   | <p><b>Profit or Loss From Farming</b></p> <p>▶ Attach to Form 1040, Form 1041, Form 1065, or Form 1065-B.</p> <p>▶ See Instructions for Schedule F (Form 1040).</p> | <p>OMB No. 1545-0074</p> <p style="font-size: 2em; font-weight: bold;">2000</p> <p>Attachment<br/>Sequence No. <b>14</b></p> |
| <p>Name of proprietor<br/><b>Ben Plowen - Example 4, Scenario 2</b></p>   |   | <p>Social security number (SSN)</p>  |
| <p>A Principal product. Describe in one or two words your principal crop or activity for the current tax year.<br/><b>Grain</b></p>   |   | <p>B Enter code from Part IV<br/>▶ <b>111100</b></p>   |
| <p>C Accounting method: (1) <input checked="" type="checkbox"/> Cash (2) <input type="checkbox"/> Accrual</p>   |   | <p>D Employer ID number (EIN), if any</p>  |
| <p>E Did you "materially participate" in the operation of this business during 2000? If "No," see page F-2 for limit on passive losses. <input checked="" type="checkbox"/> Yes <input type="checkbox"/> No</p>   |   |  |
| <p><b>Part I Farm Income—Cash Method. Complete Parts I and II (Accrual method taxpayers complete Parts II and III, and line 11 of Part I.)</b><br/><b>Do not include sales of livestock held for draft, breeding, sport, or dairy purposes; report these sales on Form 4797.</b></p>  |   |  |
| <p>1 Sales of livestock and other items you bought for resale . . . . .</p> <p>2 Cost or other basis of livestock and other items reported on line 1 . . . . .</p> <p>3 Subtract line 2 from line 1 . . . . .</p> <p>4 Sales of livestock, produce, grains, and other products you raised . . . . .</p> <p>5a Total cooperative distributions (Form(s) 1099-PATR) . . . . .</p> <p>6a Agricultural program payments (see page F-2) . . . . .</p> <p>7 Commodity Credit Corporation (CCC) loans (see page F-3):</p> <p>    a CCC loans reported under election . . . . .</p> <p>    b CCC loans forfeited . . . . .</p> <p>8 Crop insurance proceeds and certain disaster payments (see page F-3):</p> <p>    a Amount received in 2000 . . . . .</p> <p>    c If election to defer to 2001 is attached, check here ▶ <input type="checkbox"/> . . . . .</p> <p>9 Custom hire (machine work) income . . . . .</p> <p>10 Other income, including Federal and state gasoline or fuel tax credit or refund (see page F-3) <b>Hedging</b></p> <p>11 <b>Gross income.</b> Add amounts in the right column for lines 3 through 10. If accrual method taxpayer, enter the amount from page 2, line 51 . . . . .</p> | <p>1</p> <p>2</p> <p>3</p> <p>4</p> <p>5a</p> <p>6a</p> <p>7a</p> <p>7b</p> <p>8a</p> <p>8b</p> <p>8c</p> <p>9</p> <p>10</p> <p>11</p>                              | <p><b>107,100</b></p> <p><b>&lt;8000&gt;</b></p> <p><b>99,100</b></p>  |

## E. REPORTING OF A SPECULATIVE TRANSACTION

If a farm producer sells a commodity and buys an equivalent amount of commodity futures contracts, the futures contracts is **not** treated as a hedge because the contracts increase rather than reduce risk.

**Transactions that do not reduce risk.** A transaction that is not entered into to reduce a taxpayer's risk is not a hedging transaction. For example, assume that a taxpayer produces a commodity for sale, **sells the commodity, and enters into a long futures or forward contract** in that commodity in the hope that the price will increase. Because the long position does not reduce risk, the transaction is **not a hedging transaction**. Moreover, gain or loss on the contract is not made ordinary on the grounds that it is a surrogate for inventory [Treas. Reg. §1.1221-2(c)(1)(vii)].

**Example 5.** Audrey Handler does not have enough on-farm storage for her soybean crop. However, she did not want to pay the elevator to store her 10,000-bushel soybean crop, so she sold it to the elevator when she harvested it in October 2000 for \$5.20 per bushel. Since she thought the price of soybeans would increase, she bought two futures contracts for 10,000 bushels of soybeans. The futures contracts cost her \$55,000. On December 31, 2000, her futures contracts were worth \$57,000, and she



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sold them in February 2001 for \$61,000. Audrey uses cash accounting. What are the income tax consequences of these transactions to Audrey?

Audrey must report the \$5.20 per bushel sale price of her soybeans as income on her 2000 Schedule F. Since Audrey no longer owned a soybean crop at the time she purchased the futures contracts, the contracts are **not** treated as a hedge. Therefore, her futures contracts are subject to the marked-to-market rules and must be reported on Form 6781 for both 2000 and 2001. She should use the information on the Form 1099-B that she receives from her broker to complete her Form 6781. Audrey is speculating, not hedging.

|  |  |  |  |
|--|--|--|--|
| 7979 <input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED  |  | <b>Proceeds From<br/>Broker and<br/>Barter Exchange<br/>Transactions</b>     |  |
| PAYER'S name, street address, city, state, ZIP code, and telephone no.<br><br><b>Wiley Broker<br/>101 Main Street<br/>Rural KS 56789</b> |  | 1a Date of sale  | <b>2000</b><br>Form <b>1099-B</b>                              |
|  |  | 1b CUSIP No.   |  |
| PAYER'S Federal identification number<br><b>67 - 8111256</b>   |  | RECIPIENT'S identification number<br><b>100 - 01 - 6781</b>                  | 2 Stocks, bonds, etc.<br>\$                                    |
|  |  | 3 Bartering<br>\$  | 4 Federal income tax withheld<br>\$                            |
| RECIPIENT'S name<br><b>Audrey Handler</b>  |  | 5 Description<br><b>Soybean RFC</b><br><b>Regulated Futures Contracts</b>    |  |
| Street address (including apt. no.)<br><b>Route 3</b>  |  | 6 Profit or (loss) realized in 2000<br>\$                                    | 7 Unrealized profit or (loss) on open contracts—12/31/99<br>\$ |
| City, state, and ZIP code<br><b>Rural KS 56789</b>   |  | 8 Unrealized profit or (loss) on open contracts—12/31/2000<br><b>\$ 2000</b> | 9 Aggregate profit or (loss)<br><b>\$ 2000</b>                 |
| Account number (optional)  | 2nd TIN Not.<br><input type="checkbox"/> |  |  |

**Copy A  
For  
Internal Revenue  
Service Center**  
  
File with Form 1096.  
For Privacy Act and  
Paperwork  
Reduction Act  
Notice, see the  
**2000 General  
Instructions for  
Forms 1099, 1098,  
5498, and W-2G.**

|  |   |  |
|--|---|--|
| Form <b>6781</b><br><br>Department of the Treasury<br>Internal Revenue Service   | <b>Gains and Losses From Section 1256<br/>Contracts and Straddles</b><br><br>▶ Attach to your tax return. | OMB No. 1545-0644<br><br><b>2000</b><br>Attachment<br>Sequence No. <b>82</b> |
| Name(s) shown on tax return<br><b>Audrey Handler - Example 5</b>   |   | Identifying number<br><b>100 - 01 - 6781</b>                                 |
| Check applicable box(es) (see instructions):   |   |  |
| <span style="margin-right: 20px;">A <input type="checkbox"/> Mixed straddle election</span> <span style="margin-right: 20px;">C <input type="checkbox"/> Mixed straddle account election</span><br><span style="margin-right: 20px;">B <input type="checkbox"/> Straddle-by-straddle identification election</span> <span style="margin-right: 20px;">D <input type="checkbox"/> Net section 1256 contracts loss election</span> |   |  |

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

| (a) Identification of account   | (b) (LOSS) | (c) GAIN     |
|---|------------|--------------|
| 1 <b>RFC - Soybean Futures - 10,000</b>   |            | <b>2,000</b> |
| 2 Add amounts on line 1 in columns (b) and (c)  | 2 ( )      | <b>2,000</b> |
| 3 Net gain or (loss). Combine columns (b) and (c) of line 2   |            | <b>2,000</b> |
| 4 Form 1099-B adjustments. See instructions and attach schedule   |            |              |
| 5 Combine lines 3 and 4   |            | <b>2,000</b> |
| <i>Note: If line 5 shows a net gain, skip line 6 and enter the gain on line 7. Partnerships and S corporations, see instructions.</i> |            |              |
| 6 If you have a net section 1256 contracts loss and checked box D, enter the amount to be carried back                                |            |              |
| 7 Subtract line 6 from line 5   |            | <b>2,000</b> |
| 8 Short-term capital gain or (loss). Multiply line 7 by 40%. Enter here and include on Schedule D. See instructions                   |            | <b>800</b>   |
| 9 Long-term capital gain or (loss). Multiply line 7 by 60%. Enter here and include on Schedule D. See instructions                    |            | <b>1,200</b> |

# 2000 Workbook

7979

VOID  CORRECTED

|  |   |   |  |  |
|--|---|---|--|--|
| PAYER'S name, street address, city, state, ZIP code, and telephone no.<br><b>Wiley Broker</b><br><b>101 Main Street</b><br><b>Rural KS 56789</b> |   | 1a Date of sale<br><b>2-13-01</b>   | OMB No. 1545-0715<br><div style="font-size: 2em; text-align: center;">2001</div> Form 1099-B | Proceeds From<br>Broker and<br>Barter Exchange<br>Transactions<br><br><b>Copy A</b><br>For<br>Internal Revenue<br>Service Center<br><br>File with Form 1096.<br>For Privacy Act and<br>Paperwork<br>Reduction Act<br>Notice, see the<br>2000 General<br>Instructions for<br>Forms 1099, 1098,<br>5498, and W-2G. |
|  |   | 1b CUSIP No.  |  |  |
| 2 Stocks, bonds, etc.<br>\$  | Reported to IRS } <input type="checkbox"/> Gross proceeds<br>} <input type="checkbox"/> Gross proceeds less commissions and option premiums |   |  |  |
| PAYER'S Federal identification number<br><b>67 - 8111256</b>   | RECIPIENT'S identification number<br><b>100 - 01 - 6781</b>   | 3 Bartering<br>\$   | 4 Federal income tax withheld<br>\$  |  |
| RECIPIENT'S name<br><b>Audrey Handler</b>  |   | 5 Description<br><b>Soybean RFC</b><br><b>Regulated Futures Contracts</b> |  |  |
| Street address (including apt. no.)<br><b>Route 3</b>  |   | 6 Profit or (loss) realized in 2001<br>\$ <b>6000</b>                     | 7 Unrealized profit or (loss) on open contracts—12/31/00<br>\$ <b>2000</b>                   |  |
| City, state, and ZIP code<br><b>Rural KS 56789</b>   |   | 8 Unrealized profit or (loss) on open contracts—12/31/2001<br>\$          | 9 Aggregate profit or (loss)<br>\$ <b>4000</b>   |  |
| Account number (optional)  | 2nd TIN Not. <input type="checkbox"/>   |   |  |  |

Form **6781**

## Gains and Losses From Section 1256 Contracts and Straddles

OMB No. 1545-0644

2001

Attachment  
Sequence No. 82

Department of the Treasury  
Internal Revenue Service

▶ Attach to your tax return.

Name(s) shown on tax return

**Audrey Handler - Example 5**

Identifying number  
**100 - 01 - 6781**

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

### Part I Section 1256 Contracts Marked to Market

| (a) Identification of account   | (b) (LOSS)   | (c) GAIN     |
|---|--------------|--------------|
| <b>1 RFC - Soybean Futures - 10,000</b>   |              | <b>4,000</b> |
| <b>2</b> Add amounts on line 1 in columns (b) and (c)   | <b>2</b> ( ) | <b>4,000</b> |
| <b>3</b> Net gain or (loss). Combine columns (b) and (c) of line 2  | <b>3</b>     | <b>4,000</b> |
| <b>4</b> Form 1099-B adjustments. See instructions and attach schedule  | <b>4</b>     |              |
| <b>5</b> Combine lines 3 and 4  | <b>5</b>     | <b>4,000</b> |
| <i>Note: If line 5 shows a net gain, skip line 6 and enter the gain on line 7. Partnerships and S corporations, see instructions.</i> |              |              |
| <b>6</b> If you have a net section 1256 contracts loss and checked box D, enter the amount to be carried back                         | <b>6</b>     |              |
| <b>7</b> Subtract line 6 from line 5  | <b>7</b>     | <b>4,000</b> |
| <b>8</b> Short-term capital gain or (loss). Multiply line 7 by 40%. Enter here and include on Schedule D. See instructions            | <b>8</b>     | <b>1,600</b> |
| <b>9</b> Long-term capital gain or (loss). Multiply line 7 by 60%. Enter here and include on Schedule D. See instructions             | <b>9</b>     | <b>2,400</b> |

## F. NONEQUITY OPTIONS

Nonequity options, which include options based on regulated stock indexes and interest rate futures, are taxed like regulated futures contracts. Therefore, they are reported under the marked-to-market rules of Section 1256. These options, if held at year-end, are treated as if they were sold at fair market value. Any gain or loss is initially reported on Form 6781. **Form 1099-B is generally not issued for an index option.**

Nonequity options include:

- debt options
- commodity futures options (**Example:** corn or wheat options contracts on the Chicago Board of Trade)

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- currency options (**Example:** U.S. Treasury Bills options contracts on the Chicago Mercantile Exchange)
- broad-based stock index options (**Example:** Standard & Poor's 500 Index options contracts on the Chicago Board Options Exchange)

**Example 6.** Peggy expects a surge in stock prices. Instead of buying several individual stocks, she decides to buy an “out of the money” October 2000 S&P 500 Index call option when the index is at about the 1,500 level. Peggy is the “holder” (buyer) of the call options. Following are the details on her purchase of the option.

**Practitioner Note.** The technical name for the S&P 500 Index is the **S&P 500 Composite Stock-Price Index**. Each option contract (a put or a call option) represents 100 shares of the underlying S&P 500.

|  |                  |
|--|------------------|
| Date options bought  | August 31, 2000  |
| Strike price   | \$1,600          |
| Amount of premium Peggy paid to the “writer” (seller) of the options<br>(100 shares × \$10 per share price on 8-31-00) | \$1,000          |
| <b>Plus:</b> Commission  | 75               |
| Net amount Peggy paid for the call option  | \$1,075          |
| Expiration date of the October option (third Friday of the month)  | October 20, 2000 |

**Practitioner Note.** As a “holder” (buyer) of the option, Peggy’s risk is limited to the premium plus the commission she paid to buy the option. If the market goes down instead of up as she expects, her call option will expire worthless, and she will have a loss of \$1,075.

The stock market explodes to the upside and the S&P 500 Index climbs to 1,800 on October 19, 2000, a day before expiration of the option. As the “holder” of the call option, Peggy has the right to buy the underlying S&P 500 Index for the strike price of \$1,600. Peggy sells the option on October 19 to close out (offset) her prior option purchase.

**Practitioner Note.** Peggy’s belief that the market would move higher was correct. Therefore, her call options increased in value.

Following are the details on the sale of her option.

|   |                  |
|---|------------------|
| Date options sold   | October 19, 2000 |
| Sales price at market value   | \$1,800          |
| <b>Less:</b> Purchase price (strike price granted as holder of the call option) | -1,600           |
| Gain per share  | \$200            |
| Total value (100 share × \$200 gain per share)                                  | \$20,000         |
| <b>Less:</b> Commission on sale of call options                                 | (75)             |
| Net sales price of call option  | \$19,925         |

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Peggy's gain on this stock index option is \$18,850.

|                         |                |
|-------------------------|----------------|
| Sales price             | \$19,925       |
| <b>Less: Cost basis</b> | <b>(1,075)</b> |
| \$1256 gain             | \$18,850       |

The gain will be reported initially on Form 6781. Assume that Peggy has no other open or closed \$1256 transactions in 2000. See the completed 2000 Form 6781 for Peggy.

**Practitioner Note.** Forms 1099-B are not required for sale of options. However, brokerage firms do show details on the sale of options on the annual tax reporting statements sent to clients.

|   |  |  |
|---|--|--|
| Form <b>6781</b><br><br>Department of the Treasury<br>Internal Revenue Service  | <b>Gains and Losses From Section 1256<br/>                 Contracts and Straddles</b><br><br>► Attach to your tax return. | OMB No. 1545-0644<br><br><b>2000</b><br>Attachment<br>Sequence No. <b>82</b> |
| Name(s) shown on tax return<br><b>Peggy</b>   |  | Identifying number   |
| Check applicable box(es) (see instructions): <span style="margin-left: 20px;">A <input type="checkbox"/> Mixed straddle election</span> <span style="margin-left: 20px;">C <input type="checkbox"/> Mixed straddle account election</span><br><span style="margin-left: 20px;">B <input type="checkbox"/> Straddle-by-straddle identification election</span> <span style="margin-left: 20px;">D <input type="checkbox"/> Net section 1256 contracts loss election</span> |  |  |
| <b>Part I Section 1256 Contracts Marked to Market</b>   |  |  |
| (a) Identification of account   | (b) (LOSS)   | (c) GAIN   |
| 1 <b>October 2000 S&amp;P 500 Index call option</b>   |  | <b>18,850</b>  |
| 2 Add amounts on line 1 in columns (b) and (c) . . . . .  | 2 ( )  | <b>18,850</b>  |
| 3 Net gain or (loss). Combine columns (b) and (c) of line 2 . . . . .   | 3  | <b>18,850</b>  |
| 4 Form 1099-B adjustments. See instructions and attach schedule . . . . .   | 4  |  |
| 5 Combine lines 3 and 4 . . . . .   | 5  | <b>18,850</b>  |
| <i>Note: If line 5 shows a net gain, skip line 6 and enter the gain on line 7. Partnerships and S corporations, see instructions.</i>   |  |  |
| 6 If you have a net section 1256 contracts loss and checked box D, enter the amount to be carried back . . . . .  | 6  |  |
| 7 Subtract line 6 from line 5 . . . . .   | 7  | <b>18,850</b>  |
| 8 Short-term capital gain or (loss). Multiply line 7 by 40%. Enter here and include on Schedule D. See instructions . . . . .   | 8  | <b>7,540</b>   |
| 9 Long-term capital gain or (loss). Multiply line 7 by 60%. Enter here and include on Schedule D. See instructions . . . . .  | 9  | <b>11,310</b>  |

## III. MUTUAL FUND DISTRIBUTIONS

Practitioners should be aware of some income tax issues that arise for owners of mutual funds. To properly report income and expenses, distributions from the fund must be properly classified and the taxpayer's basis in the shares of the fund must be properly calculated.

### A. CLASSIFYING DISTRIBUTIONS

Distributions that shareholders receive from a mutual fund are classified as one of four types for income tax purposes.

1. Ordinary dividends
2. Capital gain distributions

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3. Exempt-interest dividends
4. Return of capital (nontaxable) distributions

For income tax purposes, a shareholder must also report undistributed capital gains that are allocated to the shareholder by the mutual fund.

## 1. Ordinary Dividends

The most common dividends are ordinary dividends, which are paid out of the earnings and profits of the mutual fund. These dividends are reported by the mutual fund in box 1 of Form 1099-DIV and should be carried to line 9 of the shareholder's Form 1040. If over \$400 from all payors, first report on line 5 of Schedule B.

## 2. Capital Gains Distributions

Distributions paid out of the mutual fund's net realized long-term capital gains are classified as capital gain distributions. Such distributions are reported by the shareholder as long-term capital gains regardless of the length of time the shareholder has held the mutual fund shares. Capital gain distributions are reported by the mutual fund in box 2a of Form 1099-DIV and should be carried to line 13 of the shareholder's Schedule D (Form 1040) if the Schedule D is being filed for other transactions or to line 13 of the shareholder's Form 1040 if the shareholder is **not** filing a Schedule D.

**Exception.** A taxpayer does not have to file Schedule D if **all three** of the following apply.

1. The only amounts reported on Schedule D are capital gain distributions from box 2a of **Forms 1099-DIV** or substitute statements.
2. None of the Forms 1099-DIV or substitute statements has an amount in box 2b (28% rate gain), box 2c (unrecaptured §1250 gain), or box 2d (§1202 gain).
3. If **Form 4952** (relating to investment interest expense deduction) is being filed, the amount on line 4e of that form is not more than zero.

If all three of the above apply, the taxpayer can enter capital gain distributions on line 13 of Form 1040 and check the box on that line. In this case the Capital Gain Tax Worksheet for Line 40 should be used to calculate the tax.

**Practitioner Note.** If the shareholder receives a capital gain distribution on shares that are held six months or less and sold at a loss, the loss must be reported as a long-term capital loss to the extent of the capital gain distribution.

**Example 7.** On April 10, 2000, Raul bought 100 shares of a mutual fund for \$2,000. On June 29, 2000, the mutual fund declared a capital gain distribution of \$2 per share, which is taxed as long-term capital gain. This taxable distribution increased his basis in the fund by \$200. On July 10, 2000, Raul sold all of his shares for \$1,750. If it were not for the capital gain distribution, Raul's loss simply would be a short-term loss of \$250 (\$1,750 - \$2,000). However, the part of the loss (after the basis adjustment for the capital gain distribution) that is not more than the capital gain distribution (\$200) must be reported as a long-term capital loss.

The capital gain distribution increased his basis in the mutual fund to \$2,200 (\$2,000 + \$200). Now Raul has a loss of \$450 on the sale of the mutual fund (\$1,750 - \$2,200) and a \$200 capital gain distribution. **The net loss is still \$250, but the reporting is altered** so that \$200 of the loss is reported as long-term capital loss (offsetting the \$200 capital gain distribution). The remaining loss of \$250 can be reported as a short-term capital loss. If Raul had reported the entire loss of \$450 as a short-term capital

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loss, and he wound up with both net short-term capital loss and net long-term capital gains, the misreporting could alter his tax liability.

**SCHEDULE D  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)

Name(s) shown on Form 1040

**Capital Gains and Losses**

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

OMB No. 1545-0074

**1999**

Attachment  
Sequence No. **12**

Your social security number

**Raul - Example 7**

**Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less**

| (a) Description of property<br>(Example: 100 sh. XYZ Co.) | (b) Date acquired<br>(Mo., day, yr.) | (c) Date sold<br>(Mo., day, yr.) | (d) Sales price<br>(see page D-5) | (e) Cost or other basis<br>(see page D-5) | (f) GAIN or (LOSS)<br>Subtract (e) from (d) |
|---|--------------------------------------|----------------------------------|-----------------------------------|---|---|
| <b>1</b><br><b>Mutual Fund</b>                            | <b>4-10-00</b>                       | <b>7-10-00</b>                   | <b>972</b>                        | <b>1222</b>                               | <b>&lt;250&gt;</b>                          |

**Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year**

| (a) Description of property<br>(Example: 100 sh. XYZ Co.)  | (b) Date acquired<br>(Mo., day, yr.) | (c) Date sold<br>(Mo., day, yr.) | (d) Sales price<br>(see page D-5) | (e) Cost or other basis<br>(see page D-5) | (f) GAIN or (LOSS)<br>Subtract (e) from (d) | (g) 28% RATE GAIN<br>* or (LOSS)<br>(see instr. below) |
|--|--------------------------------------|----------------------------------|-----------------------------------|---|---|--|
| <b>8</b><br><b>Mutal Fund</b>  | <b>4-10-00</b>                       | <b>7-10-00</b>                   | <b>778</b>                        | <b>978</b>                                | <b>&lt;200&gt;</b>                          |  |
| <b>(long term due to CGD)</b>  | <b>6-29-00</b>                       |                                  |                                   |   |   |  |
| <b>9</b> Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . .  |                                      |                                  | <b>9</b>                          |   |   |  |
| <b>10</b> Total long-term sales price amounts. Add column (d) of lines 8 and 9 . . . . .   |                                      |                                  | <b>10</b>                         |   |   |  |
| <b>11</b> Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .                 |                                      |                                  |                                   |   | <b>11</b>                                   |  |
| <b>12</b> Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1. . . . .  |                                      |                                  |                                   |   | <b>12</b>                                   |  |
| <b>13</b> Capital gain distributions. See page D-1 . . . . .   |                                      |                                  |                                   |   | <b>13</b>                                   | <b>200</b>   |
| <b>14</b> Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1998 Capital Loss Carryover Worksheet . . . . . |                                      |                                  |                                   |   | <b>14</b>                                   | ( ) ( )  |
| <b>15</b> Combine lines 8 through 14 in column (g). . . . .  |                                      |                                  |                                   |   | <b>15</b>                                   |  |
| <b>16</b> Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f) ▶<br>Next: Go to Part III on the back.  |                                      |                                  |                                   |   | <b>16</b>                                   | <b>-0-</b>   |

\* 28% Rate Gain or Loss includes all "collectibles gains and losses" (as defined on page D-5) and up to 50% of the eligible gain on qualified small business stock (see page D-4).

### 3. Exempt Interest Dividends

Tax-exempt interest received by the mutual fund retains its character when it is distributed to the shareholders. Therefore, exempt-interest dividends are not included in the shareholder's income but must be included on line 8b of the shareholder's Form 1040 for information-reporting purposes. The mutual fund does **not** report the exempt-interest dividends on Form 1099-DIV but does report them to shareholders by separate notification.

If the shareholder receives exempt interest dividends on shares that are held six months or less and sold at a loss, the loss is not allowed to the extent of the exempt interest dividends.

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## 4. Return of Capital (Nontaxable) Distributions

A distribution that is not out of earnings and profits of the mutual fund is called a return of capital. These distributions reduce the shareholder's basis in the mutual fund shares until the basis reaches zero. Return of capital distributions received after the shareholder's basis is reduced to zero are treated as capital gains. They are long-term capital gains if the shares have been held for more than one year and short-term capital gains if the shares have been held for one year or less.

**Example 8.** Marla bought shares in a mutual fund in 1996 for \$15 per share. She received return of capital distributions as shown in the following table. Those distributions reduce her basis or must be reported as capital gains as shown in the table.

| Year | Return of Capital Distribution | Remaining Basis | Capital Gains |
|------|--------------------------------|-----------------|---------------|
| 1996 | \$4                            | \$11            | -0-           |
| 1997 | 3                              | 8               | -0-           |
| 1998 | 2                              | 6               | -0-           |
| 1999 | 4                              | 2               | -0-           |
| 2000 | 3                              | -0-             | \$1           |

## 5. Undistributed Capital Gains

If the mutual fund keeps its long-term capital gains, the shareholder must still report as long-term capital gains any amount the mutual fund allocates to the shareholder. The shareholder's basis in the mutual fund shares is increased by the amount included in income and is decreased by any credit the shareholder receives for income taxes paid by the mutual fund on the retained capital gains. The mutual fund will report the shareholder's share of undistributed capital gains and credit for income taxes paid on Form 2439, Notice to Shareholder of Undistributed Long-Term Capital Gains.

### B. BASIS

The taxpayer's basis in mutual fund shares is the amount paid for the share plus any commissions or load charges paid for the purchase.

**Exception.** If the shareholder disposes of mutual fund shares within 90 days of purchase and acquires new shares for which the commission or load charge is reduced or waived, the commission or load charge paid for the original shares is not added to the basis of the original shares to the extent the commission or load charge is reduced for the new shares. The amount that is not allowed to be added to the basis of the original shares is added to the basis of the new shares unless they are disposed of within 90 days and new shares are acquired for which the commission or load charge is reduced.

The shareholder's basis is increased by the shareholder's share of undistributed capital gains and is reduced by return of capital (nontaxable) distributions.

**Observation.** Records must be kept of reinvested dividends to make sure the shareholder includes the dividends in basis when the sale of shares is reported. Taxpayers should not overlook the increase in basis of a tax-exempt fund that is due to the receipt of tax-exempt dividends.

### C. Reporting Mutual Fund Distributions on Form 1040

The following guide from IRS Publication 564, *Mutual Fund Distributions*, summarizes the reporting of mutual fund distributions.

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## Reporting Mutual Fund Distributions on Form 1040

| IF you receive...  | AND...  | THEN report the distribution on...                         |
|--|---|--|
| Ordinary dividends (Form 1099-DIV, box 1)  | Your total ordinary dividends received are \$400 or less <ul style="list-style-type: none"> <li>• Your total ordinary dividends received are more than \$400, or</li> <li>• You received ordinary dividends as a nominee</li> </ul> | Form 1040, line 9  |
| Capital gain distributions (Form 1099-DIV, boxes 2a–2d)                          | You have to file Schedule D   | Schedule D, line 13, column (f)                            |
|  | You do not have to file Schedule D  | Form 1040, line 13, and Capital Gain Tax Worksheet, line 2 |
|  | You have unrecaptured §1250 gain (box 2c)   | Schedule D, line 25 (See Schedule D instructions)          |
|  | You have §1202 gain (box 2d)  | See Schedule D instructions                                |
| Return of capital (nontaxable) distributions (Form 1099-DIV, box 3) <sup>1</sup> |   | Generally, not reported                                    |
| Exempt-interest dividends (Not shown on Form 1099-DIV)                           |   | Form 1040, line 8b   |
| Undistributed capital gains (Form 2439, boxes 1a–1d)                             | You have total undistributed capital gains (box 1a)   | Schedule D, line 11, column (f)                            |
| You have unrecaptured §1250 gain (box 1c)  |   | Schedule D, line 25 (See Schedule D instructions)          |
| You have §1202 gain (box 1d)   |   | See Schedule D instructions                                |

<sup>1</sup>Report any amount in excess of your basis in your mutual fund shares on Schedule D, line 8 column (f) (or on Schedule D, line 1, if you held your mutual fund shares one year or less).

### D. EXCHANGING SHARES OF A MUTUAL FUND

**Any** exchange of shares from one mutual fund for shares in another mutual fund is a taxable exchange—even if there is no sales charge because the funds are within the same family. The shareholder must report gain or loss on the transaction and calculate basis in the new shares as if the old shares were sold for cash and the new shares were purchased for cash.

**Example 9.** Chang paid \$20 per share for 100 shares of Oil Well Mutual Fund in 1995. In 2000 when the shares were worth \$30 per share, he traded them for 300 shares of Oil Hole Mutual Fund. He was charged no fees for the exchange.

Chang must report his  $\$30 - \$20 = \$10$  per share ( $\$10 \times 100 = \$1,000$ ) gain on the Oil Well Mutual Fund shares on his Schedule D (Form 1040) as long-term capital gain. His basis in the Oil Hole Mutual Fund shares is  $\$3,000/300 = \$10$  per share.



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## Mutual Fund Sales Reporting Options

**Example 10.** Elvis Holly had the following transactions in 1999 and 2000 in Convertible Securities Mutual Fund:

| Date     | Description of Transaction                | Price per share | Purchase price | No. of shares bought | Sales price | No. of shares sold |
|----------|---|-----------------|----------------|----------------------|-------------|--------------------|
| 1-15-99  | Initial purchase                          | \$14.41         | \$9,000.00     | 624.566              | N/A         | N/A                |
| 3-16-99  | Reinvest income dividend                  | 14.45           | 87.44          | 6.051                | N/A         | N/A                |
| 6-22-99  | Reinvest income dividend                  | 14.46           | 88.29          | 6.106                | N/A         | N/A                |
| 9-14-99  | Reinvest income dividend                  | 14.86           | 89.14          | 5.999                | N/A         | N/A                |
| 12-14-99 | Reinvest short-term capital gain dividend | 15.34           | 154.25         | 10.055               | N/A         | N/A                |
| 12-14-99 | Reinvest capital gain dividend            | 15.34           | 102.84         | 6.704                | N/A         | N/A                |
| 2-2-00   | Partial sale                              | 15.78           | N/A            | N/A                  | \$5,600.00  | 354.880            |
| 3-8-00   | Final sale to liquidate fund              | 16.14           | N/A            | N/A                  | 5,085.33    | 315.076            |
|          | TOTALS                                    |                 | \$9,682.64     | 669.956              | \$10,685.33 | 669.956            |

**Question 1.** Regarding the two sales in 2000, what are Elvis's options?

**Answer 1.** Elvis has four options:

1. Specific share identification
2. First-in First-out (FIFO)
3. Average cost basis—single category method
4. Average cost basis—double category method

### Rules for Specific Share Identification Option

If taxpayers can definitely identify the shares they sold, they can use the basis of those particular shares to figure gain or loss. They must adequately identify the mutual fund shares sold via

1. Written notification and instructions to the mutual fund informing the fund to sell shares that you bought on a particular date and at a particular purchase price
2. Receipt of **confirmation in writing** from the mutual fund acknowledging their notification and instructions

**Observation.** This method is time-consuming and is seldom used. The notification must be made prior to the sale, but most investors don't have the time (or don't take the time) to comply with the requirements. The advantage to the taxpayer is that he or she can often generate **either** a profit **or** a loss on the sale based on the particular shares selected. **This method cannot be used with on-line sales.**

### Rules for First-in First-out (FIFO)

With adequate records of the various purchase dates and amounts, this method is fairly simple. Use the cost basis of the shares the taxpayers acquired first as the basis of the shares sold. Therefore, the oldest shares still available are considered to be sold first. Following is a table with an example to show how the FIFO method is applied.

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## How to Figure a Gain or Loss on a Sale of Shares in a Mutual Fund Using the FIFO Method

| Date     | Action                  | Share Price | No. of Shares | Shares Owned |
|----------|-------------------------|-------------|---------------|--------------|
| 2/4/99   | Invest \$4,000          | \$25        | 160           | 160          |
| 8/5/99   | Invest \$4,800          | \$20        | 240           | 400          |
| 12/16/99 | Reinvest \$300 dividend | \$30        | 10            | 410          |
| 9/29/00  | Sell \$6,720            | \$32        | 210           | 200          |

\*To figure the capital gain on the 210 shares sold on 9/29/00, calculate gain based on the first 210 shares bought, namely the 160 shares purchased on 2/4/99 and 50 of those purchased on 8/5/99.

|           |                                |
|-----------|--------------------------------|
| \$4,000   | (cost of 160 shares on 2/4/99) |
| + \$1,000 | (cost of 50 shares on 8/5/99)  |
| <hr/>     |                                |
| \$5,000   | (total cost)                   |
| <br>      |                                |
| \$6,720   | (proceeds from 9/29/00 sale)   |
| - \$5,000 | (total cost)                   |
| <hr/>     |                                |
| \$1,720   | long-term capital gain         |

**Question 2.** Using the facts given in Example 16 and the FIFO method, what is the basis of the 354.880 shares that Elvis sold on February 2, 2000?

**Answer 2.** \$5,113.82, which is 354.880 shares  $\times$  \$14.41.

**Question 3.** What is the basis of the 315.076 shares that Elvis sold on March 8, 2000?

**Answer 3.** \$4568.82, which is the total basis of \$9,682.64 less the \$5,113.82 basis used for the February 2, 2000 partial sale.

**Question 4.** Are the two sales long-term, short-term, or mixed?

**Answer 4.** The partial sale on February 2, 2000, is all long-term because the 354.880 shares were purchased January 16, 1999. The final sale on March 8, 2000, is part long-term and part short-term.

# 2000 Workbook

**SCHEDULE D  
(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)

Name(s) shown on Form 1040

## Capital Gains and Losses

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

OMB No. 1545-0074

2000

Attachment  
Sequence No. **12**

Your social security number

Elvis Holly - Example 19 Answer 4

**Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less**

| (a) Description of property<br>(Example: 100 sh. XYZ Co.)  | (b) Date acquired<br>(Mo., day, yr.) | (c) Date sold<br>(Mo., day, yr.) | (d) Sales price<br>(see page D-5) | (e) Cost or other basis<br>(see page D-5) | (f) GAIN or (LOSS)<br>Subtract (e) from (d) |     |
|--|--------------------------------------|----------------------------------|-----------------------------------|---|---|-----|
| <b>1</b><br>45.39 sh Conv.   | various                              | 3 - 8 - 00                       | 733                               | 658                                       | 75  |     |
| <b>Securities Mut. Fd.</b>   |                                      |                                  |                                   |   |   |     |
|  |                                      |                                  |                                   |   |   |     |
|  |                                      |                                  |                                   |   |   |     |
| 2 Enter your short-term totals, if any, from Schedule D-1, line 2 . . . . .  |                                      |                                  | 2                                 |   |   |     |
| 3 Total short-term sales price amounts. Add column (d) of lines 1 and 2 . . . . .  |                                      |                                  | 3                                 | 733                                       |   |     |
| 4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .                           |                                      |                                  |                                   |   | 4   |     |
| 5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .              |                                      |                                  |                                   |   | 5   |     |
| 6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 1998 Capital Loss Carryover Worksheet . . . . . |                                      |                                  |                                   |   | 6   | ( ) |
| 7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f) ▶   |                                      |                                  |                                   |   | 7   | 75  |

**Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year**

| (a) Description of property<br>(Example: 100 sh. XYZ Co.)   | (b) Date acquired<br>(Mo., day, yr.) | (c) Date sold<br>(Mo., day, yr.) | (d) Sales price<br>(see page D-5) | (e) Cost or other basis<br>(see page D-5) | (f) GAIN or (LOSS)<br>Subtract (e) from (d) | (g) 28% RATE GAIN<br>* or (LOSS)<br>(see instr. below) |
|---|--------------------------------------|----------------------------------|-----------------------------------|---|---|--|
| <b>8</b><br>354.88 sh. Conv.  | 1 - 15 - 99                          | 2 - 2 - 00                       | 5600                              | 5114                                      | 486   |  |
| <b>Securities Mut. Fund</b>   |                                      |                                  |                                   |   |   |  |
| 269.69 sh. Conv.  | 1 - 15 - 99                          | 3 - 8 - 00                       | 4353                              | 3911                                      | 442   |  |
| <b>Securities Mut. Fund</b>   |                                      |                                  |                                   |   |   |  |
|   |                                      |                                  |                                   |   |   |  |
| 9 Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . .  |                                      |                                  | 9                                 |   |   |  |
| 10 Total long-term sales price amounts. Add column (d) of lines 8 and 9 . . . . .   |                                      |                                  | 10                                | 9953                                      |   |  |
| 11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . .                 |                                      |                                  |                                   |   | 11  |  |
| 12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1 . . . . .   |                                      |                                  |                                   |   | 12  |  |
| 13 Capital gain distributions. See page D-1 . . . . .   |                                      |                                  |                                   |   | 13  |  |
| 14 Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1998 Capital Loss Carryover Worksheet . . . . . |                                      |                                  |                                   |   | 14  | ( ) ( )  |
| 15 Combine lines 8 through 14 in column (g) . . . . .   |                                      |                                  |                                   |   | 15  |  |
| 16 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f) ▶   |                                      |                                  |                                   |   | 16  | 928  |

\* 28% Rate Gain or Loss includes all "collectibles gains and losses" (as defined on page D-5) and up to 50% of the eligible gain on qualified small business stock (see page D-4).

# 2000 Workbook

## Rules for Average Cost Basis—Single Category Method

**This is the most common method chosen by investors.** All shares purchased are included in a single category. The basis of **each** share is the total basis of **all** shares **at the time of sale**, divided by the total number of shares **at the time of sale**. In determining holding period, the shares sold are considered to be those shares acquired first.

**Question 5.** Using the given facts and the average cost basis—single category method, what is the basis of the 354.880 shares sold on February 2, 2000?

**Answer 5.** \$5,223.83, which is the total purchase price for all shares of \$9,862.64 divided by 669.956 (the total number of shares as of February 2, 2000) = \$14.72 average cost per share × 354.880 (the number of shares sold on February 2, 2000).

Elvis's average cost of all shares purchased is \$14.72 per share. He sold 354.880 shares on February 2, 2000.  $354.880 \text{ shares} \times \$14.72 = \$5,223.83$  basis of the shares sold on February 2, 2000.

**Question 6.** What is the basis of the 315.076 shares that Elvis sold on March 8, 2000?

**Answer 6.** \$4,638.81, which is the total purchase price of all shares of \$9,862.64 less the \$5,223.83 basis used for the partial sale on February 2, 2000.

**Observation.** The average cost basis—single category method is popular and simple. However, in order to elect either average cost method (single or double category), the taxpayer must write on the return or attach to the return a note indicating the method chosen. If that is not done and the IRS examines the return, the IRS examiner must use the FIFO method.

**Practitioner Note.** Many mutual funds now report annually the average cost basis—single category information to their shareholders.

## Rules for Average Cost Basis—Double Category Method

All shares in an account at the time of **each** sale are divided into two categories: short-term and long-term. Shares held longer than one year are long-term.

The basis of **each** share in a category is the total basis of **all** shares in that category at the time of sale divided by the total shares in the category. If a taxpayer does not specify to the mutual fund which shares are to be sold, you must first use the shares in the long-term category, and then any remaining shares sold are considered sold from the short-term category.

**Observation.** This method is rarely used since it is time-consuming.

## E. HANDLING FORM 2439

Form 2439 reports the taxpayer's share of undistributed long-term capital gains from a regulated investment company (including a mutual fund) or real estate investment trust.

**Example 11.** Celia Short has a substantial investment in Conn Mutual Corporate Investors, a regulated investment company. In January 2001, Celia receives Form 2439 from Conn Mutual reporting the following undistributed long-term capital gains (Box 1a) and tax paid by Conn Mutual on the above gains (Box 2).

# 2000 Workbook

VOID     CORRECTED    (99)

|  |   |  |
|--|---|--|
| Regulated investment company or real estate investment trust's name, address, and ZIP code<br><br><b>Conn Mutal Corporate Investors</b><br><b>1400 Delaware Street</b><br><b>Hartford CT 06100</b> | OMB No. 1545-0145<br><br><div style="text-align: center; font-size: 2em;">2000</div><br><br>Form <b>2439</b>                | <b>Notice to Shareholder of Undistributed Long-Term Capital Gains</b><br><br>For calendar year 2000, or other tax year of the regulated investment company or the real estate investment trust beginning ....., 2000, and ending ....., 20 ..... |
| Regulated investment company or real estate investment trust's identification number<br><b>04 - 2439061</b>  | <b>1a</b> Total undistributed long-term capital gains<br>\$ <b>27448</b>  | <b>Copy A</b><br><br>Attach to Form 1120-RIC or Form 1120-REIT<br><br><b>For Instructions and Paperwork Reduction Act Notice, see back of Copies A and D.</b>  |
| Shareholder's identification number<br><b>450 - 61 - 2439</b>  | <b>1b</b> 28% rate gain<br>\$<br><br><b>1c</b> Unrecaptured sec. 1250 gain<br>\$  |  |
| Shareholder's name, address, and ZIP code<br><b>Celia Short</b><br><b>15 Memory Lane</b><br><b>Far Away, ID 82439</b>  | <b>1d</b> Section 1202 gain<br>\$   |  |
|  | <b>2</b> Tax paid by the regulated investment company or real estate investment trust on the box 1a gains<br>\$ <b>9607</b> |  |

Celia reports the undistributed long-term capital gains on Schedule D.

**SCHEDULE D**  
**(Form 1040)**

Department of the Treasury  
Internal Revenue Service (99)  
Name(s) shown on Form 1040

### Capital Gains and Losses

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

OMB No. 1545-0074

2000

Attachment Sequence No. **12**

**Celia Short - Example 11**

Your social security number  
**450 : 61 : 2439**

**Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year**

| (a) Description of property<br>(Example: 100 sh. XYZ Co.)  | (b) Date acquired<br>(Mo., day, yr.) | (c) Date sold<br>(Mo., day, yr.) | (d) Sales price<br>(see page D-5) | (e) Cost or other basis<br>(see page D-5) | (f) GAIN or (LOSS)<br>Subtract (e) from (d) | (g) 28% RATE GAIN or (LOSS)<br>* (see instr. below) |
|--|--------------------------------------|----------------------------------|-----------------------------------|---|---|---|
| <b>8</b>   |                                      |                                  |                                   |   |   |   |
|  |                                      |                                  |                                   |   |   |   |
|  |                                      |                                  |                                   |   |   |   |
|  |                                      |                                  |                                   |   |   |   |
| <b>9</b> Enter your long-term totals, if any, from Schedule D-1, line 9 . . . . .  |                                      |                                  |                                   |   |   |   |
| <b>10</b> Total long-term sales price amounts. Add column (d) of lines 8 and 9 . . . . .   |                                      |                                  |                                   |   |   |   |
| <b>11</b> Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824 . . . . . |                                      |                                  |                                   |   | <b>27,448</b>                               |   |

Celia reports the tax paid by Conn Mutual on Form 1040 under Payments on line 63 and checks box a.

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Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return (x) 1999** (99) IRS Use Only—Do not write or staple in this space. OMB No. 1545-0074

For the year Jan. 1–Dec. 31, 1999, or other tax year beginning , 1999, ending

**Label** (See instructions on page 18.) Use the IRS label. Otherwise, please print or type.

**Label HERE**

Your first name and initial: **Celia** Last name: **Short**

If a joint return, spouse's first name and initial Last name

Home address (number and street). If you have a P.O. box, see page 18. Apt. no. **15 Memory Lane**

City, town or post office, state, and ZIP code. If you have a foreign address, see page 18. **Far Away ID 82439**

Your social security number: **450 61 2439**

Spouse's social security number

**IMPORTANT!** You must enter your SSN(s) above.

**Presidential Election Campaign** (See page 18.) Do you want \$3 to go to this fund? . . . . . If a joint return, does your spouse want \$3 to go to this fund? . . . . .

| Payments   | 57 | 58 | 59a | 60 | 61 | 62 | 63           | 64        |
|--|----|----|-----|----|----|----|--------------|-----------|
| 57 Federal income tax withheld from Forms W-2 and 1099 . . . . .   |    |    |     |    |    |    |              |           |
| 58 1999 estimated tax payments and amount applied from 1998 return . . . . .                               |    |    |     |    |    |    |              |           |
| 59a <b>Earned income credit.</b> Attach Sch. EIC if you have a qualifying child                            |    |    |     |    |    |    |              |           |
| b Nontaxable earned income: amount . . . . . and type ▶ . . . . .  |    |    |     |    |    |    |              |           |
| 60 Additional child tax credit. Attach Form 8812 . . . . .   |    |    |     |    |    |    |              |           |
| 61 Amount paid with request for extension to file (see page 48)  |    |    |     |    |    |    |              |           |
| 62 Excess social security and RRTA tax withheld (see page 48)  |    |    |     |    |    |    |              |           |
| 63 Other payments. Check if from a <input type="checkbox"/> Form 2439 b <input type="checkbox"/> Form 4136 |    |    |     |    |    |    | <b>9,607</b> |           |
| 64 Add lines 57, 58, 59a, and 60 through 63. These are your total payments . . . . . ▶                     |    |    |     |    |    |    |              | <b>64</b> |

**Important Reminder.** The taxpayer should increase his or her basis in the regulated investment company or the interest in the REIT by the difference between the gain reported and the credit claimed for the tax paid.

Therefore, Celia would increase her basis in Conn Mutual Corporate Investors by \$17,841, the difference between the gain reported on Schedule D (\$27,448) and the tax reported on line 63 of Form 1040 (\$9,607).

## IV. WASH-SALE RULES AND MUTUAL FUND LOSS DEDUCTIONS

### A. GENERAL WASH-SALE RULES

A wash sale occurs when the taxpayer sells or trades stock or securities (including mutual fund shares), and within 30 days before or after the sale the taxpayer

- Buys substantially identical stock or securities
- Acquires substantially identical stock or securities in a fully taxable trade, or
- Acquires a contract or option to buy substantially identical stock or securities

**I.R.C. §1091 disallows the recognition of losses from sales of stock or securities in a wash sale.**

If a loss is disallowed because of the wash sale rules, the **disallowed loss is added to the basis of the new stock or securities.** The effect of this adjustment is to postpone the loss deduction until the disposition of the new stock or securities. The holding period for the new stock or securities begins on the same day as the holding period of the stock or securities sold.

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**Example 12.** Kant Wynn buys 100 shares of Worstco stock for \$1,000. Kant sells these shares for \$750, and within 30 days of the sale he buys 100 shares of Worstco for \$800. Because Kant bought substantially identical stock, he cannot deduct the loss of \$250 on the sale. However, he can add the disallowed loss (\$250) to the cost of the new stock (\$800) to obtain his basis of the new stock, which is \$1,050.

## B. APPLICATION TO MUTUAL FUNDS

Shareholders of an open-end mutual fund realize gain or loss on shares at the time of redemption. A wash-sale loss disallowance can be triggered in either of two ways:

- The purchase of additional fund shares during the wash-sale period
- An ordinary or capital gain dividend and subsequent reinvestment in additional shares of the fund

**Practitioner Note.** With the combination of declining fund net asset values (NAVs) in some funds and capital gain distributions, this may be a significant issue in 2000.

**Example 13.** Hy Roller participates in an automatic savings plan with Big Profit Mutual Fund. On the first of each month Hy's checking account is drafted for \$100 to purchase additional shares in Big Profit. Hy redeemed shares in Big Profit at a loss on 12-27-00. Under the wash sale rules, the current deductibility of the loss is limited due to the purchase of additional shares in Big Profit on 12-1-00 and 1-1-01.

**Example 14.** Big Profit Mutual Fund distributes income and capital gains to shareholders on 12-8-00. In this case Hy does not make monthly investments, but he has elected the automatic reinvestment option with Big Profit. Thus, his income and capital gain dividend are used to purchase additional shares of Big Profit. The loss Hy realizes from the partial redemption of shares on 12-27-00 is limited under the wash sale rules.

## C. REPLACEMENT OF SOLD SHARES WITH SAME NUMBER OF PURCHASED SHARES

If the taxpayer acquires the same number of shares as were sold under the wash sale rules, the determination of the basis in the new shares is relatively simple.

**Example 15.** Hy Roller redeems 100 shares of Big Profit Mutual Fund on May 9, 2000, when the net asset value (NAV) is \$26 per share. His cost basis in these shares is \$38 per share. On May 26, Hy purchases 100 shares of Big Profit at a cost (NAV) of \$33 per share.

Hy's loss on the sale is \$1,200 (\$2,600 sales price less \$3,800 cost basis). The loss is disallowed under the wash-sale rules. Hy's basis in the 100 shares purchased is \$4,500 (the actual cost of \$3,300 plus the disallowed loss of \$1,200). The holding period for the 100 new shares includes the holding period of the shares sold.

## D. UNEQUAL SHARES SOLD AND PURCHASED

**It is unlikely that the shares purchased will exactly equal the shares sold.** The regulations under I.R.C. §1091 provide rules for the basis calculation when the taxpayer purchases either more or fewer shares (during the wash sale period) than the number of shares sold at a loss. See "Wash-Sale Rules Muddy Mutual Fund Loss Deductions," Craig White, *Practical Tax Strategies*, March 1999, pp. 132-137 for an excellent discussion of this issue.

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**Fewer Shares Purchased.** When fewer shares are purchased than are sold, the loss disallowance determination is made more complex by the possibility that the shares producing the loss (the old shares) were purchased on different dates and that the acquired shares disallowing the loss (the new shares) are acquired on different dates. Treas. Reg. §1.1091-1(b) states that when the wash-sale rules apply to more than one loss, the disallowance is taken in the order the losses are generated. If the losses are realized on the same day and the order of disposition cannot be determined, the stock or securities are deemed to be disposed of in the order originally acquired.

Treas. Reg. §1091-1(c) stipulates that the shares of stock or securities acquired are matched in accordance with the order of their acquisition with an equal number of the shares of stock or securities sold. In other words, each new share (purchased) can only disallow the loss on one old share (sold).

**Example 16.** Tuff Tymes began investing in the Lost Hope Mutual Fund in December, 1999, as indicated below. Tuff redeems 100 shares of Lost Hope on December 27, 2000. He specifically identifies the December 20, 1999 shares as the first 50 shares redeemed and the August 15, 2000 shares as the second 50 shares redeemed.

| Date     | Transaction  | Shares | Cost per share |
|----------|--------------|--------|----------------|
| 12-20-99 | Purchase     | 50     | \$42           |
| 08-15-00 | Purchase     | 50     | 48             |
| 12-05-00 | Purchase     | 30     | 40             |
| 12-15-00 | Reinvestment | 15     | 38             |
| 12-27-00 | Redemption   | 50     | 35             |
| 12-27-00 | Redemption   | 50     | 35             |
| 01-05-01 | Purchase     | 30     | 36             |

Tuff has a realized loss of \$350 ( $\$35 - \$42 \times 50$  shares) on the first 50 shares redeemed on December 27 and a realized loss of \$650 ( $\$35 - \$48 \times 50$ ) on the second 50 shares redeemed that day.

For the December 27 redemption, the wash-sale period begins November 27, 2000, and ends January 26, 2001. Tuff acquired 75 shares of Lost Hope Fund during this period and sold 100 shares. Thus, he purchased fewer shares than he sold.

The loss on the first 50 shares redeemed is fully disallowed. The sale of the first 50 shares is matched with the December 5, 2000 purchase (30 shares), the December 15, 2000 reinvestment (15 shares), and the January 5, 2001 purchase (5 shares only). The sale of the second 50 shares on December 27, 2000 results in a match with the 25 remaining shares purchased on January 5.

The basis and holding period of the shares purchased during the wash-sale period are listed below.

| Date Purchased | Cost per Share | Disallowed Loss per Share | Basis per Share | Number of Shares | Basis   | Holding Period Starts |
|----------------|----------------|---------------------------|-----------------|------------------|---------|-----------------------|
| 12-05-00       | \$40           | \$7                       | \$47            | 30               | \$1,410 | 12-21-99              |
| 12-15-00       | \$38           | \$7                       | \$45            | 15               | 675     | 12-21-99              |
| 01-05-01       | \$36           | \$7                       | \$43            | 5                | 215     | 12-21-99              |
| 01-05-01       | \$36           | \$13                      | \$49            | 25               | 1,225   | 08-16-00              |

The remaining loss of \$325 on the December 27 redemption [25 shares purchased on August 15, 2000 for \$48 per share (or \$1,200), and redeemed on December 27, 2000 for \$35 per share (or \$875)] is allowed as a loss under the wash sale rules. Because of this holding period, the loss is a short-term capital loss. This may be recharacterized as a long-term loss to the extent of capital-gain dividends received on the shares, if the redeemed shares were held 6 months or less [I.R.C. §1.1091-1(d)].



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**Example 17.** Assume Tuff, from Example 16 above, has the transactions as indicated, except that he redeems 60 shares of Lost Hope Fund on December 27, 2000. He specifically identifies the December 20, 1999 shares as the first 50 shares redeemed and 10 of the August 15, 2000 shares as the remaining 10 shares redeemed. Since Tuff redeems fewer shares (60) than the shares acquired during the wash-sale period (75), the entire loss is disallowed.

The basis and holding period of the shares purchased during the wash-sale period are listed below:

| Date Purchased | Cost per Share | Disallowed Loss per Share | Basis per Share | Number of Shares | Basis   | Holding Period Starts |
|----------------|----------------|---------------------------|-----------------|------------------|---------|-----------------------|
| 12-05-00       | \$40           | \$7                       | \$47            | 30               | \$1,410 | 12-21-99              |
| 12-15-00       | \$38           | \$7                       | \$45            | 15               | 675     | 12-21-99              |
| 01-05-01       | \$36           | \$7                       | \$43            | 5                | 215     | 12-21-99              |
| 01-05-01       | \$36           | \$13                      | \$49            | 10               | 490     | 08-16-00              |
| 01-05-01       | \$36           | 0                         | \$36            | 15               | 540     | 01-06-01              |

## V. INVESTMENT CLUBS

### A. GENERAL INFORMATION

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 by-laws.

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.

### B. TAXPAYER IDENTIFICATION NUMBER

Each club must have an employer identification number (EIN) to use when filing its return. The club's EIN also may have to be given to the payer of dividends or other income from investments recorded in the club's name (Rev. Rul. 64-8, 1964-1 C.B.480).

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

### C. TAX TREATMENT OF THE CLUB

In most cases, 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. **An investment club classified as a partnership ordinarily recognizes as its main source of income dividends, interest, and short-or long-term capital gains on sales of stocks or securities.**

**Club files Form 1065.** If the investment club is treated as a partnership, it must file Form 1065 U.S. Partnership Return of Income. However, partners in the club, report on their individual return their 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.) **Partners must report these items whether or not they actually receive any distribution from the partnership.**

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**Business Code.** The NAIC recommends using code “525990 Other Financial Vehicles” for item C on page 1 of Form 1065.

## D. EXPENSES OF PRODUCING INCOME

An investment club usually cannot deduct, on a partnership return, any of the items normally classified as business or income-producing expenses that are paid out of its own income and are chargeable to its income-producing activities. According to the IRS, mere investment activities, even if carried on jointly, as in the case of an investment club, are not activities in carrying on a trade or business for purposes of I.R.C. §162. The activities of an investment club (partnership) are viewed essentially as those of the individual investor, and expenses incurred by the partnership are deductible under I.R.C. §212. Each partner takes into account separately his or her distributive share of such nonbusiness expenses (Rev. Rul. 75-523, 1975-2 C.B. 350 and IRS Publication 550, *Investment Income and Expenses* (for 1999 returns), p. 25).

**Example 18.** The Boardtown Loungers, an investment club, incurs \$1,470 of expenses for postage, stationery, safe deposit box rental, bank charges, and accounting and investment fees during 2000. When filing Form 1065 for 2000, the club will report the \$1,470 of deductions on Line 10 of Schedule K. **None of the expenses will be reported on page 1 of Form 1065.**

Form 1065 (2000)

Page **3**

| <b>Schedule K Partners' Shares of Income, Credits, Deductions, etc.</b>                                    |  |                              |                  |
|--|--|------------------------------|------------------|
|  |  | (a) Distributive share items | (b) Total amount |
| <b>Income (Loss)</b>   | 1 Ordinary income (loss) from trade or business activities (page 1, line 22) . . . . .       | 1                            |                  |
|  | 2 Net income (loss) from rental real estate activities ( <i>attach Form 8825</i> ) . . . . . | 2                            |                  |
|  | 3a Gross income from other rental activities . . . . .                                       | 3a                           |                  |
|  | b Expenses from other rental activities ( <i>attach schedule</i> ) . . . . .                 | 3b                           |                  |
|  | c Net income (loss) from other rental activities. Subtract line 3b from line 3a . . . . .    | 3c                           |                  |
|  | 4 Portfolio income (loss): a Interest income . . . . .                                       | 4a                           |                  |
|  | b Ordinary dividends . . . . .   | 4b                           |                  |
|  | c Royalty income . . . . .   | 4c                           |                  |
|  | d Net short-term capital gain (loss) ( <i>attach Schedule D (Form 1065)</i> ) . . . . .      | 4d                           |                  |
|  | e Net long-term capital gain (loss) ( <i>attach Schedule D (Form 1065)</i> ):                |                              |                  |
|  | (1) 28% rate gain (loss) ▶ . . . . . (2) Total for year . . . . . ▶                          | 4e(2)                        |                  |
| f Other portfolio income (loss) ( <i>attach schedule</i> ) . . . . .                                       | 4f   |                              |                  |
| 5 Guaranteed payments to partners . . . . .  | 5  |                              |                  |
| 6 Net section 1231 gain (loss) (other than due to casualty or theft) ( <i>attach Form 4797</i> ) . . . . . | 6  |                              |                  |
| 7 Other income (loss) ( <i>attach schedule</i> ) . . . . .   | 7  |                              |                  |
| <b>Deductions</b>  | 8 Charitable contributions ( <i>attach schedule</i> ) . . . . .                              | 8                            |                  |
|  | 9 Section 179 expense deduction ( <i>attach Form 4562</i> ) . . . . .                        | 9                            |                  |
|  | 10 Deductions related to portfolio income (itemize) . . . . .                                | 10                           | <b>1,470</b>     |
|  | 11 Other deductions ( <i>attach schedule</i> ) . . . . .                                     | 11                           |                  |

**Attachment.** Form 1065, Schedule K, p. 3, Line 10

### Deductions Related to Portfolio Income

|                             |                |
|-----------------------------|----------------|
| Postage                     | \$ 110         |
| Bank Charges                | 60             |
| Safe Deposit Box Rental     | 100            |
| Stationery & Office Expense | 150            |
| Accounting Fees             | 400            |
| Investment Fees             | 650            |
|                             | <b>\$1,470</b> |

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The partnership uses Schedule K-1 to allocate to each member the amount of his or her share of deductions shown on Schedule K.

**Practitioner Note.** If an individual investor in an investment club incurs travel expenses for trips taken to investment convention sites to meet with representatives of several companies in which the investor (through the investment club) holds stock, the expenditures cannot be deducted under §212 as investment expenses. Expenses of any convention, seminar, conference, or similar meeting are not deductible as an investment expense [I.R.C. §274(h)(7)]. Expenses of attending a stockholder's meeting are also non-deductible (Rev. Rul. 56-511, 1956-2 C.B. 170).

**Meal and Entertainment Expenditures for Club Meetings.** Meal and entertainment expenses incurred for club meetings are not deductible in computing the taxable income of the partnership or in determining the tax liability of any of the partners or members (GCM 33469, March 28, 1967).

Such expenses cannot be deducted under I.R.C. §162 (since no trade or business exists) and cannot be deducted as travel expenses under I.R.C. §212 since the members are not away from "home" while attending the club meetings.

## E. REPORTING CAPITAL GAINS AND LOSSES

Capital gains and losses are not entered on page 1, Form 1065. However, capital gains and losses are reported on Schedule D (Form 1065). The net short-term or long-term capital gains and losses from Schedule D are then entered on Schedule K, and each partner's share is entered on Schedule K-1. Gains and losses that are specially allocated to partners are not reported on Schedule D (Form 1065) (unless they are from another partnership). Specially allocated short-term or long-term capital gains and losses are entered on the applicable partner's Schedule K-1, and the total amount is entered on Schedule K.

## F. SCHEDULES L AND M OF FORM 1065

If the partnership's total receipts for the tax year are less than \$250,000; the partnership's total assets at the end of the tax year are less than \$600,000; and Schedules K-1 are filed with the return and furnished to the partners on or before the due date of the partnership return (including extensions), Schedules L, M-1, and M-2 do not have to be completed. In addition, total assets do not have to be listed on page one of Form 1065 (Item F) and the analysis of the partner's account on Schedule K-1 (Item J) does not have to be completed.

**Observation.** The practitioner may want to consider completing this information even for a small investment club, since it provides useful data for the club members. Schedule K-1, Item J shows a partner's (1) capital account at the beginning of the year, (2) capital contributed during the year, (3) share of the items of income (or loss) included in the ordinary income or loss on page 1 of Form 1065, (4) withdrawals and distributions, and (5) capital account at the end of the year.

## G. CLUB MEMBER'S RETURN

Each member's share of each type of income shown on Schedule K and on Schedule K-1 is to be computed on the ratio that his number of participating shares in the club bears to the total outstanding number of participating shares. The actual contributions of each member as they stand at the end of the club's annual accounting period (usually the calendar year) are to be taken into account in determining the distributive share of the income. Each club member will report his or her shares of the club's dividends, interest income, capital gains and losses, royalty income, §1231 gains and losses, and other income (loss) on the member's individual Form 1040. Club expenses will be deducted by each

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member on Schedule A as Miscellaneous Itemized Deductions (subject to the 2% of AGI limit) if the member claims itemized deductions.

## H. INVESTMENT CLUB REPORTING

**Example 19.** A group of 10 retired individuals, known as the Boardtown Loungers, formed an investment club on March 7, 1996. They have made periodic capital contributions to the club since its inception and have used available funds to invest in selected stocks. For the tax year 2000, the Boardtown Loungers report the following transactions:

|  |         |
|--|---------|
| Member Contributions   | \$6,000 |
| Member Withdrawals   | -0-     |
| Interest Income  | 240     |
| Ordinary Dividends   | 800     |
| Capital Gains and Losses   |         |
| 1. 100 shares of Worstco stock sold October 26, 2000<br>acquired May 11, 1998, \$3,400 | \$2,800 |
| 2. 100 shares of Bestco stock sold August 10, 2000<br>acquired March 8, 2000, \$3,300  | \$5,500 |
| 3. Mutual fund capital gain distributions  | \$1,900 |
| Club Expenses:   |         |
| Postage  | \$36    |
| Bank charges   | 48      |
| Office Expense   | 116     |
| Accounting Fees  | 200     |
| Investment Fees  | 300     |
|  | <hr/>   |
|  | \$700   |

|  |   |  |  |   |  |
|--|---|--|--|---|--|
| Form <b>1065</b><br>Department of the Treasury<br>Internal Revenue Service   |   | <b>U.S. Return of Partnership Income</b>   |  | OMB No. 1545-0099                                       |  |
|  |   | For calendar year 2000, or tax year beginning ....., 2000, and ending ....., 20.....<br>▶ See separate instructions. |  | <b>2000</b>   |  |
| A Principal business activity<br><b>Finance</b>  | Use the IRS label. Otherwise, please print or type. | Name of partnership<br><b>Boardtown Loungers - Example 19</b>  |  | D Employer identification number<br><b>99 : 1234567</b> |  |
| B Principal product or service<br><b>Investment Club</b>   |   | Number, street, and room or suite no. If a P.O. box, see page 12 of the instructions.<br><b>12 Creek Street</b>      |  | E Date business started<br><b>3-7-96</b>                |  |
| C Business code number   |   | City or town, state, and ZIP code<br><b>Bug Tussle, AR 72000</b>   |  | F Total assets (see page 12 of the instructions)<br>\$  |  |
| G Check applicable boxes: (1) <input type="checkbox"/> Initial return    (2) <input type="checkbox"/> Final return    (3) <input type="checkbox"/> Change in address    (4) <input type="checkbox"/> Amended return<br>H Check accounting method: (1) <input type="checkbox"/> Cash    (2) <input type="checkbox"/> Accrual    (3) <input type="checkbox"/> Other (specify) ▶ .....<br>I Number of Schedules K-1. Attach one for each person who was a partner at any time during the tax year ▶ ..... <b>10</b> |   |  |  |   |  |

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**Schedule K Partners' Shares of Income, Credits, Deductions, etc.**

|   |   | (a) Distributive share items | (b) Total amount |              |
|---|---|------------------------------|------------------|--------------|
| <b>Income (Loss)</b>  | <b>1</b> Ordinary income (loss) from trade or business activities (page 1, line 22) . . . . .                                 |                              | <b>1</b>         |              |
|   | <b>2</b> Net income (loss) from rental real estate activities ( <i>attach Form 8825</i> ) . . . . .                           |                              | <b>2</b>         |              |
|   | <b>3a</b> Gross income from other rental activities . . . . .   | <b>3a</b>                    |                  |              |
|   | <b>b</b> Expenses from other rental activities ( <i>attach schedule</i> ) . . . . .   | <b>3b</b>                    |                  |              |
|   | <b>c</b> Net income (loss) from other rental activities. Subtract line 3b from line 3a . . . . .                              |                              | <b>3c</b>        |              |
|   | <b>4</b> Portfolio income (loss): <b>a</b> Interest income . . . . .  |                              | <b>4a</b>        | <b>240</b>   |
|   | <b>b</b> Ordinary dividends . . . . .   |                              | <b>4b</b>        | <b>800</b>   |
|   | <b>c</b> Royalty income . . . . .   |                              | <b>4c</b>        |              |
|   | <b>d</b> Net short-term capital gain (loss) ( <i>attach Schedule D (Form 1065)</i> ) . . . . .                                |                              | <b>4d</b>        | <b>2,200</b> |
|   | <b>e</b> Net long-term capital gain (loss) ( <i>attach Schedule D (Form 1065)</i> ):  |                              |                  |              |
|   | <b>(1)</b> 28% rate gain (loss) ▶ . . . . . <b>(2)</b> Total for year . . . . . ▶   |                              | <b>4e(2)</b>     | <b>1,300</b> |
|   | <b>f</b> Other portfolio income (loss) ( <i>attach schedule</i> ) . . . . .   |                              | <b>4f</b>        |              |
|   | <b>5</b> Guaranteed payments to partners . . . . .  |                              | <b>5</b>         |              |
| <b>6</b> Net section 1231 gain (loss) (other than due to casualty or theft) ( <i>attach Form 4797</i> ) . . . . . |   | <b>6</b>                     |                  |              |
| <b>7</b> Other income (loss) ( <i>attach schedule</i> ) . . . . .   |   | <b>7</b>                     |                  |              |
| <b>Deductions</b>   | <b>8</b> Charitable contributions ( <i>attach schedule</i> ) . . . . .  |                              | <b>8</b>         |              |
|   | <b>9</b> Section 179 expense deduction ( <i>attach Form 4562</i> ) . . . . .  |                              | <b>9</b>         |              |
|   | <b>10</b> Deductions related to portfolio income (itemize) . . . . .  |                              | <b>10</b>        | <b>700</b>   |
|   | <b>11</b> Other deductions ( <i>attach schedule</i> ) . . . . .   |                              | <b>11</b>        |              |
| <b>Credits</b>  | <b>12a</b> Low-income housing credit:   |                              |                  |              |
|   | <b>(1)</b> From partnerships to which section 42(j)(5) applies for property placed in service before 1990 . . . . .           |                              | <b>12a(1)</b>    |              |
|   | <b>(2)</b> Other than on line 12a(1) for property placed in service before 1990 . . . . .                                     |                              | <b>12a(2)</b>    |              |
|   | <b>(3)</b> From partnerships to which section 42(j)(5) applies for property placed in service after 1989 . . . . .            |                              | <b>12a(3)</b>    |              |
|   | <b>(4)</b> Other than on line 12a(3) for property placed in service after 1989 . . . . .                                      |                              | <b>12a(4)</b>    |              |
|   | <b>b</b> Qualified rehabilitation expenditures related to rental real estate activities ( <i>attach Form 3468</i> ) . . . . . |                              | <b>12b</b>       |              |
|   | <b>c</b> Credits (other than credits shown on lines 12a and 12b) related to rental real estate activities . . . . .           |                              | <b>12c</b>       |              |
|   | <b>d</b> Credits related to other rental activities . . . . .   |                              | <b>12d</b>       |              |
| <b>13</b> Other credits . . . . .   |   | <b>13</b>                    |                  |              |
| <b>Investment Interest</b>  | <b>14a</b> Interest expense on investment debts . . . . .   |                              | <b>14a</b>       |              |
|   | <b>b (1)</b> Investment income included on lines 4a, 4b, 4c, and 4f above . . . . .   |                              | <b>14b(1)</b>    | <b>840</b>   |
|   | <b>(2)</b> Investment expenses included on line 10 above . . . . .  |                              | <b>14b(2)</b>    | <b>700</b>   |

**Analysis of Net Income (Loss)**

|   |               |                          |                            |                  |                         |                    |
|---|---------------|--------------------------|----------------------------|------------------|-------------------------|--------------------|
| <b>1</b> Net income (loss). Combine Schedule K, lines 1 through 7 in column (b). From the result, subtract the sum of Schedule K, lines 8 through 11, 14a, 17f, and 18b . . . . . |               | <b>1</b>                 |                            |                  |                         |                    |
| <b>2</b> Analysis by partner type:  | (i) Corporate | (ii) Individual (active) | (iii) Individual (passive) | (iv) Partnership | (v) Exempt organization | (vi) Nominee/Other |
| <b>a</b> General partners   |               | <b>3,640</b>             |                            |                  |                         |                    |
| <b>b</b> Limited partners   |               |                          |                            |                  |                         |                    |

**Schedule L Balance Sheets per Books** (Not required if Question 5 on Schedule B is answered "Yes.")

| Assets   | Beginning of tax year |               | End of tax year |               |
|--|-----------------------|---------------|-----------------|---------------|
|  | (a)                   | (b)           | (c)             | (d)           |
| <b>1</b> Cash . . . . .  |                       | <b>4,000</b>  |                 | <b>3,640</b>  |
| <b>2a</b> Trade notes and accounts receivable . . . . .            |                       |               |                 |               |
| <b>b</b> Less allowance for bad debts . . . . .                    |                       |               |                 |               |
| <b>3</b> Inventories . . . . .                                     |                       |               |                 |               |
| <b>4</b> U.S. government obligations . . . . .                     |                       |               |                 |               |
| <b>5</b> Tax-exempt securities . . . . .                           |                       |               |                 |               |
| <b>6</b> Other current assets ( <i>attach schedule</i> ) . . . . . |                       | <b>45,000</b> |                 | <b>55,000</b> |
| <b>7</b> Mortgage and real estate loans . . . . .                  |                       |               |                 |               |
| <b>8</b> Other investments ( <i>attach schedule</i> ) . . . . .    |                       |               |                 |               |
| <b>9a</b> Buildings and other depreciable assets . . . . .         |                       |               |                 |               |
| <b>b</b> Less accumulated depreciation . . . . .                   |                       |               |                 |               |
| <b>10a</b> Depletable assets . . . . .                             |                       |               |                 |               |
| <b>b</b> Less accumulated depletion . . . . .                      |                       |               |                 |               |

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|   |  |               |  |               |
|---|--|---------------|--|---------------|
| 11 Land (net of any amortization) . . . . .                       |  |               |  |               |
| 12a Intangible assets (amortizable only) . . . . .                |  |               |  |               |
| b Less accumulated amortization . . . . .                         |  |               |  |               |
| 13 Other assets ( <i>attach schedule</i> ) . . . . .              |  |               |  |               |
| 14 <b>Total assets</b> . . . . .                                  |  | <b>49,000</b> |  | <b>58,640</b> |
| <b>Liabilities and Capital</b>                                    |  |               |  |               |
| 15 Accounts payable . . . . .                                     |  |               |  |               |
| 16 Mortgages, notes, bonds payable in less than 1 year . . . . .  |  |               |  |               |
| 17 Other current liabilities ( <i>attach schedule</i> ) . . . . . |  |               |  |               |
| 18 All nonrecourse loans . . . . .                                |  |               |  |               |
| 19 Mortgages, notes, bonds payable in 1 year or more . . . . .    |  |               |  |               |
| 20 Other liabilities ( <i>attach schedule</i> ) . . . . .         |  |               |  |               |
| 21 Partners' capital accounts . . . . .                           |  | <b>49,000</b> |  | <b>58,640</b> |
| 22 <b>Total liabilities and capital</b> . . . . .                 |  | <b>49,000</b> |  | <b>58,640</b> |

**Schedule M-1**      **Reconciliation of Income (Loss) per Books With Income (Loss) per Return**  
 (Not required if Question 5 on Schedule B is answered "Yes." See page 29 of the instructions.)

|   |              |  |              |
|---|--------------|--|--------------|
| 1 Net income (loss) per books . . . . .   | <b>3,640</b> | 6 Income recorded on books this year not included on Schedule K, lines 1 through 7 (itemize):                                    |              |
| 2 Income included on Schedule K, lines 1 through 4, 6, and 7, not recorded on books this year (itemize): . . . . .  |              | a Tax-exempt interest \$ . . . . .   |              |
| 3 Guaranteed payments (other than health insurance) . . . . .   |              | 7 Deductions included on Schedule K, lines 1 through 11, 14a, 17f, and 18b, not charged against book income this year (itemize): |              |
| 4 Expenses recorded on books this year not included on Schedule K, lines 1 through 11, 14a, 17f, and 18b (itemize): |              | a Depreciation \$ . . . . .  |              |
| a Depreciation \$ . . . . .   |              | 8 Add lines 6 and 7 . . . . .  |              |
| b Travel and entertainment \$ . . . . .   |              | 9 Income (loss) (Analysis of Net Income (Loss), line 1). Subtract line 8 from line 5 . . . . .                                   | <b>3,640</b> |
| 5 Add lines 1 through 4 . . . . .   | <b>3,640</b> |  |              |

**Schedule M-2**      **Analysis of Partners' Capital Accounts** (Not required if Question 5 on Schedule B is answered "Yes.")

|   |               |   |               |
|---|---------------|---|---------------|
| 1 Balance at beginning of year . . . . .    | <b>49,000</b> | 6 Distributions: a Cash . . . . .                               |               |
| 2 Capital contributed during year . . . . . | <b>6,000</b>  | b Property . . . . .  |               |
| 3 Net income (loss) per books . . . . .     | <b>3,640</b>  | 7 Other decreases (itemize): . . . . .                          |               |
| 4 Other increases (itemize): . . . . .      |               | 8 Add lines 6 and 7 . . . . .                                   |               |
| 5 Add lines 1 through 4 . . . . .           | <b>58,640</b> | 9 Balance at end of year. Subtract line 8 from line 5 . . . . . | <b>58,640</b> |

**SCHEDULE D**  
**(Form 1065)**

## Capital Gains and Losses

OMB No. 1545-0099

▶ Attach to Form 1065.

2000

Department of the Treasury  
Internal Revenue Service

Name of partnership

Employer identification number

**Boardertown Loungers - Example 19**

**99 1234567**

**Part I**      **Short-Term Capital Gains and Losses—Assets Held 1 Year or Less**

| (a) Description of property<br>(e.g., 100 shares of "Z" Co.)                             | (b) Date acquired<br>(month, day, year) | (c) Date sold<br>(month, day, year) | (d) Sales price<br>(see instructions) | (e) Cost or other basis<br>(see instructions) | (f) Gain or (loss)<br>((d) minus (e)) |
|--|---|-------------------------------------|---------------------------------------|---|---------------------------------------|
| <b>100 sh. Bestco</b>  | <b>3-8-00</b>                           | <b>8-10-00</b>                      | <b>5,500</b>                          | <b>3,300</b>                                  | <b>2,000</b>                          |
|  |   |                                     |                                       |   |                                       |
|  |   |                                     |                                       |   |                                       |
|  |   |                                     |                                       |   |                                       |
| 2 Short-term capital gain from installment sales from Form 6252, line 26 or 37 . . . . . |   |                                     |                                       | 2   |                                       |
| 3 Short-term capital gain (loss) from like-kind exchanges from Form 8824 . . . . .       |   |                                     |                                       | 3   |                                       |

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|  |   |              |  |
|--|---|--------------|--|
| 4 Partnership's share of net short-term capital gain (loss), including specially allocated short-term capital gains (losses), from other partnerships, estates, and trusts . . . . . | 4 |              |  |
| 5 <b>Net short-term capital gain or (loss).</b> Combine lines 1 through 4 in column (f). Enter here and on Form 1065, Schedule K, line 4d or 7 . . . . .                             | 5 | <b>2,200</b> |  |

**Part II Long-Term Capital Gains and Losses—Assets Held More Than 1 Year**

| (a) Description of property<br>(e.g., 100 shares<br>of "Z" Co.) | (b) Date acquired<br>(month, day, year) | (c) Date sold<br>(month, day, year) | (d) Sales price<br>(see instructions) | (e) Cost or other basis<br>(see instructions) | (f) Gain or (loss)<br>((d) minus (e)) | (g) 28% rate gain<br>or (loss)<br>*(see instr. below) |
|---|---|-------------------------------------|---------------------------------------|---|---------------------------------------|---|
| 6 <b>100 sh. Worstco</b>  | <b>5-11-98</b>                          | <b>10-26-00</b>                     | <b>2,800</b>                          | <b>3,400</b>                                  | <b>&lt;600&gt;</b>                    |   |
|   |   |                                     |                                       |   |                                       |   |
|   |   |                                     |                                       |   |                                       |   |
|   |   |                                     |                                       |   |                                       |   |

|  |    |              |  |
|--|----|--------------|--|
| 7 Long-term capital gain from installment sales from Form 6252, line 26 or 37 . . . . .  | 7  |              |  |
| 8 Long-term capital gain (loss) from like-kind exchanges from Form 8824 . . . . .  | 8  |              |  |
| 9 Partnership's share of net long-term capital gain (loss), including specially allocated long-term capital gains (losses), from other partnerships, estates, and trusts . . . . . | 9  |              |  |
| 10 Capital gain distributions . . . . .  | 10 | <b>1,900</b> |  |
| 11 Combine lines 6 through 10 in column (g). Enter here and on Form 1065, Schedule K, line 4e(1) or 7 . . . . .  | 11 |              |  |
| 12 <b>Net long-term capital gain or (loss).</b> Combine lines 6 through 10 in column (f). Enter here and on Form 1065, Schedule K, line 4e(2) or 7 . . . . .                       | 12 | <b>1,300</b> |  |

\*28% rate gain or (loss) includes all "collectibles gains and losses" as defined in the instructions.

|  |   |  |
|--|---|--|
| <p><b>SCHEDULE K-1</b><br/><b>(Form 1065)</b><br/><small>Department of the Treasury<br/>Internal Revenue Service</small></p>   | <p><b>Partner's Share of Income, Credits, Deductions, etc.</b><br/>▶ See separate instructions.<br/>For calendar year 1999 or tax year beginning , 1999, and ending ,</p> | <p>OMB No. 1545-0099<br/><b>2000</b></p>   |
| <p>Partner's identifying number ▶ <b>123 - 45 - 6789</b></p>   |   | <p>Partnership's identifying number ▶ <b>99 : 1234567</b></p>  |
| <p>Partner's name, address, and ZIP code<br/><b>Any Member</b><br/><b>100 Winner Circle</b><br/><b>Bug Trussle AR 72000</b></p>  |   | <p>Partnership's name, address, and ZIP code<br/><b>Boardtown Loungers</b><br/><b>12 Creek Street</b><br/><b>Bug Tussle AR 72000</b></p>   |
| <p>A This partner is a <input type="checkbox"/> general partner <input type="checkbox"/> limited partner<br/><input type="checkbox"/> limited liability company member</p> <p>B What type of entity is this partner? ▶ <b>Individual</b></p> <p>C Is this partner a <input type="checkbox"/> domestic or a <input type="checkbox"/> foreign partner?</p> <p>D Enter partner's percentage of: (i) Before change or termination (ii) End of year</p> <p>Profit sharing . . . . . % <b>10</b> %</p> <p>Loss sharing . . . . . % <b>10</b> %</p> <p>Ownership of capital . . . . . % <b>10</b> %</p> <p>E IRS Center where partnership filed return:</p> |   | <p>F Partner's share of liabilities (see instructions):<br/>Nonrecourse . . . . . \$ .....</p> <p>Qualified nonrecourse financing . . . . . \$ .....</p> <p>Other . . . . . \$ .....</p> <p>G Tax shelter registration number . . . . . ▶ .....</p> <p>H Check here if this partnership is a publicly traded partnership as defined in section 469(k)(2) . . . . . <input type="checkbox"/></p> <p>I Check applicable boxes: (1) <input type="checkbox"/> Final K-1 (2) <input type="checkbox"/> Amended K-1</p> |

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| J Analysis of partner's capital account: <b>Memphis</b>                        |   |   |  |   |
|--|---|---|--|---|
| (a) Capital account at beginning of year                                       | (b) Capital contributed during year                                       | (c) Partner's share of lines 3, 4, and 7, Form 1065, Schedule M-2 | (d) Withdrawals and distributions  | (e) Capital account at end of year (combine columns (a) through (d))                                      |
| <b>4,900</b>   | <b>600</b>  | <b>364</b>  | ( )  | <b>5,864</b>  |
| (a) Distributive share item  |   |   | (b) Amount   | (c) 1040 filers enter the amount in column (b) on:  |
| Income (Loss)  | 1 Ordinary income (loss) from trade or business activities . . . . .      | 1   |  | } See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).                                      |
|  | 2 Net income (loss) from rental real estate activities . . . . .          | 2   |  |   |
|  | 3 Net income (loss) from other rental activities . . . . .                | 3   |  |   |
|  | 4 Portfolio income (loss):  |   |  | } Sch. B, Part I, line 1<br>Sch. B, Part II, line 5<br>Sch. E, Part I, line 4<br>Sch. D, line 5, col. (f) |
|  | a Interest . . . . .  | 4a  | <b>24</b>  |   |
|  | b Ordinary dividends . . . . .  | 4b  | <b>80</b>  |   |
|  | c Royalties . . . . .   | 4c  |  |   |
|  | d Net short-term capital gain (loss) . . . . .                            | 4d  | <b>200</b>   |   |
|  | e Net long-term capital gain (loss):                                      |   |  | } Sch. D, line 12, col. (g)<br>Sch. D, line 12, col. (f)  |
|  | (1) 28% rate gain (loss) . . . . .  | e(1)  |  |   |
| (2) Total for year. . . . .  | e(2)  | <b>130</b>  | } Enter on applicable line of your return.   |   |
| f Other portfolio income (loss) (attach schedule) . . . . .                    | 4f  |   |  |   |
| 5 Guaranteed payments to partner . . . . .                                     | 5   |   | } See page 6 of Partner's Instructions for Schedule K-1 (Form 1065).<br>Enter on applicable line of your return. |   |
| 6 Net section 1231 gain (loss) (other than due to casualty or theft) . . . . . | 6   |   |  |   |
| 7 Other income (loss) (attach schedule) . . . . .                              | 7   |   |  |   |
| Deductions   | 8 Charitable contributions (see instructions) (attach schedule) . . . . . | 8   |  | } Sch. A, line 15 or 16   |
|  | 9 Section 179 expense deduction . . . . .                                 | 9   |  |   |
|  | 10 Deductions related to portfolio income (attach schedule) . . . . .     | 10  | <b>70</b>  | } See pages 7 and 8 of Partner's Instructions for Schedule K-1 (Form 1065).                               |
|  | 11 Other deductions (attach schedule) . . . . .                           | 11  |  |   |

|                          | 25 Supplemental information required to be reported separately to each partner (attach additional schedules if more space is needed): |
|--------------------------|---|
| Supplemental Information | <b>Line 10: Deductions related to portfolio income</b>  |
|                          | <b>Postage</b> <span style="float: right;"><b>\$ 36</b></span>  |
|                          | <b>Bank Charges</b> <span style="float: right;"><b>48</b></span>  |
|                          | <b>Office Expenses</b> <span style="float: right;"><b>116</b></span>  |
|                          | <b>Accounting Fees</b> <span style="float: right;"><b>200</b></span>  |
|                          | <b>Investment Fees</b> <span style="float: right;"><b>300</b></span>  |
|                          | <b>Total</b> <span style="float: right;"><b>\$ 700 X 10% = \$ 70</b></span>   |

## I. CHANGES IN MEMBERSHIP

A partnership is considered as terminated if within a 12-month period there is a sale or exchange (between members or non-members) of 50 percent or more of the total interest in partnership capital and profits. Otherwise, if the continuing members carry on the investment club with or without a successor to replace a member who withdraws or dies, the partnership (investment club) continues its existence for income tax purposes.

**Practitioner Note.** A new partnership formed as a result of a termination caused by a 50% or more change in ownership will retain the employer identification number of the terminated partnership [Treas. Reg. §301.6109-1(d)(2)(iii)]. **Therefore, the partnership does not have to apply for a new EIN.**



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**Example 20.** Ben Traveler, one of ten equal members of the Boardtown Loungers, has decided to move from Bug Tussle to Park City, Utah. Since he will no longer be able to actively participate in the investment club, he sells his membership to Nellie Newcomer, who just retired in Bug Tussle. Since the transfer of his partnership interest is only 10%, the club continues its existence as before, only with a new member. In the year of transfer there will be a final K-1 for Ben and an initial K-1 for Nellie.

When a partner withdraws from the investment club, it must be decided whether to pay the partner cash or to transfer securities to the withdrawing partner. If cash is chosen, the funds could be generated by new members, by increased contributions of existing members, by sale of securities, or simply by using funds already on hand.

**Example 21.** May Migration is a member of the Boardtown Loungers Investment Club. May is planning to move to Lonesome Rock, Arizona and sends a letter in early August requesting a full withdrawal from the club. May has a basis (and a capital account) of \$3,200. The fair market of May's partnership interest as of August 31 is \$4,300. There is not enough cash on hand to pay May, so the remaining partners decide to increase their contributions for September. This generates sufficient cash to pay May the value of her account in cash, \$4,300.

**No §754 Election.** If the partnership has not made a §754 election to adjust the basis of partnership property in the event of a sale or exchange of a partnership interest, or upon a partner's death, the following consequences result:

May receives proceeds of \$4,300 and the remaining partners acquire additional units for the basis of May's capital account. An entry is made on the club's books as follows:

|   |              |
|---|--------------|
| Debit: May, Capital                       | \$3,200      |
| Debit: Surplus Unrealized Gains Disbursed | <u>1,100</u> |
| Credit: Cash                              | \$4,300      |

The Surplus Unrealized Gains Disbursed sits on the books until the stock or securities are sold or until the club is liquidated (whichever comes first).

**Section 754 Election.** If a §754 election has been or is being made to step up the basis of partnership property, the following consequences result:

May still receives the \$4,300 of cash for her partnership interest, but the remaining partners who contributed the funds to buy out May's interest can step up their basis in the partnership property by \$1,100. This additional basis can then be allocated to the specific stocks that created the gain recognized by May. Sample journal entries are

|                             |                |
|-----------------------------|----------------|
| 1. Debit: May, Capital      | \$3,200        |
| Debit: §754 Adjustment      | <u>1,100</u>   |
| Credit: Cash                | \$4,300        |
| 2. Debit: Individual Stocks | <u>\$1,100</u> |
| Credit: §754 Adjustment     | \$1,100        |

In this case, the gains recognized by May have been incorporated into the stock or security bases.

**Section 754 Elections for Investment Partnerships.** Due to the frequency of partner admissions and withdrawals in an investment club, many authorities advise against a §754 election. The potential benefit is relatively small compared to the record keeping necessary to track the various basis adjustments, particularly when the basis adjustment for any single partner will usually be so small.

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The club treasurer will also do a partial closing of the books to determine May's share of income and expenses as of August 31:

|                 |      |
|-----------------|------|
| Expenses        | \$80 |
| Dividend Income | \$20 |

May's K-1 for the year will reflect these items, which will be transferred to her personal tax return. May will also report the capital gain from the sale of the partnership interest.

Her basis is determined as follows:

|  |         |
|--|---------|
| Basis at time of withdrawal              | \$3,200 |
| Adjustment for allocated dividend income | \$ 20   |
| Adjustment for allocated expenses        | \$ (80) |
| Adjusted basis for gain (loss)           | \$3,140 |

Therefore, May will report capital gain (short-term or long-term, depending on the holding period of the partnership interest) of \$1,160 on her withdrawal from the club.

|  |         |
|--|---------|
| Amount received on withdrawal          | \$4,300 |
| Adjusted basis in partnership interest | \$3,140 |
| Realized Gain                          | \$1,160 |

**Practitioner Note.** If the capital account (basis) is not adjusted for annual taxable items (such as dividends and expenses), the partners end up being double taxed on these items when they do withdraw from the club.

## J. LIQUIDATION OF THE INVESTMENT CLUB

Gain on liquidation of a partnership investment club is recognized to a member who receives in the liquidation an amount of money which exceeds the basis of his interest in the club. **If both money and stock or securities are received, only the money is taken into account in determining gain.** The stock or securities take as their basis the difference between the member's basis in his or her liquidated interest and the amount of money received on the liquidation.

Loss is recognized to a partner only upon the liquidation of his or her entire interest in the partnership and only if the property distributed consists solely of money (and certain receivables and inventory items, which an investment club normally does not have).

**Example 22.** Will Penny is a member of Lost Hope Investment Club. The club decides to liquidate and distributes to Will his pro rata share of cash (\$2,500) and shares of stock with a fair market value of \$10,000. The stock has a basis to the club of \$4,800. Will has a basis in his partnership interest of \$7,300. Will recognizes no gain since the cash received (\$2,500) does not exceed his basis (\$7,300). Will takes a basis in the stock received of \$4,800. The club recognizes no gain or loss on the distribution to Will.

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**Practitioner Note.** Generally, under I.R.C. §731(c), distributions of marketable securities (which include publicly traded stock) are treated as distributions of cash. If this section applies, the gain inherent in the securities is recognized upon distribution. However, marketable securities distributed by an investment partnership to a partner who only contributed money or certain financial instruments to the partnership are not treated as money [I.R.C. §731(c)(3)(A)]. Therefore Will does not recognize gain on the distribution of the stock.

## Summary

|                                    |                  |
|------------------------------------|------------------|
| Will's basis in partnership        | \$7,300          |
| Less cash received                 | <u>– \$2,500</u> |
| Remaining basis allocated to stock | \$4,800          |
| No Gain or Loss is Recognized      |                  |

## K. OTHER ISSUES

**1. Self-employment Tax.** A member's share of income from an investment club partnership is not SE income if the club limits its activities to the following activities.

- Investing in savings certificates, stock, or securities.
- Collecting interest or dividends for its members' accounts.

(IRS Publication 533, *Self-Employment Tax*, 1999, p. 5).

**2. Keeping up with Members' Basis.** An investment club is generally subject to partnership and partner basis rules. Therefore, the basis of an interest in an investment club, if acquired by a contribution of property, including money, to the club, is the amount of money plus the adjusted basis of the property to the contributing club member at the time of the contribution. This basis is increased by the member's distributive share of the investment club's taxable income for the tax year and prior tax years, plus the member's share of the exempt income of the club. The basis is decreased (but not below zero) by distributions by the investment club (in the amount of money and the club's basis of other property distributed) and by the sum of the member's share of the losses and nondeductible expenses of the club.

## VI. FOREIGN TAX CREDIT AND FORM 1116

### A. WHAT IS THE FOREIGN TAX CREDIT?

The foreign tax credit is intended to relieve U.S. taxpayers of the double tax burden when their foreign source income is taxed by both the United States and the foreign country from which the income comes. Generally, if the foreign tax rate is higher than the U.S. rate, there is no U.S. tax on the foreign income. If the foreign tax rate is lower than the U.S. rate, U.S. tax on the foreign income is limited to the difference between the rates. Because the foreign tax credit applies only with respect to foreign source income, it generally cannot reduce U.S. taxes on U.S. source income.

## B. CHOICE TO TAKE CREDIT OR DEDUCTION

Taxpayers can choose each tax year to take the amount of any qualified foreign taxes paid or accrued during the year as a foreign tax credit **or as an** itemized deduction. They can change their choice for each year's taxes.

- 1. To choose the foreign tax credit**, taxpayers usually must complete and attach Form 1116, Foreign Tax Credit, to their U.S. tax return.
- 2. To choose their foreign tax deduction**, taxpayers claim the taxes as an itemized deduction on Schedule A, Form 1040.
- 3. Choice applies to all qualified foreign taxes.** If taxpayers choose to take a credit for foreign taxes, they generally must take the credit for **all** qualified foreign taxes. Taxpayers cannot deduct any of these taxes. Conversely, if taxpayers choose to deduct qualified foreign taxes, they must deduct all of them. They cannot take a credit for any of them.
- 4. Why choose the credit?** Although no one rule covers all situations, it is generally better to take a credit for qualified foreign taxes than to deduct them as an itemized deduction. This is so because
  - A credit reduces actual U.S. income tax on a dollar-for-dollar basis, but a deduction reduces only income subject to tax.
  - Taxpayers can choose to take the foreign tax credit even if they do not itemize their deductions. They are allowed the standard deduction in addition to the credit.
  - If taxpayers choose to take a credit for the foreign taxes paid, and the taxes paid exceed the credit limit for the tax year, they can carry over or carry back the excess to another tax year. (See "Limit on the Credit," discussed later.)

**Example 23.** For 2000, Hale and Misty Raines have adjusted gross income of \$50,000, including \$20,000 of dividend income from foreign sources. They file a joint return and can claim two \$2,800 exemptions. They paid \$2,000 in foreign income taxes on the dividend income. If they take the foreign taxes as an itemized deduction, their total itemized deductions are \$10,000. Their taxable income is \$34,400 and their tax is \$5,160.

If Hale and Misty take the foreign tax credit instead, their itemized deductions are only \$8,000. Their taxable income is \$36,400, and their tax before the credit is \$5,460. After the credit, however, their tax is only \$3,276. Therefore, their tax is \$1,884 lower ( $\$5,160 - \$3,276$ ) by taking the credit.

**Example 24.** In 2000, Dusty Rhodes receives investment income of \$5,000 from a foreign country, which imposes a tax of \$3,500 on that income. He reports on his U.S. tax return this income as well as \$34,000 of income from U.S. Sources. Dusty is single, entitled to one \$2,800 exemption, and has other itemized deductions of \$4,500. If he deducts the foreign tax on his U.S. return, his taxable income is \$28,200 ( $\$5,000 + \$34,000 - \$2,800 - \$4,500 - \$3,500$ ) and his tax is \$4,484.

If Dusty takes the credit instead, his taxable income is \$31,700 ( $\$5,000 + \$34,000 - \$2,800 - \$4,500$ ) and his tax before the credit is \$5,464. Dusty can take a foreign tax credit of only \$699 because of the limits imposed (discussed later). Dusty's tax after the credit is \$4,765 ( $\$5,464 - \$699$ ), which is \$281 more than if he deducts the foreign tax.

If Dusty chooses the credit, he will have unused foreign taxes of \$2,801 ( $\$3,500 - \$699$ ). When deciding whether to take the credit or the deduction in 2000, Dusty will need to consider whether he can benefit from a carryback or carryover of that unused foreign tax. The unused foreign tax can be carried back two years and forward five years.

# 2000 Workbook

## Computation of Tax Liability

|   | With Foreign<br>Tax<br>Deduction | With Foreign<br>Tax<br>Credit |
|---|----------------------------------|-------------------------------|
| Investment Income   | \$ 5,000                         | \$ 5,000                      |
| Other Income  | 34,000                           | 34,000                        |
|   | <hr/>                            | <hr/>                         |
| Adjusted Gross Income                                     | \$39,000                         | \$39,000                      |
| Itemized Deductions                                       |                                  |                               |
| Foreign tax   | (3,500)                          | (0)                           |
| Other   | (4,500)                          | (4,500)                       |
| Personal Exemption  | (2,800)                          | (2,800)                       |
|   | <hr/>                            | <hr/>                         |
| Taxable Income  | \$28,200                         | \$31,700                      |
| Tax Due Before Credits                                    | 4,484                            | 5,464                         |
| Less Foreign Credit (after limits)                        | (0)                              | (699)                         |
|   | <hr/>                            | <hr/>                         |
| Net Tax Liability   | \$ 4,484                         | \$ 4,765                      |
| Unused foreign taxes available for carryback or carryover | \$ -0-                           | \$ 2,801                      |

**5. Making or changing the choice.** Taxpayers can make or change their choice to claim a deduction or credit at any time during the period within 10 years from the due date for filing the return for the tax year for which they make the claim. Taxpayers make or change their choice on their tax return (or on an amended return) for the year your choice is to be effective.

**Example 25.** Novice Investor paid foreign taxes for the last 13 years and chose to deduct them on his U.S. income tax returns. Novice was timely in both filing his returns and paying his U.S. tax liability. In February 2000 he files an amended return for tax year 1989 choosing to take a credit for his 1989 foreign taxes because he now realizes that the credit is more advantageous than the deduction for that year. Because his return for 1989 was not due until April 15, 1990, this choice is timely (within 10 years).

Because there is a limit on the credit for his 1989 foreign tax, he has unused 1989 foreign taxes. Ordinarily, he first carries back unused foreign taxes and claims them as a credit in the 2 preceding tax years. If Novice is unable to claim all of them in those 2 years, he carries them forward to the 5 years following the year in which they arose.

Because he originally did not choose to take a credit for his foreign taxes and the 10-year period for changing the choice for 1987 and 1988 has passed, he cannot carry the unused 1989 foreign taxes back to tax years 1987 and 1988.

Because the 10-year periods have not passed for his 1990 through 1994 income tax returns, he can still choose to carry *forward* any unused 1989 foreign taxes. However, he must reduce the unused 1989 foreign taxes that he carries forward by the amount that would have been allowed as a carryback if he had timely carried back the foreign tax to tax years 1987 and 1988.

**Practitioner Note.** The 10-year period for making or changing the choice to claim a deduction or a credit for foreign taxes paid does not alter the limitation period for refund claims. Generally, taxpayers must file a claim for refund within three years from the date the original return is filed or within two years from the date the tax was paid, whichever is later.

### C. FOREIGN TAXES ALLOCABLE TO EXCLUDED INCOME

Taxpayers cannot deduct or take a credit for foreign taxes paid on income excluded under the foreign earned income exclusion or the foreign housing exclusion.

## D. WHAT FOREIGN TAXES QUALIFY FOR THE CREDIT?

Generally, only income, war profits, and excess profits taxes (income taxes) paid or accrued during the tax year to a foreign country or a U.S. possession qualify for the foreign tax credit.

To determine whether a foreign levy is an income tax, it must be compared to the U.S. income tax. Therefore, a foreign levy is an income tax only if

- a. It is a tax; that is, it is **not** payment for a specific economic benefit, and
- b. The predominant character of the tax is that of an income tax in the U.S. sense.

## E. LIMIT ON THE CREDIT

The foreign tax credit is limited to the same proportion of total U.S. tax that taxable income from sources outside the United States bears to total taxable income.

**Avoiding Form 1116. Exemption from foreign tax credit limit.** Taxpayers are not subject to this limit and can **claim the credit without using Form 1116** if the following requirements are met.

1. The taxpayer is an individual.
2. The taxpayer's only foreign source gross income for the tax year is passive income.
3. The taxpayer's qualified foreign taxes for the tax year are not more than \$300 (\$600 if filing a joint return).
4. All of the taxpayer's gross foreign income and the foreign taxes are reported to him or her on a payee statement (such as a Form 1099-DIV or 1099-INT).
5. The taxpayer elects this procedure for the tax year.

**Observation.** If a taxpayer makes this election, he or she cannot carry back or carry over any unused foreign tax to or from this tax year.

**Example 26.** Wannabe Rich, a single bank teller in Drained Swamp, Florida, has invested in two international mutual funds. For 2000, the income reported on Forms 1099-DIV for the two funds total \$1,200, and the foreign tax, withheld (in U.S. dollars), is \$260. Since Wannabe is (1) an individual taxpayer, (2) her only foreign source income is the \$1,200 of dividends (passive income), (3) her foreign taxes are not more than \$300, and (4) all qualified foreign taxes are reported on Form 1099-DIV (or other payee statement, such as Form 1099-INT), Wannabe can choose to not file Form 1116 and enter her foreign tax credit directly on line 46 of Form 1040.

## F. CAPITAL GAINS AND LOSSES

If taxpayers have any capital gains or losses, they may have to make certain adjustments when figuring their foreign source taxable income and your foreign tax credit.

If taxpayers file a Schedule D (Form 1040), Capital Gains and Losses, and both lines 16 and 17 of that schedule are gains, they must adjust the amount you enter on line 17 of Form 1116. You must also make this adjustment if they received capital gain distributions, and they figured their tax using the Capital Gain Tax Worksheet (found in the Form 1040 instructions). Complete the Worksheet for Line 17, found in the Form 1116 instructions, to figure this amount.

If taxpayers have any foreign source capital gain or loss, they must adjust the amount of capital gain, or capital loss, they enter on line 1 or 5 of Form 1116. The Form 1116 instructions contain worksheets for making the adjustment.

# 2000 Workbook

## G. HOW TO CLAIM THE CREDIT

Taxpayers must file Form 1116 to claim a credit for foreign taxes. They are also required to translate their foreign income and taxes into U.S. dollars.

**Observation.** See Item E above for taxpayer eligibility to avoid Form 1116 if certain requirements are met.

**Taxpayers must file a separate Form 1116** for each of the following types of income for which they claim a foreign tax credit:

1. Passive income (such as **dividends**, interest, rents, royalties and annuities)
2. High withholding tax interest
3. Financial services income
4. Shipping income
5. Dividends from a DISC or former CISC
6. Certain distributions from a FSC or former FSC
7. Lump-sum distributions
8. General limitation income—all other income from sources outside the United States

**Practitioner Note.** The Foreign Tax Credit can be quite complex. See IRS Publication 514 for more information.

## H. SIMPLE EXAMPLE—FILLED-IN FORM 1116 (FROM PUBLICATION 514)

**Example 27.** Betsy Wilson is single, under 65, and a U.S. citizen. She earned \$21,000 working as a night auditor in Pittsburgh. She owns 200 shares in XYZ mutual fund that invests in German corporations. She received a dividend of \$620 from XYZ, which withheld and paid tax of \$93 to Germany on her dividend. XYZ reported this information to her on Form 1099-DIV.

Betsy elects to be exempt from the foreign tax credit limit because her only foreign taxable income is passive income (dividend of \$620) and the amount of taxes paid (\$93) is not more than \$300. To claim the \$93 as a credit, Betsy enters \$93 on line 46 of Form 1040. She does not file Form 1116. However, she cannot carry any unused foreign taxes to this tax year.

If Betsy does not elect to be exempt from the foreign tax credit limit, she will need to complete a Form 1116 as follows.

To complete Form 1116, Betsy fills in her name and social security number, and checks the box for passive income. In Part I of the form she writes the name of the foreign country in column A and shows on line 1 the amount of income (\$620) and type of income (dividends) she received from XYZ. Next, since Betsy does not itemize her deductions, she puts her standard deduction (\$4,400) on line 3a and completes 3b and 3c. Her gross foreign source income (line 3d) is \$620 and gross income from all sources (line 3e) is \$21,620. She enters \$126 on line 6. Line 7 is \$494, the difference between lines 1 and 6.

In Part II, Betsy checks the “Paid” box and enters on lines A and 8 the amount of tax XYZ withheld and paid to Germany.

In Part III, Betsy figures her credit as shown on the completed form. The computation shows that she may take only \$62 of the amount paid to Germany as a credit against her U.S. income tax. The remaining \$31 is available for a carryback and/or carryover. Because this is the only Form 1116 that Betsy must complete, she does not need to fill in lines 22 through 29 of Part IV.

# 2000 Workbook

Form **1116**  
 Department of the Treasury  
 Internal Revenue Service (99)

## Foreign Tax Credit

(Individual, Estate, Trust, or Nonresident Alien Individual)  
 ▶ Attach to Form 1040, 1040NR, 1041, or 990-T.  
 ▶ See separate instructions.

OMB No. 1545-0121  
**2000**  
 Attachment  
 Sequence No. **19**

Name **Betsy Wilson - Example 27** Identifying number as shown on page 1 of your tax return **111 - 00 - 1111**

Use a separate Form 1116 for each category of income listed below. See **Categories of Income** on page 3 of the instructions. Check only one box on each Form 1116. Report all amounts in U.S. dollars except where specified in Part II below.

- |  |   |  |
|--|---|--|
| <input checked="" type="checkbox"/> a Passive income     | <input type="checkbox"/> d Shipping income  | <input type="checkbox"/> g Lump-sum distributions      |
| <input type="checkbox"/> b High withholding tax interest | <input type="checkbox"/> e Dividends from a DISC or former DISC                                       | <input type="checkbox"/> h Section 901(j) income       |
| <input type="checkbox"/> c Financial services income     | <input type="checkbox"/> f Certain distributions from a foreign sales corporation (FSC) or former FSC | <input type="checkbox"/> i Income re-sourced by treaty |
|  |   | <input type="checkbox"/> j General limitation income   |

k Resident of (name of country) ▶ **United States**

**Note:** If you paid taxes to only one foreign country or U.S. possession, use column A in Part I and line A in Part II. If you paid taxes to more than one foreign country or U.S. possession, use a separate column and line for each country or possession.

### Part I Taxable Income or Loss From Sources Outside the United States (for Category Checked Above)

|  | Foreign Country or U.S. Possession |   |   | Total<br>(Add cols. A, B, and C.) |
|--|------------------------------------|---|---|-----------------------------------|
|  | A                                  | B | C |                                   |
| <b>1</b> Enter the name of the foreign country or U.S. possession . . . . . ▶  | <b>Germany</b>                     |   |   |                                   |
| <b>1</b> Gross income from sources within country shown above and of the type checked above. See page 7 of the instructions: . . . . . | 620                                |   |   | 1                                 |
| <b>2</b> Expenses <b>definitely related</b> to the income on line 1 (attach statement) . . . . .                                       |                                    |   |   |                                   |
| <b>3</b> Pro rata share of other deductions <b>not definitely related</b> :  |                                    |   |   |                                   |
| <b>a</b> Certain itemized deductions or standard deduction. See instructions . . . . .   | 4,400                              |   |   |                                   |
| <b>b</b> Other deductions (attach statement) . . . . .   | -0-                                |   |   |                                   |
| <b>c</b> Add lines 3a and 3b . . . . .   | 4,400                              |   |   |                                   |
| <b>d</b> Gross foreign source income. See instructions . . . . .   | 620                                |   |   |                                   |
| <b>e</b> Gross income from all sources. See instructions . . . . .   | 21,620                             |   |   |                                   |
| <b>f</b> Divide line 3d by line 3e. See instructions . . . . .   | .0287                              |   |   |                                   |
| <b>g</b> Multiply line 3c by line 3f. . . . .  | 126                                |   |   |                                   |
| <b>4</b> Pro rata share of interest expense. See instructions:   |                                    |   |   |                                   |
| <b>a</b> Home mortgage interest (use worksheet on page 9 of the instructions) . . . . .  |                                    |   |   |                                   |
| <b>b</b> Other interest expense . . . . .  |                                    |   |   |                                   |
| <b>5</b> Losses from foreign sources . . . . .   |                                    |   |   |                                   |
| <b>6</b> Add lines 2, 3g, 4a, 4b, and 5 . . . . .  | 126                                |   |   | 6                                 |
| <b>7</b> Subtract line 6 from line 1. Enter the result here and on line 14, page 2 . . . . . ▶   |                                    |   |   | 7                                 |
|  |                                    |   |   | <b>494</b>                        |

### Part II Foreign Taxes Paid or Accrued (See page 9 of the instructions.)

| Country  | Credit is claimed for taxes (you must check one)<br>(m) <input type="checkbox"/> Paid<br>(n) <input type="checkbox"/> Accrued | Foreign taxes paid or accrued |              |   |               |                              |              |  | (x) Total foreign taxes paid or accrued (add cols. (t) through (w)) |   |
|--|---|-------------------------------|--------------|---|---------------|------------------------------|--------------|--|---|---|
|  |   | In foreign currency           |              |   |               | In U.S. dollars              |              |  |   |   |
|  |   | Taxes withheld at source on:  |              |   |               | Taxes withheld at source on: |              |  |   | (w) Other foreign taxes paid or accrued |
| (o) Date paid or accrued   | (p) Dividends   | (q) Rents and royalties       | (r) Interest | (s) Other foreign taxes paid or accrued | (t) Dividends | (u) Rents and royalties      | (v) Interest |  |   |   |
| <b>A</b>   | <b>12 - 31 - 00</b>   | <b>167</b>                    |              |   |               | <b>93</b>                    |              |  | <b>93</b>   |   |
| <b>B</b>   |   |                               |              |   |               |                              |              |  |   |   |
| <b>C</b>   |   |                               |              |   |               |                              |              |  |   |   |
| <b>8</b> Add lines A through C, column (x). Enter the total here and on line 9, page 2 . . . . . ▶ |   |                               |              |   |               |                              |              |  | <b>8</b>  | <b>93</b>                               |

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# 2000 Workbook

## Part III Figuring the Credit

|   |    |               |  |
|---|----|---------------|--|
| 9 Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I . . . . .  | 9  | <b>93</b>     |  |
| 10 Carryback or carryover (attach detailed computation) . . . . .   | 10 | <b>-0-</b>    |  |
| 11 Add lines 9 and 10 . . . . .   | 11 | <b>93</b>     |  |
| 12 Reduction in foreign taxes. See page 10 of the instructions . . . . .  | 12 | <b>-0-</b>    |  |
| 13 Subtract line 12 from line 11. This is the total amount of foreign taxes available for credit . . . . .  | 13 | <b>93</b>     |  |
| 14 Enter the amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I. See page 10 of the instructions . . . . .   | 14 | <b>494</b>    |  |
| 15 Adjustments to line 14. See page 10 of the instructions. . . . .   | 15 | <b>-0-</b>    |  |
| 16 Combine the amounts on lines 14 and 15. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 17 through 21.) . . . . .   | 16 | <b>494</b>    |  |
| 17 <b>Individuals:</b> Enter the amount from Form 1040, line 37. If you are a nonresident alien, enter the amount from Form 1040NR, line 36.<br><b>Estates and trusts:</b> Enter your taxable income without the deduction for your exemption . . . . .<br><i>Caution: If you figured your tax using the special rates on capital gains, see page 12 of the instructions.</i> | 17 | <b>17,220</b> |  |
| 18 Divide line 16 by line 17. If line 16 is more than line 17, enter "1". . . . .   | 18 | <b>.0287</b>  |  |
| 19 <b>Individuals:</b> Enter the amount from Form 1040, line 40. If you are a nonresident alien, enter the amount from Form 1040NR, line 39.<br><b>Estates and trusts:</b> Enter the total of Form 1041, Schedule G, lines 1a and 1b, or the total of Form 990-T, lines 36 and 37. . . . .  | 19 | <b>2,163</b>  |  |
| 20 Multiply line 19 by line 18 (maximum amount of credit) . . . . .   | 20 | <b>62</b>     |  |
| 21 Enter the <b>smaller</b> of line 13 or line 20. If this is the only Form 1116 you are completing, skip lines 22 through 30 and enter this amount on line 31. Otherwise, complete the appropriate line in Part IV. See page 12 of the instructions. . . . . ▶   | 21 | <b>62</b>     |  |

## Part IV Summary of Credits From Separate Parts III (See page 12 of the instructions.)

|   |    |           |  |
|---|----|-----------|--|
| 22 Credit for taxes on passive income . . . . .   | 22 |           |  |
| 23 Credit for taxes on high withholding tax interest . . . . .  | 23 |           |  |
| 24 Credit for taxes on financial services income . . . . .  | 24 |           |  |
| 25 Credit for taxes on shipping income . . . . .  | 25 |           |  |
| 26 Credit for taxes on dividends from a DISC or former DISC and certain distributions from a FSC or former FSC . . . . .  | 26 |           |  |
| 27 Credit for taxes on lump-sum distributions . . . . .   | 27 |           |  |
| 28 Credit for taxes on income re-sourced by treaty . . . . .  | 28 |           |  |
| 29 Credit for taxes on general limitation income . . . . .  | 29 |           |  |
| 30 Add lines 22 through 29. . . . .   | 30 | <b>62</b> |  |
| 31 Enter the <b>smaller</b> of line 19 or line 30 . . . . .   | 31 |           |  |
| 32 Reduction of credit for international boycott operations. See instructions for line 12 on page 10 . . . . .  | 32 |           |  |
| 33 Subtract line 32 from line 31. This is your <b>foreign tax credit</b> . Enter here and on Form 1040, line 43; Form 1040NR, line 42; Form 1041, Schedule G, line 2a; or Form 990-T, line 40a. . . . . ▶ | 33 | <b>62</b> |  |

**Practitioner Note.** Year-end statements from many international and foreign mutual funds do not contain sufficient detailed information to separate foreign income and foreign taxes country by country. However, the instructions to Line 1, Form 1116, state:

## **Line 1—Foreign Country or U.S. Possession**

Generally, if you received income from, or paid taxes to, more than one foreign country or U.S. possession, report information on a country-by-country basis on Form 1116, Parts I and II. Use a separate column in Part I and a separate line in Part II for each country or possession. If you paid taxes to more than three countries or possessions, attach additional sheets following the format of Parts I and II.

If the country-by-country data are missing, but the total foreign income and foreign tax paid are known, the practitioner may consider using the term “Various” in place of the specific countries.

## **VII. TAX PLANNING: MARK TO MARKET ELECTION FOR 2001**

I.R.C. §1(h)(2)(A) states that for taxable years beginning after December 31, 2000, any gain from the sale or exchange of property **held more than 5 years** which would otherwise be taxed at the 10% rate instead will be taxed at an 8% rate. The 10% rate only applies to gains falling within the 15% ordinary income tax bracket. In other words, the taxpayer must have an unused 15% bracket amount in order to qualify for the 10% (and the new 8%) rate on capital gains.

**Practitioner Note.** It does not matter when the holding period begins for property to qualify for the 8% maximum rate on capital gains.

Under I.R.C. §1(h)(2)(B), any gain from the sale or exchange of property **held more than 5 years and the holding period for which begins after December 31, 2000**, which would otherwise be taxed at a 20% rate will be taxed at an 18% rate. Under §311(e) of the Taxpayer Relief Act of 1997, P.L. 105-34, taxpayers may elect to apply this reduced rate to gains associated with capital assets and property used in a trade or business acquired before January 1, 2001, and sold on or after January 3, 2006.

**In making the election, the taxpayer must treat the asset that is subject to the election as if it is sold on January 2, 2001, for an amount equal to its fair market value. This phantom paper gain is taxed in the year 2001 at the rate previously applicable.** In most cases, this rate would, under I.R.C. §1(h)(1)(E), be the 20% rate.

**Subsequent to the mark to market election, the asset's basis is its fair market value as of January 2, 2001, and the reduced capital gains rate applies to any further increases in fair market value. Any loss is not allowed (and the disallowed loss is not added to the basis of the asset).** A taxpayer may make the **election** with respect to some assets and not with respect to others.

**Example 28.** Ima Prudent acquires 100 shares of Slo Gro Inc. stock on March 15, 1998 for \$6,000. As of January 2, 2001, the stock has increased in value to \$6,550. Ima plans to hold the stock for the required 5-year period. She expects the stock to continue to increase in value, but at an accelerated rate. Ima is usually in at least the 28% tax bracket.

If Ima elects to recognize the mark to market gain as of January 2, 2001, she must report \$550 (\$6,550 – \$6,000) of gain and will pay \$110 (\$550 × 20%) of tax on that gain on her 2001 return. Her basis in the stock will then be \$6,550, and her holding period will begin on January 2, 2001.

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Since the appreciation in the stock is less than 13.888% but greater than zero, and since Ima expects the stock to appreciate in the future, she should strongly consider making the election to mark to market.

If Ima sells the stock on January 3, 2006, for \$10,550, she must report \$4,000 ( $\$10,550 - \$6,550$ ) of long-term capital gain and will pay \$720 ( $\$4,000 \times 18\%$ ) of tax on that gain in 2006.

If Ima did **not** make the election to recognize gain on January 2, 2001, her gain on the January 3, 2006, sale is \$4,550 ( $\$10,550 - \$6,000$ ). Her tax on that gain is \$910 ( $\$4,550 \times .20$ ).

Therefore, the election accelerates the payment of \$110 of taxes, but reduces the total taxes paid by \$80 ( $\$910 - \$110 - \$720$ ).

**Practitioner Note.** If Ima makes the election and the gain is in the 15% bracket when she sells the stock, she needlessly accelerated the tax on the gain recognized on January 1, 2001 since the gain would have been taxed at 8% without the election.



2000 Income Tax School

## ELECTRONIC FILING

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