Chapter 3: Investment Issues

Corrections were made to this workbook through January of 2008. No subsequent modifications were made.

ISSUE 1: TRADERS VERSUS INVESTORS

BACKGROUND INFORMATION

The term "day trading" was generally reserved for commodity traders until the 1990s bull market in stocks. The latest bull market in stocks, which commenced in mid-2003, has resulted in more taxpayers claiming to be "traders" as opposed to mere investors. **The purpose of Issue 1 is to assist preparers in determining if their clients meet the "trader" definition.** This determination is problematic because the code does not use or define the terms "trader" or "investor." The only guidance is provided by court case opinions.

In most cases, taxpayers who actively engage in securities investing find it difficult to meet the "trader" definition. An analysis of court cases supports this. However, if a client can legitimately meet the "trader" status definition, significant tax advantages are available that are denied to "investors."

DEFINITION OF A TRADER

Special rules apply to traders who are in the business of trading securities for their own account. **To be engaged in business as a trader, all the following tests must be met:**[1]

1. The taxpayer must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation.
2. The taxpayer's trading activity must be substantial.
3. The taxpayer must carry on the activity continuously and regularly.[2]

The following facts and circumstances should be considered in determining if an activity is a securities trading business:

- Typical holding periods for securities bought and sold
- The frequency and dollar amount of trades during the year
- The extent to which the taxpayer pursues the activity to produce income for a livelihood
- The amount of time devoted to the trading activity

1. IRS, "Tax Topic 429 — Traders in Securities (Information for Form 1040 Filers)," www.irs.gov/taxtopics/tc429.html
2. *Comm'r v. Groetzinger*, 107 S.Ct. 980 (1987)

If the nature of the trading activity does not qualify as a business, the taxpayer is considered an investor, not a trader. It does not matter whether the taxpayer calls himself a trader or a "day trader."

The inherent difficulty in meeting the **substantial** and **continuous and regular** tests that a trader must meet is demonstrated by an analysis of one of the many court cases dealing with these tests.

Paoli v. Commissioner, TC Memo 1991-351, July 31, 1991

Facts. Stephen Paoli was an employee of his closely-held manufacturing corporation. He and his wife filed jointly for 1982. On that return, they reported 326 sales of stocks and option contracts on Schedule D. Many of the 326 sales were day trades. Following is a recap of their 1982 Schedule D:

Net short-term capital loss	($ 759,444)
Net long-term capital loss	(271,778)
Net capital loss reported on Schedule D	**($1,031,222)**

In addition, they filed a 1982 Schedule C showing a $64,300 deduction for margin interest paid to six brokerage firms. **The IRS reclassified the Schedule C business interest as investment interest deductible on Schedule A subject to limitations.**

Mr. Paoli contended that he was a **stock trader** who was "actively and continuously engaged in the **business** of buying and selling securities." He further argued that he "did not hold stocks for long periods of time hoping for capital appreciation, but sought short-term swing gains on a regular and active basis." Therefore, his margin interest constituted **business interest** deductible under IRC §163(a).

Tax Court Holding. In order to qualify as a **trader** who is engaged in a trade or business, a taxpayer's activities must be **frequent, regular, and continuous.** The primary purpose for engaging in the activity must be for income or profit. A trader must seek to profit from short-term market swings, rather than from long-term appreciation and income.

"Whether Mr. Paoli's activities constitute a trade or business is a question of fact. He has not proved that his pattern of buying and selling stocks was sufficiently regular and continuous during the **entire year of 1982** to constitute a trade or business" (emphasis added).

Note. Mr. Paoli made only one stock sale in October and none in either November or December. That fact, in particular, convinced the court that his trading activity failed the regular and continuous tests. See pages 474 and 475 in the 2004 *University of Illinois Federal Tax Workbook* for more information on the "trader versus investor" issue.

Observation. At best, this is a "gray" area of tax law. However, two examples follow, each with an **opinion** about whether the activity qualifies as a trader or investor activity.

Example 1. Beth quit her teaching job in June 2006 to devote at least 30 hours per week to buying and selling stocks and stock options from her home office. She was engaged in this activity from June 2006 through December 2007. Beth focused on a fairly narrow list of large-cap multinational company stocks and options.

She generally made at least two trades on each day the major stock exchanges were open. She took two 10-day vacations in 2007 and did not make any trades during those periods. She made a total of 420 completed trades in 2007, none of which involved stocks held more than 30 calendar days. Beth is married and her husband, Steve, is a full-time employee.

Beth likely qualifies as a trader for 2007 because her activity meets the substantial, continuous, and regular tests. The fact that she has no employment is favorable to this designation. One 10-day vacation would have been better than two, but that factor alone probably is not sufficient to deny her trader status.

Example 2. Kurt is a single, 30-year-old self-employed consultant and workaholic. He normally works 50 hours per week as a consultant, which mainly occurs at the offices of clients. He also spends a minimum of 10 hours per week researching and trading stocks from his home office.

Kurt made a total of 65 completed trades in 2007. His longest holding period in 2007 was 21 trading days. His 2007 trading activity produced a net short-term gain of $40,000.

Kurt is considered an **investor** for the following reasons:

- He has more than a full-time consulting business which is his principal business activity.
- His trading activity does not meet the continuous and regular tests.
- The quantity of his 2007 completed trades (65) is small compared with the activity of a legitimate trader. Therefore, his activity also fails the substantial test.

TAX ADVANTAGES FOR TRADERS

Traders are allowed to deduct all investment-related expenses on Schedule C as a trade or business expense. A taxpayer who qualifies as a trader can deduct the following expenses on Schedule C and avoid the investment interest rules and the 2% of AGI limitations imposed on investors:

- Margin interest (fully deductible on Schedule C with no limitation)
- Office in-home expenses (subject to the net profit limitation)
- Investment publications and newsletters
- §179 deduction on the **trading use portion** of computers, fax machines, or office equipment **used more than 50%** for the trading business
- Investment management software

However, traders who do **not** make the mark-to-market election (discussed later), similar to the rules for stock investors, **are** subject to the:

- $3,000 maximum net capital loss limitation, and
- Wash sale rules.

Caution. Preparers should attach a statement to the returns of their stock-trader clients which explains that they qualify as traders rather than investors. The statement should explain why the taxpayer has filed a Schedule C which reports expenses only.

MARK-TO-MARKET ELECTION UNDER IRC §475(f)

Traders who make a mark-to-market election qualify for additional tax benefits:

1. **They are allowed to report gains and losses from their trading activity as ordinary gains and losses on Form 4797, Part II.** As a result, the $3,000 capital loss limitation which applies to investors is waived.
2. **The wash sale rules[3] are waived.** This tax benefit eliminates time-consuming recordkeeping necessary to comply with the wash sale rules. Traders, as opposed to investors, typically have many transactions which would normally fall under the wash sale disallowance rules.

3. IRC §1091(a)

The primary disadvantages of the mark-to-market election are:

- Any long-term gains are taxed at the taxpayer's ordinary tax rate, and
- Unrealized gains on securities held at the end of the year are taxed as if the stocks were sold.

Once a mark-to-market election is made, securities held at year-end are treated as if they were sold at their market value on December 31. Basis in the stocks is adjusted accordingly.

Rules for Making a Mark-to-Market Election. The taxpayer must first satisfy the tests to qualify as a trader rather than an investor. The election must be made by the due date (not including extensions) of the tax return for the year **prior to the year** for which the election becomes effective. The election is made by attaching a statement either to the tax return, or to a request for an extension of time to file the return. The statement should include the following information:

1. That the election is being made under IRC §475(f)
2. The first year for which the election is effective
3. The trade or business for which the election pertains[4]

In addition, the taxpayer also must file Form 3115, *Application for Change in Accounting Method*.[5]

Example 3. Since 2005, Brian has qualified as a trader; however, he did not make a mark-to-market election. He now wants to make the election and have it effective at the **earliest** possible date. He must file the election with his **2007** return by April 15, 2008. **The election will be effective for the 2008 calendar year.** He must also file Form 3115 no later than the due date of his **2008** return, including extensions.

Jamie v. Commissioner, TC Memo 2007-22, February 5, 2007

An analysis of this court case demonstrates how a mark-to-market election could have benefited the taxpayer.

Note. It's important to understand that when this case went to Tax Court, **the IRS and the taxpayer agreed (stipulated) that the taxpayer was a trader and not a mere investor during the years 2000, 2001, and 2002.** This concession by the IRS is surprising because: (1) the number of completed trades in each of the three years in question is relatively small (118, 81, and 53), and (2) the taxpayer deducted significant amounts of margin interest on his three Schedules C related to the trading activity.

Facts. Dr. Jamie was a self-employed physician during 2000, 2001, and 2002. His physician practice for the three years in question was reported on Schedule C. He also traded stocks and reported this activity on separate Schedules C for the three years. He identified his principal business for this activity as "stock day trader" in 2000, "trader" in 2001, and "day trader" in 2002. His stock trading Schedules C are summarized in the following chart:

Year	Number of Transactions	Gross Receipts	Total Basis	Loss Before Interest Expense	Interest Expense	Schedule C Loss Reported
2000	118	$14,487,667	$16,409,654	($1,921,987)	$56,760	($1,978,747)
2001	81	655,764	993,906	(338,142)	39,246	(377,388)
2002	53	1,788,341	2,040,663	(252,322)	0	(252,322)

4. Rev. Proc. 99-17, 1999-1 CB 503, and the 2006 Form 1040, Schedule D, instructions, pages D-3 and D-4

5. IRS, "Topic 429 — Traders in Securities (Information for Form 1040 Filers)," www.irs.gov/taxtopics/tc429.html

Dr. Jamie did **not** elect to use a mark-to-market election for his stock trading business in any of the three years. He did, however, claim the following net operating loss (NOL) carryovers which offset his reported medical practice net profit for 2001 and 2002:

Year	NOL Carryover Reported
2001	$ 545,907
2002	2,027,136

In its examination, the IRS disallowed the claimed Schedule C stock trading losses and instead allowed a maximum $3,000 capital loss for all three years. In addition, the IRS disallowed the NOL carryovers to 2001 and 2002. The additional tax assessed for the three years was nearly $817,000. Accuracy-related penalties for substantial understatement of tax of over $163,000 were also assessed.

Tax Court Holding. "The courts have consistently held, in keeping with the definition of capital asset under IRC §1221, that the character of gains or losses from a taxpayer's buying and selling securities on his own account is capital and not ordinary, even though the taxpayer may be engaged in a trade or business with regard to such trading activity."[6]

Thus, the court determined that the ordinary losses claimed for the stock trading business were capital losses. The additional tax and penalties assessed by the IRS were sustained by the court.

Analysis. The tax treatment of sales of securities by **traders** who are engaged in a trade or business depends on whether a trader has previously made a mark-to-market election. This election is available beginning with tax years ending after August 5, 1997, for commodity dealers and **traders of securities** or commodities. Since Dr. Jamie had not made the election, his trading losses for the three years were:

1. Treated as capital losses,
2. Reportable on Schedule D, rather than on Schedule C (where he reported them), and
3. Subject to the maximum $3,000 capital loss limitation.

> **Note.** Though not explained in the court opinion, it appears that since the IRS agreed that Dr. Jamie qualified as a trader, he was allowed to fully deduct his considerable margin interest on his 2000 and 2001 Schedules C.

However, **if** Dr. Jamie had made a timely mark-to-market election for his 2000 tax return, he could have treated the three Schedule C trading losses (before interest expense) as:

1. Ordinary business losses,
2. Reportable in Part II, Form 4797, and
3. Not subject to the maximum $3,000 capital loss limitation.

> **Note.** Rev. Proc. 99-17 can be found on page 52 of *Internal Revenue Bulletin* 1999-7 at **www.irs.gov/pub/irs-irbs/irb99-07.pdf.**

6. *Marrin v. Comm'r*, 147 F.3d 147 (2nd Cir. 1998) *aff'g* TC Memo 1997-24, January 11, 1997

Summary. If clients qualify as stock traders, rather than investors, preparers should make a timely §475(f) election, especially if the client has large trading losses. However, in order for the election to be effective for a trader's **2007 tax return**, it must have been made by April 17, 2007, the due date (not including extensions) for the 2006 tax return (the year prior to the year for which the election becomes effective).

> **Note.** A concise explanation of the **Special Rules for Traders in Securities** can be found in IRS Pub. 550, *Investment Income and Expenses*, page 72.

FORMS INCLUDED IN TAX RETURNS OF TRADERS

Traders who have **not made a mark-to-market election** will include the following with their returns:

- A Schedule C, with investment expenses and no income, and
- A Schedule D, which reports numerous securities transactions.

Traders who **have made a mark-to market election** will include the following with their returns:

- A Schedule C, with investment expenses and no income, and
- A Form 4797, which reports numerous securities transactions in Part II.

A Schedule SE is **not** required in either case since net trading profit is exempt from self-employment tax.[7]

ISSUE 2: PLANNING FOR THE ZERO TAX RATE ON NET CAPITAL GAINS AND QUALIFIED DIVIDENDS

BACKGROUND INFORMATION

Prior to the passage of the Tax Increase Prevention and Reconciliation Act of 2005 (TIPRA), the zero tax rate on net capital gains and qualified dividends was applicable only for 2008. However, TIPRA extended this taxpayer-friendly provision for an additional two tax years. **Therefore, the zero tax rate applies for the 2008, 2009, and 2010 tax years.**

> **Note.** Unless extended again by future legislation, this zero tax rate for low-income taxpayers reverts to 10% beginning in 2011.

Many preparers and financial planners are devising tax planning strategies to take advantage of the unprecedented zero tax rate on net capital gains and qualified dividends. **Issue 2** analyzes several of these strategies.

> **Note.** The tax rate schedules, standard deductions, and exemptions used in the following examples for **2008 calculations are estimated.** Actual 2008 amounts will differ.

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7. IRS Pub. 550, *Investment Income and Expenses*, page 72

EXPLANATION OF THE ZERO TAX RATE

Although the zero tax rate is effective for 2008, 2009, and 2010, the result is not an exclusion from gross income of net capital gains and qualified dividends. These two income items are still required to be included in AGI, but the tax on that income will be 0% to the extent the gains would fall into the two lowest tax brackets.

> **Note.** The following example involves a married couple who file a joint return for **2008**. It assumes that the upper limit for the 15% tax bracket for joint filers is $66,200 of 2008 taxable income.

Example 4. Homer and Hilda Hull report the following on their 2008 joint return:

Interest income	$ 5,000
Pension and annuity income (taxable portion)	10,000
Dividend income (all qualified from Caterpillar stock)	5,000
Long-term capital gain (sale of Caterpillar stock inherited in 1970)	70,000
2008 AGI	**$90,000**
Less: standard deduction (assumed)	(11,100)
Less: exemptions (2 × $3,500) (assumed)	(7,000)
2008 taxable income	**$71,900**
2008 tax (from the Qualified Dividends and Capital Gain Tax Worksheet — not shown)	**$ 855**

Observations for Example 4

1. The Hull's taxable income of $71,900 is less than the total of their $75,000 of net capital gain plus qualified dividends ($70,000 + $5,000). Therefore, the tax rate on their first $66,200 of taxable income is zero.

> **Note.** The assumed upper limit for the 15% tax bracket for 2008 is $66,200. The Hull's tax rate is zero to the extent that their 2008 taxable income remains within this tax bracket.

2. Their remaining taxable income of $5,700 ($71,900 – $66,200) is taxed at 15%. $5,700 × 15% = **$855,** which is their 2008 total tax. Their income above $66,200 is in the 25% tax bracket, but the maximum tax rate on qualified dividends and capital gains is 15% because the standard deduction and exemptions reduce ordinary income first.

Example 5. Assume that the Hulls sold the Caterpillar stock in 2007 rather than in 2008 and that their other 2007 income is equal to their 2008 other income. If this is the case, their **2007** tax is **$4,505** as shown below:

2007 AGI (same as the 2008 AGI in **Example 4**)	**$90,000**
Less: standard deduction	(10,700)
Less: exemptions (2 × $3,400)	(6,800)
2007 taxable income	**$72,500**
2007 tax (from the Qualified Dividends and Capital Gain Tax Worksheet—not shown)	**$ 4,505**

Planning Tip 1. Stock market returns have been favorable in 2006 and 2007, and many taxpayers have large unrealized long-term gains. Investment decisions should never be made solely on tax implications. **However, as shown in Examples 4 and 5, if the value of Caterpillar stock did not decline in 2008 from the closing price in 2007, the Hulls could have saved $3,650 in federal income tax if they had waited until 2008 to sell it.**

It is suggested that preparers advise their tax clients of the zero tax rate in effect for 2008, 2009, and 2010. As shown in **Example 4,** the Hulls benefited from the tax law change even though their 2008 AGI was $90,000. The zero tax rate is especially beneficial to taxpayers who have large long-term capital gains and whose other taxable income is relatively low.

Note. Any tax planning advice given to clients should always include the caveat that it is based on present tax law, that Congress can eliminate the favorable zero tax rate, and that it can do so retroactively.

Example 6. Dwight, a 50-year-old single man, became disabled in late 2006. Consequently, his 2007 gross income is significantly lower than his 2006 AGI. He owns 120 acres of low-basis farmland, which was inherited in 1984.

Dwight's neighbor wants to buy the land and is willing to pay $5,500 per acre for it, or $660,000 (120 × $5,500). Fortunately, Dwight visits your office in July 2007 and wants your tax planning advice before any contract is signed.

Question 6A. What tax advice is appropriate?

Answer 6A. After careful thought, you tell Dwight the following:

- Since farmland in the area has increased at a steady pace during this decade, it is your opinion that it is unlikely that its value will decrease between July 2007 and January 2008.
- Based on current law, Dwight should consider an installment sale of the land in January 2008. The installment sale contract should be constructed to include principal payments in 2008, 2009, and 2010 to benefit from the zero tax rate.
- Alternatively, Dwight may want to consider an installment agreement effective immediately with a small principal payment in 2007 and the balance spread over 2008, 2009, and 2010.

Planning Tip 2. The installment method can be used to take advantage of the zero tax rate for 2008, 2009, and 2010. In addition, installment sales can often eliminate or reduce AMT liability in the year of sale for taxpayers who would otherwise report an extremely large long-term gain. See pages 51–54 in the 2006 *University of Illinois Federal Tax Workbook* for more information on this planning strategy.

Note. The following example involves a single individual who files a **2008** return. It assumes that the upper limit for the 15% tax bracket for single taxpayers is $33,100 of 2008 taxable income.

Example 7. Peg is a 63-year-old widow whose primary income is Ameren common stock dividends. She reports the following on her **2008** return:

Interest income	$ 3,000
Social security benefits (taxable portion: $11,000 × 85%)	9,350
Dividends (all qualified from Ameren stock)	35,000
2008 AGI	**$47,350**
Less: standard deduction **(assumed)**	(5,550)
Less: exemption **(assumed)**	(3,500)
2008 taxable income	**$38,300**
2008 tax (from the Qualified Dividends and Capital Gain Tax Worksheet — not shown)	**$ 1,110**

Observation for Example 7. Peg's total tax of $1,110 consists of the following:

Type of Income	Portion of Taxable Income	Applicable Tax Rate	Tax
Ordinary	$ 3,300	10%	$ 330
Qualified dividends (15% bracket)	29,800	0%	0
Qualified dividends (25% bracket)	5,200	15%	780
	$38,300		**$1,110**

Example 8. Assume that Peg's **2007** income is equal to her 2008 income. If this is the case, her **2007** tax is $2,788 as shown below:

2007 AGI (same as 2008 AGI in **Example 7)**	**$47,350**
Less: standard deduction	(5,350)
Less: exemption	(3,400)
2007 taxable income	**$38,600**
2007 tax (Qualified Dividends and Capital Gain Tax Worksheet — not shown)	**$ 2,788**

Planning Tip 3. As shown in **Examples 7 and 8,** the zero tax rate is very beneficial to taxpayers with significant qualified dividend income. **With identical AGI in both years, Peg's 2008 tax of $1,110 is only 40% of her 2007 tax of $2,788.** Taxpayers whose 2008, 2009, and 2010 AGI consist mainly of interest, nonqualified dividends, and taxable social security benefits will probably have higher federal tax liabilities than taxpayers like Peg in **Example 7.**

Note. Example 9 shows how Peg's 2008 tax of $1,110 in **Example 7** would be much higher if her 2008 AGI consists only of interest income and taxable social security benefits.

Example 9. Peg is a 63-year-old widow whose primary income is interest on certificates of deposit. She reports the following on her **2008** return:

Interest income	$38,000
Social security benefits (taxable portion: $11,000 × 85%)	9,350
2008 AGI	**$47,350**
Less: standard deduction (assumed)	(5,550)
Less: exemption (assumed)	(3,500)
2008 taxable income	**$38,300**
2008 tax (estimated from tax table)	**$ 5,925**

Observation for Example 9. Peg's estimated $5,925 tax in **Example 9** is over five times her $1,110 tax in **Example 7.** Qualified dividends, which are tax-favored in 2007, are even more tax advantaged in 2008, 2009, and 2010.

Planning Tip 4. Closely-held C corporations, especially those with considerable cash, should consider paying dividends to their shareholders starting in 2008. However, corporations paying large dividends should not ignore paying reasonable compensation, a common IRS exam issue.

Planning Tip 5. Taxpayers whose top tax bracket is 25% or higher should consider gifting appreciated property instead of cash to recipients whose top bracket is 15% or below. However, donor parents and grandparents should be warned that the anticipated tax savings may not materialize if the recipient is a child or grandchild subject to the kiddie tax rules.

Example 10. Ryan and Pam, a high-income married couple, own 10,000 shares of Microsoft. Their basis in the stock is $4 per share. If they sell any Microsoft shares in 2008, the tax rate on their long-term gain will be 15%. Their two children, ages 25 and 26, are graduate students in 2008 and each of their 2008 incomes are below $15,000.

Ryan and Pam give 1,000 shares of their Microsoft stock to each child in 2008. Both children immediately sell their gifted shares and realize a $25,000 long-term gain. The tax for each child on the $25,000 gain is zero since both are in the 15% or less tax bracket in 2008.

Note. The 2007 Small Business Tax Act made significant changes in the widespread strategy used by many wealthy parents. This family tax planning strategy involved gifting low-basis appreciated property to dependent children age 18 or older. The result was that the low-income children could use the 5% capital gains tax rate (in 2007) or the 0% capital gains tax rate (in 2008, 2009, and 2010) on the long-term gains when the children sold the property. This strategy has been **eliminated** beginning in 2008 for most children under age 24. See Chapter 14, "New Legislation," for details on this tax law change.

ISSUE 3: COMMON INVESTMENT REPORTING ERRORS

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

Example 11. Jack Spratt owns 500 acres of farmland which he crop-share leases to a tenant farmer. Jack does not materially participate in the farm rental operation and uses Form 4835, *Farm Rental Income and Expenses*, to report rental income and expenses. He had the following closed commodity futures transactions in 2007:

Note. The Net Sales Price column in the chart below represents the amount Jack received after subtracting a $200 broker commission for each commodity trade.

Contract	Short or Long Position	Date Bought	Cost Basis	Date Sold	Net Sales Price	Gain or Loss
10,000 bu. Dec. 07 corn	Long	6/10/07	$36,000 ($3.60/bu.)	9/17/07	$33,800 ($3.40/bu.)	($2,200)
5,000 bu. Mar. 08 beans	Long	5/15/07	$38,500 ($7.70/bu.)	9/17/07	$36,700 ($7.38/bu.)	(1,800)
Total loss on closed commodity futures contracts						**($4,000)**

Note. Jack had no open (uncompleted) futures or options contracts on either December 31, 2006, or December 31, 2007. Therefore, boxes 9 and 10 on Jack's 2007 Form 1099-B are blank.

For Example 11

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no. **Cornbelt Commodities LLC** **777 Prosperity Road** **Dixon, IL 61021**	1a Date of sale or exchange 1b CUSIP no.	OMB No. 1545-0715 **2007** Form **1099-B**	**Proceeds From Broker and Barter Exchange Transactions**
	2 Stocks, bonds, etc. $	Reported to IRS } ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums	
PAYER'S federal identification number **36-0000777** — RECIPIENT'S identification number **123-45-6789**	3 Bartering $	4 Federal income tax withheld $	
RECIPIENT'S name **Jack Spratt**	5 No. of shares exchanged	6 Classes of stock exchanged	**Copy B** **For Recipient** This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.
Street address (including apt. no.) **123 North 4th Street**	7 Description		
City, state, and ZIP code **Oregon, IL 61061**	8 Profit or (loss) realized in 2007 $ **(4000.00)**	9 Unrealized profit or (loss) on open contracts—12/31/2006 $	
CORPORATION'S name	10 Unrealized profit or (loss) on open contracts–12/31/2007 $	11 Aggregate profit or (loss) $ **(4000.00)**	
Account number (see instructions) **63401**	12 If the box is checked, the recipient cannot take a loss on their tax return based on the amount in box 2 . . ☐		

Form **1099-B** (keep for your records) Department of the Treasury - Internal Revenue Service

Potential Reporting Error. Jack is speculating, not hedging. **The $4,000 loss should not be reported on Jack's 2007 Form 4835.** Rather, the loss must first be reported on Form 6781, *Gains and Losses from Section 1256 Contracts and Straddles*, where 40% of the loss, or $1,600, is treated as a short-term capital loss. The remaining 60%, or $2,400, is treated as a long-term capital loss. Both amounts are carried to Jack's 2007 Schedule D. If Jack has no other capital transactions in 2007, he is limited to the maximum $3,000 capital loss deduction on his 2007 Schedule D.

Note. Hedging is a **risk management** tool that either users or producers utilize to protect against **unfavorable price fluctuations** of commodities they expect to either buy or sell in the future. A producer of a commodity must sell short in order to be in a hedging position. A consumer of a commodity must be a buyer (long position) in order to be considered hedging.

In other words, the initial transaction must be a **sale** of a commodity that the producer expects to produce. If the price of the commodity falls, he is protected because he locked in a higher price for it.

Both of Jack's commodity futures positions were long because he expected the price of both corn and beans to rise. Because his initial transactions were purchases of commodities, he increased his risk. When the price fell, he lost on **both** the commodity futures positions and on the elevator price he received for his 2007 corn and beans. Therefore, his commodity transactions were speculative and not hedging.

For more information on hedging versus speculation, see pages 413–417 of the 2004 *Univeristy of Illinois Federal Tax Workbook.*

For Example 11

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 | 2007 | Attachment Sequence No. 82

Name(s) shown on tax return: **Jack Spratt** | Identifying number: **123-45-6789**

Check all applicable boxes (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 Cornbelt Commodities LLC**		**4,000**	
2	Add the amounts on line 1 in columns (b) and (c)	2	(**4,000**)	
3	Net gain or (loss). Combine line 2, columns (b) and (c)	3		**(4,000)**
4	Form 1099-B adjustments. See instructions and attach schedule	4		
5	Combine lines 3 and 4	5		**(4,000)**
	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 above, enter the amount of loss to be carried back. Enter the loss as a positive number	6		
7	Combine lines 5 and 6	7		**(4,000)**
8	**Short-term capital gain or (loss).** Multiply line 7 by 40% (.40). Enter here and include on the appropriate line of Schedule D (see instructions)	8		**(1,600)**
9	**Long-term capital gain or (loss).** Multiply line 7 by 60% (.60). Enter here and include on the appropriate line of Schedule D (see instructions)	9		**(2,400)**

Part II — Gains and Losses From Straddles. Attach a separate schedule listing each straddle and its components.

Section A—Losses From Straddles

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

Example 12. Ellie bought a 7% $10,000 (face value) corporate bond in 2007 which matures on July 31, 2010. Her broker's confirmation statement showed the following:

Date of purchase (trade date)	July 15, 2007
Purchase price (includes $500 premium)	$10,500
Accrued interest paid (to seller)	320
Total amount paid by Ellie	$10,820

The interest payment dates are February 1 and August 1. Ellie received her first $350 interest payment on August 1, 2007. Her 2007 tax reporting statement from Midwest Securities reports the $350 interest income in the Form 1099-INT section. The accrued interest of $320 Ellie paid is shown on the year-end statement from the brokerage company.

Potential Reporting Error. The taxpayer may fail to reduce interest income by the $320 accrued interest paid. See Ellie's partially completed Schedule B.

> **Note.** Ellie's cost basis in the bond of $10,500 includes a $500 premium. Since the bond yields taxable interest, she may elect to amortize the $500 premium over the remaining life of the bond.[8] Ellie chooses **not** to amortize the premium. Therefore, her cost basis for computing gain or loss on the sale or the maturity of the bond is $10,500. If she holds it until it matures in 2010, she will report a $500 long-term capital loss on her 2010 Schedule D (sales price of $10,000 less basis of $10,500).

8. IRC §171(c)

For Example 12

Schedules A&B (Form 1040) 2007 — 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. **Ellie**

Your social security number **999 : 99 : 9999**

Schedule B—Interest and Ordinary Dividends

Attachment Sequence No. 08

Part I Interest			Amount
(See page B-1 and the instructions for Form 1040, line 8a.)	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 ▶		
	Midwest Securities, Inc.		**350**
	First National Bank		**800**
	Subtotal		**1,150**
	Less accrued interest		**(320)**
		1	
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.	2 Add the amounts on line 1	2	**830**
	3 Excludable interest on series EE and I U.S. savings bonds issued after 1989. Attach Form 8815	3	
	4 Subtract line 3 from line 2. Enter the result here and on Form 1040, line 8a ▶	4	**830**
	Note. If line 4 is over $1,500, you must complete Part III.		**Amount**

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

Example 13. On August 1, 2005, Dale bought a 7% $10,000 (face value) municipal bond issued by the city of Dallas. Following are the details regarding Dale's bond purchase:

Date bond was issued	June 1, 2005
Face value of bond	$10,000
Maturity date	May 31, 2012
Earliest call date	May 31, 2007
Interest rate of bond	7%
Premium paid by Dale	$500
Total amount Dale paid for the bond (includes the $500 premium and a $10 commission)	$10,510

Interest payment dates are June 1 and December 1. The bond was called on May 31, 2007. Dale received four interest payments of $350 as shown in the chart below. He also received a $10,000 redemption check on May 31, 2007.

Date Interest Paid	Amount of Interest Dale Received
December 1, 2005	$350
June 1, 2006	350
December 1, 2006	350
June 1, 2007	350

Question 13A. Since Dale paid $10,510 for the bond and his redemption check was $10,000, is he entitled to deduct a $510 long-term capital loss on his 2007 Schedule D?

Answer 13A. No. The premium on tax-exempt bonds must be amortized to the earliest call date based on the call price.[9] For the bond Dale bought, that date is May 31, 2007, and the call price is $10,000.

Note. The required amortization of the $500 premium is **not deductible** because the interest income is not taxable. The nondeductible $500 premium amortization **does reduce the basis** of the bond.[10]

Question 13B. Will Dale receive a 2007 Form 1099-B for the $10,000 redemption price of the bond?

Answer 13B. Yes. It will be included in the 2007 tax reporting statement sent by Dale's brokerage firm.

Question 13C. What is the amount of Dale's 2007 long-term capital loss on the call and redemption of the bond?

Answer 13C. It is $10, which represents the purchase commission Dale paid. His basis is $10,010.

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 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8	City of Dallas tax-exempt bond	08/01/05	05/31/07	10,000	10,010	(10)
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	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-2 of the instructions				13	
14	Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions				14	( )
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back				15	(10)

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 11338H **Schedule D (Form 1040) 2007**

ERROR 4: FAILURE TO INCLUDE REINVESTED DIVIDENDS AS PART OF COST BASIS

Many taxpayers reinvest dividends automatically, especially those from mutual funds. This practice can cause preparers to spend extra time trying to calculate the cost basis when all or portions of a mutual fund are sold by clients who fail to keep proper records. Fortunately, most mutual fund companies keep accurate records of these dividend reinvestments and report the correct cost basis of any shares sold by a shareholder. Mutual fund companies use the

9. Rev. Rul. 60-17, 1960-1 CB 124 and Treas. Reg. §1.171-1(a)(1)

10. Treas. Reg. §1.1016-5(b)(3)

single-category method to calculate the average cost basis of the shares sold. Many mutual fund companies and/or brokerage firms include the average cost basis of all shares sold during the year in the year-end tax reporting statement. If this is done, the preparer's task of computing the basis of the shares sold is simplified.

If the cost basis for mutual fund shares sold is not reported in the annual tax reporting statement, a phone call to the toll-free number of the mutual fund is recommended to obtain the information pertaining to the cost and purchase dates of reinvested dividends. In some cases, the mutual fund company charges a fee for providing a printout of all reinvested dividends. The website of the mutual fund can also be used to obtain account information for past years. Some mutual funds provide up to 10 years of account history online.

The same problem can surface when clients sell individual stocks for which dividends have been reinvested. A phone call to the shareholder services department of the company will usually result in the necessary cost basis information. Taxpayers are not allowed to use the average cost basis for individual stocks. They must use either the "specific identification method" or the "first-in, first-out method."[11]

Preparers should consider two strategies to prevent the time-consuming chore of ascertaining the correct cost basis of securities sold by their tax clients:

- Inform new clients that they are expected to keep accurate cost basis for all securities, including reinvested dividends of mutual funds and individual stocks. This will probably require teaching clients how to keep these records.

> **Note.** Clients who never switch brokerage firms can usually rely on the firm for accurate cost basis information.

- Insist on being furnished all annual tax reporting statements from mutual funds and brokerage firms.

> **Note.** Practitioners can request that their client add them to the client's mutual fund or brokerage statements as an "interested party." The mutual fund or brokerage firm will then send copies of client statements directly to the practitioner or even grant access to the client's information on the brokerage website.

ERROR 5: FAILURE TO WAIT UNTIL MARCH TO PREPARE SCHEDULE B FOR CLIENTS WHO OWN REMICs

REMICs are real estate mortgage investment conduits created by the Tax Reform Act of 1986. They are a type of multi-class mortgage-related security in which interest and principal payments from mortgages are structured into separately traded securities. Collateralized mortgage obligations (CMOs) can also be issued in REMIC form. Brokerage firms often sell REMIC securities to their clients.

Question A. What form is used to report income to taxpayers who own REMICs?

Answer A. Form 1099-OID, *Original Issue Discount.*

Question B. When is this form required to be furnished to recipients of REMIC income?

Answer B. It is usually furnished sometime in March. REMIC issuers are not required to provide information necessary to properly report income until February. Therefore, IRS regulations allow brokerage firms 30 days from receipt of the income information to issue Form 1099-OID for the income earned from REMICs. Most brokerage firms send the required Form 1099-OID by March 15.

11. Treas. Reg. §1.1012-1(c)(2)

24,893

2006 1099-OID, REMIC

WACHOVIA SECURITIES

Sub / Branch / Rep / Account No / CAP Account No
XXX XX XXXX XXXXXXXX XXXXXXXXXX

Page 3 of 7

Payer: As of Date: 3/08/07

JOE TAXPAYER
673 ANYWHERE DRIVE
MIDDLEOFNOWHERE, IL 68832-4437

Your Federal Identification Number: 999-99-9999

Summary of Reportable Tax Information

1099-OID Original Issue Discount - Summary

IRS Box		Amount
1	Original Issue Discount for 2006	0.00
2	Other Periodic Interest	3,341.67
4	**Federal Income Tax Withheld**	**0.00**
5	Description	See Below
6	Original Issue Discount on Treasury Obligations	0.00
7	Investment Expenses	0.00

The amounts in IRS Boxes 1, 2, and 6 are composed of the item(s) reported on the Form 1099-OID on a later page in this package. Each item is reported to the Internal Revenue Service individually.

THIS IS YOUR FORMS 1099 OID, REMIC (COPY B FOR RECIPIENT) - PLEASE RETAIN FOR TAX PREPARATION PURPOSES
The above is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction will be imposed on you if the income is taxable and the IRS determines that it has not been reported.

YL332866 944782 2087402883920105

Question C. The 2006 Form 1099-OID, REMIC shows $3,341.67 of other periodic interest in box 2. Where is this income reported on the 2006 return?

Answer C. On Schedule B, Part I, as interest income. Following are the **Instructions for Recipient** from the reverse of Copy B of the 2007 Form 1099-OID. They pertain to box 2, Other Periodic Interest.

> ***Box 2.*** *Shows other interest on this obligation for the year, which is an amount separate from the OID. If you held the obligation the entire year, report this amount as interest income on your tax return. If you disposed of the obligation or acquired it from another holder during the year, see* ***Pub. 550*** *for reporting instructions. If there is an amount in both boxes 2 and 6, the amount in box 2 is interest on a U.S. Treasury obligation and is exempt from state and local income taxes.*

Question D. Will the $3,341.67 of "other periodic interest" reported in box 2 on the 2006 Form 1099-OID, REMIC (shown above) match the REMIC interest actually received by Sam Taxpayer during 2006?

Answer D. **No,** as explained in the 2006 *REMIC Tax Guide* published by Wachovia Securities:

> *REMIC securities are taxable on an accrual rather than cash basis. Since there is a payment delay on mortgage securities, there is likely to be a difference between the income "earned" in a given year and the income actually received. Therefore, income will be reported prior to it being received. This difference is likely to be the greatest in the year the security is purchased. Generally, the difference will reverse over the life of the bond.*

Question E. Should a buyer of a REMIC security make an adjustment on Schedule B for accrued interest paid on its purchase, similar to what is shown in **Example 12?**

Answer E. No. Because REMIC securities are reported based on the owner's holding period, not on the amount of interest actually received, the buyer should not make an adjustment for accrued interest paid.[12]

ISSUE 4: CLASS ACTION LAWSUIT SETTLEMENTS — SECURITIES VIOLATIONS

BACKGROUND INFORMATION

Investor-initiated lawsuits for alleged securities violations by corporations, brokerage firms, investment banking firms, and mutual fund companies are very common. When investor clients receive their court-approved settlements from these lawsuits, preparers may not be aware of the settlement amount, because Forms 1099-MISC are rarely sent by the plaintiffs' law firm. The settlement amounts are often significant and should be reported on the recipient's return. The following example involves a class action settlement paid by a mutual fund company in 2007.

Example 14. Harry and Mary Sherry bought and sold shares in Southland Municipal Bond Fund, a no-load fund. The monthly dividends were received in cash and not reinvested. The chart below shows their purchase and sale of shares of the mutual fund:

Date Purchased	No. of Shares Purchased	Purchase Price/Share	Total Cost Basis
February 18, 2002	5,000	$10.50	$52,500
Date Sold	**No. of Shares Sold**	**Sale Price/Share**	**Total Sale Price**
December 23, 2002	5,000	8.20	41,000

Harry and Mary reported the **$11,500 short-term capital loss** on their **2002 Schedule D** along with other capital gains and losses. Due to subsequent losses, they have a $5,000 short-term capital loss carryover from 2006 to 2007.

They were members of class action litigation against Southland Group, Inc., the mutual fund company that operated the bond fund. The lawsuit originated in the U.S. District Court and made the following allegations:

- Officers of Southland committed several acts in violation of SEC regulations.
- These improper acts misled investors who purchased shares in Southland Municipal Bond Fund during the class period.
- Southland's improper acts reduced the value of fund shares, harming investors who bought or sold shares during the class period.

The class action period alleged in the litigation began on January 3, 2001, and ended on October 10, 2003. Since Harry and Mary bought their shares during the class period, they were entitled to share in any settlement proceeds.

Although Southland admitted no wrongdoing, it agreed to disburse a $40 million settlement to class action members who filed the proper claims with the court. **Harry and Mary received a $1,200 settlement check on January 5, 2007.**

---

12. 2006 *REMIC Tax Guide* from Wachovia Securities, LLC

The following explanation was attached to the top of their check:

Dear Class Member,

The enclosed check represents your proportionate share of the distribution from the Southland Shareholder Class Action Settlement Fund.

IMPORTANT TAX INFORMATION: None of your distribution has been previously taxed. Please retain this memorandum for your files, as you will not receive any additional information regarding your distribution.

Because the tax treatment of this distribution varies based on the recipients' tax status and treatment of their investments, you should consult your tax advisor to determine the tax consequences, if any, from this distribution. Please note that the Internal Revenue Service has issued regulations under Internal Revenue Code Section 468B which provide in part:

> *"Whether a distribution to a claimant is included in the claimant's gross income is generally determined by reference to the claim in respect of which the distribution is made and as if the distribution were made directly by the transferor."*[13]

All other inquiries concerning this distribution should be directed to the Claims Administrator at 1-800-XXX-XXXX.

Note. Harry and Mary paid no attorney fees since the fees were awarded directly to the plaintiffs' law firm by the court. This procedure is referred to as the "common fund theory of recovery." The tax result is that Harry and Mary do not have to include their portion of the court-awarded attorney fees in their 2007 gross income.[14] This tax treatment applies to "opt-out" class action lawsuits.

DISCUSSION OF LAW

The Supreme Court formulated the proper tax treatment of damages received for court-ordered judgments and court-awarded settlements. The court established the **"origin and nature of the claim"** rule. Under this theory, the origin and nature of the claim determine how the settlement is treated for tax purposes.[15]

The origin and nature of the claim theory holds that monetary damages assume the same character as the original property that was lost or damaged for purposes of reporting taxable income. Therefore, damages received for harm to capital assets (such as mutual fund shares) are treated as a capital gain if they exceed the property's basis.

However, if the damages do not exceed the property's basis, the damage proceeds are considered nontaxable return of capital.

Since the lawsuit settlement compensated Harry and Mary for the reduction in value of their shares during the class period, **their $1,200 settlement is capital in nature.** The lawsuit did not allege that the improper acts caused a reduction in dividends, only that the value of shares was diminished.

Tax Solution for Example 14. Since Harry and Mary already reported their entire $11,500 short-term capital loss on the sale of the bond fund on their 2002 Schedule D, they have already used all of their $52,500 basis. **The nature of their original 2002 capital loss was short-term. Therefore, the $1,200 settlement check they received in 2007 is treated as a short-term capital gain.** The $1,200 is reported as a short-term sale with zero basis on their 2007 Schedule D, Part I.

13. Treas. Reg. §1.468B-4

14. Letter Ruling 200316040 (February 28, 2002)

15. *United States v. Don Gilmore*, 83 S.Ct. 623 (1963)

Harry and Mary's only other reportable 2007 capital transactions are:

- A $3,000 short-term gain on the sale of a vacant lot, and
- The $5,000 short-term capital loss carryover from 2006.

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

Capital Gains and Losses

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

OMB No. 1545-0074
2007
Attachment Sequence No. 12

Name(s) shown on return: **Harry and Mary Sherry**
Your social security number: **200 00 0000**

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 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1	**Class action settlement**	**NA**	**01/05/07**	**1,200**	**0**	**1,200**
	Vacant lot	**02/11/07**	**11/28/07**	**33,000**	**30,000**	**3,000**
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			**34,200**		
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 10 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions . . . 6					(**5,000**)
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f) . . . 7					**(800)**

> **Note.** A recent Supreme Court decision involving Tellabs, Inc., of Naperville, Illinois, will make it more difficult for shareholders to file class action lawsuits against corporations. The decision, which was issued on June 21, 2007, was an eight to one ruling in favor of the company. The lawsuit claimed that Tellab's CEO misled investors when he made encouraging public statements about the company's future profitability. The Supreme Court decision focused on an interpretation of a law passed by Congress in 1995 to curb abusive shareholder lawsuits.[16]
>
> See Letter Ruling 200724012 for a decision that coincides with the tax solution for **Example 14.**

16. *Tellabs, Inc. v. Makor Issues & Rights, Ltd.*, 127 S.Ct. 2499 (2007)

ISSUE 5: REPORTING INCOME FROM A CHARITABLE REMAINDER TRUST

Note. See pages 199–209 of the 2004 *University of Illinois Federal Tax Workbook* for more information on charitable remainder trusts.

Purpose

Preparers may have clients who give cash or appreciated property such as farmland or stocks to a charitable organization in exchange for lifetime income or income guaranteed for a certain period of years. **Issue 5** explains how to properly report charitable remainder trust income. A typical example follows.

Example 15. Fred is a 65 year old widower with no children who owns 10,000 shares of McDonald's stock. He bought these shares by exercising incentive stock options when he worked for the company. The 10,000 shares are worth $450,000 ($45/share) and Fred's cost basis is only $80,000. The stock's current dividend yield is 2%.

Fred wants to increase his cash flow without paying additional taxes. His attorney advises him to establish a **charitable remainder annuity trust (CRAT)** with his alma mater. Fred follows the advice and established one in 2007. In exchange for the 10,000 shares of stock, Fred will receive a 6% fixed annuity for his lifetime. When he dies, the university will own the stock.

Types of Charitable Remainder Trusts

The two common types of a charitable remainder trust are:

- Charitable remainder annuity trust (CRAT) (explained in **Examples 15, 16 and 17**), and
- Charitable remainder unitrust (CRUT).

Note. A more common term for a charitable remainder annuity trust (CRAT) is a **charitable gift annuity.** This more common name is used for the remainder of the **Issue 5** discussion.

See pages 209–211 of the 2004 *University of Illinois Federal Tax Workbook* for more information on charitable gift annuities.

Tax Advantages of Charitable Remainder Trusts

There are three tax advantages for establishing a charitable remainder trust:

1. **Income tax deduction.** A charitable contribution deduction is allowed in the year the trust is established.[17]

   Example 16. Assume in **Example 15** that Fred receives $300,000 during the remainder of his life in annuity payments from the trustee (his alma mater) based on the single life expectancy tables and current interest rates. Fred's 2007 charitable contribution deduction is $150,000 ($450,000 value of the gifted stock – $300,000 expected lifetime income).

   Tax Solution for Example 16. Fred is entitled to a $150,000 charitable contribution deduction for 2007, the year he gave the stock to his alma mater. The deduction is limited to 30% of Fred's 2007 AGI because it was a gift of long-term capital gain property.[18] If his 2007 AGI is $70,000, his contribution deduction is limited to $21,000. He can carryover the remaining $129,000 ($150,000 – $21,000) for five years to his 2008 through 2012 tax returns.

17. IRC §170(f)(2)(A) and Treas. Reg. §1.170A-6
18. IRC §170(b)(1)(C)(i)

2. **Elimination of capital gains tax.** The potentially large tax on the gain on the sale of the appreciated asset is avoided by exchanging it for a charitable gift annuity.

   Example 17. In **Example 15,** if Fred sold the stock in 2007, his long-term capital gain would be $370,000 ($450,000 sales price – $80,000 basis). **His federal income tax attributable to the gain would be $62,287:**

Capital gains tax ($370,000 × 15%)	$55,500
Additional tax on the phaseout of his personal exemption ($2,267 × 25%)	567
Alternative minimum tax	6,220[a]
Additional tax caused by the stock sale	$62,287

[a] Based on AMT law in effect on August 14, 2007.

   Because he donated the stock in exchange for a charitable gift annuity, the additional tax of $62,287 is eliminated.

3. **Estate tax exclusion.** If a taxpayer is the only beneficiary of a charitable remainder trust he establishes, the value of the trust's assets are excluded for federal estate tax purposes on his death. Because of the marital deduction, this is true also if a spouse who is a U.S. citizen is the only surviving beneficiary.

   Example 18. In **Example 15,** Fred's alma mater will own 10,000 shares of stock when he dies. Therefore, the value of the stock at his death is **excluded** from Fred's gross estate on Form 706.[19]

Taxation of Annual Payments. In **Example 15,** Fred's 2007 fixed annuity payment consists of three elements:

- Ordinary income,
- Capital gain income, and
- Tax-free return of principal.

Fred's alma mater, the trustee, provides him with the necessary information to give to his tax preparer in order to properly report the first two elements on his tax return.

19. IRC §2055(e)(2)

The following comprehensive example includes completed 2007 schedules and forms, including a Form 1099-R from the donee.

Example 19. Dan and Ann Walton decide to establish a charitable gift annuity with their alma mater, Western Illinois University (WIU). Following are the facts regarding this investment:

1. Date the charitable gift annuity was established	May 23, 2007
2. Value of property gifted to WIU in exchange for the annuity	$100,000
3. Description of the property gifted to WIU	1800 shares of Coca Cola stock
4. Dan and Ann's cost basis in the jointly-owned stock	$20,000
5. Dan and Ann's holding period for the donated stock	Long-term
6. Date of the gift of the 1800 shares of stock to WIU	May 23, 2007 (Dan's 65th birthday)
7. Type of annuity	On two lives, Dan as the first person and Ann as the second person
8. Ages of Dan and Ann on May 23, 2007, the date of the gift	Dan: 65, Ann: 64 yrs & 7 mo
9. Date of Dan's first annuity payment	June 23, 2007
10. Payout rate set by WIU	5.6%
11. Monthly annuity payment to Dan (or Ann after his death)	$466.67

Question 19A. What is the amount of Dan and Ann's 2007 charitable contribution deduction for this gift?

Answer 19A. It is $31,550 before any AGI limitations.

Note. Using the factors found in IRS Pub. 1457, *Actuarial Values*, the present value of the annuity is $68,450. Therefore, the charitable gift amount is the difference between the value of the gifted stock ($100,000) less the present value of the annuity ($68,450) which Dan and Ann receive in exchange for the stock.

Question 19B. Will WIU furnish all necessary 2007 tax information to the Waltons regarding the charitable gift annuity?

Answer 19B. Yes.

Question 19C. Dan and Ann's 2007 tax return reports an AGI of $90,000 and they are entitled to the following charitable contributions on their 2007 Schedule A:

Cash donated to First Christian Church	$ 4,000
Stock donated to WIU in exchange for annuity	31,550
Total charitable contributions	**$35,550**

How much of the $35,550 can they deduct after the AGI limitations are applied?

Answer 19C. They can deduct $31,000, as computed using Worksheet 2 from IRS Pub. 526, *Charitable Contributions*. A recap of the worksheet calculations that apply the AGI limitations follows.

Fully deductible cash contribution to the church, a 50% organization	$ 4,000
30% of AGI limitation ($90,000 AGI × 30% = $27,000)	27,000
Deductible on the Walton's 2007 Schedule A	**$31,000**

Note. Form 8283, *Noncash Charitable Contributions*, must be prepared and included with the Waltons' 2007 tax return. It supports the $27,000 deduction for the donated stock.

Question 19D. What is the amount of their charitable contribution carryover to 2008?

Answer 19D. The carryover amount is $4,550 ($35,550 – $31,000).

In 2007, WIU makes seven monthly annuity payments to Dan of $466.67, totaling $3,266.69. WIU provides the following information to Dan regarding the composition of these payments:

Ordinary income	$1,669.28
Capital gain	1,597.16
Tax-free return of principal	.25
Total received by Dan in 2007	**$3,266.69**

In January 2008, WIU sends Dan a 2007 Form 1099-R. It is shown below. Code F in box 7 indicates the distribution is from a charitable gift annuity.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, and ZIP code	**Western Illinois University**
1 Gross distribution	$ 3266.69
2a Taxable amount	$ 3266.44
OMB No. 1545-0119	2007 Form **1099-R**
	Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.
2b Taxable amount not determined ☐	Total distribution ☐
PAYER'S federal identification number	
RECIPIENT'S identification number	**444-44-4444**
3 Capital gain (included in box 2a)	$ 1597.16
4 Federal income tax withheld	$
RECIPIENT'S name	**Dan Walton**
5 Employee contributions /Designated Roth contributions or insurance premiums	$ .25
6 Net unrealized appreciation in employer's securities	$
Street address (including apt. no.)	
City, state, and ZIP code	
7 Distribution code(s)	F
IRA/ SEP/ SIMPLE	☐
8 Other	$ %
9a Your percentage of total distribution	%
9b Total employee contributions	$
1st year of desig. Roth contrib.	
10 State tax withheld	$ $
11 State/Payer's state no.	
12 State distribution	$ $
Account number (see instructions)	**CGA 728**
13 Local tax withheld	$ $
14 Name of locality	
15 Local distribution	$ $

Copy B Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.

This information is being furnished to the Internal Revenue Service.

Form **1099-R** Department of the Treasury — Internal Revenue Service

Question 19E. How do the Waltons properly report the Form 1099-R amounts on their 2007 joint return?

Answer 19E. See the following table.

Box on 1099-R	Amount	Where Reportable on the 2007 Form 1040
Box 1: Gross distribution	$3,266.69	Line 16a, Pension and annuities
Box 2: Taxable amount	3,266.44	$1,669.28 is reported on line 16b, "Taxable amount of pensions and annuities"[a]
Box 3: Capital gain	1,597.16	Part II of Schedule D as a long-term capital gain
Box 5: Employee contributions	.25	Omitted (excludable)

[a] $1,669.28 is the ordinary income element of the 2007 annuity distribution, the taxable amount of $3266.44 less the capital gain portion of $1597.16.

For Example 19

Form **1040** Department of the Treasury—Internal Revenue Service **U.S. Individual Income Tax Return 2007** (99) IRS Use Only—Do not write or staple in this space.

Label (See instructions on page 16.) **Use the IRS label.** Otherwise, please print or type. LABEL HERE

For the year Jan. 1–Dec. 31, 2007, or other tax year beginning , 2007, ending , 20 OMB No. 1545-0074

Your first name and initial: Dan	Last name: Walton	Your social security number: 444 44 4444
If a joint return, spouse's first name and initial: Ann	Last name: Walton	Spouse's social security number: 333 33 3333
Home address (number and street). If you have a P.O. box, see page 16.	Apt. no.	▲ You **must** enter your SSN(s) above. ▲
City, town or post office, state, and ZIP code. If you have a foreign address, see page 16.		Checking a box below will not change your tax or refund.

Presidential Election Campaign ▶ Check here if you, or your spouse if filing jointly, want $3 to go to this fund (see page 16) ▶ ☐ You ☐ Spouse

Filing Status

Check only one box.

1 ☐ Single
2 ☒ Married filing jointly (even if only one had income)
3 ☐ Married filing separately. Enter spouse's SSN above and full name here. ▶
4 ☐ Head of household (with qualifying person). (See page 17.) If the qualifying person is a child but not your dependent, enter this child's name here. ▶
5 ☐ Qualifying widow(er) with dependent child (see page 17)

Exemptions

6a ☒ **Yourself.** If someone can claim you as a dependent, **do not** check box 6a
b ☒ **Spouse**
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 19)
				☐
				☐
				☐
				☐

If more than four dependents, see page 19.

No. of children on 6c who:
- lived with you
- 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 on lines above ▶ 2

Income

Attach Form(s) W-2 here. Also attach Forms W-2G and 1099-R if tax was withheld.

If you did not get a W-2, see page 23.

Enclose, but do not attach, any payment. Also, please use Form 1040-V.

7	Wages, salaries, tips, etc. Attach Form(s) W-2		
8a	**Taxable** interest. Attach Schedule B if required		14,000
b	**Tax-exempt** interest. **Do not** include on line 8a	8b	
9a	Ordinary dividends. Attach Schedule B if required		29,000
b	Qualified dividends (see page 23)	9b 21,000	
10	Taxable refunds, credits, or offsets of state and local income taxes (see page 24)		
11	Alimony received		
12	Business income or (loss). Attach Schedule C or C-EZ		
13	Capital gain or (loss). Attach Schedule D if required. If not required, check here ▶ ☐		1,597
14	Other gains or (losses). Attach Form 4797		
15a	IRA distributions 15a / b Taxable amount (see page 25)		
16a	Pensions and annuities 16a 3,267 / b Taxable amount (see page 26)		1,669
17	Rental real estate, royalties, partnerships, S corporations, trusts, etc. Attach Schedule E		43,734
18	Farm income or (loss). Attach Schedule F		
19	Unemployment compensation		
20a	Social security benefits 20a / b Taxable amount (see page 27)		
21	Other income. List type and amount (see page 29)		
22	Add the amounts in the far right column for lines 7 through 21. This is your **total income** ▶		90,000

Adjusted Gross Income

23	Educator expenses (see page XX)	23	
24	Certain business expenses of reservists, performing artists, and fee-basis government officials. Attach Form 2106 or 2106-EZ	24	
25	Health savings account deduction. Attach Form 8889	25	
26	Moving expenses. Attach Form 3903	26	
27	One-half of self-employment tax. Attach Schedule SE	27	
28	Self-employed SEP, SIMPLE, and qualified plans	28	
29	Self-employed health insurance deduction (see page 29)	29	
30	Penalty on early withdrawal of savings	30	
31a	Alimony paid b Recipient's SSN ▶	31a	
32	IRA deduction (see page 31)	32	
33	Student loan interest deduction (see page 33)	33	
34	Tuition and fees deduction. Attach Form 8917	34	
35	Domestic production activities deduction. Attach Form 8903	35	
36	Add lines 23 through 31a and 32 through 35		
37	Subtract line 36 from line 22. This is your **adjusted gross income** ▶		90,000

For Disclosure, Privacy Act, and Paperwork Reduction Act Notice, see page 80. Cat. No. 11320B Form **1040** (2007)

For Example 19

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

Capital Gains and Losses

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

OMB No. 1545-0074
2007
Attachment Sequence No. 12

Name(s) shown on return: **Dan and Ann Walton**
Your social security number: **444 44 4444**

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 of the instructions)	(e) Cost or other basis (see page D-7 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 10 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions . . . 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-6 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8	From Form 1099-R					1,597
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					
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-2 of the instructions . . . 13					
14	Long-term capital loss carryover. Enter the amount, if any, from line 15 of your **Capital Loss Carryover Worksheet** on page D-7 of the instructions . . . 14					( )
15	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f). Then go to Part III on the back . . . 15					1,597

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 11338H **Schedule D (Form 1040) 2007**

ISSUE 6: PUTS AND CALLS

BACKGROUND INFORMATION

Option. An option is an investment that gives the owner the right to buy or sell property in the future at a stated price. The property is usually stock, securities, or commodities. The stated price is often called the **strike** price or **exercise** price.

Call Option. A call option is the **right to buy** from the seller of the option, at any time before a specified future date, a stated number of shares of stock at a specified price.

Put Option. A put option is the **right to sell** to the seller of the option, at any time before a specified date, a stated number of shares at a specified price.

Put and call **stock** options are **equity options** as opposed to nonequity options, discussed later. They are issued by writers (sellers) and holders (buyers) in exchange for cash premiums. Puts and calls may terminate in one of three ways:

- The holder (buyer) **exercises** the option.
- The writer (seller) **closes the open put or call option by selling it** prior to either exercise or expiration.
- The put or call option **expires**.

Note. The balance of **Issue 6** uses the terms **"seller"** (rather than "writer") and **"buyer"** (rather than "holder") of puts and calls.

BUYERS OF PUTS AND CALLS

A **buyer** of a put or call stock option may not deduct its cost. It is a capital expenditure.

Sale of a Put or Call before Either Exercise or Expiration. If the buyer sells the put or call prior to either exercise or expiration, the difference between its cost and the amount received for it is capital gain or loss. The resulting capital gain is either long-term or short-term, depending on the holding period, which ends on the date of sale.

Exercise of a Call. If a **buyer of a call exercises** his right to buy the underlying stock, the cost of the call is added to the basis of the stock acquired from the seller of the call.

Exercise of a Put. If the **buyer of a put exercises** his right to sell the underlying stock, the amount realized is reduced by the cost of the put when figuring gain or loss. Any gain or loss on the sale of the underlying stock is long-term or short-term depending on the holding period of the underlying stock.

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

Example 20. On June 15, 2007, Chad **bought** two December 2007 Wal-Mart calls with a strike price of $60. The options gave Chad the **right to buy** 200 shares of Wal-Mart stock at $60 per share on or before the call expiration date. That date is the third Friday in December 2007. Chad paid the following for the two calls:

Cost of two calls ($250 × 2)	$500
Plus: commission	40
Total cost of the two calls	**$540**

> **Note.** Chad expected the price of Wal-Mart stock to rise. If it did, he intended to either exercise his two calls and acquire 200 shares from the seller of the call or sell the two calls for a profit.

The price of Wal-Mart stock **declined** and Chad let his two call options **expire** on the expiration date, December 21, 2007. Chad has a short-term capital loss. He is considered to have sold the calls on the expiration date. Chad's partially completed 2007 Schedule D is shown below.

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

Capital Gains and Losses

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

OMB No. 1545-0074 — 2007 — Attachment Sequence No. 12

Name(s) shown on return: **Chad** — Your social security number: **987 65 4321**

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 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1 2 Wal-Mart Dec. 2007 Call Options	06/15/07	12/21/07	Expired	540	(540)

> **Note.** The Schedule D above and the one for **Example 27** (shown later) are completed in accordance with IRS instructions for Schedule D:
>
> *If an option you purchased expired, enter the expiration date in column (c) and enter "EXPIRED" in column (d). If an option that was granted (written) expired, enter the expiration date in column (b) and enter "EXPIRED" in column (e). Complete the other columns as appropriate.*
>
> Not all tax software accepts non-numeric entries in columns (d) and (e). In that case, $0 should be entered into those fields as appropriate.

Example 21. Use the same facts as **Example 20,** except the price of Wal-Mart stock **increased** as Chad expected. He **exercised** his calls on October 10, 2007, and acquired the 200 shares at the agreed price (called "strike price" or "exercise price") of $60 per share. His total basis of the 200 shares is shown below.

Cost of two calls bought on June 15, 2007	$540
Cost of 200 shares bought on October 10, 2007 (200 × $60)	12,000
Total basis of the 200 shares acquired via exercise of calls	**$12,540**

> **Note.** The holding period for property acquired via an exercise of call begins on **the day after** the call is exercised.[20] It does **not** include the holding period of the call. Therefore, Chad's holding period for the 200 shares begins on October 11, 2007.

20. Rev. Rul. 70-598, 1970-2 CB 168

Example 22. Use the same facts as **Example 20,** except instead of exercising the two calls, he **sold** the calls on October 10, 2007, for $1,000 (after commission). Chad's partially completed 2007 Schedule D is shown below.

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

Capital Gains and Losses

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

OMB No. 1545-0074 — **2007** — Attachment Sequence No. **12**

Name(s) shown on return: **Chad** — Your social security number: **987 65 4321**

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 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1 2 Wal-Mart Dec. 2007 Call Options	06/15/07	10/10/07	1,000	540	460

Example 23. Annette's neighbor, an employee of Cardinal Bagel Company, told her that the company was mismanaged and might file for bankruptcy. Annette thought the stock price of the company would decline dramatically. Therefore, on June 18, 2007, Annette **bought** 100 December 2007 puts of Cardinal Bagel with a strike price of $10.

The put options gave Annette the **right to sell** to the seller of the puts 10,000 shares of Cardinal Bagel for $10 a share on or before the put expiration date. That date is the third Friday in December 2007. Annette paid the following for the 100 puts:

Cost of 100 puts ($15 × 100)	$1,500
Plus: commission	500
Cost of the 100 puts	**$2,000**

Her disgruntled neighbor's information concerning her employer was groundless. The price of Cardinal Bagel stock **increased** and Annette let her puts **expire** on December 21, 2007, the expiration date of the puts. Her short-term capital loss is $2,000. Her 2007 Schedule D is completed in the same manner as explained for Chad in **Example 20.**

Example 24. Use the same facts as **Example 23,** except the price of Cardinal Bagel stock **declined** as Annette expected. On December 13, 2007, she bought 10,000 shares of Cardinal Bagel at the market price of $2 per share from her broker. Her cost in the 10,000 shares is shown below:

Purchase price of the 10,000 shares (10,000 × $2)	$20,000
Plus: commission	500
Cost basis of the 10,000 shares	**$20,500**

On December 21, 2007, Annette **exercised** her puts. Consequently, the seller of the puts was obligated to buy her 10,000 shares for the agreed strike price of $10 per share. Annette sold her 10,000 shares to the seller of the puts on December 21, 2007. This stock sale is reported in the Form 1099-B section of her brokerage firm's 2007 Tax Reporting Information.

When a put is exercised by the put buyer, the sales price of the underlying acquired stock must be reduced by the cost of the put when computing gain or loss. Annette's sales price of the 10,000 shares is shown below:

Gross sales price of the 10,000 shares (10,000 × $10)	$100,000
Less: commission on sale of the 10,000 shares	(2,000)
Less: Annette's cost of the 100 puts	(2,000)
Net sales price of the 10,000 shares	**$ 96,000**

Annette's partially completed 2007 Schedule D is shown below.

SCHEDULE D (Form 1040) — **Capital Gains and Losses** — OMB No. 1545-0074 — 2007

Department of the Treasury Internal Revenue Service (99) — ▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040). ▶ Use Schedule D-1 to list additional transactions for lines 1 and 8. — Attachment Sequence No. 12

Name(s) shown on return: **Annette** — Your social security number: **100 10 1000**

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 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1 **10,000 shares Cardinal Bagel Co.**	**12/13/07**	**12/21/07**	**96,000**	**20,500**	**75,500**

> **Caution.** The sales price shown on Schedule D column (d) should match the amount reported on the 1099-B from the brokerage company. If it does not, the taxpayer might get a notice from the IRS that additional tax is due. Therefore, if the brokerage company shows the selling price net of commission, but does not reduce the selling price by the cost of the puts, the $2,000 cost of the puts should be added to the cost in the stocks shown in column (e).

Example 25. Use the same facts as **Example 24,** except that instead of exercising the puts, she **sold** the 100 puts on August 9, 2007, at the market price of $40 per put. Her sales price for the 100 puts is shown below:

Gross sales price (100 × $40)	$4,000
Less: commission	(500)
Net sales price of the 100 puts	**$3,500**

Annette's partially completed 2007 Schedule D is shown below.

SCHEDULE D (Form 1040) — **Capital Gains and Losses** — OMB No. 1545-0074 — 2007

Department of the Treasury Internal Revenue Service (99) — ▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040). ▶ Use Schedule D-1 to list additional transactions for lines 1 and 8. — Attachment Sequence No. 12

Name(s) shown on return: **Annette** — Your social security number: **100 10 1000**

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 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1 **100 Cardinal Bagel Co. Dec. 2007 put options**	**06/18/07**	**08/09/07**	**3,500**	**2,000**	**1,500**

SELLERS OF PUTS AND CALLS

If a taxpayer sells a put or a call, the amount received from the buyer is not included in gross income at the time of the sale. Instead, it is carried in a deferred account until:

1. The obligation expires,
2. The buyer of the put or call exercises the option, or
3. The seller engages in a closing transaction to complete the previous short sale of the put or call (buys a put or call at market price to close the short sale). For example, if the seller buys back the option before the option expires, he has engaged in a closing transaction.

If the put or call **expires**, the amount received by the seller of the put or call is always a **short-term** capital gain.[21]

Exercise of a Put. If a put is exercised by the buyer, the **seller of the put** must buy the underlying stock at the agreed strike (or option) price from the buyer of the put.

Example 26. Use the same fact as **Example 23.** The seller of the 100 puts that Annette bought was obligated to buy the 10,000 shares of the underlying stock for the agreed strike price of $10 per share.

The seller of the 100 puts must reduce his basis in the acquired underlying stock by the amount the seller received for the puts.[22] Therefore, the seller's basis of the 10,000 shares of Cardinal Bagel stock is **$98,500** as shown below.

Purchase price of the 10,000 shares on December 21, 2007	$100,000
Less: premium the seller received on June 18, 2007 from Annette (100 puts at $15)	(1,500)
Basis of the 10,000 shares for the seller of the puts (disregarding commissions)	**$ 98,500**

Note. The seller's holding period for the 10,000 shares begins on December 22, 2007, the day after they were purchased from Annette.

Exercise of a Call. If a call is exercised by the buyer, the **seller of the call** must sell the underlying stock at the agreed strike price to the buyer of the call. The amount received from the sale of the call is added to the amount received from the sale of the stock. The gain or loss is long-term or short-term depending on the holding period of the underlying stock.

Example 27. Juan bought 100 shares of Ameren on April 9, 2007, at $49 per share. His total cost including commissions was $5,000. In July 2007, Juan's broker advised him to sell a **covered call** on the 100 shares of Ameren, because the broker predicted that the price of Ameren would either remain flat or decline. Juan followed his broker's advice. Following are the details regarding his sale of the call option:

Call date of sale	July 12, 2007
Number of shares (one call option)	100
Agreed strike price	$55
Call expiration date (3rd Friday of month)	December 21, 2007
Amount of premium Juan received after commission	$600

Juan's broker was correct; the value of Ameren stock **declined** slightly after Juan sold his covered call in July 2007. Consequently, the buyer of Juan's call did not exercise the call option, and it expired worthless.

---

21. Treas. Reg. §1.1234-1(b)

22. Rev. Rul. 58-234, 1958-1 CB 279

Juan has a short-term capital gain of $600. Note on his 2007 Schedule D that the date acquired in column (b) is the date that the option expired and the date sold in column (c) is the actual date that the option was sold.

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

Capital Gains and Losses

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

OMB No. 1545-0074 — 2007 — Attachment Sequence No. 12

Name(s) shown on return: Juan — Your social security number: 001 01 0001

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 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1 Ameren Dec. 2007 call option	12/21/07	07/12/07	600	Expired	600

Note. Selling **covered calls** by an investor who already owns the underlying stock is a widespread conservative investment strategy used in an attempt to effectively increase the dividend yield.

Example 28. Use the same facts as **Example 27,** except the prediction of Juan's broker was incorrect; the value of Ameren stock **increased** to $60 on the call expiration date of December 21, 2007. Therefore, the buyer of Juan's call **exercised** it and bought Juan's 100 shares of Ameren stock for the strike price of $55 per share.

Juan's sales price of the 100 shares consists of two elements:

Amount of the call premium he received on July 12, 2007	$ 600
Amount received when call was exercised by the buyer on December 21, 2007 ($55 × 100 shares)	5,500
Gross sale price	$6,100
Less: commission on the 100 shares sold	(100)
Net sales price	**$6,000**

Juan has a $1,000 short-term capital gain. His 2007 Schedule D is shown below.

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

Capital Gains and Losses

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

OMB No. 1545-0074 — 2007 — Attachment Sequence No. 12

Name(s) shown on return: Juan — Your social security number: 001 01 0001

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 of the instructions)	(e) Cost or other basis (see page D-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1 100 shares Ameren	04/09/07	12/21/07	6,000	5,000	1,000

The following table from IRS Pub. 550, *Investment Income and Expenses (For 2006 Returns)*, summarizes the tax treatment of puts and calls for stocks. The table refers to holders (buyers) and writers (sellers).

Table 4-1. **Puts and Calls**

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

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

Note. Sales of put and call options are not reported in the Form 1099-B Tax Reporting Information section from brokerage firms. However, any realized gains or losses from completed put and call transactions are often reported in the Realized Gains and Losses section of the year-end Tax Reporting Information. Most of the completed gains and losses are short-term transactions.

TAX TREATMENT FOR IRC §1256 NONEQUITY PUTS AND CALLS

Different rules apply for reporting **nonequity** put and call options. The mark-to-market rules of IRC §1256 are used for these puts and calls. These options, if held at year-end, are treated as if they were sold at fair market value on the last trading day of the year. Any gain or loss is initially reported on Form 6781, *Gains and Losses from Section 1256 Contracts and Straddles*. **Nonequity** puts and calls 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 Board of Trade), and
- Broad-based stock index options (**Example:** Standard and Poor's (S&P) 500 Index option contract on the Chicago Board Options Exchange).

Note. If a taxpayer buys a **nonequity** option as a **hedge** against business risks, the gain or loss is not reported on Form 6781 (e.g., a corn **put option** bought by a farmer to protect against a decline in the price of corn the farmer will produce for sale in the future). It is reported as ordinary income or loss on the applicable business schedule. See **Issue 3,** "Common Investment Reporting Errors," earlier in this chapter for more information about hedging versus speculating and preparing Form 6781.

Many investors buy puts and calls on numerous broad-based stock indexes. Investors cannot sell a put or call on these indexes.

Caution. Some sophisticated investor clients may buy puts and calls on broad-based stock indexes such as the S&P 500 Index and the NYSE Composite Index. These trades, either completed during the year or open at year-end, must be reported on Form 6781 rather than Schedule D. The mark-to-market rules must be used to value the open year-end positions. For more information and an example with a completed Form 6781, see pages 181–183 in the 2001 *University of Illinois Farm Income Tax School Workbook.*

ISSUE 7: SALE OF EMPLOYER SECURITIES ACQUIRED VIA DISTRIBUTIONS FROM ESOPs

BACKGROUND

An employee stock ownership plan (ESOP) can be established as a retirement plan under IRC §402. This type of plan is designed as a stock bonus plan and/or money purchase plan which invests primarily in securities of the employer. Employees may contribute before- or after-tax money into the plan. Distributions from the plan are generally taxed the same as distributions from other qualified retirement plans.

Note. It is estimated that 24 million taxpayers own about $400 billion of company stock in their employers' savings plans.[23]

TAXATION OF LUMP-SUM DISTRIBUTIONS

Lump-sum distributions of employer stock qualify for special treatment.[24] The **net unrealized appreciation (NUA)** related to ESOP shares distributed in a lump-sum transaction is not taxed until the shares are sold.[25] NUA is the amount by which the market value of the stock exceeds the cost basis at the time of the distribution.

Furthermore, any gain on the sale of the ESOP stock, up to the amount of the NUA, is treated as a **long-term capital gain regardless of when the stock was distributed to the employee.[26]** Any gain in excess of NUA is considered short-term or long-term depending on the length of time the stock was "in the hands" of the employee.

Even if the transaction does **not** qualify as a lump-sum distribution, the NUA related to shares purchased with after-tax money of the employee still qualifies for special treatment.[27]

23. Fidelity Research Institute, May 2007

24. IRC §402(e)(4)

25. IRC §402(e)(4)(A)

26. IRS Notice 98-24

27. Treas. Reg. §1.402(a)-1(b)(1)(i)(b)

To qualify as a **lump-sum distribution**, the employee's entire balance in the plan must be distributed:

- Because of the employee's death,
- After the employee attains age 59$^1/_2$,
- After the employee separates from service, **or**
- After the employee has become disabled.

As long as the **entire** balance is distributed **within one tax year**, multiple distributions may qualify as a lump-sum distribution. Distributions in which part of the balance is rolled over may also qualify.[28] **If the employee participates in other employer-sponsored retirement plans, the balances in the other plans do not have to be included in the ESOP distribution as long as the other retirement plans are different types than the ESOP.** For example, profit sharing plans and stock bonus plans are considered different types of plans when determining if the employee's entire plan balance has been distributed.[29]

28. Letter Ruling 200003058, (January 21, 2000); Letter Ruling 200038057, (June 28, 2000)

29. Prop. Treas. Regs. §§1.402(e)-2(d)(1)(v) & (e)(1)(i)

Example 29. Kevin Bird, age 60, is single and works at Caterpillar, Inc. He is a participant in the employees' investment plan, a qualified ESOP plan. He has purchased stock with after-tax money over the years. On April 20, 2006, he withdrew 337 shares from the plan in a lump-sum distribution. He received the following letter shortly after the shares were distributed to him.

DISTRIBUTION STATEMENT
CATERPILLAR, INC.
EMPLOYEES' INVESTMENT PLAN — PART 1

APRIL 2006
SSN 999-00-0000

K. I. Bird
293 Herman St.
Pekin, IL 61554-5647

In connection with your distribution from the Employees' Investment Plan, you are entitled to **337.3644** shares. A check is enclosed representing the fractional share and if applicable, cash dividends and government securities in your account. A stock certificate for the full shares of Caterpillar, Inc., common stock was recently mailed to you by the company's stock transfer agent. If you have not received it, please contact your Benefits Office.

If this distribution results in taxable income, you will also receive, after the end of the year, a Form 1099-R showing the amount of taxable income you should report when preparing your tax return for **2006**. The following information and the enclosed information notes are provided for your use in preparing your federal income tax return and for determining your cost basis per share so that on subsequent sale of the stock you will be able to calculate any gain or loss:

A.	VALUE OF DISTRIBUTION	$17,946.00
B.	DEDUCT NONTAXABLE PORTION	$14,274.00
C.	DEDUCT NET UNREALIZED APPRECIATION	$2,779.00
	d. ORDINARY INCOME	$893.00
	e. CAPITAL GAIN	$0.00
F.	FEDERAL INCOME TAX BASIS PER SHARE	$44.95
G.	MARKET VALUE PER SHARE FOR 337 SHARES	$53.1950
H.	DATE HOLDING PERIOD BEGAN FOR 337 SHARES	04/20/06
I.	CONTRIBUTION BALANCE AFTER DISTRIBUTION	0
	1986 BALANCE	$0.00
	"NEW" BALANCE	$0.00

Do not file this form with your federal income tax return. This is for your own use. It is important, however, that you keep this with your other supporting tax records.

CATERPILLAR, INC.
AUTHORIZED REPRESENTATIVE

Kevin's Form 1099-R, received in January 2007, is shown below:

☐ VOID ☐ CORRECTED

PAYER'S name, street address, city, state, and ZIP code **Caterpillar, Inc.** **The Northern Trust Co.** **100 NE Adams Street** **Peoria, IL 61629-4125**		1 Gross distribution $ **17946.00** 2a Taxable amount $ **893.00**	OMB No. 1545-0119 **2006** Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
		2b Taxable amount not determined ☐	Total distribution ☐	**Copy 1 For State, City, or Local Tax Department**
PAYER'S federal identification number **XX-XXXXXXX**	RECIPIENT'S identification number **999-00-0000**	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $	
RECIPIENT'S name **Kevin I. Bird**		5 Employee contributions /Designated Roth contributions or insurance premiums $ **14274.00**	6 Net unrealized appreciation in employer's securities $ **2779.00**	
Street address (including apt. no.) **293 Herman Street**		7 Distribution code(s) **7** IRA/ SEP/ SIMPLE ☐	8 Other $ %	
City, state, and ZIP code **Pekin, IL 61554**		9a Your percentage of total distribution %	9b Total employee contributions $	
	1st year of desig. Roth contrib.	10 State tax withheld $ $	11 State/Payer's state no.	12 State distribution $ $
Account number (see instructions)		13 Local tax withheld $ $	14 Name of locality	15 Local distribution $ $

Form **1099-R**   Department of the Treasury — Internal Revenue Service

Observation for Example 29. Note how the amounts on the 1099-R correspond to the amounts shown in the letter:

- The amount in box 1 ($17,946) equals the amount on line A of the letter.
- The amount in box 2a ($893) equals line D of the letter.
- The amount in box 5 ($14,274) equals line B of the letter.
- The amount in box 6 ($2,779) equals line C of the letter.

Sale of the Distributed ESOP Shares. Kevin sold his 337 shares of ESOP stock on May 2, 2006, for $17,148. His gain on the sale is $2,000 as shown below.

Sales price of the 337 shares (after commission)	$17,148
Less: basis (337 shares × $44.95 — see Line F of letter)	(15,148)
Gain (treated as long-term)	**$ 2,000**

Since the $2,000 gain is **less** than the NUA of $2,779 (line C of the letter), the entire gain is afforded long-term treatment on Kevin's 2006 Schedule D (not shown). Kevin's gain is long-term even though he held the ESOP stock for less than one month.[30]

30. IRS Notice 98-24 (March 23, 1998)

Form 1099-R Reporting for 2006. On his 2006 Form 1040, Kevin reported the following:

Box on Form 1099-R	Amount	Where Reported
1. Gross distribution	$17,946	Line 16a, pensions and annuities
2. Taxable amount	893	Line 16b, taxable amount

Note. The $2,000 gain qualifies for special tax treatment on the Illinois state income tax return. Illinois tax preparers should refer to the "Illinois Department of Revenue" chapter for a full analysis of this topic.

Example 30. Use the same facts as **Example 29.** If Kevin sold the shares for $19,148 on May 2, 2006, part of his gain would be taxed as a long-term capital gain, and part of his gain would be taxed as a short-term capital gain as shown below.

Sales price of the 337 shares (after commission)	$19,148
Less: basis (337 shares × $44.95 — see Line F of letter)	(15,148)
Gain	$ 4,000
NUA at time of distribution (Box 6 on 1099-R; taxed as long-term gain)	(2,779)
Appreciation subsequent to distribution (taxed as short-term gain)	$ 1,221

On the other hand, **if Kevin held the shares until April 22, 2007, all the gain would be taxed as long-term.**

Note. Kevin's holding period for his $1,221 short-term capital gain begins on April 21, 2006, the day **after** the ESOP shares were distributed to him. It ends on May 2, 2006, when he sold them.