INVESTMENT REPORTING

ISSUE 1: U.S. SAVINGS BONDS

GENERAL INFORMATION

With the recent decline in the stock market, more taxpayers are making alternate investments, such as buying corporate or municipal bonds, certificates of deposit, or U.S. savings bonds. In addition, Series I (and to a lesser extent, Series EE) U.S. saving bonds are increasingly being used to fund college expenses, because of the interest exclusion available. Form 8815 (Exclusion of Interest from Series EE and I U.S. Savings Bonds Issued After 1989) is used to exclude some or all of the bond interest. The discussion that follows concentrates on the tax reporting rules for

- Series EE bonds (which replaced E bonds in 1980)

- Series HH bonds (which replaced H bonds in 1980)
- Series I bonds (first offered in 1998)
- Exclusion of interest on Form 8815

SERIES EE BONDS

These bonds were first offered in July 1980 and are issued at discount. The face value is the minimum amount the bondholder is paid if the bond is held to **final maturity,** which is **30 years from the issue date.** EE bonds are purchased for half of face value and are available in face value denominations ranging from $50 to a maximum of $10,000. EE bonds have several tax advantages, including:

1. Tax deferral of interest until the **earlier** of the year the bonds are **cashed** or the year they **reach final maturity** (see Example 1)
2. Interest is exempt from all state and local income taxes
3. Part or all of the interest may be excludable from federal income tax on Form 8815

The increase in the redemption value may be reported annually as interest income by cash-basis taxpayers. However, few taxpayers make this election.

Example 1. Joan purchased a $5,000 EE bond issued in December 1986 for $2,500. She did **not** elect to report the increase in redemption value annually. She redeemed it in April 2001 for $5,544 to pay the balance due on her 2000 Form 1040. **Her 2001 interest income is $3,044** ($5,544 – cost basis of $2,500).

Observations for Example 1

1. Joan will receive a 2001 Form 1099-INT from the financial institution that cashed her EE bond, reporting the $3,044 interest income amount in Box 3.
2. If Joan had waited until June 1, 2001 to cash her EE bond, she would have received $144 more ($5,688 rather than $5,544). Her interest income would have been $3,188. Interest accrues only **twice** a year on EE bonds issued before March 1, 1993. The **interest accrual dates** for Joan's EE bond issued in December 1986 are **December 1** and **June 1.**

> **Practitioner Note.** If the bonds are cashed before the month of interest accrual, some interest will be lost, as shown in Example 1. **E and EE bonds are cashed on the first day of either of the interest accrual months no interest is lost.** See www.savingsbonds.gov for complete information, including a savings bond calculator page.

3. The interest rate on EE bonds issued between May 1 and October 31, 2001, is 4.5%. The rate for EE bonds issued between November 1, 2001, and April 30, 2002, will be announced November 1.

SERIES HH BONDS

These bonds were first offered in January 1980. **They can be acquired only in exchange for E or EE bonds.** HH bonds allow the owners of E and EE bonds the opportunity to continue the deferral of interest for an additional 20 years. They are issued in face amounts of $500 to $10,000, and interest is paid semiannually. The interest is taxable when received. HH bonds reach **final maturity** and cease paying interest **20 years from the issue date.** The Bureau of Public Debt issues the annual Form 1099-INT to the bondholder.

E bonds are eligible for exchange for one year after they reach maturity, with continued deferral of accrued interest. Matured H bonds may be reinvested in HH bonds, but there is no further deferral of interest. Interest on HH bonds issued after October 1, 1989, is paid by direct deposit.

Example 2. Ryan bought a $1,000 Series E bond in February 1971 for $750. The guaranteed interest rate was 6.5%. He did **not** elect to report the increase in redemption value annually. His E bond reached **final maturity** on February 1, 2001, **30 years from the issue date.**

However, Ryan forgot about the E bond and discovered it in June 2001 when he inspected his lock box. The bond had a redemption value of $5,064 on June 1, 2001, and had earned interest of $4,314. Since Ryan didn't need the money and wanted to minimize 2001 income taxes, he decided to exchange the E bond for HH bonds.

In exchange for the E bond, Ryan received the following on June 2001:

1. A $5,000 HH bond with an issue date of June 2001. It showed a deferred interest amount from the E bond of $4,250
2. $64 in cash

Tax Result for Example 2

1. Ryan must report the $64 cash as interest income on his 2001 tax return.
2. Ryan will receive his first semiannual interest payment on the $5,000 HH bond on December 1, 2001. The initial interest payment will be $100 ($5,000 × 4% ÷ 2).

> **Practitioner Note.** HH bonds issued **on or after March 1, 1993,** pay 4% interest. This includes matured HH bonds that are **reinvested** in newly-issued HH bonds on or after March 1, 1993. See the Individual Taxpayer Problems chapter.

3. Ryan will report a total of $164 of interest income on his 2001 Schedule B from the E and HH bonds ($64 + $100).

SERIES I BONDS

These bonds were first offered in September 1998. I bonds were designed to ensure a real rate of return over and above the inflation rate. The interest rate on I bonds issued between May 1 through October 31, 2001, is 5.92%. The tax advantages of I bonds are identical to those for EE bonds, with the exception that they cannot be exchanged for HH bonds. They are purchased at face value. I bonds reach **final maturity** and cease paying interest **30 years from the issue date.** If the bonds are cashed within the first five years of the issue date, three months' interest is forfeited.

I bonds are purchased in face value denominations ranging from $50 to $10,000. Interest is accrued semiannually. Similar to E and EE bonds, the excess of the redemption value over the purchase price represents the interest income amount. **A maximum of $30,000** of I bonds may be purchased annually per social security number.

EXCLUSION OF INTEREST ON FORM 8815

> **Practitioner Note.** The following example uses EE bonds as the funding source for college expenses simply because I bonds are a recent option. Due to the higher rate of interest, I bonds are currently the preferred funding source for exclusion of future interest on Form 8815.

Example 3. Scott and Dawn, a married couple, bought an EE bond as co-owners in 1990 when they were both 35 years old. They cashed the EE bond in 2001 to help pay for their daughter Jenna's freshman college expenses. Jenna is their dependent. Pertinent facts regarding the EE bond and Jenna's 2001 college expenses are as follows:

Purchase date of EE bond	June 10, 1990
Denomination of EE bond	$10,000
Purchase price of EE bond (50% of face value)	$ 5,000
Interest rate of EE bond	6%
Date the EE bond was cashed	June 4, 2001
Redemption value including interest	$9,584
Interest earned on EE bond	$4,584
Amount of Jenna's freshman college tuition and fees paid by Scott and Dawn in 2001	$9,700
Amount of tuition and fees used for Hope credit	$2,000

Practitioner Note. Jenna did not have any nontaxable educational benefits such as scholarship grants in 2001. She entered Nebraska Wesleyan University in August 2001, as a first-semester freshman. Her first semester tuition of $9,700 was paid in 2001 in two installments.

Question 1. Will the Hope credit that Scott and Dawn claim on their 2001 joint return affect the calculation of the interest exclusion on Form 8815?

Answer 1. Yes. Beginning in 1998, the 1997 Taxpayer Relief Act added a new **reduction** in calculating the amount of tuition and fees that qualify for the exclusion of interest from EE or I bonds [I.R.C. §135(d)(2)]. This amendment **prevents** taxpayers from receiving a **double tax benefit** by claiming **both** the savings bond interest exclusion on Form 8815 **and either** the Hope credit or the Lifetime Learning credit for the same expenses.

Practitioner Note. A decision must be made as to which tax benefit will be used first. In most cases, it will be most beneficial for taxpayers to claim the Hope or Lifetime Learning credits **first** on Form 8863. Any **remaining** tuition and fees then can be reported on line 2, Form 8815.

Technicalities of the Exclusion on Form 8815

1. The EE or I bonds must be purchased after 1989. In Example 3, the $10,000 EE bond was purchased in 1990.
2. The bonds must be registered in the taxpayer's name alone, with or without a beneficiary, or in the name of the taxpayer and spouse (not a dependent child) as co-owners. In Example 3, Scott and Dawn bought the EE bond as co-owners with no named beneficiary.
3. The taxpayer who purchases the EE or I bond must be at least 24 years old before the issue date of the bond. In Example 3, Scott and Dawn were both 35 years old in 1990 when the EE bond was purchased.
4. Qualified higher education expenses reported on line 2, Form 8815 are limited to tuition and fees, identical to the requirements for the Hope or Lifetime Learning credits on Form 8863. In Example 3, $9,700, the first semester's tuition paid in 2001, is the amount to be considered for **both** Form 8863 and line 2, Form 8815.
5. The qualified higher education expenses may be for the benefit of the taxpayer, spouse, or a dependent for whom an exemption is claimed. In Example 3, Scott and Dawn claim Jenna's exemption on their 2001 joint Form 1040.
6. The taxpayer must use **both** the principal and interest from the EE or I bonds cashed during the year to pay for tuition and fees of the student. In Example 3, the tuition of $7,700 ($9,700 total, less $2,000 used on Form 8863), was **less** than the EE bond proceeds of $9,584. Therefore, this

requirement was **not** met. Form 8815 computes the pro rata percentage of excludable interest, which is .803 for Scott and Dawn.

See the following completed 2001 forms and schedules for Scott and Dawn for Example 3:

- Form 1040
- Schedule B
- Form 8863 (Education Credits)
- Form 8815 (Exclusion of Interest from EE Bond)
- Line 9 Worksheet from Form 8815 Instructions

Example 3

Form **1040** Department of the Treasury—Internal Revenue Service
U.S. Individual Income Tax Return **2001** (99) IRS Use Only—Do not write or staple in this space.

For the year Jan. 1–Dec. 31, 2001, or other tax year beginning , 2001, ending , 20 OMB No. 1545-0074

Label (See instructions on page 19.) **Use the IRS label.** Otherwise, please print or type. LABEL HERE

Your first name and initial	Last name	Your social security number
Scott		
If a joint return, spouse's first name and initial	Last name	Spouse's social security number
Dawn		
Home address (number and street). If you have a P.O. box, see page 19.	Apt. no.	
City, town or post office, state, and ZIP code. If you have a foreign address, see page 19.		

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

Presidential Election Campaign (See page 19.) **Note.** Checking "Yes" will not change your tax or reduce your refund. Do you, or your spouse if filing a joint return, want $3 to go to this fund? ▶ You ☐ Yes ☐ No Spouse ☐ Yes ☐ No

Filing Status — Check only one box.

1 ☐ Single
2 ☒ Married filing joint return (even if only one had income)
3 ☐ Married filing separate return. Enter spouse's social security no. above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 19.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (year spouse died ▶). (See page 19.)

Exemptions

6a ☒ **Yourself.** If your parent (or someone else) can claim you as a dependent on his or her tax return, **do not** check box 6a
b ☒ **Spouse**

No. of boxes checked on 6a and 6b: 2

c **Dependents:**

(1) First name Last name	(2) Dependent's social security number	(3) Dependent's relationship to you	(4) ✓ if qualifying child for child tax credit (see page 20)
Jenna	111 11 1111	Daughter	☐
Austin	222 22 2222	Son	☒
			☐
			☐
			☐
			☐

If more than six dependents, see page 20.

No. of your children on 6c who:
- lived with you: 2
- did not live with you due to divorce or separation (see page 20)

Dependents on 6c not entered above

d Total number of exemptions claimed — Add numbers entered on lines above ▶ 4

Example 3

Income	7	Wages, salaries, tips, etc. Attach Form(s) W-2	7	78,000
Attach Forms W-2 and W-2G here. Also attach Form(s) 1099-R if tax was withheld.	8a	**Taxable** interest. Attach Schedule B if required	8a	1,900
	b	**Tax-exempt** interest. **Do not** include on line 8a — 8b		
	9	Ordinary dividends. Attach Schedule B if required	9	
	10	Taxable refunds, credits, or offsets of state and local income taxes (see page 22)	10	
	11	Alimony received	11	
	12	Business income or (loss). Attach Schedule C or C-EZ	12	
	13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐	13	
	14	Other gains or (losses). Attach Form 4797	14	
If you did not get a W-2, see page 21.	15a	Total IRA distributions — 15a — **b** Taxable amount (see page 23)	15b	
	16a	Total pensions and annuities — 16a — **b** Taxable amount (see page 23)	16b	
	17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E	17	
Enclose, but do not attach, any payment. Also, please use **Form 1040-V.**	18	Farm income or (loss). Attach Schedule F	18	
	19	Unemployment compensation	19	
	20a	Social security benefits — 20a — **b** Taxable amount (see page 25)	20b	
	21	Other income. List type and amount (see page 25)	21	
	22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶	22	79,900
Adjusted Gross Income	23	IRA deduction (see page 27) — 23		
	24	Student loan interest deduction (see page 27) — 24		
	25	Medical savings account deduction. Attach Form 8853 — 25		
	26	Moving expenses. Attach Form 3903 — 26		
	27	One-half of self-employment tax. Attach Schedule SE — 27		
	28	Self-employed health insurance deduction (see page 29) — 28		
	29	Self-employed SEP, SIMPLE, and qualified plans — 29		
	30	Penalty on early withdrawal of savings — 30		
	31a	Alimony paid **b** Recipient's SSN ▶ — 31a		
	32	Add lines 23 through 31a	32	
	33	Subtract line 32 from line 22. This is your **adjusted gross income** ▶	33	79,900

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 56. Cat. No. 11320B Form **1040** (2001)

Example 3

Form 1040 (2001) Page **2**

Tax and Credits	34	Amount from line 33 (adjusted gross income)			34	79,900
	35a	Check if: ☐ **You** were 65 or older, ☐ Blind; ☐ **Spouse** was 65 or older, ☐ Blind. Add the number of boxes checked above and enter the total here ▶ 35a				
	b	If you are married filing separately and your spouse itemizes deductions, or you were a dual-status alien, see page 31 and check here ▶ 35b ☐				
Standard Deduction for Most People Single: \$4,550 Head of household: \$6,650 Married filing jointly or Qualifying widow(er): \$7,600 Married filing separately: \$3,800	36	Enter your **itemized deductions** from Schedule A, line 28, **or standard deduction** shown on the left. **But** see page 31 to find your standard deduction if you checked any box on line 35a or 35b **or** if someone can claim you as a dependent			36	8,400
	37	Subtract line 36 from line 34			37	71,500
	38	If line 34 is \$96,700 or less, multiply \$2,900 by the total number of exemptions claimed on line 6d. If line 34 is over \$99,725, see the worksheet on page 32 for the amount to enter			38	11,600
	39	**Taxable income.** Subtract line 38 from line 37. If line 38 is more than line 37, enter -0-			39	59,900
	40	**Tax** (see page 32). Check if any tax is from **a** ☐ Form(s) 8814 **b** ☐ Form 4972			40	10,829
	41	Alternative minimum tax. Attach Form 6251			41	
	42	Add lines 40 and 41 ▶			42	10,829
	43	Foreign tax credit. Attach Form 1116 if required	43			
	44	Credit for child and dependent care expenses. Attach Form 2441	44			
	45	Credit for the elderly or the disabled. Attach Schedule R	45			
	46	Education credits. Attach Form 8863	46	1,500		
	47	Child tax credit (see page 36)	47	600		
	48	Adoption credit. Attach Form 8839	48			
	49	Other. Check if from **a** ☐ Form 3800 **b** ☐ Form 8396 **c** ☐ Form 8801 **d** ☐ Form (specify)	49			
	50	Add lines 43 through 49. These are your **total credits**			50	2,100
	51	Subtract line 50 from line 42. If line 50 is more than line 42, enter -0- ▶			51	8,729
Other Taxes	52	Self-employment tax. Attach Schedule SE			52	
	53	Social security and Medicare tax on tip income not reported to employer. Attach Form 4137			53	
	54	Tax on IRAs, other retirement plans, and MSAs. Attach Form 5329 if required			54	
	55	Advance earned income credit payments from Form(s) W-2			55	
	56	Household employment taxes. Attach Schedule H			56	
	57	Add lines 51 through 56. This is your **total tax** ▶			57	8,729

Payments

If you have a qualifying child, attach Schedule EIC.

58	Federal income tax withheld from Forms W-2 and 1099	58	10,903		
59	2001 estimated tax payments and amount applied from 2000 return	59			
60a	**Earned income credit (EIC)**	60a			
b	Nontaxable earned income: amount ▶ and type ▶				
61	Excess social security and RRTA tax withheld (see page 50)	61			
62	Additional child tax credit. Attach Form 8812	62			
63	Amount paid with request for extension to file (see page 50)	63			
64	Other payments. Check if from a ☐ Form 2439 b ☐ Form 4136	64			
65	Add lines 58, 59, 60a, and 61 through 64. These are your **total payments** ▶			65	10,903

Refund

Have it directly deposited! See page 50 and fill in 67b, 67c, and 67d.

66	If line 65 is more than line 57, subtract line 57 from line 65. This is the amount you **overpaid**			66	2,174
67a	Amount of line 66 you want **refunded to you** ▶			67a	2,174
▶ b	Routing number ▶ c Type: ☐ Checking ☐ Savings				
▶ d	Account number				
68	Amount of line 66 you want **applied to your 2001 estimated tax** ▶	68			

Amount You Owe

69	If line 57 is more than line 65, subtract line 65 from line 57. This is the **amount you owe**. For details on how to pay, see page 51 ▶			69	
70	Estimated tax penalty. Also include on line 69	70			

Sign Here

Joint return? See page 19. Keep a copy for your records.

Under penalties of perjury, I declare that I have examined this return and accompanying schedules and statements, and to the best of my knowledge and belief, they are true, correct, and complete. Declaration of preparer (other than taxpayer) is based on all information of which preparer has any knowledge.

Your signature	Date	Your occupation	Daytime phone number ( )
Spouse's signature. If a joint return, **both** must sign.	Date	Spouse's occupation	May the IRS discuss this return with the preparer shown below (see page 52)? ☐ **Yes** ☐ **No**

Paid Preparer's Use Only

Preparer's signature ▶	Date	Check if self-employed ☐	Preparer's SSN or PTIN
Firm's name (or yours if self-employed), address, and ZIP code ▶		EIN	
		Phone no. ( )	

Form **1040** (2001)

Schedules A&B (Form 1040) 2001 — OMB No. 1545-0074 — Page **2**

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side. — **Your social security number**

Scott and Dawn

Schedule B—Interest and Ordinary Dividends

Attachment Sequence No. **08**

Part I Interest

(See page B-1 and the instructions for Form 1040, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

Note. If you had over $400 in taxable interest, you must also complete Part III.

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶	1	
	U.S. Treasury - EE Bonds		4,584
	Teachers Credit Union		283
	1st State Bank (CD)		714
2	Add the amounts on line 1	2	5,581
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989 from Form 8815, line 14. You **must** attach Form 8815	3	3,681
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	1,900

Form **8863**

Department of the Treasury
Internal Revenue Service

Education Credits (Hope and Lifetime Learning Credits)

► See instructions on pages 2 and 3. ► Attach to Form 1040 or Form 1040A.

OMB No. 1545-1618

2001

Attachment Sequence No. 51

Name(s) shown on return: *Scott and*

Your social security number

Part I **Hope Credit. Caution:** *The Hope credit may be claimed for no more than **2** tax years for the **same** student.*

1	**(a)** Student's name (as shown on page 1 of your tax return) First, Last	**(b)** Student's social security number (as shown on page 1 of your tax return)	**(c)** Qualified expenses (but **do not** enter more than $2,000 for each student). See instructions	**(d)** Enter the **smaller** of the amount in column (c) or $1,000	**(e)** Subtract column (d) from column (c)	**(f)** Enter one-half of the amount in column (e)
	Jenna	*111 11 1111*	*2,000*	*1,000*	*1,000*	*500*
2	Add the amounts in columns (d) and (f)		**2**	*1,000*		*500*
3	Tentative Hope credit. Add the amounts on line 2, columns (d) and (f) ►				**3**	*1,500*

Part II **Lifetime Learning Credit**

4	**(a)** Student's name (as shown on page 1 of your tax return) First, Last	**(b)** Student's social security number (as shown on page 1 of your tax return)	**(c)** Qualified expenses. See instructions
Caution: *You cannot take the Hope credit and the lifetime learning credit for the same student.*			

5	Add the amounts on line 4, column (c), and enter the total	5	
6	Enter the **smaller** of line 5 or $5,000	6	
7	Tentative lifetime learning credit. Multiply line 6 by 20% (.20) ►	7	

Part III **Allowable Education Credits**

8	Tentative education credits. Add lines 3 and 7			8	*1,500*
9	Enter: $100,000 if married filing jointly; $50,000 if single, head of household, or qualifying widow(er)	9	*100,000*		
10	Enter the amount from Form 1040, line 34 (or Form 1040A, line 20)*	10	*79,900*		
11	Subtract line 10 from line 9. If line 10 is equal to or more than line 9, **stop;** you cannot take any education credits	11	*20,100*		
12	Enter: $20,000 if married filing jointly; $10,000 if single, head of household, or qualifying widow(er)	12	*20,000*		
13	If line 11 is equal to or more than line 12, enter the amount from line 8 on line 14 and go to line 15. If line 11 is less than line 12, divide line 11 by line 12. Enter the result as a decimal (rounded to at least three places)			13	× .
14	Multiply line 8 by line 13 ►			14	*1,500*
15	Enter the amount from Form 1040, line 42 (or Form 1040A, line 26)			15	*10,823*
16	Enter the total, if any, of your credits from Form 1040, lines 43 through 45 (or from Form 1040A, lines 27 and 28)			16	*0*
17	Subtract line 16 from line 15. If line 16 is equal to or more than line 15, **stop;** you cannot take any education credits			17	*10,823*
18	**Education credits.** Enter the **smaller** of line 14 or line 17 here and on Form 1040, line 46 (or Form 1040A, line 29) ►			18	*1,500*

*See Pub. 970 for the amount to enter if you are filing Form 2555, 2555-EZ, or 4563 or you are excluding income from Puerto Rico.

For Paperwork Reduction Act Notice, see page 4. Cat. No. 25379M Form **8863** (2001)

Form **8815** Department of the Treasury Internal Revenue Service (99)

Exclusion of Interest From Series EE and I U.S. Savings Bonds Issued After 1989

(For Filers With Qualified Higher Education Expenses)

▶ **Attach to Form 1040 or Form 1040A.**

OMB No. 1545-1173

2001

Attachment Sequence No. **57**

Name(s) shown on return: *Scott and Dawn*

Your social security number

1 (a) Name of person (you, your spouse, or your dependent) who was enrolled at or attended an eligible educational institution	(b) Name and address of eligible educational institution
Jenna	*Nebraska Wesleyan University* *Lincoln, NE*

If you need more space, attach a statement.

2	Enter the total qualified higher education expenses you paid in 2001 for the person(s) listed in column (a) of line 1. See the instructions to find out which expenses qualify	2	*7,700*
3	Enter the total of any nontaxable educational benefits (such as nontaxable scholarship or fellowship grants) received for 2001 for the person(s) listed in column (a) of line 1. See instructions	3	*0*
4	Subtract line 3 from line 2. If zero or less, **stop.** You **cannot** take the exclusion	4	*7,700*
5	Enter the total proceeds (principal and interest) from all series EE and I U.S. savings bonds **issued after 1989** that you **cashed during 2001**	5	*9,584*
6	Enter the interest included on line 5. See instructions	6	*4,584*
7	If line 4 is equal to or more than line 5, enter "1.000." If line 4 is less than line 5, divide line 4 by line 5. Enter the result as a decimal (rounded to at least three places)	7	× *.803*
8	Multiply line 6 by line 7	8	*3,681*
9	Enter your modified adjusted gross income. See instructions — 9: *83,581* **Note:** *If line 9 is $70,750 or more if single or head of household, or $113,650 or more if married filing jointly or qualifying widow(er),* ***stop.*** *You* ***cannot*** *take the exclusion.*		
10	Enter: $55,750 if single or head of household; $83,650 if married filing jointly or qualifying widow(er) — 10: *83,650*		
11	Subtract line 10 from line 9. If zero or less, skip line 12, enter -0- on line 13, and go to line 14 — 11: *0*		
12	Divide line 11 by: $15,000 if single or head of household; $30,000 if married filing jointly or qualifying widow(er). Enter the result as a decimal (rounded to at least three places)	12	× .
13	Multiply line 8 by line 12	13	*0*
14	**Excludable savings bond interest.** Subtract line 13 from line 8. Enter the result here and on Schedule B (Form 1040), line 3, or Schedule 1 (Form 1040A), line 3, whichever applies ▶	14	*3,681*

General Instructions

Section references are to the Internal Revenue Code.

Purpose of Form

If you cashed series EE or I U.S. savings bonds in 2001 that were issued after 1989, you may be able to exclude from your income part or all of the interest on those bonds. Use this form to figure the amount of any interest you may exclude.

Who May Take the Exclusion

You may take the exclusion if **all four** of the following apply.

1. You cashed qualified U.S. savings bonds in 2001 that were issued after 1989.

2. You paid qualified higher education expenses in 2001 for yourself, your spouse, or your dependents.

3. Your filing status is any status **except** married filing separately.

4. Your modified AGI (adjusted gross income) is less than: $70,750 if single or head of household; $113,650 if married filing jointly or qualifying widow(er). See the instructions for line 9 to figure your modified AGI.

U.S. Savings Bonds That Qualify for Exclusion

To qualify for the exclusion, the bonds must be series EE or I U.S. savings bonds issued after 1989 in your name, or, if you are married, they may be issued in your name and your spouse's name. Also, you must have been age 24 or older before the bonds were issued. A bond bought by a parent and issued in the name of his or her child under age 24 does not qualify for the exclusion by the parent or child.

Recordkeeping Requirements

Keep the following to verify the amount of interest you exclude.

- Bills, receipts, canceled checks, or other documents showing you paid qualified higher education expenses in 2001.
- A written record of each post-1989 series EE or I bond that you cash. Your record must include the serial number, issue date, face value, and total redemption proceeds (principal and interest) of each bond. You may use **Form 8818,** Optional Form To Record Redemption of Series EE and I U.S. Savings Bonds Issued After 1989.

For Paperwork Reduction Act Notice, see back of form. Cat. No. 10822S Form **8815** (2001)

5

Specific Instructions

Line 1

Column (a). Enter the name of the person who was enrolled at or attended an eligible educational institution or for whom you made contributions to an education (Ed) IRA or a qualified state tuition program. This person must be you, your spouse, or your dependent(s) claimed on line 6c of Form 1040 or Form 1040A. An **eligible educational institution** is generally any accredited public, nonprofit, or private college, university, vocational school, or other postsecondary institution. The institution must be eligible to participate in the student aid programs administered by the Department of Education. Virtually all accredited postsecondary institutions meet this requirement.

Column (b). Enter the name and address of the institution. If the person was enrolled at or attended more than one, list all of them. Also, if you contributed to an Ed IRA for the person, enter "Ed IRA" and the name and address of the financial institution where the account is located. For contributions to a QSTP, enter "QSTP" and the name and address of the program.

Line 2

Qualified higher education expenses include tuition and fees required for the enrollment or attendance of the person(s) listed on line 1, column (a), at the institution(s) listed in column (b). They also include contributions to an Ed IRA or a qualified state tuition program for the person(s) listed on line 1. Qualified expenses **do not** include expenses for:

- Room and board or
- Courses involving sports, games, or hobbies that are not part of a degree or certificate granting program.

Do not include on line 2 expenses that were:

- Covered by nontaxable educational benefits paid directly to, or by, the educational institution,
- Used to figure an education credit on **Form 8863,** or
- Used to figure the excludable amount of a distribution from an Ed IRA.

Line 3

Enter on this line the total qualified higher education expenses included on line 2 that were covered by **nontaxable educational benefits.** These benefits include:

- Scholarship or fellowship grants excludable from income under section 117.
- Veterans' educational assistance benefits.
- Employer-provided educational assistance benefits that are not included in box 1 of your W-2 form(s).
- Payments, waivers, or reimbursements of educational expenses under a qualified state tuition program.
- Any other payments (but **not** gifts, bequests, or inheritances) for educational expenses that are exempt from income tax by any U.S. law.

Do not include on line 3 nontaxable educational benefits paid directly to, or by, the educational institution.

Example. You paid $10,000 of qualified higher education expenses in 2001 to the college your son attended. None of the expenses are used to figure an education credit or the excludable amount of an Ed IRA distribution. You claim your son as a dependent on line 6c of your 2001 tax return. Your son received a $2,000 nontaxable scholarship grant for 2001, which was paid directly to him. In this case, enter $10,000 on line 2 and $2,000 on line 3.

Line 6

If you reported any of the interest before 2001, see **Pub. 550** for the amount to enter. Otherwise, enter the amount from Form 8818, line 8 (if you used that form to record the bonds cashed), or use the worksheet below to figure the amount to enter.

Line 6 Worksheet (keep a copy for your records)

1. Enter the amount from Form 8815, line 5		1.	
2. Enter the face value of all post-1989 series EE bonds cashed in 2001	2.		
3. Multiply line 2 by 50% (.50)	3.		
4. Enter the face value of all series I bonds cashed in 2001	4.		
5. Add lines 3 and 4		5.	
6. Subtract line 5 from line 1. Enter the result here and on Form 8815, line 6		6.	

Line 9

Follow these steps before you fill in the **Line 9 Worksheet** below.

Step	Action
1	If you received social security benefits, use **Pub. 915** to figure the taxable amount of your benefits.
2	If you made contributions to a traditional IRA for 2001 and you were covered by a retirement plan at work or through self-employment, use **Pub. 590** to figure your IRA deduction.
3	If you file Form 1040, figure any amount to be entered on the dotted line next to line 32.
4	Complete the following lines on your return if they apply. **IF you file Form...** — **THEN complete lines...** 1040 — 8b, 9–21, 23, and 25–31a 1040A — 8b, 9–14b, and 16
5	If any of the following apply, see Pub. 550: • You are filing **Form 2555** or **2555-EZ** (relating to foreign earned income), or **Form 4563** (exclusion of income for residents of American Samoa), • You have employer-provided adoption benefits for 2000, • You are excluding income from Puerto Rico, **or** • You have investment interest expense attributable to royalty income.

Line 9 Worksheet (keep a copy for your records)

1. Enter the amount from line 2 of **Schedule B** (Form 1040) or **Schedule 1** (Form 1040A)	1.	*5,581*
2. **Form 1040 filers,** add the amounts on lines 7, 9 through 14, 15b, 16b, 17 through 19, 20b, and 21. Enter the total. **Form 1040A filers,** add the amounts on lines 7, 9, 10, 11b, 12b, 13, and 14b. Enter the total	2.	*78,000*
3. Add lines 1 and 2	3.	*83,581*
4. **Form 1040 filers,** enter the total of the amounts from lines 23 and 25 through 31a, plus any amount entered on the dotted line next to line 32. **Form 1040A filers,** enter the amount from line 16	4.	*0*
5. Subtract line 4 from line 3. Enter the result here and on Form 8815, line 9	5.	*83,581*

Paperwork Reduction Act Notice. We ask for the information on this form to carry out the Internal Revenue laws of the United States. You are required to give us the information. We need it to ensure that you are complying with these laws and to allow us to figure and collect the right amount of tax.

You are not required to provide the information requested on a form that is subject to the Paperwork Reduction Act unless the form displays a valid OMB control number. Books or records relating to a form or its instructions must be retained as long as their contents may become material in the administration of any Internal Revenue law. Generally, tax returns and return information are confidential, as required by section 6103.

The time needed to complete and file this form will vary depending on individual circumstances. The estimated average time is: **Recordkeeping,** 53 min.; **Learning about the law or the form,** 13 min.; **Preparing the form,** 38 min.; and **Copying, assembling, and sending the form to the IRS,** 20 min.

If you have comments concerning the accuracy of these time estimates or suggestions for making this form simpler, we would be happy to hear from you. See the instructions for Form 1040 or Form 1040A.

ISSUE 2: BONDS BOUGHT AT PREMIUM AND DISCOUNT

The tax reporting rules that follow explain the rules for:

- Taxable bonds bought at a premium
- Tax-exempt bonds bought at a premium
- Taxable and tax-exempt bonds bought at market discount

> **Note.** Original issue discount (OID) is not discussed. See pages 598–600 in the *1998 Farm Income Tax School Workbook* for information on OID.

TAXABLE BONDS BOUGHT AT A PREMIUM

During periods of falling interest rates such as 2001, the value of a previously issued becomes taxable bond may increase. In that case, the secondary buyer of the bond must pay a premium. The premium becomes part of the basis of the bond. An election can be made to **amortize** the premium over the remaining life of the bond. If this election is made, the amortized premium is deducted on Schedule B, and the basis of the bond is decreased by the deduction. If the bond is held to maturity, the basis of the bond is reduced by the entire premium to its face value. The tax result at maturity is neither gain nor loss on Schedule D, when the bond is redeemed for its face value.

Example 1. Brett bought a General Motors bond on April 30, 2001 through his brokerage account with Edward Jones Investments. Following are the details regarding the purchase:

Date of purchase		April 30, 2001
Purchase price of bond		
Face value of bond	$10,000	
Accrued interest	300	
Premium paid	700	
Total amount paid for bond		**$11,000**
Original issue date of bond		Dec. 31, 1996
Maturity date of bond		Dec. 31, 2006
Semiannual interest payments dates:		June 30 and December 31
Interest received in 2001		
Paid June 30	$450	
Paid December 31	450	
Total 2001 interest received		**$ 900**

Question 1. May Brett choose not to amortize the $700 premium?

Answer 1. Yes. If so, Brett's basis in the bond is $10,700. If he holds it to maturity, he will realize a $700 long-term capital loss on his 2006 Schedule D (Form 1040).

Question 2. If Brett chooses to amortize the $700 bond premium, how is the premium amortized over the remaining life of the bond?

Answer 2. Since the bond was issued after September 27, 1985, the constant yield method **must be** used to calculate the amortization. The calculation is complex, as explained in IRS Publication 1212, *List of Original Issue Discount Instruments.*

Practitioner Note. The straight-line method, which is still used by many practitioners, is technically not allowable for bonds issued after September 27, 1985. If a client has a substantial amount of bond premium amortization for the tax year, an IRS examiner could propose exam adjustments if the straight-line method is improperly used.

The calculation is complex because the $700 premium is not allocated on a straight-line basis over the 12 remaining interest payments on the bond. The premium must be allocated by treating each $450 interest payment on the bond as if part of it is interest on the $11,000 purchase price of the bond and the balance is a return of part of the $700 premium. To calculate that allocation, the effective interest rate on the $11,000 purchase must first be computed.

Practitioner Note. IRS Publication 550, *Investment Income and Expenses* gives the following guidance on amortizing the bond premium.

1. A constant yield method determined by using the bond's basis at the close of each accrual period must be used.
2. APR must be carried to at least 2 decimal places.
3. Accrual periods may vary in length but must be no longer than 1 year.

Some financial calculators and financial software will make the necessary computations if the purchase and payment information is entered. For this example, the following information should be entered:

1. Deposited $11,000 on April 30, 2001.
2. Withdrew $450 every six months beginning June 30, 2001 and ending June 30, 2006.
3. Withdrew $10,450 on December 31, 2006.

The financial calculator or software will report that the effective annual interest rate is 7.454%. It will also report the allocation of the withdrawals between interest and net change in the balance as follows:

Interest			Net Change	
6/30/2001	137.04		312.96	
12/31/2001	398.33		51.67	
2001 Total		535.37		364.63
6/30/2002	396.41		53.59	
12/31/2002	394.41		55.59	
2002 Total		790.82		109.18
6/30/2003	392.34		57.66	
12/31/2003	390.19		59.81	
2003 Total		782.53		117.47
6/30/2004	387.96		62.04	
12/31/2004	385.65		64.35	
2004 Total		773.61		126.39
6/30/2005	383.25		66.75	
12/31/2005	380.76		69.24	
2005 Total		764.01		135.99
6/30/2006	378.18		71.82	
12/31/2006	375.48		10,074.52	
2006 Total		753.66		10,146.34
Total		**$4,400.00**		**$11,000.00**

The above information can be used to make the following allocations:

1. The $450 interest payment received on June 30, 2001 includes not only interest on the $11,000 investment and amortization of the $700 bond premium, but also a payment of interest that had accrued on the bond at the time of the April 30, 2001 purchase. Consequently, $300 of the $312.96 change in the deposit balance is allocated to that accrued interest and the remaining $12.96 is allocated to amortization of the $700 bond premium. The remaining $137.04 of the $450 payment is allocated to interest.
2. The $450 interest payment received on December 31, 2001 is allocated between interest and amortization of the $700 bond premium as follows:

Interest	$398.33
Amortization of bond premium	51.67
Total	$450.00

Practitioner Note. For 2001, the taxpayer will receive a Form 1099-INT showing $900 of interest. That interest should be reported on Schedule B (Form 1040). The Schedule B (Form 1040) should also report the $300 of accrued interest as nominee interest and the $65 ($12.96 + $51.67) amortization of the $700 bond premium. That will leave a net $535 of interest income from the General Motors bond.

Schedules A&B (Form 1040) 2001 — OMB No. 1545-0074 — Page **2**

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side. ***Brett***

Your social security number

Schedule B—Interest and Ordinary Dividends

Attachment Sequence No. **08**

Part I Interest

(See page B-1 and the instructions for Form 1040, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶		
	Edward Jones Investments		*900*
	Motorola Federal Credit Union		*213*
	First State Bank		*510*
	Subtotal		*1,623*
	ABP Adjustment		*(65)*
	Less: Accrued Interest	1	*(300)*
2	Add the amounts on line 1	2	*1,258*
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989 from Form 8815, line 14. You **must** attach Form 8815	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	*1,258*

3. The allocation of the $900 received in 2002 through 2005 is allocated between interest and amortization of the $700 bond premium as shown above.
4. The $10,450 payment received on December 31, 2006 must be allocated not only between interest and amortization of bond premium but also to return of the $10,000 face value of the bond. Consequently, $375.48 is allocated to interest. $74.52 is allocated to amortization of the $700 bond premium and $10,000 is allocated to return of the face value of the bond.

Observation. Over the six year period, Brett receives $15,400 of payments that are allocated as follows:

Interest earned	$ 4,400
Accrued interest	300
Bond premium	700
Face value of bond	10,000
Total	$15,400

TAX-EXEMPT BONDS BOUGHT AT A PREMIUM

The tax reporting rules for tax-exempt bonds, such as municipal bonds, bought at a premium are summarized below.

1. The premium paid must be amortized.
2. The amortized amount is **not deductible,** since the interest income on the bond is not taxable for federal tax purposes.
3. The amount of the annual amortized premium reduces the basis in the tax-exempt bond.
4. If held to maturity, there will be no gain nor loss on Schedule D in the year of redemption, since the basis will equal the face value redemption amount.
5. For state tax purposes, if the interest is included as income under state tax rules, the amortized amount of bond premium should be deducted on the state return.

TAXABLE AND TAX-EXEMPT BONDS BOUGHT AT MARKET DISCOUNT

A taxable or tax-exempt bond may be purchased at a market discount due to a rising interest rate environment. Usually, the discount is accounted for when the bond is sold or when it matures. An election can be made to include the discount ratably as interest income, but this election is rarely used. The following example explains the general tax reporting rule for taxable and tax-exempt bonds **bought on or after May 1, 1993.**

Example 2. Faith bought a $10,000 face value Ford Motor Company bond on February 14, 1996 for $9,200. There was no original issue discount (OID). The bond matured on October 1, 2001. Since Faith held the bond to maturity, she received the $10,000 face amount on October 1, 2001.

Question 1. How is Faith's $800 gain reported on her 2001 return?

Answer 1. She must report the $800 gain as **interest income** on her 2001 Schedule B (Form1040). The gain due to the market discount is not afforded capital gain treatment.

Faith will receive a 2001 Form 1099-B for the $10,000 redemption amount. Her completed 2001 Schedules B and D are shown below.

Practitioner Note. The tax result would be the **same** in Example 2 if Faith had bought a tax-exempt bond on or after May 1, 1993, rather than a corporate bond.

Schedules A&B (Form 1040) 2001 OMB No. 1545-0074 Page 2

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side. *Faith*

Your social security number

Schedule B—Interest and Ordinary Dividends

Attachment Sequence No. 08

Note. If you had over $400 in taxable interest, you must also complete Part III.

Part I Interest

(See page B-1 and the instructions for Form 1040, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

Line	Description		Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶	1	
	Accrued market discount gain on Ford Motor Co. bond		*800*
2	Add the amounts on line 1	2	*800*
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989 from Form 8815, line 14. You **must** attach Form 8815	3	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	*800*

SCHEDULE D (Form 1040)

Department of the Treasury Internal Revenue Service (99)

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

2001

Attachment Sequence No. 12

Name(s) shown on Form 1040 *Faith*

Your social security number

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8	*Ford Motor Co. Bond*	*2-14-96*	*10-1-01*	*10,000*	*9,200*	*800*	
	Accrued Market Discount					*(800)*	
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	*10,000*			
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	*2,130*	
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1999 Capital Loss Carryover Worksheet				14	( )	( )
15	Combine column (g) of lines 8 through 14				15		
16	**Net long-term capital gain or (loss).** Combine column (f) of lines 8 through 14 ▶ **Next:** Go to Part III on the back.				16	*2,130*	

***28% rate gain or loss** includes **all** "collectibles gains and losses" (as defined on page D-6) and up to 50% of the eligible gain on qualified small business stock (see page D-4).

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2001**

5

TECHNICALITIES FOR REPORTING MARKET DISCOUNT GAIN ON BONDS

1. Tax-exempt bonds bought **before May 1, 1993** are **not** subject to the market discount gain rule that results in interest income. Therefore, any gain on these bonds is afforded capital gain treatment.

Example 3. Assume the same facts as in Example 2 **except** that Faith bought a Phoenix Library municipal bond on **April 30, 1993.** Her market discount gain of $800 will be reported on her 2001 Schedule D as a **long-term capital gain** rather than as interest income. Her completed 2001 Schedule D (Form 1040) follows:

SCHEDULE D (Form 1040)
Department of the Treasury Internal Revenue Service (99)

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
2001
Attachment Sequence No. **12**

Name(s) shown on Form 1040: *Faith*
Your social security number

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8	*Phoenix Library municipal bond*	*4-30-93*	*10-1-01*	*10,000*	*9,200*	*800*	
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	*10,000*			
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	*2,130*	
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1999 Capital Loss Carryover Worksheet				14	( )	( )
15	Combine column (g) of lines 8 through 14				15		
16	**Net long-term capital gain or (loss).** Combine column (f) of lines 8 through 14 ▶ **Next:** Go to Part III on the back.				16	*2,930*	

***28% rate gain or loss** includes **all** "collectibles gains and losses" (as defined on page D-6) and up to 50% of the eligible gain on qualified small business stock (see page D-4).

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2001**

2. Taxable bonds bought **before May 1, 1993,** are subject to the market discount gain rule that results in interest income **if the bond was issued after July 18, 1984.**
3. Taxable bonds bought **before May 1, 1993,** are **not** subject to the market discount gain rule that results in interest income **if the bond was issued before July 19, 1984.**

ISSUE 3: STOCK OPTIONS

The tax reporting rules and planning suggestions that follow explain the rules for the two types of stock options granted by corporate employers:

- Incentive Stock Options, commonly called ISOs, or qualified stock options
- Nonqualified Stock Options, commonly called NQSOs

INCENTIVE STOCK OPTIONS (ISOs)

General Information

An incentive stock option gives the employee the right to buy a fixed number of shares of the employer's stock as a set price (the **grant price**) for a certain number of years. The grant price is normally the fair market value (market price) of the stock at the time the option is granted. At a later time, assuming the stock has increased in value, the employee can exercise the option by purchasing the stock at the lower grant price. That presents an opportunity for the employee to sell the ISO acquired shares at the higher current market price.

Tax Treatment Rules. Employees will treat gain on the sale of ISO stock as capital gain **unless** the employee does **not** hold the stock for the required period. The **required holding period** for obtaining the favorable capital gain treatment is:

5

- **More** than two years after the ISO was granted (the grant date)
- **More** than one year after the stock was actually acquired by exercise of the ISO (the exercise date) [I.R.C. §422(a)(1)]

The AMT Tax Trap of ISOs

The ISO gold mine of the 1990s has turned into financial quicksand in 2000 and 2001. You may have clients who unwisely did what an employee of Cisco Systems Corporation did. The sad story that follows was widely reported by several news agencies.

An employee of Cisco Systems exercised his ISOs for employer stock in February 2000 before the tech stock wreck that began a month later. His **phantom profit,** which was the difference between the exercise price and the market price of Cisco stock on the exercise date, was $6.5 million. He did not sell the Cisco stock he acquired via exercise of the ISO in 2000. When his accountant prepared the employee's joint 2000 tax return, he indeed was the bearer of bad news. **The AMT liability on the 2000 return was about $2 million.**

> **Practitioner Note.** The split-adjusted price of Cisco common stock on February 15, 2000, was $64. The price of Cisco common stock on August 13, 2001, was $18, a decline of 72%.

Example 1. **(strategies to avoid the AMT tax trap.)**

Luke, an employee of Sun Corporation, exercised his ISO in 2001. Following are the facts regarding the ISO exercise:

Date the ISO was granted by employer	January 1, 1999
Number of shares covered by grant	1,000
Grant price per share	$ 10
Date the ISO for the 500 shares was exercised	March 7, 2001
Market price per share on exercise date	$ 65
Spread amount per share ($65 – 10)	$ 55
Phantom (paper) gain on exercise of ISO (1000 shares × $55)	$55,000

Luke visits your office in November 2001 for year-end tax planning. He has not sold the 1,000 shares acquired by the exercise. The price of Sun Corporation common stock is now $20.

You prepare a 2001 Form 6251 (AMT) for Luke and his wife, Kara, using estimated figures for some entries on Form 6251 (refer to the completed Form 6251).

Form **6251**

Department of the Treasury
Internal Revenue Service

Alternative Minimum Tax-Individuals

▶ See separate instructions.

▶ Attach to Form 1040 or Form 1040NR.

OMB No. 1545-0227

2001

Attachment Sequence No. **32**

Name(s) shown on Form 1040: *Luke and Kara*

Your social security number

Part I Adjustments and Preferences

		Line	Amount
1	If you itemized deductions on Schedule A (Form 1040), go to line 2. Otherwise, enter your standard deduction from Form 1040, line 36, here and go to line 6	1	
2	Medical and dental. Enter the smaller of Schedule A (Form 1040), line 4 **or** 2½% of Form 1040, line 34	2	
3	Taxes. Enter the amount from Schedule A (Form 1040), line 9	3	*9,800*
4	Certain interest on a home mortgage **not** used to buy, build, or improve your home	4	
5	Miscellaneous itemized deductions. Enter the amount from Schedule A (Form 1040), line 26	5	
6	Refund of taxes. Enter any tax refund from Form 1040, line 10 or line 21	6	(*400*)
7	Investment interest. Enter difference between regular tax and AMT deduction	7	
8	Post-1986 depreciation. Enter difference between regular tax and AMT depreciation	8	
9	Adjusted gain or loss. Enter difference between AMT and regular tax gain or loss	9	
10	Incentive stock options. Enter excess of AMT income over regular tax income	10	*55,000*
11	Passive activities. Enter difference between AMT and regular tax income or loss	11	
12	Beneficiaries of estates and trusts. Enter the amount from Schedule K-1 (Form 1041), line 9	12	
13	Tax-exempt interest from private activity bonds issued after 8/7/86	13	
14	Other. Enter the amount, if any, for each item below and enter the total on line 14.	14	

a Circulation expenditures		**h** Loss limitations	
b Depletion		**i** Mining costs	
c Depreciation (pre-1987)		**j** Patron's adjustment	
d Installment sales		**k** Pollution control facilities	
e Intangible drilling costs		**l** Research and experimental	
f Large partnerships		**m** Section 1202 exclusion	
g Long-term contracts		**n** Tax shelter farm activities	
		o Related adjustments	

		Line	Amount
15	Total Adjustments and Preferences. Combine lines 1 through 14 ▶	15	*64,400*

Part II Alternative Minimum Taxable Income

		Line	Amount
16	Enter the amount from **Form 1040, line 37.** If less than zero, enter as a (loss) ▶	16	*38,500*
17	Net operating loss deduction, if any, from Form 1040, line 21. Enter as a positive amount	17	
18	If Form 1040, line 34, is over $128,950 (over $64,475 if married filing separately), and you itemized deductions, enter the amount, if any, from line 9 of the worksheet for Schedule A (Form 1040), line 28	18	( )
19	Combine lines 15 through 18 ▶	19	*102,900*
20	Alternative tax net operating loss deduction. See page 6 of the instructions	20	
21	**Alternative Minimum Taxable Income.** Subtract line 20 from line 19. (If married filing separately and line 21 is more than $165,000, see page 7 of the instructions.) ▶	21	*102,900*

Part III Exemption Amount and Alternative Minimum Tax

22 **Exemption Amount.** (If this form is for a child under age 14, see page 7 of the instructions.)

IF your filing status is . . .	AND line 21 is not over . . .	THEN enter on line 22 . . .
Single or head of household	$112,500	$35,750
Married filing jointly or qualifying widow(er)	150,000	49,000
Married filing separately	75,000	24,500

If line 21 is **over** the amount shown above for your filing status, see page 7 of the instructions.

		Line	Amount
22	Exemption Amount	22	*49,000*
23	Subtract line 22 from line 21. If zero or less, enter -0- here and on lines 26 and 28 and stop here ▶	23	*53,900*
24	If you reported capital gain distributions directly on Form 1040, line 13, **or** you completed Schedule D (Form 1040) and have an amount on line 25 or line 27 (or would have had an amount on either line if you had completed Part IV) (as refigured for the AMT, if necessary), go to Part IV of Form 6251 to figure line 24. **All others:** If line 23 is $175,000 or less ($87,500 or less if married filing separately), multiply line 23 by 26% (.26). Otherwise, multiply line 23 by 28% (.28) and subtract $3,500 ($1,750 if married filing separately) from the result ▶	24	*14,014*
25	Alternative minimum tax foreign tax credit. See page 7 of the instructions	25	
26	Tentative minimum tax. Subtract line 25 from line 24 ▶	26	*14,014*
27	Enter your tax from Form 1040, line 40 (minus any tax from Form 4972 and any foreign tax credit from Form 1040, line 43)	27	*4,039*
28	**Alternative Minimum Tax.** Subtract line 27 from line 26. If zero or less, enter -0-. Enter here and on Form 1040, line 41 ▶	28	*9,975*

For Paperwork Reduction Act Notice, see page 8 of the instructions. Cat. No. 13600G Form **6251** (2001)

Luke and Kara's 2001 Form 1040 and Schedule A are not shown, but see below for the estimated information as computed by you in their tax planning session in November 2001. They can claim two children as exemptions, neither of whom was under age 17 at the end of 2001. Two scenarios are shown next.

> **Practitioner Note.** The estimated information shown next in **Scenario 1** assumes that they will **not** sell the 1,000 shares of employer stock acquired by exercise of the ISO in 2001.

Scenario 1

INFORMATION FROM LUKE AND KARA'S 2001 FORM 1040 AND SCHEDULE A

AGI including $400 state income tax refund	$ 53,500
Itemized deductions including $9,800 of taxes on line 9, Schedule A	(15,000)
Exemptions (4 × $2,900)	(11,600)
Taxable income	$ 26,900
Tax from tax table (line 40, Form 1040)	$ 4,039

If Luke and Kara do **not** sell the 1,000 shares of ISO acquired stock in 2001, their total tax liability will be $14,014, which consists of:

Regular tax (line 40, Form 1040)	$ 4,039
AMT (line 41, Form 1040)	9,975
Total tax if they do not sell the 1,000 shares	**$14,014**

Scenario 2: Tax Strategy to Avoid the AMT Tax Trap

The stock has declined from $65 a share on the exercise date of March 7, 2001, to $20 when they visit your office in November. Unless they expect the price of the stock to rebound quickly, you should probably advise them to sell the 1,000 shares before the end of 2001.

They take your advice and sell the 1,000 shares on November 29, 2001, for $20 per share. Their gain on the sale is $10,000, as shown below.

Sales price (1,000 shares × $20)	$ 20,000
Less: Exercise price on March 7, 2001 (1,000 × $10)	(10,000)
Gain on sale (treated as compensation income)	$ 10,000

As a result, the estimated information from their 2001 Form 1040 will now be:

AGI including the extra $10,000 compensation income	$ 63,500
Itemized deductions (same as previous estimate)	(15,000)
Exemptions (4 × $2,900)	(11,600)
Taxable income	$ 36,900
Tax from tax table (line 40, Form 1040)	**$ 5,539**

Question 1. Under Scenario 2, where the 1,000 shares are sold in 2001, have Luke and Kara avoided the AMT tax trap?

Answer 1. Yes. Since Luke acquired the 1,000 shares by exercising the ISO, and sold them **in the same tax year,** the tax treatment under regular tax and the AMT rules is the **same.** No AMT adjustment is required on line 10 of the 2001 Form 6251 in Scenario 2 [I.R.C. §56(b)(3)]. This is referred to as the **limit rule** for AMT liability because Luke made a **"disqualifying sale"** of the 1,000 shares.

Question 2. Since the $10,000 gain on the 1,000 shares sold is treated as compensation income, where should the $10,000 be reported on Luke and Kara's 2001 return?

Answer 2. If the $10,000 is not shown as wages on Luke's 2001 Form W-2, include it on line 7, Form 1040 (Wages) and attach an explanatory statement.

Question 3. Assume Luke thinks that the price of his employer's stock will increase quickly. What is the revised tax result in **Scenario 2** if Luke buys back 1,000 shares of his employer's stock on December 15, 2001 for $18 a share?

Answer 3. In a word, disastrous, due to Proposed Regulation §1.422A-1(b)(2). The tax effect of this regulation is that the favorable **limit rule** (discussed in Answer 1) is **ignored** if the **disqualifying sale** (the sale of the 1,000 shares on November 29, 2001 for $20 per share) is **one that would be subject to the wash-sale rules *if* there had been a loss on the sale.**

Revised Tax Result for Scenario 2 if Luke buys back the 1,000 shares within the 30 day wash-sale loss period after the November 29, 2001 sale:

1. For **regular tax** purposes, Luke must report **$55,000 of compensation income** for 2001. This is 1,000 shares × $55, the difference between the $65 market value at exercise, and the $10 exercise purchase price.
2. The $55,000 is added to the basis of the 1,000 shares. Luke's cost basis in the 1,000 shares for regular tax purposes is $65,000 ($10,000 exercise purchase price plus the $55,000 of 2001 compensation income).
3. Therefore, for regular tax purposes, Luke now has a **$45,000 wash-sale loss** on the November 29th sale as shown below.

Sales price (1,000 shares × $20)	$ 20,000
Less: Basis	(65,000)
Wash-sale loss in 2001 (not deductible)	**$(45,000)**

Practitioner Note. See pages 500–503 in the *2000 Farm Income Tax School Workbook* for more information on **avoiding AMT** when clients exercise ISOs. See also pages 522–524 in the same book for computing the **Minimum Tax Credit** on Form 8801 in the years after ISO stock is acquired. This credit can be a significant source of tax savings in tax years following the year of an ISO exercise. This is especially true in the year the ISO acquired stock is sold.

Example 2 (holding period can be met with the resulting gain afforded capital gain treatment)

Hannah's employer granted her an ISO on March 10, 1998, to buy 100 shares of its stock for $30 per share. She exercised the ISO and acquired the 100 shares on October 15, 1998, when the value of the stock was $45 per share.

Hannah sold the 100 shares on June 2, 2001, for $50 per share. Assume she had no expenses of sale. Her **gain** is $2,000 (sales price of $5,000 less her cost of $3,000).

Her $2,000 gain will be a long-term capital gain on her 2001 Schedule D, as the date of sale (June 2, 2001) is **both:**

- **More** than two years after the ISO was granted on March 10, 1998
- **More** than one year after the stock was acquired by the exercise of the ISO on October 15, 1998

Practitioner Note. In **Example 2,** Hannah exercised her ISO and held the ISO acquired stock for the required dual holding periods to qualify the gain on the sale for long-term treatment. However, many employees exercise their ISOs and sell the stock immediately. This is called a **cashless exercise.** The resulting gain on the ISO acquired stock is treated as compensation income and is reported as wages on the employee's Form W-2. For a thorough analysis of a cashless exercise, see pages 334–340 in the *1999 Farm Income Tax School Workbook.* No employment taxes are to be paid on an ISO exercise until 2003. See *Notice 2001-14.*

NONQUALIFIED STOCK OPTIONS (NQSOs)

The rules for NQSOs are found in I.R.C. §83: "Property transferred in connection with performance of services." NQSOs can be granted to employees, independent contractors, and to the beneficiaries of both. In practically all cases, NQSOs are taxed as **compensation income** when the stock option is **exercised** by the recipient.

5

Example 3. Dewey-Cheatam, Inc., a cash basis calendar year law firm, performed legal services for Advance, Inc., a start-up Web development company, in 2001. The law firm's legal bill was $100,000, but it agreed to accept $70,000 in cash and an NQSO to purchase 10,000 shares of Advance, Inc. at 10¢ a share. No FMV of the option could be determined. Dewey-Cheatam exercised the option in December 2001, when the stock was selling for 90¢ per share. The 80¢ per share difference is treated as fee income. On its 2001 Form 1120, Dewey-Cheatam, Inc. will report the following as fee income from Advance Inc.

Cash received	$70,000
Exercise price spread of NQSO (10,000 shares × 80¢)	8,000
Total fee income from Advance, Inc. for 2001	**$78,000**

Many corporations grant NQSOs to both their employees and independent contractors. The independent contractor or employee who receives them is expecting an increase in the price of the NQSO acquired stock. In almost all cases, the difference between the FMV of the stock and the **exercise price spread** is treated as **compensation income.** Any subsequent increase in the price of the acquired stock would be eligible for long-term capital gain treatment if held more than one year from the exercise date by an individual recipient (such as an employee).

Observation. If the FMV does not exceed the exercise price, there is no compensation income.

Practitioner Note. Advance, Inc. should issue a Form 1099-MISC to Dewey-Cheatam for legal services in the amount of $78,000.

Example 4. Advance hired Stacy on March 1, 2001. She was given the choice of a $50,000 annual cash salary or a NQSO for 50,000 shares of Advance common stock at 30¢ a share. The option period expired on February 28, 2002. Stacy chose the NQSO. She exercised the NQSO in September 2001 when the stock was selling for $1.60 a share.

Example 4 Tax Results. Stacy will recognize **$65,000 of compensation income** (50,000 shares × $1.30 spread amount) on her 2001 Form W-2 from Advance, Inc. Advance, Inc. will be entitled to a wage deduction in 2001 of $65,000 [I.R.C. §83(h)]. If Stacy sells the 50,000 shares in 2003 for $3.30 per share, she will report a $100,000 long-term capital gain on her 2003 Schedule D (Form 1040). Her $100,000 gain is equal to 50,000 shares × $2 per share increase after the exercise date.

ISSUE 4: CALCULATING STOCK BASIS AFTER SPIN-OFFS

GENERAL INFORMATION

With the increasing number of spin-offs by companies intent on increasing shareholder value, many practitioners may be faced with calculating stock basis after a spin-off. Many brokerage firms' monthly statements will show the correct basis for the parent company stock and new spin-off company stock. However, practitioners may want to make their own calculations to ensure accuracy. A good starting point for practitioners is the **Web site of the parent company.** Most Web sites of a parent company will include an investor services link that will show the information necessary to compute stock basis following the spin-off.

Preface for Example 1

Example 1 involves a spin-off of McDATA Class A common stock to shareholders of EMC common stock on February 8, 2001. The example is fairly uncomplicated, due to the following facts:

- The EMC stock was initially acquired on a single date. There were no multiple purchases of EMC stock on different dates.
- There were two 2-for-1 stock splits of EMC stock after the initial purchase date, and one partial sale of EMC stock after the second stock split.
- None of the EMC stock had been given to charity or to family members prior to the stock splits or prior to the partial sale of EMC stock.

Example 1. Kelly initially bought EMC common stock in 1999. See below for information relating to her stock purchase.

Date of purchase	January 14, 1999
Number of shares purchased	200
Purchase price per share	$93.875
Total purchase price including commission	$19,013.50

The EMC stock split 2-for-1 on two different occasions as shown in the chart below.

Dates of 2-for-1 Stock Split	Number of Shares Owned After Split
June 4, 1999	400
June 8, 2000	800

Kelly sold 250 shares of EMC after the second split. See below for information regarding the sale.

Date of sale	July 17, 2000
Number of shares sold	250
Sales price per share	$81.25
Sales price after commission	$20,037.48

Practitioner Note. Kelly's completed 2000 Schedule D (Form 1040) is not shown, but her basis in the 250 shares was $5,941.72 ($19,013.50 ÷ 800 shares × 250). Her 2000 long-term capital gain on the 250 shares of EMC was $14,095.76 ($20,037.48 sales price – $5,941.72 basis).

After this partial sale, Kelly had 550 remaining shares of EMC common stock (800 shares less 250 shares sold).

Question 1. What is Kelly's basis in the 550 remaining shares?

Answer 1. $13,071.78, computed as follows:

Cost basis of 200 shares bought January 14, 1999	$19,013.50
$19,013.50 ÷ 800 shares × 550 remaining shares	**$13,071.78**

You can also simply subtract the basis allocated to the 250 shares previously sold from the original basis of the stock.

Original basis of 800 shares	$19,013.50
Less basis of 250 shares sold	(5,941.72)
Basis of 550 remaining shares	**$13,071.78**

On February 8, 2001, EMC spun off McDATA Corporation Class A stock to its shareholders. Kelly received 20 shares of McDATA Class A common stock in the spin-off.

Practitioner Note. Kelly also received **$9.24 cash in lieu of the .24379 fractional share of McDATA stock** in the spin-off. The date of this sale was February 13, 2001. Her holding period for the fractional share of McDATA stock is the same as her holding period for the 550 shares of EMC stock she owned prior to the spin-off. Therefore, her **gain** on the sale of the fractional McDATA share is **long-term.** See Kelly's completed 2001 Schedule D (Form 1040) for details on the sale of the fractional share.

Kelly received a letter from EMC a few days after the spin-off. The heading was **Important U.S. Tax Information for McData Spin-off.** Pertinent parts of the letter are shown next.

Pertinent Portion of Letter EMC Sent to Its Shareholders

"97.81% of your predistribution tax basis in your EMC shares should be allocated to your EMC shares, and the remaining 2.19% should be allocated to your shares of McDATA Class A common stock (including any fractional share interest)."

Using the percentages shown in the letter, the stock bases of Kelly's EMC and McDATA shares are calculated as follows:

Item	Cost Basis	Allocated to EMC Stock	Allocated to McDATA Stock
550 EMC Shares	$13,072 (rounded)	$12,786 (97.81%) (rounded)	$286 (2.19%) (rounded)

Item	Allocated Basis	Basis per Share
550 shares EMC	$12,786	$23.25 (rounded)
20.24379 shares McDATA	286	14.13 (rounded)

Kelly's completed 2001 Schedule D (Form 1040) for the sale of the fractional share of McDATA is shown below.

Practitioner Note. Calculation of long-term gain on the sale of .24379 fractional share of McDATA on February 13, 2001:

Sales price	$9.24
Less: Cost basis ($14.13 × .24379)	(3.44)
Long-term gain	**$5.80**

SCHEDULE D (Form 1040)

Department of the Treasury Internal Revenue Service (99)

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

2001

Attachment Sequence No. 12

Name(s) shown on Form 1040: *Kelly*

Your social security number

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8	*.24379 sh.*	*1-14-99*	*2-13-01*	*9 24*	*3 44*	*5 80*	
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	*9 24*			
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 1999 Capital Loss Carryover Worksheet				14	( )	( )
15	Combine column (g) of lines 8 through 14				15		
16	**Net long-term capital gain or (loss).** Combine column (f) of lines 8 through 14 ► **Next:** Go to Part III on the back.				16	*5 80*	

***28% rate gain or loss** includes **all** "collectibles gains and losses" (as defined on page D-6) and up to 50% of the eligible gain on qualified small business stock (see page D-4).

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2001**

Practitioner Note. See pages 527–530 in the *2000 Farm Income Tax School Workbook* for an analysis of a more complicated computation of stock basis following a spin-off.

ISSUE 5: TAX REPORTING FOR BROAD-BASED STOCK INDEX OPTIONS

Broad-based stock index options are nonequity options which are taxed like regulated futures contracts. Therefore, they are reported under the mark-to-market rules of I.R.C. §1256. These options, if held at year-end, are treated as if they had been sold at fair market value. Any gain or loss is initially reported on Form 6781. A Form 1099-B is not required for the sale of an index option.

Nonequity options include:

- Debt options
- Commodity futures options (**Example:** corn or wheat option contracts on the Chicago Board of Trade)
- Currency options (**Example:** U.S. Treasury bonds option contracts on the Chicago Mercantile Exchange)
- Broad-based stock index options (**Example:** Standard & Poor's (S&P) 500 Index option contracts on the Chicago Board Options Exchange)

Practitioner Note. If the taxpayer buys the nonequity option as a hedge against business risks, the gain or loss is not reported on Form 6781. It is reported as ordinary income or loss on the return for the business.

Preface to Example 1

Example 1 involves a call option in the S&P 500 index. Since it is a **broad-based** stock index option contract, it qualifies as a **nonequity option** and is reported under the mark-to-market rules of I.R.C. §1256.

Practitioner Note. There has been some confusion about tax reporting changes for broad-based stock index options made by the Community Renewal Tax Relief Act of 2000. These changes do not affect individual investors like Peggy in Example 1 who buy put or call options on broad-based stock indexes.
The Joint Committee on Taxation's "Blue Book" Explanation states: "As under prior law, listed options that are not 'equity options' are considered 'nonequity options' to which I.R.C. §1256 applies for all taxpayers. For example, options relating to . . . broad-based stock indexes will continue to be treated as nonequity options under I.R.C. §1256."

The technical name for the **S&P 500 Index is the S&P 500 Composite Stock Price Index.** It is the U.S. benchmark index for professional investors.

Example 1. Peggy expects a surge in stock prices. Instead of buying several individual stocks, she decides to buy an "out of the money" October 2001 S&P Index call option when the index is at the 1,300 level. A call option is out-of-the-money if the exercise, or strike, price is greater than the market price of the underlying security, or security index. Peggy is the **holder** (**buyer**) of the call option. Following are details on her purchase of the call option.

Date option bought	July 10, 2001
Strike price	$1,400
Amount Peggy paid to the "writer" (seller) of the option	
(100 units × $10 per unit price on 7-10-01)	$1,000
Plus: Commission	$ 75
Net amount Peggy paid for the call option	$1,075
Expiration date of the October option (third Friday of the month)	October 19, 2001

Peggy's call option is "out of the money" since the strike price of $1,400 exceeds the current market value of $1,300.

Practitioner Note. As a holder (buyer) of the option, Peggy's risk is limited to the premium plus commission she paid. **If the market goes down instead of up, as she expects, her call option will expire worthless, and her I.R.C. §1256 loss will be $1,075.** This call option transaction will be reported on Peggy's 2001 Form 6781. Of the $1,075 loss, 40%, or $430, will be a short-term capital loss and 60%, or $645, will be a long-term capital loss.

The stock market turns bullish and the S&P 500 Index climbs to 1,500 on October 18, 2001, a day before expiration of Peggy's call 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 $1,400.** Peggy could **exercise** her option on October 18. But instead she sold her option for $10,000. Her belief that the market would move higher was correct. Therefore, her call option increased in value. Following are the details on Peggy's sale of the call option on October 18, 2001.

Date option sold	October 18, 2001
Sales price at market value	$10,000
Less: Commission	(75)
Net amount realized on sale of option	**$9,925**

Peggy's gain on this broad-based stock index call option transaction is $8,850.

Net amount realized	$ 9,925
Less: Cost basis	(1,075)
I.R.C. §1256 gain	**$ 8,850**

The gain will be reported initially on Form 6781. Assume Peggy has no other open or closed §1256 transactions in 2001. See the completed 2001 Form 6781 for Peggy.

Form **6781**

Department of the Treasury
Internal Revenue Service

Gains and Losses From Section 1256 Contracts and Straddles

▶ **Attach to your tax return.**

OMB No. 1545-0644

2001

Attachment Sequence No. **82**

Name(s) shown on tax return	Identifying number
Peggy	

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

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

	(a) Identification of account		(b) (Loss)	(c) Gain
1	*October 2001 S&P 500 Index call option*			*8,850*
2	Add amounts on line 1 in columns (b) and (c)	2	( )	*8,850*
3	Net gain or (loss). Combine columns (b) and (c) of line 2	3		*8,850*
4	Form 1099-B adjustments. See instructions and attach schedule	4		
5	Combine lines 3 and 4	5		*8,850*
	Note: *If line 5 shows a net gain, skip line 6 and enter the gain on line 7. Partnerships and S corporations, see instructions.*			
6	If you have a net section 1256 contracts loss and checked box D, enter the amount to be carried back	6		
7	Subtract line 6 from line 5	7		*8,850*
8	Short-term capital gain or (loss). Multiply line 7 by 40%. Enter here and include on Schedule D. See instructions	8		*3,540*
9	Long-term capital gain or (loss). Multiply line 7 by 60%. Enter here and include on Schedule D. See instructions	9		*5,310*

Note. Forms 1099-B are not required for option sales. Most brokerage firms report option information to clients on an annual investment summary statement. Practitioners should carefully review these statements.

ISSUE 6: WASH-SALE RULES

GENERAL RULES

A **wash sale** occurs when a taxpayer sells stock or securities, and within 30 days before or after the sale a taxpayer:

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

I.R.C. §1091 disallows the recognition of losses from wash sales. Any loss disallowed by the wash-sale rules 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 securities includes the holding period of the wash-sale securities.

PREFACE TO EXAMPLE 1

Example 1 uses 2000 facts rather than 2001 facts in order to show the information Todd received from his broker. Assuming that your client knows nothing about the wash-sale rules, this brokerage information could be the key to reporting the wash sale correctly.

Example 1. Todd made many stock transactions in 2000, including one wash-sale transaction. He bought and sold on two occasions in October and November of 2000 NASDAQ-100 tracking stock, commonly called QQQs (their trading symbol). The details regarding Todd's 2000 wash sale are shown below. The numbers are rounded.

Item	Date Bought	Date Sold	Cost Basis	Sales Price	Short-term Loss
250 sh. QQQs	10-11-00	10-13-00	$19,734	$18,656	($1,078)
500 sh. QQQs	10-19-00	11-13-00	41,484	34,984	(6,500)

A portion of the 2000 *Investment Report* Todd received from his brokerage firm is shown next. This Investment Report is in addition to the 2000 Tax Reporting Statement that showed various 2000 Form 1099 figures. Due to omitting cents, the $1,078 wash-sale loss reported on Schedule D-1 shows as a $1,077.40 Wash-Sale Disallowed Loss on the Investment Report.

2000 Investment Report
January 1, 2000 – December 31, 2000

Ultra Service Account—Todd

Realized Gain/Loss and Cost Basis Information from Sales

Security	Date Acquired	Date of Sale	Sales price per share/unit	Quantity	Proceeds	Total Cost Basis	Gain/Loss (+/–) Holding Period (ST, LT)
NASDAQ 100 TR UNIT SER 1	10/11/00	10/13/00	74.69	250	18,656.30	19,733.70 f	– 1,077.40 ST
	Wash Sale Disallowed Loss					–1,077.40	1,077.40 ST
	various	11/13/00	70.00	500	34,983.88	42,561.10 f	– 7,577.22 ST
Net total short				**750**	**53,640.18**	**61,217.40**	**- 7,577.22**

ST–short-term LT–long-term
a – Average Cost Single Category f – First-in, First-out (FIFO)

Practitioner Note. QQQ is the trading symbol for Qubes, an exchange trading fund (ETF) that tracks the NASDAQ 100. Another popular ETF is SPY (Spiders), which tracks the S&P 500. An alternative to traditional index mutual funds, ETFs can be bought and sold throughout the day, rather than just at the close of trading. Most of them have avoided annual capital gains distributions. As of May 2001, the *Los Angeles Times* reported that there were 85 ETFs with $72.7 billion in assets.

Question 1. Is Todd's $1,078 short-term loss on the 250 shares deductible?

Answer 1. No, because the wash-sale disallowance rule applies. Within 30 days after the October 13 sales date, Todd bought 500 shares of QQQs on October 19.

Question 2. What are the tax consequences to Todd?

Answer 2. The $1,078 disallowed wash-sale loss on the 250 shares is added to the basis of the first 250 of the 500 replacement shares bought October 19.

Question 3. How are these two transactions reported on Todd's 2000 Schedule D?

Answer 3. The 2000 Schedule D (Form 1040) Instructions state:

> "Report a wash sale on line 1 or line 8. Enter the full amount of the loss in column (f). Directly below the line on which you reported the loss, enter 'Wash Sale' in column (a), and enter as a positive amount in column (f) the amount of the loss not allowed."

Refer to Todd's completed 2000 Schedule D-1 (Form 1040) below for the two sales.

SCHEDULE D-1 (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Continuation Sheet for Schedule D (Form 1040)
► See instructions for Schedule D (Form 1040).
► Attach to Schedule D if you need more space to list transactions for lines 1 and 8.

OMB No. 1545-0074
2000
Attachment Sequence No. 12A

Name(s) shown on Form 1040: *Todd*
Your social security number

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

(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) Gain or (loss). Subtract (e) from (d)
1 *250 sh.*	*10-11-00*	*10-13-00*	*18,656*	*19,734*	*<1,078>*
Wash Sale					*1,078*
500 sh. QQQs	*10-11-00 & 10-19-00*	*11-13-00*	*34,984*	*42,561*	*<7,577>*

OBSERVATIONS REGARDING TODD'S SCHEDULE D

1. The date acquired in column (b) for 250 of the 500 shares is the same as for the initial purchase date of the 250 shares sold on Oct. 13, 2000.
2. The cost basis in column (e) for the 500 shares of $42,561 includes the disallowed wash-sale loss on the initial sale of the 250 shares.
3. See the Sample Investment Report relating to this transaction, for complete figures, including cents.

TECHNICALITIES OF THE WASH-SALE RULES

Technicality 1. The wash-sale rules apply only if **substantially identical** replacement stock is acquired within the 61-day period starting 30 days prior to the sale and ending 30 days after the sale.

Example 2. Brenda bought 100 shares of General Motors Corporation stock in 2000. If she sells it at a loss in 2001 and immediately replaces it with 100 shares of Ford Motor Company stock, the wash-sale rules will not apply.

Technicality 2. A taxpayer cannot avoid the wash-sale rules by purchasing replacement stock in the spouse's name.

Example 3. Jim bought 100 shares of AT&T stock in 1999 in his own name and sold it at a loss in 2001. His wife Rita bought 100 rep1acement shares of AT&T in her own name within the 61-day wash-sale period in 2001. Jim's 200l loss will be disallowed under the related party rules.

> **Practitioner Note.** The related party loss rules of I.R.C. §267 have been successfully used by IRS to disallow a stock sale loss with facts similar to Example 3. (*McWilliams v. Commissioner,* 67 S. Ct. 1477 (1967).) IRS has won other court cases with facts similar to Example 3 when the wife bought replacement stock within the wash-sale period with funds furnished by the husband.

Technicality 3. When **fewer** replacement shares are purchased during the 61-day wash sale period than sold in the wash-sale transaction, Treas. Reg. §1.1091-1(b) disallows only a portion of the loss. The solution provided by the regulations is logical but somewhat complex as shown in Example 4 below.

Example 4. Cindy bought the following shares of ABC Corporation stock.

Date Bought	# of Shares Bought	Purchase Price
December 5, 2000	300	$6,000
March 5, 2001	150	3,600
March 15, 2001	75	1,950

On April 2, 2001, she sold the 300 shares she bought in December 2000 for $3,900. Her **loss** on this sale was $2,100 (basis of $6,000 less sales price of $3,900). **Since she bought 225 replacement shares (150 + 75) within 30 days before the sale, 75% (225 ⁄ 300) of her $2,100 loss is disallowed.**

RECAP OF THE SALE OF THE 300 SHARES ON APRIL 2, 2001

Loss on the sale	$(2,100)
Portion of loss disallowed by wash-sale rule (75%)	1,575
Portion of loss allowed (25%)	525

The $1,575 disallowed loss is **added** to the basis of the replacement stock on a prorated basis as shown below.

Item	Cost	Add Wash-Sale Loss	Basis
150 sh. bought 3-5-01	$3,600	$1,050 (2/3)	$4,650
75 sh. bought 3-15-01	$1,950	525 (1/3)	2,475
Total wash-sale loss		**$1,575**	

The holding period for the 150 and the 75 replacement shares is the same as for the 300 wash-sale shares. Since the 300 shares were bought on December 5, 2000, the holding period for the replacement shares begins on the next day—December 6, 2000.

Practitioner Note. See page 411 in the *2000 Farm Income Tax School Workbook* for more information when **fewer** replacement shares are purchased.

Technicality 4. The wash-sale rules also apply to the sale of options and mutual funds. Automatic reinvestment of dividends in a stock or bond mutual fund will often result in a wash sale. This is especially true for a **partial** sale of a **bond fund** when **monthly dividends are reinvested.** Partial sales of stock mutual funds can also result in a wash sale when dividends are reinvested.

Example 5. Tina bought 1,000 shares of a stock mutual fund in 1996 and reinvested all dividends. She received a capital gain dividend on December 10, 2000. She made a partial redemption of the fund on December 31, 2000, and had a loss on the sale. The loss she realized on the partial sale will be restricted by the wash-sale rules. Tina's 2000 investment report from the mutual fund showed the wash-sale computations.

Technicality 5. The wash-sale rules do not specifically prohibit a taxpayer from buying substantially identical replacement stock in a tax-deferred retirement account. The related party rules apply to a fiduciary and a beneficiary, but not to a retirement plan and a beneficiary who is not the fiduciary.

Example 6. Chad sold 500 shares of Coca Cola common stock at a loss on July 10, 2001. He bought 500 shares of the same stock on August 7, 2001, in his self-directed IRA. The wash-sale rules apparently do not apply.

Practitioner Note. With the bearish and volatile stock market tendencies, expect your clients to report substantial 2001 capital losses on stock and mutual fund sales. Some of those losses will be restricted by the wash-sale rules. Since your clients may only bring in year-end statements, you may decide to question them about any large securities losses incurred in December 2001. If they repurchased the stock or mutual fund in January 2002, the wash-sale rules could apply. You should inquire about possible January 2002 repurchases.

ISSUE 7: CALCULATION OF BASIS FOR MUTUAL- FUND SALES

Calculating the basis for mutual-fund sales can be time-consuming, especially if the taxpayer has poor or incomplete records, or has reinvested dividends. The easiest cost basis method is the **single-category average cost basis method.** Almost all mutual-fund companies now report single-category basis numbers on annual statements furnished to customers. However, the sing1e-category method may not be the best method to minimize the tax bite on fund sales, assuming there is a gain.

SINGLE-CATEGORY AVERAGE COST-BASIS RULES AND REQUIREMENTS

1. Once the election is made to use this cost-basis method, it must be used in the future for all subsequent sales of the **same** mutual fund.
2. Even though all unsold shares of a mutual fund are included in the computation of average basis, the sale may result in **both** short-term and long-term gains. In determining the holding period, the shares sold are considered to be those first acquired.
3. In order to use the single-category average basis method, the taxpayer should clearly show on the tax return that it has been used. A notation on the Schedule D (Form 1040) is one way of complying with this requirement

FIRST-IN, FIRST-OUT METHOD (FIFO)

The **FIFO** (first-in, first-out) **method** must be used if the taxpayer takes no action to use an alternative method. It is the default method for IRS examiners. Using the FIFO method gives the taxpayer the best chance that any gain on the sale will be long-term. In a declining stock market like 2001, it also may generate either the biggest loss or the smallest gain. The reason, of course, is that the oldest (and possibly most expensive) shares are considered sold first.

Example 1. This example shows two different ways to figure basis in a mutual fund. It compares the cost basis using FIFO and single-category average cost basis methods. Dividend reinvestment was terminated after the initial dividend payment in December 1999.

Date	Action	Share Price	Number of Shares	Total 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
9-29-01	Sell $6,720	$32	210	200

1. **FIFO Cost Basis Calculation.** To figure the basis of the 210 shares sold on September 29, 2001, use the share price of the first 210 shares bought, (the 160 shares bought on February 4, 1999, and 50 of the 240 shares bought on August 5, 1999).

$4,000	(cost of 160 shares bought on 2-4-99)
1,000	(cost of 50 of the 240 shares bought on 8-5-99)
$5,000	**FIFO cost basis**

2. **Single-Category Average Cost Basis.** To figure the basis of the 210 shares sold on September 29, 2001, use the average basis of all 410 shares owned on September 29, 2001.

$9,100	(cost of all 410 shares—$4,000 + $4,800 + $300)
÷ 410	(total number of shares owned on date of sale)
$22.20	(average cost per share)
$22.20	
× 210	(number of shares sold)
$4,662	**Single-category average cost basis**

Practitioner Note. See the completed 2001 Schedule D for Example 2 using the single-category average basis method. The gain is long-term since the 210 shares were acquired in 1999.

SCHEDULE D (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

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
2001
Attachment Sequence No. **12**

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6)	(e) Cost or other basis (see page D-6)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8	*210 sh. Titan Mutual Fund*	*Various*	*9-29-01*	*6,720*	*†4,662*	*2,058*	
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	*6,720*			
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	*1,430*	
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 1999 Capital Loss Carryover Worksheet				14	( )	( )
15	Combine column (g) of lines 8 through 14				15		
16	**Net long-term capital gain or (loss).** Combine column (f) of lines 8 through 14 ► **Next:** Go to Part III on the back.				16	*3,488*	

***28% rate gain or loss** includes **all** "collectibles gains and losses" (as defined on page D-6) and up to 50% of the eligible gain on qualified small business stock (see page D-4).

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2001**

† Single-category average cost basis

SPECIFIC SHARE IDENTIFICATION METHOD

The **specific share identification method** can often be effectively used to generate either a gain or loss on the sale, depending on which shares are selected. However, most taxpayers who make their own trading decisions are not aware of this basis option. If the notification requirements are not met **prior** to the mutual fund sale, this basis method cannot be used. The specific share ID method can be very useful for year-end tax planning sales of mutual funds.

Example 2. T. J. began investing in the Aggressive Growth stock mutual fund in 1993. He has reinvested all dividends, which have averaged over $5,000 annually. As of December 1, 2001, T. J. has realized long-term capital losses of $35,000 on other investments. Even though the fund's Net Asset Value (NAV) has declined by 20% in 2001, T. J. could realize a substantial gain using the specific share identification method if he decides to sell some of the fund shares before the end of 2001. To do this, T. J. would select the lowest-cost shares to be sold.

T. J. decides to make a partial redemption of shares in the Agressive Growth fund. Before he makes the sale, he must notify the mutual fund and identify which shares he wants to sell. The preferred method to make this required identification is by letter, a copy of which T. J. keeps. He asks for and receives a written confirmation of his request from the mutual fund on December 23, 2001.

T. J. makes the partial sale of shares in the mutual fund on December 28, 2001. His long-term gain on the sale is $31,000. **Netting this gain with his losses of $35,000 produces a tax result for T. J. of a $4,000 net long-term capital loss for 2001.**

> **Practitioner Note.** Some mutual fund companies will not issue a written confirmation. The IRS requires independent third party written verification [Reg. §1.1012-1]. This is a potential tax trap for online transactions. Taxpayers may need to choose between online trading and the use of specific share identification reporting.

ISSUE 8: NEW 8% AND 18% CAPITAL GAIN RATES

SECTION 1. THE NEW 8% RATE EFFECTIVE FOR 2001 SALES

Taxpayers in the 15% tax bracket in 2001 are eligible for the lower 8% capital gain rate for sales made in 2001 of property held for **more than five years.** In the examples that follow, these gains are called **"five-year gains"** to differentiate them from 2001 gains where the five-year holding period was not met. The latter are called "**other capital gains"** in the examples.

The lower 8% capital gain rate applies only to capital gains that would have been taxed at the old 10% rate. The amount of 2001 taxable income is an important factor in determining whether a 2001 capital gain will be taxed at 8% or 20%. The new 2001 Tax Rate Schedules for Single and for Married Filing Jointly are shown as follows, to assist in analyzing the examples.

SINGLE—SCHEDULE X

If Taxable Income Is:		The Tax Is:	
Over	*But Not Over*		*Of the Amount Over*
$ –0–	$ 27,050	. . . . 15%	$ –0–
$ 27,050	$ 65,550	$ 4,057.50 + 27.5%	$ 27,050
$ 65,550	$136,750	$14,645.00 + 30.5%	$ 65,550
$136,750	$297,350	$36,361.00 + 35.5%	$136,750
$297,350	. . . .	$93,374.00 + 39.1%	$297,350

MARRIED FILING JOINTLY OR QUALIFYING WIDOW(ER)—SCHEDULE Y-1

If Taxable Income Is:		The Tax Is:	
Over	*But Not Over*		*Of the Amount Over*
$ –0–	$ 45,200	. . . . .15%	$ –0–
$ 45,200	$109,250	$ 6,780.00 + 27.5%	$ 45,200
$109,250	$166,500	$24,393.75 + 30.5%	$109,250
$166,500	$297,350	$41,855.00 + 35.5%	$166,500
$297,350	. . . .	$88,306.75 + 39.1%	$297,350

Example 1. Sam is single. His 2001 income and deductions exclusive of capital gains are shown below.

Salary income	$30,000
Less: Standard deduction	(4,550)
Less: Exemption (1)	(2,900)
2001 Taxable income before capital gains	$22,550

The $22,550 shown above is **$4,500 less** than the $27,050 ceiling for the 15% tax bracket. Therefore, the maximum amount of **five-year gains** that will qualify for the lower 8% rate is $4,500.

Sam owns 500 shares of stock that he inherited from his uncle in 1990. He sells it in 2001 and realizes a $20,000 long-term capital gain. This is a **five-year gain** and qualifies for the lower 8% rate.

Question 1. What portion of Sam's $20,000 **five-year gain** on the stock sale is eligible for the new 8% capital gain rate?

Answer 1. $4,500.

Question 2. How much tax will Sam owe in 2001 on the $20,000 five-year gain?

Answer 2. $3,460. See below for the computations.

$4,500 × 8%	$ 360
The balance of the $20,000 gain is $15,500.	
$15,500 × 20%	3,100
Tax Sam will owe on the five-year gain	**$3,460**

Refer to Sam's completed 2001 Schedule D (Form 1040). **The $3,460 tax on the $20,000 long-term gain equals the figures on lines 31 ($360) and 37 ($3,100) on Sam's 2001 Schedule D (Form 1040).**

Example 1

SCHEDULE D (Form 1040)
Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

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

OMB No. 1545-0074
2001
Attachment Sequence No. 12

Name(s) shown on Form 1040: *Sam*

Your social security number

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8	*500 sh. ABC*	*INHERITED*	*11-14-01*	*46,000*	*26,000*	*20,000*	
9	Enter your long-term totals, if any, from Schedule D-1, line 9		9				
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)		10	*46,000*			
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 of the instructions				13		
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 2000 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). **Next:** Go to Part III on the back.				16	*20,000*	

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

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Example 1

Schedule D (Form 1040) 2001 Page **2**

Part III Taxable Gain or Deductible Loss

17	Combine lines 7 and 16 and enter the result. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13, and complete Form 1040 through line 39	17	*20,000*
	Next: • If both lines 16 and 17 are gains **and** Form 1040, line 39, is more than zero, complete Part IV below. • Otherwise, skip the rest of Schedule D and complete Form 1040.		
18	If line 17 is a loss, enter the **smaller** of that loss or ($3,000) (or, if married filing separately, ($1,500)) here and on Form 1040, line 13. Then complete Form 1040 through line 37	18	( )
	Next: • If the loss on line 17 is more than the loss on line 18 **or** if Form 1040, line 37, is less than zero, skip **Part IV** below and complete the **Capital Loss Carryover Worksheet** on page D-6 of the instructions before completing the rest of Form 1040. • Otherwise, skip **Part IV** below and complete the rest of Form 1040.		

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-7 of the instructions	19					
	If line 15 or line 19 is more than zero, see the instructions for line 40 on page D-8 of the instructions. Otherwise, go to line 20.						
20	Enter your taxable income from Form 1040, line 39			20	*42,550*		
21	Enter the **smaller** of line 16 or line 17	21	*20,000*				
22	If you are deducting investment interest expense on Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0-	22	*0*				
23	Subtract line 22 from line 21. If zero or less, enter -0-			23	*20,000*		
24	Subtract line 23 from line 20. If zero or less, enter -0-			24	*22,550*		
25	Figure the tax on the amount on line 24. Use the Tax Table or Tax Rate Schedules, whichever applies					25	*3,386*
26	Enter the **smaller** of: • The amount on line 20 **or** • $45,200 if married filing jointly or qualifying widow(er); $27,050 if single; $36,250 if head of household; or $22,600 if married filing separately			26	*27,050*		
	If line 26 is greater than line 24, go to line 27. Otherwise, skip lines 27 through 33 and go to line 34.						
27	Enter the amount from line 24			27	*22,550*		
28	Subtract line 27 from line 26. If zero or less, enter -0- and go to line 34			28	*4,500*		
29	Enter your qualified 5-year gain, if any, from line 5 of the worksheet on page D-8	29	*20,000*				
30	Enter the **smaller** of line 28 or line 29			30	*4,500*		
31	Multiply line 30 by 8% (.08)					31	*360*
32	Subtract line 30 from line 28			32	*0*		
33	Multiply line 32 by 10% (.10)					33	*0*
	If the amounts on lines 23 and 28 are the same, skip lines 34 through 37 and go to line 38.						
34	Enter the **smaller** of line 20 or line 23			34	*20,000*		
35	Enter the amount from line 28 (if line 28 is blank, enter -0-)			35	*4,500*		
36	Subtract line 35 from line 34			36	*15,500*		
37	Multiply line 36 by 20% (.20)					37	*3,100*
38	Add lines 25, 31, 33, and 37					38	*6,846*
39	Figure the tax on the amount on line 20. Use the Tax Table or Tax Rate Schedules, whichever applies					39	*8,327*
40	**Tax on all taxable income (including capital gains).** Enter the **smaller** of line 38 or line 39 here and on Form 1040, line 40					40	*6,846*

Schedule D (Form 1040) 2001

Example 2. Chris and Anna file a joint return for 2001. Chris is employed and Anna stays home to care for their child. Their 2001 income and deductions exclusive of capital gains are shown below.

Chris's salary	$ 65,000
Less: Itemized deductions (taxes and interest)	(15,000)
Less: Exemptions (3 × $2,900)	(8,700)
2001 Taxable income before capital gains	$ 41,300

The $41,300 shown above is **$3,900 less** than the $45,200 ceiling for the 15% tax bracket. Therefore, the maximum amount of **five-year gains** that will qualify for the lower 8% rate is $3,900.

Chris and Anna made two stock sales in 2001. The details of the two sales are shown next.

Five-year gain on employer stock	$2,000
Other capital gain on stock held for 3 years	5,000
Total 2001 long-term capital gain	**$7,000**

Question 1. How much tax will Chris and Anna owe in 2001 on the two long-term capital gains?

Answer 1. $970. See below for the computations.

1. All of the $2,000 **five-year gain** is taxed at 8% as it is less than $3,900.	
$2,000 × 8%	$160
2. $1,900 remains of the $42,500 tax bracket ($3,900 – the five-year gain of $2,000)	
Therefore, the first $1,900 of the $5,000 **other capital gain** is taxed at 10%	
$1,900 × 10%	190
3. The $3,100 remainder of the $5,000 **other capital gain** is taxed at 20%	
$3,100 × 20%	620
Total tax owed on the $7,000 of long-term gains	**$970**

See the completed 2001 Schedule D (Form 1040) form for Chris and Anna. **The $970 tax on both types of long-term gain equals the figures on lines 31 ($160), 33 ($190), and 37 ($620) on the 2001 Schedule D (Form 1040).**

Example 2

SCHEDULE D (Form 1040)
Department of the Treasury Internal Revenue Service (99)

Capital Gains and Losses

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

OMB No. 1545-0074
2001
Attachment Sequence No. 12

Name(s) shown on Form 1040: *Chris and Anna*
Your social security number

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1						
2	Enter your short-term totals, if any, from Schedule D-1, line 2		2			
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d)		3			
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 2000 Capital Loss Carryover Worksheet				6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f).				7	

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8	*100 sh. Tellabs*	*10-3-96*	*11-30-01*	*2,500*	*500*	*2,000*	
	400 sh. Walgreen	*1-3-98*	*1-14-01*	*16,000*	*11,000*	*5,000*	
9	Enter your long-term totals, if any, from Schedule D-1, line 9		9				
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)		10	*18,500*			
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 of the instructions				13		
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 2000 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) **Next:** Go to Part III on the back.				16	*7,000*	

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

For Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2001**

Example 2

Schedule D (Form 1040) 2001 Page **2**

Part III **Taxable Gain or Deductible Loss**

17	Combine lines 7 and 16 and enter the result. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13, and complete Form 1040 through line 39	17	*7,000*
	Next: • If both lines 16 and 17 are gains **and** Form 1040, line 39, is more than zero, complete Part IV below. • Otherwise, skip the rest of Schedule D and complete Form 1040.		
18	If line 17 is a loss, enter the **smaller** of that loss or ($3,000) (or, if married filing separately, ($1,500)) here and on Form 1040, line 13. Then complete Form 1040 through line 37	18	( )
	Next: • If the loss on line 17 is more than the loss on line 18 **or** if Form 1040, line 37, is less than zero, skip **Part IV** below and complete the **Capital Loss Carryover Worksheet** on page D-6 of the instructions before completing the rest of Form 1040. • Otherwise, skip **Part IV** below and complete the rest of Form 1040.		

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

19	Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-7 of the instructions	19					
	If line 15 or line 19 is more than zero, see the instructions for line 40 on page D-8 of the instructions. Otherwise, go to line 20.						
20	Enter your taxable income from Form 1040, line 39			20	*48,300*		
21	Enter the **smaller** of line 16 or line 17	21	*7,000*				
22	If you are deducting investment interest expense on Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0-	22	*0*				
23	Subtract line 22 from line 21. If zero or less, enter -0-			23	*7,000*		
24	Subtract line 23 from line 20. If zero or less, enter -0-			24	*41,300*		
25	Figure the tax on the amount on line 24. Use the Tax Table or Tax Rate Schedules, whichever applies					25	*6,199*
26	Enter the **smaller** of: • The amount on line 20 **or** • $45,200 if married filing jointly or qualifying widow(er); $27,050 if single; $36,250 if head of household; or $22,600 if married filing separately			26	*45,200*		
	If line 26 is greater than line 24, go to line 27. Otherwise, skip lines 27 through 33 and go to line 34.						
27	Enter the amount from line 24			27	*41,300*		
28	Subtract line 27 from line 26. If zero or less, enter -0- and go to line 34			28	*3,900*		
29	Enter your qualified 5-year gain, if any, from line 5 of the worksheet on page D-8	29	*2,000*				
30	Enter the **smaller** of line 28 or line 29			30	*2,000*		
31	Multiply line 30 by 8% (.08)					31	*160*
32	Subtract line 30 from line 28			32	*1,900*		
33	Multiply line 32 by 10% (.10)					33	*190*
	If the amounts on lines 23 and 28 are the same, skip lines 34 through 37 and go to line 38.						
34	Enter the **smaller** of line 20 or line 23			34	*7,000*		
35	Enter the amount from line 28 (if line 28 is blank, enter -0-)			35	*3,900*		
36	Subtract line 35 from line 34			36	*3,100*		
37	Multiply line 36 by 20% (.20)					37	*620*
38	Add lines 25, 31, 33, and 37					38	*7,169*
39	Figure the tax on the amount on line 20. Use the Tax Table or Tax Rate Schedules, whichever applies					39	*7,639*
40	**Tax on all taxable income (including capital gains).** Enter the **smaller** of line 38 or line 39 here and on Form 1040, line 40					40	*7,169*

Schedule D (Form 1040) 2001

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SUMMARY FOR SECTION 1

This rate reduction will benefit taxpayers in the 15% tax bracket in 2001. Due to the significant increase in the last decade in the percentage of those who own stock, many taxpayers may benefit from the lower 8% rate in 2001. That, of course, assumes that they were wise or lucky and sold stocks at a gain in 2001 that they held for more than five years. That assumption may be optimistic, considering the stock market performance of 2001.

From a planning perspective, practitioners might want to advise clients in the 15% tax bracket to keep appreciated stocks for five years and a day for 2001 and later sales. Of course, that advice may be wrong if an appreciated stock held less than five years and a day turns into a losing stock held for five-plus years.

SECTION 2. THE NEW 18% RATE THAT WILL BE EFFECTIVE FOR 2006 SALES AND THE POTENTIAL ELECTION ON THE 2001 TAX RETURN

Taxpayers who owned property before 2001 may make a deemed sales election for 2001 to restart the holding period with a new basis equal to fair market value on the election date. Any gain must be recognized; any loss is not deductible. No regulations have been issued, but the following guidance was included in the 2000 Instructions for Form 4797 and IRS Publication 553. Technical corrections to TRA '97 enacted in 2000 have been incorporated.

1. Taxpayers (other than corporations) and pass-through entities may elect to treat certain assets held on January 1, 2001, as having been sold and then reacquired on the same date (commonly called the mark-to-market capital gain election).
2. Pass-through entities include mutual funds, real estate investment trusts, S corporations, partnerships, estates, trusts, and common trust funds. For grantor trusts, the grantor of the trust must make the election.
3. Any readily tradable stock owned and not sold before January 2, 2001, for which the election is made, is deemed to have been sold January 2, 2001, at its closing market price and reacquired on that date for the same amount.

Practitioner Note. Readily tradable stock includes shares issued by an open-end mutual fund.

4. Any other capital asset or property used in a trade or business (I.R.C. §1231 property) held for the entire year of 2001, for which the election is made is deemed to have been sold and reacquired on January 1, 2001, for its fair market value on that date. This can include a taxpayer's interest in a pass-through entity.
5. The purpose of the election is to make future gain on the asset eligible for an 18% (instead of 20%) capital gain tax rate.

Practitioner Note. The 18% rate won't begin until sales of capital assets in 2006. The reason for this is that a capital asset, the holding period for which begins after 2000, must be held for more than five years. The new 18% capital gain rate beginning in 2006 will benefit taxpayers in the 25% and higher tax brackets.

6. If the election is made, any **gain** on a deemed sale **must be recognized** on the 2001 tax return. A **loss** from a deemed sale is **not allowed** in any tax year, but the asset will be eligible for the 18% rate on any future gain. The election is irrevocable.
7. To make the election, report the deemed sale(s) on a timely filed (including extensions) 2001 tax return. If the deemed sale results in a loss, enter zero instead of the amount of the loss. Attach a statement to the return, stating that an election has been made under I.R.C. §311 of the Tax-

payer Relief Act of 1997 and specify the asset(s) for which the election is made. A sample election follows.

Practitioner Note. If no election is made on the timely filed 2001 tax return, an amended return (2001 Form 1040X) can be filed for a calendar-year taxpayer to make the election. In this case, the 2001 Form 1040X must be filed **no later than October 15, 2002.** At the top of the 2001 Form 1040X, write: **"Election Under I.R.C. §311 of the Taxpayer Relief Act of 1997."** See pp. 440–443 of the *1999 Farm Income Tax School Workbook* for information regarding late elections.

8. The gains shown below do **not** qualify for either the new lower 8% or 18% capital gain rates:

- Gain on sale of collectibles
- I.R.C. §1202 gain (from sale of qualified small business stock)
- Unrecaptured I.R.C. §1250 gain (this gain due to depreciation deductions on real estate will continue to be taxed at a maximum 25% tax rate)

The following **planning examples** are provided to help practitioners make election decisions that **might** be beneficial to clients. The word **"might"** is very appropriate because the required five-year holding period to take advantage of the lower 18% rate is a very long time. It is very difficult to make a planning decision in 2002 (for 2001 tax returns) without a crystal ball that shows what 2006 will bring.

Sample Election

Election under §311 of the Taxpayer Relief Act of 1997

Name		Taxpayer identification number
Tax form number		Tax year ending date
Description of Property	Date Acquired	Fair market value on valuation date
		$
		$
		$

Example 3. Lois, a single individual, owns 200 shares of stock that she purchased in 1998 for $40 a share. The stock's closing price on January 2, 2001, was $42. She is a long-term investor and will probably hold the stock until 2006. Her 2001 salary is $95,000.

Question 1. With these facts, should you advise Lois to make the mark-to-market election for the stock on her 2001 timely filed tax return?

Answer 1. Probably. Her paper gain is only $400 (200 shares × $2 price increase) on January 2, 2001. Her tax cost on the elected gain is only $80 ($400 gain × 20%). This assumes she has net capital gain income in 2001. If the stock appreciates, any subsequent gain in 2006, or in a later year when she sells the stock, will be taxed at 18%.

Now, assume the same facts for Lois as in Example 3, and that the election was not made on her timely filed 2001 return. Also assume that on September 30, 2002, the stock closed at $130 a share.

Question 2. Should you consider filing a 2001 Form 1040X for her by the October 15, 2002 deadline to make the election?

Answer 2. Yes. Knowing the price of the stock in 2006 is impossible on September 30, 2002 but the $88 increase in price indicates there may be a large gain on the ultimate sale. Therefore, the extra $80 tax cost in making the election on Lois's amended 2001 return certainly appears to be smart tax planning.

Example 4. Ted owns 500 shares of stock that he bought in 1999 for $20 a share. The stock's closing price on January 2, 2001, was $60. Ted is a long-term investor and expects to hold the stock until 2006. Ted has $15,000 long-term capital loss carryover to 2001. He also has net realized long-term capital losses of $8,000 for 2001 transactions, including capital gain dividends. He had no short-term transactions in 2001.

Question 1. Should Ted make the election on his 2001 timely filed return to report the $20,000 (500 shares × $40 price increase) paper gain?

Answer 1. He should consider making the election since the result will be no change to Ted's 2001 tax liability. With the $20,000 elected paper gain, Ted will have a net $3,000 long-term capital loss for 2001 ($23,000 of losses less the $20,000 elected paper gain). Any future appreciation of the 500 shares will be taxed at 18% rather than 20% if they are held until 2006 or later. However, making the election could be detrimental to Ted if he has capital gains soon after 2001 that would have been offset by the $20,000 capital loss carryover.

Example 5. Jim bought 1,000 shares of stock in 1998 for $5 a share. The stock's closing price on January 2, 2001, was $12. On March 1, 2002, before you prepare Jim's 2001 return, he sold the stock for $20 a share. His only other 2001 long-term gain is $1,000 of capital gain dividends.

Question 1. Should Jim make the election on his 2001 return to report the $7,000 (1,000 shares × $7 price increase) paper gain?

Answer 1. Jim should consider making the election if he has an unused 10% bracket in 2001. By making the election, the $15,000 long-term gain (1,000 shares × $15 price increase) can be **split between two tax years.** The $7,000 elected paper gain (1,000 shares × $7 price increase as of January 2, 2001) will be reported in **2001,** along with the $1,000 capital gain dividends.

The remaining $8,000 long-term gain will be reported on Jim's **2002** return. His $8,000 **2002** gain is computed as follows:

Sales price (1,000 shares × $20) on March 1, 2002	$ 20,000
Less: Mark-to-market elected cost (1,000 shares × $12 closing price on Jan. 2, 2001)	(12,000)
2002 realized gain	**$ 8,000**

SUMMARY FOR SECTION 2

The previous examples in Section 2 involve stock sales. However, the election can be made for **any other capital asset,** for example, a vacant lot held for speculative purposes. The election can also be made for I.R.C. §1231 business property. **Examples:** (1) **farmland** owned by a farmer or landlord, or a (2) **warehouse** owned by an S corporation.

Example 6. Roger, an operating farmer, bought 100 acres of farmland in 1998 for $3,000 per acre. He farms the land. The fair market value of the 100 acres on January 1, 2001, is $3,200 per acre. Due to recent development trends, he thinks the land could sell for $10,000 an acre by 2006. Assume he has no other 2001 capital transactions. If he makes the election on his 2001 return, he will pay $4,000 tax on the phantom $20,000 gain ($20,000 × 20% = $4,000 tax).

Example 6 Analysis. If he **makes the election** in 2001 and sells the land in March 2006 for $10,000 per acre, **his 2006 gain will be $680,000** ($1 million sales price less $320,000 cost basis). His 2006 tax on the gain will be $122,400 ($680,000 × 18%).

If he **doesn't make the 2001 election, his 2006 gain will be $700,000** ($1 million sales price less $300,000 cost basis). His 2006 tax on the sale will be $140,000 ($700,000 × 20%).

The overall tax savings from making the election is $13,600 ($140,000 – $4,000 – $122,400). However, an I.R.C. §1031 tax-deferred exchange in 2006 would be the preferred tax-saving strategy, assuming Roger does not want or need $1 million in cash in 2006.

Some tax advisors are suggesting this strategy: Prepare timely filed 2001 Forms 1040 with no election. Then review the facts in September 2002 to determine if an election on an amended return makes tax sense. The 2001 Form 1040X must be filed no later than October 15, 2002. See the boxed note on page 197 for details.

> **Practitioner Caution.** One danger in making the election on the 2001 return is that the taxpayer **might be in the 15% tax bracket when the asset is sold** in 2006 or a later year. In that case, the 2001 election would **needlessly accelerate the tax** on the phantom gain. The reason is that the gain in 2006 or a later year would be taxed at 8% without the election. This assumes, of course, that current tax laws do not change before 2006!

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One planning issue that surfaced has been refuted by IRS. The 2001 Schedule D Instructions will explain that a deemed sale of a **personal residence** on the 2001 Form 1040 **cannot** be followed by an I.R.C. §121 exclusion of the gain. The authority is I.R.C. §311(e)(2)(A) of the Tax Relief Act of 1997, which states that any gain resulting from the election "shall be recognized notwithstanding any provision of the Internal Revenue Code of 1986."

Finally, 2006 is relatively far in the future. Predicting future tax law changes is impossible. The lower 18% capital gain rate is a planning issue. What appears to be wise tax planning in 2001 can in reality become unwise in 2006 due to factors over which a practitioner has no control.

ISSUE 9: COMMON INVESTMENT REPORTING ERRORS

ERROR 1: FAILURE TO REPORT SPECULATIVE COMMODITY TRANSACTIONS ON FORM 6781

Facts. Brian owns 300 acres of farmland that he crop-share leases to a tenant farmer. Brian does not materially participate in the farm rental operation and uses Form 4835 to report farm rental income and expenses. He had the following closed commodity futures transactions in 2001:

Contract	Short or Long Position?	Date Bought	Cost Basis	Date Sold	Sales Price	Gain or (Loss)
1. 10,000 bu. Dec. 01 Corn	Long	6-8-01	$19,700	9-17-01	$15,400	$(4,300)
2. 5000 bu. Mar. 02 Beans	Long	5-3-01	22,500	9-17-01	$ 20,100	(2,400)
Total 2001 loss on commodity futures contracts						**$ 6,700**

> **Practitioner Note.** Brian had no open commodity futures or options contracts on either December 31, 2000 or December 31, 2001.

Potential reporting error. Since Brian is speculating and not hedging, the loss is not reported on Form 4835. Instead the net $6,700 loss must first be reported on Form 6781, with 40% of the loss ($2,680) as a short-term capital loss and 60% ($4,020) as a long-term capital loss. Both amounts are carried to Brian's 2001 Schedule D. If Brian has no other capital transactions in 2001, he will be limited to the $3,000 maximum capital loss deduction on his 2001 Schedule D. Deducting the $6,700 loss as a hedging loss on his 2001 Form 4835 is incorrect.

Observation. Since Brian did not protect himself from the risk of unfavorable price fluctuations in the corn and beans he received as crop share rents, he is speculating and not hedging. Brian was speculating because he was a producer and his commodity contract positions were long. This means that he purchased commodity contracts (long), rather than selling contracts (short position). A producer of a commodity must sell by way of a commodity contract to be reducing risk (and thus have a hedging transaction). When a taxpayer purchases a commodity contract for a commodity he or she is producing, risk exposure is increased and the transaction is deemed speculative.

Refer to Brian's completed 2001 Form 6781.

orm **6781**

epartment of the Treasury
nternal Revenue Service

Gains and Losses From Section 1256 Contracts and Straddles

► **Attach to your tax return.**

OMB No. 1545-0644

2001

Attachment Sequence No. **82**

ame(s) shown on tax return: *Brian*

Identifying number

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

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

	(a) Identification of account		**(b) (Loss)**	**(c) Gain**
1	*Form 1099 - B from ADM Brokerage*		*6,700*	
2	Add amounts on line 1 in columns (b) and (c)	2	(*6,700*)	
3	Net gain or (loss). Combine columns (b) and (c) of line 2		3	*<6,700>*
4	Form 1099-B adjustments. See instructions and attach schedule		4	
5	Combine lines 3 and 4		5	*<6,700>*
	Note: *If line 5 shows a net gain, skip line 6 and enter the gain on line 7. Partnerships and S corporations, see instructions.*			
6	If you have a net section 1256 contracts loss and checked box D, enter the amount to be carried back		6	
7	Subtract line 6 from line 5		7	*<6,700>*
8	Short-term capital gain or (loss). Multiply line 7 by 40%. Enter here and include on Schedule D. See instructions		8	*<2,680>*
9	Long-term capital gain or (loss). Multiply line 7 by 60%. Enter here and include on Schedule D. See instructions		9	*<4,020>*

ERROR 2: FAILURE TO CONSIDER ACCRUED INTEREST PAID BY THE BUYER OF BONDS

Facts. Maria bought a $10,000 (face value) 6% corporate bond in 2001. Her broker's confirmation slip showed the following:

Date of purchase	July 15, 2001
Purchase price (includes $500 premium)	$10,500
Accrued interest paid (to seller)	275
Total amount paid to seller	$10,775

The interest payment dates are February 1 and August 1. Maria received her first $300 interest payment on August 1, 2001. Her 2001 tax reporting statement from her brokerage firm reported the $300 interest income under the Form 1099-INT section.

Potential reporting error: Failing to reduce interest income by the $275 accrued interest paid by Maria on the 2001 Schedule B. See Maria's partially completed Schedule B (Form 1040).

> **Observation.** Maria's cost basis in the corporate bond is $10,500. Although the $275 paid for the accrued interest is included in her purchase amount, none of it is allocated to basis since it offsets interest income on Schedule B.

Schedules A&B (Form 1040) 2001 — OMB No. 1545-0074 — Page **2**

Name(s) shown on Form 1040. Do not enter name and social security number if shown on other side. *Maria* — **Your social security number**

Schedule B—Interest and Ordinary Dividends

Attachment Sequence No. **08**

Part I Interest

(See page B-1 and the instructions for Form 1040, line 8a.)

Note. If you received a Form 1099-INT, Form 1099-OID, or substitute statement from a brokerage firm, list the firm's name as the payer and enter the total interest shown on that form.

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see page B-1 and list this interest first. Also, show that buyer's social security number and address ▶		
	Prudential Securities Inc.		*300*
	Peoples State Bank		*1,200*
	Subtotal		*1,500*
	Less Accured Interest Paid		*<275>*
		1	
2	Add the amounts on line 1	**2**	*1,225*
3	Excludable interest on series EE and I U.S. savings bonds issued after 1989 from Form 8815, line 14. You **must** attach Form 8815	**3**	
4	Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	**4**	*1,225*

Note. If line 4 is over $400, you must complete Part III.

> **Practitioner Note.** With more investors switching from stocks to bonds in 2001, the accrued interest paid figure could be a significant item for some clients. A careful inspection of the various annual reporting statements sent to clients by brokers is advised.

ERROR 3: REPORTING THE REDEMPTION OF A TAX-EXEMPT BOND BOUGHT AT A PREMIUM

Facts. On August 1, 1999, Pam purchased a 7% $10,000 (face value) municipal bond issued by the City of Atlanta. Following are the details concerning Pam's bond purchase.

Date bond was issued	June 1, 1996
Face value of bond	$10,000
Maturity date	May 31, 2006
Earliest call date	May 31, 2001
Interest rate of bond	7%
Premium paid by Pam	$ 500
Total amount Pam paid for bond (includes a $500 premium and a $10 commission)	$10,510

Interest payment dates are the first day of June and December. **The bond was eligible to be, and was, called on May 31, 2001.** Pam received four interest payments of $350 as shown in the chart below. She also received a $10,000 redemption check on May 31, 2001.

Date Interest Paid	Amount of Interest Pam Received
December 1, 1999	$350
June 1, 2000	$350
December 1, 2000	$350
June 1, 2001	$350

Question 1. Since Pam paid $10,510 for the bond and her redemption check in 2001 was $10,000, is she entitled to deduct a $510 capital loss on her 2001 Schedule D?

Answer 1. No. According to **Revenue Ruling 60-17,** the premium on tax-exempt bonds must be amortized to the earliest call date. For the bond Pam bought, that date is May 31, 2001. The $500 premium amortization is **not** deductible since the interest income is not taxable. However, the nondeductible $500 premium amortization **does reduce the basis in the bond.**

Question 2. Will Pam receive a 2001 Form 1099-B for the $10,000 redemption price of the bond?

Answer 2. Yes.

Question 3. What is the amount of Pam's 2001 long-term capital loss on the call and redemption of the bond?

Answer 3. $10. See Pam's completed 2001 Schedule D (Form 1040).

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	**(b)** Date acquired (Mo., day, yr.)	**(c)** Date sold (Mo., day, yr.)	**(d)** Sales price (see page D-5 of the instructions)	**(e)** Cost or other basis (see page D-5 of the instructions)	**(f) Gain or (loss)** Subtract (e) from (d)	**(g) 28% rate gain or (loss)** * (see instr. below)
8	*City of Atlanta Tax-exempt bond*	*8-1-99*	*5-31-01*	*10,000*	*10,010*	*<10>*	
9	Enter your long-term totals, if any, from Schedule D-1, line 9		9				
0	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)		10	*10,000*			
1	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		
2	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12		
3	Capital gain distributions. See page D-1 of the instructions				13		
4	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 2000 Capital Loss Carryover Worksheet				14	( )	( )
5	Combine lines 8 through 14 in column (g)				15		
6	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f) **Next:** Go to Part III on the back.				16	*<10>*	

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

or Paperwork Reduction Act Notice, see Form 1040 instructions. Cat. No. 11338H **Schedule D (Form 1040) 2001**