Chapter 8: Investment Income

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Corrections were made to this workbook through January of 2013. No subsequent modifications were made.

The IRS taxes all forms of income whether they are from earnings, passive activities, or investments. However, the taxation of investment income can be at a lesser rate (currently at a maximum of 15% for qualified dividends) or even in the form of a new Medicare tax in future years if the investment income is significant. In addition, investment income from municipal bonds is tax exempt.

However, various forms of investment income sometimes challenge the tax preparer with issues or concepts to be addressed before properly reporting that investment income on a tax return. The preparer must determine what amount of investment income must be taxed, how it is to be reported, and the appropriate tax rate.

This chapter addresses some of the more difficult investment income issues.

SCHEDULE B OVERVIEW

Schedule B, *Interest and Ordinary Dividends,* must accompany the taxpayer's Form 1040 if **any** of the following is true.

- The taxpayer has over $1,500 of interest income **or** over $1,500 of ordinary dividends.
- The taxpayer receives interest from a seller-financed mortgage, and the buyer used the property as a personal residence.
- The taxpayer receives any amount of accrued bond interest during the year.
- The taxpayer is reducing reportable bond interest by the amount of amortized bond premium.
- The taxpayer is reporting an amount of original issue discount that is less than that shown on a Form 1099-OID.
- The taxpayer uses Form 8815 to exclude interest on series I and EE U.S. savings bonds issued after 1989 to pay education expenses.
- The taxpayer received interest or ordinary dividends as a nominee.
- The taxpayer has signature or similar authority over, or a financial interest in, a foreign financial account.

SELLER-FINANCED MORTGAGES

If the taxpayer holds a mortgage on property sold to a buyer who uses the property as a personal residence, Schedule B must be used to report the mortgage interest received during the year. Schedule B must indicate the buyer's name, address, and social security number (SSN). The IRS may assess a $50 penalty for failure to provide this information. In addition, the selling taxpayer's SSN must be provided to the buyer.

NOMINEE INTEREST OR DIVIDENDS

Generally, when two or more persons own a joint bank or investment account, the Form 1099 showing the applicable interest or dividends for the year is issued to the taxpayer with the first SSN listed on the account. That taxpayer is responsible for allocating the interest or dividends in the proper amounts to the other joint accountholders. The following example illustrates this situation and demonstrates how to indicate the allocation of interest and dividends to the other accountholders within Schedule B, Parts I and II.

Example 1. Adam, Brittany, and Christina are siblings who are joint accountholders of a savings account at Eastern Bancorp. The three siblings also are joint accountholders of a brokerage account at Trivest Brokerage, which holds stock shares. They agree to equally split the interest earned on the Eastern Bancorp account and the dividends earned on the Trivest Brokerage account.

The Eastern Bancorp savings account **earns $300 of interest** during 2011. The Trivest account **earns $1,200 of dividends** during 2011.

Adam's SSN is the first SSN listed on the accounts in the records of Eastern Bancorp and Trivest Brokerage. Therefore, Adam receives a Form 1099-INT from Eastern Bancorp for the year's interest of $300. He also receives a Form 1099-DIV from Trivest in the amount of $1,200.

Adam prepares and issues Forms 1099-INT to Brittany and Christina for their respective $100 of interest from Eastern Bancorp. Adam also issues Forms 1099-DIV to Brittany and Christina for their respective $400 of dividends from Trivest.

Adam also has his own personal bank account at Pittsfield Bank, which earned $650 of interest in 2011. Because Adam has distributed interest and dividends as a nominee, he must complete and attach Schedule B to his tax return for 2011. Adam's 2011 Schedule B follows.

Note. In this chapter, 2011 forms are frequently used rather than draft 2012 IRS forms because many of the draft forms were not available as of the date of publication.

For Example 1

SCHEDULE B (Form 1040A or 1040)
Department of the Treasury Internal Revenue Service (99)

Interest and Ordinary Dividends

▶ Attach to Form 1040A or 1040. ▶ See instructions on back.

OMB No. 1545-0074
2011
Attachment Sequence No. 08

Name(s) shown on return: **Adam Jacobs**
Your social security number: **987-65-4321**

Part I Interest

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 8a.)

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

			Amount
1	List name of payer. If any interest is from a seller-financed mortgage and the buyer used the property as a personal residence, see instructions on back and list this interest first. Also, show that buyer's social security number and address ▶	1	
	Pittsfield Bank		650
	Eastern Bancorp		300
	Subtotal		950
	Nominee Distribution		(200)
2	Add the amounts on line 1	2	750
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 1040A, or Form 1040, line 8a ▶	4	750

Note. If line 4 is over $1,500, you must complete Part III.

Part II Ordinary Dividends

(See instructions on back and the instructions for Form 1040A, or Form 1040, line 9a.)

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

			Amount
5	List name of payer ▶ Trivest Brokerage	5	1,200
	Subtotal		1,200
	Nominee Distribution		(800)
6	Add the amounts on line 5. Enter the total here and on Form 1040A, or Form 1040, line 9a ▶	6	400

Note. If line 6 is over $1,500, you must complete Part III.

Note. It is not necessary to issue a Form 1099-INT or Form 1099-DIV to allocate interest or dividends if the other accountholder is the spouse of the taxpayer.

FOREIGN ACCOUNTS

Schedule B, Part III must be completed if the taxpayer:

- Had over $1,500 in taxable interest or dividends during the tax year,
- Had a foreign account,
- Received a distribution from a foreign trust, **or**
- Was a grantor of, or transferred assets to, a foreign trust.

Taxpayers who have an interest in, signature authority over, or other authority over a foreign financial account must disclose this fact in Part III of Schedule B. However, there are some exceptions. Taxpayers can indicate that they do not have an interest or authority over a foreign account if:

- The combined value of the accounts was $10,000 or less during the year,
- The accounts were with a U.S. military banking facility operated by a U.S. financial institution,
- The taxpayer is a commercial bank employee and did not have a personal interest in one or more foreign accounts in the employer's name, or
- The taxpayer is an employee of a publicly listed U.S. corporation with assets of more than $10 million and 500 or more shareholders and the employee does not have any personal interest in any foreign accounts in the employer's name. The taxpayer must receive written notice that the corporation has filed a current report regarding the account for this exception to apply.

Example 2. Reed is a Vice President of U.K. Operations of Morgan Manufacturing, LLC, a privately owned corporation which has its headquarters in the United States and a few offices in the United Kingdom. Morgan Manufacturing has several U.K. accounts in its corporate name. These accounts are held in various U.K. banks. Morgan Manufacturing maintains approximately $2 million in funds within these U.K. accounts at all times. These are the working capital accounts that Morgan uses for its U.K. manufacturing activity. Reed, as VP of U.K. Operations, has signing authority over these accounts. He signs checks for purchases of supplies, payroll, and necessary capital acquisitions for the U.K. operations. Reed's Schedule B, Part III appears as follows.

			Yes	No
Part III Foreign Accounts and Trusts (See instructions on back.)		You must complete this part if you **(a)** had over $1,500 of taxable interest or ordinary dividends; **(b)** had a foreign account; or **(c)** received a distribution from, or were a grantor of, or a transferor to, a foreign trust.		
	7a	At any time during 2011, did you have a financial interest in or signature authority over a financial account (such as a bank account, securities account, or brokerage account) located in a foreign country? See instructions	✓	
		If "Yes," are you required to file Form TD F 90-22.1 to report that financial interest or signature authority? See Form TD F 90-22.1 and its instructions for filing requirements and exceptions to those requirements	✓	
	b	If you are required to file Form TD F 90-22.1, enter the name of the foreign country where the financial account is located ▶ United Kingdom		
	8	During 2011, did you receive a distribution from, or were you the grantor of, or transferor to, a foreign trust? If "Yes," you may have to file Form 3520. See instructions on back		✓

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 17146N **Schedule B (Form 1040A or 1040) 2011**

Taxpayers having foreign accounts in excess of $10,000 will likely have FBAR filing requirements (discussed later in this chapter in the section entitled "Offshore Asset Reporting Requirements"). In addition, the taxpayer must comply with the applicable FATCA filing requirements described later.

TAXATION OF CAPITAL GAINS

A capital gain or loss arises from the **sale** or **exchange** of **capital assets.** A sale is a transfer of property for money or a promise to pay money, and an exchange is a transfer of property for other property.[1] Case law or a Code provision may also deem a specific transaction as a sale or exchange.

Generally, a capital asset is property that is **not:**

- Inventory held for sale,
- Supplies normally consumed in the course of conducting a trade or business,
- Depreciable or real property that is used in a trade or business,
- Copyrights and other creative works sold or exchanged by that work's creator,

> **Note.** A special tax election is available to treat music copyrights and compositions as capital property.[2] In addition, patents, franchises, trademarks, and trade names are capital property.

- Accounts receivable,
- U.S. government publications,
- Hedging transactions entered into in the normal course of business,[3]
- Certain commodity derivative financial instruments (such as futures, options, or swaps held by a dealer).[4]

A sale or exchange of a noncapital asset is generally treated as ordinary income or gain taxed at regular tax rates. However, a sale or exchange of a capital asset results in a capital gain or loss subject to special tax rules and rates.

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BASIC CAPITAL GAINS TAX RULES

How a capital gain is taxed in the hands of a taxpayer depends on the following factors.

- How long the taxpayer held the capital property that was sold (holding period)
- The highest tax bracket that the taxpayer's other taxable income reaches
- Whether the taxpayer has disposed of regular capital assets taxed at normal capital gains rates or has disposed of certain other special types of capital property taxed at different rates

Holding Period

A capital gain or loss is either short term or long term. This is determined by how long the taxpayer held the asset before its sale or exchange. A holding period of **one year or less** results in a **short-term gain** or loss on a sale or exchange. A short-term gain is taxed at **ordinary** income tax rates. A holding period **in excess of one year** results in a **long-term gain** or loss. Long-term gains are subject to **favorable** capital gains tax rates.

> **Note**. Generally, the holding period begins on the day **after** the taxpayer's acquisition date and ends on the disposition date.

1. *Comm'r v. C.B. Brown*, 37 TC 461 (1961), *aff'd* 325 F.2d 313, *aff'd* S.Ct. 380 US 563, 85 S.Ct. 1162; *G.T. Helvering v. William Flaccus Oak Leather Co.*, S.Ct. 313 US 247.
2. See IRS Pub. 550*, Investment Income and Expenses,* and IRC §1221(b)(3).
3. IRC §1221(a)(7).
4. IRC §1221(a)(6).

TAXPAYER'S INCOME AND TAX BRACKET

How a taxpayer's long-term capital gain is taxed depends on the amount of the **taxpayer's other taxable income** and the tax bracket in which it falls. The following tax brackets apply for 2012.

Taxable Income			
Single Individual	**Married Filing Jointly**	**Marginal Tax Rate**	**Capital Gain Rate**
$ 0– 8,700	$ 0– 17,400	10%	0%
8,701– 35,350	17,401– 70,700	15%	0%
35,351– 85,650	70,701–142,700	25%	15%
85,651–178,650	142,701–217,450	28%	15%
178,651–388,350	217,451–388,350	33%	15%
388,351+	388,351+	35%	15%

For 2011 and 2012, the normal tax rate on net capital gains (excess of net long-term capital gains less net short-term capital losses) and qualified dividends is 15%.[5] However, lower-income taxpayers can benefit from the special 0% tax rate on the amount of net capital gains plus qualified dividends that fall into either the 10% or 15% regular brackets. This is true if the taxpayer's **other taxable income** (explained later) is below the ceiling amount for the 15% bracket. The amount of net capital gains and qualified dividends that exceeds the ceiling amount for the 15% bracket is taxed at the normal 15% capital gains rate.

Note. This special 0% rate replaced a special 5% rate for 2008 through 2012. This resulted from an amendment to IRC §1(h)(1) from the Jobs and Growth Tax Relief Reconciliation Act of 2003. This amendment has a "sunset clause" that will cause the 0% rate to expire at the end of the 2012 tax year. After 2012, the normal capital gains rate is scheduled to return to its pre-2003 level of 20% with the 0% rate being replaced by a 10% rate for those taxpayers who are in the lower two tax brackets.

In the examples that follow, the term **other taxable income** is used. Other taxable income is calculated as follows.

	AGI
–	Exemptions (personal, spousal, and dependent exemptions claimed)
–	Deductions (either standard deduction or itemized deductions claimed)
	Reported taxable income
–	Net capital gain income (net long-term capital gains less net short-term capital losses)
–	Qualified dividends
	Other taxable income

Example 3. For a taxpayer with $80,000 of reported taxable income that includes $20,000 of net capital gains and $10,000 of qualified dividends, the following adjustments must be made to calculate that taxpayer's other taxable income:

Reported taxable income	$80,000
Less: net capital gain (net long-term capital gains less net short-term capital losses)	(20,000)
Less: qualified dividends	(10,000)
Other taxable income	**$50,000**

5. IRC §1(h)(1)(C) as amended by the Jobs and Growth Tax Relief Reconciliation Act of 2003, PL 108-27, Act §301(a)(1) (May 28, 2003).

A more detailed calculation of other taxable income follows.

Example 4. Naomi, a single individual under age 65, has $50,250 of **taxable income for 2012** as shown below.

Wages	$20,000
Fully taxable pension	10,000
Long-term capital gain on sale of inherited stock	30,000
AGI	$60,000
Less: personal exemption	(3,800)
Less: standard deduction	(5,950)
Naomi's 2012 reported taxable income	**$50,250**

Naomi's **other taxable income for 2012 is $20,250** as shown below.

Reported taxable income	$50,250
Less: long-term capital gain (her net capital gain)	(30,000)
Naomi's 2012 other taxable income	**$20,250**

Another example of how other taxable income is calculated follows.

Example 5. Bill and Lorna, who are both under age 65, file a joint **2012** tax return. They report the following:

Wages	$ 70,000
Schedule E net apartment rental income	25,000
Long-term capital gain on sale of stock	10,000
Schedule B ordinary dividends ($5,000 are qualified dividends)	10,000
AGI	$115,000
Less: personal exemptions (2 × $3,800)	(7,600)
Less: Schedule A itemized deductions	(15,000)
Bill and Lorna's 2012 reported taxable income	**$ 92,400**

Their **other taxable income for 2012 is $77,400** as shown below.

Reported taxable income	$92,400
Less: net capital gain ($10,000) + qualified dividends ($5,000)	(15,000)
Bill and Lorna's 2012 other taxable income	**$77,400**

Once the taxpayer's other taxable income has been determined, the taxation of a capital gain can be calculated.

Example 6. Corrine is a single individual. She has $30,000 of reported taxable income for the 2012 tax year, and $10,000 of this amount is long-term capital gain. Her income tax on $20,000 of other taxable income is as follows.

	10%	15%	Income Tax	Total Income
First bracket income	$8,700		$ 870	$ 8,700
Second bracket income		$11,300	1,695	11,300
Total			$2,565	$20,000

Corrine's $20,000 of other taxable income is low enough to keep her in the second tax bracket, which has a ceiling of $35,350 for 2012. She can make an additional $15,350 ($35,350 − $20,000) and still remain in the second tax bracket.

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Accordingly, the $10,000 capital gain falls into the second bracket, and the 0% capital gains tax rate applies. Therefore, Corrine's total tax liability for 2012 is $2,565 on her other taxable income and there is no tax on her capital gain.

Example 7. Use the same facts as **Example 6,** except Corrine has $50,000 of reported taxable income for the 2012 tax year, which includes $30,000 in long-term taxable capital gains. Her income tax on the $20,000 of other taxable income is $2,565 (as previously calculated).

The first $15,350 of her $30,000 capital gain uses the remainder of the second tax bracket, and therefore the 0% capital gains tax rate applies. The remaining $14,650 of her capital gain ($30,000 − $15,350) is subject to the 15% capital gains tax rate. The tax on this $14,650 of capital gain is $2,198 ($14,650 × 15%). Her total tax liability for 2012 is as follows.

	0% Rate	15% Rate	Total Capital Gains Tax	Total Tax Liability
Capital gain falling into first or second brackets	$15,350		0	
Capital gain falling into higher brackets		$14,650	$2,198	$2,198
Tax liability on $20,000 other taxable income				2,565
				$4,763

The 0% rate on capital gain that falls into the first or second tax brackets for a lower-income individual applies in a similar fashion to the MFJ brackets for lower-income married couples.

Example 8. Use the same facts as **Example 7,** except Corrine is married to Henry and they file jointly each year. Both spouses have combined reported taxable income of $50,000, which includes a $30,000 long-term taxable capital gain.

	10%	15%	Income Tax	Total Income
First bracket income	$17,400		$1,740	$17,400
Second bracket income		$2,600	390	2,600
Total			$2,130	$20,000

The $20,000 of other taxable income is low enough to leave Corrine and Henry in the second tax bracket, which has a ceiling for MFJ taxpayers of $70,700 for 2012. They can make an additional $50,700 ($70,700 − $20,000) and remain in the second bracket.

Therefore, the entire $30,000 capital gain falls into the second bracket and the 0% capital gains tax rate applies. Corrine and Henry's total tax liability is only $2,130, which represents the tax payable on their other taxable income.

Note. See pages 331–338 in the 2008 *University of Illinois Federal Tax Workbook* for more information regarding the 0% tax rate on net capital gains and qualified dividends. This can be found at **www.TaxSchool.illinois.edu/taxbookarchive.**

CAPITAL GAINS AND DEPRECIABLE REAL ESTATE

Depreciable and Nondepreciable Property

When a taxpayer purchases real estate, the purchase price generally covers both the land and building. However, while the building is depreciable, the land is not.[6] Therefore, it is necessary to allocate the purchase price between the land and building. The amount of the purchase price allocated to the building represents the initial basis in the building for depreciation purposes.[7]

The allocation is generally based on the relative fair market values (FMV) of the land and building. If separate FMVs for the land and building are not available, an allocation based on the relative assessed values for property tax purposes may be an acceptable method.

Example 9. Frank purchased residential real estate property for $100,000. Immediately before the purchase, Frank had an appraisal completed that indicated that the land had an FMV of $30,000 and the house and garage had an FMV of $70,000. Frank's basis in the depreciable house and garage is $70,000.

Note. IRC §1250 property includes depreciable real property. The sale of such property is subject to the possible recapture of some or all of the depreciation allowed or allowable on that property. For additional information on depreciation recapture on §1250 property, see Chapter 6, Rental Activites, in the 2011 *Federal Tax Fundamentals* workbook.

Example 10. Use the same facts as **Example 9,** except Frank did not have an appraisal that provided the relative FMVs of the land and buildings. Frank contacts the local municipality and obtains assessed values for the buildings and land for property tax purposes. The tax notices indicate that the assessed value for the land is $22,000 and the assessed value of the buildings is $66,000. The total assessed value of the property is $88,000 ($22,000 land + $66,000 buildings). Frank allocates his purchase price as follows.

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Amount of the purchase price ($100,000) allocable to basis in **buildings:**

$$\begin{aligned}\textbf{Basis in buildings} &= \textbf{Total purchase price} \times \frac{\textbf{Assessed value of buildings}}{\textbf{Total property assessed value}} \\ &= \$100{,}000 \times \frac{\$66{,}000}{\$88{,}000} \\ &= \$75{,}000\end{aligned}$$

Amount of the purchase price ($100,000) allocable to basis in **land:**

$$\begin{aligned}\textbf{Basis in land} &= \textbf{Total purchase price} \times \frac{\textbf{Assessed value of land}}{\textbf{Total property assessed value}} \\ &= \$100{,}000 \times \frac{\$22{,}000}{\$88{,}000} \\ &= \$25{,}000\end{aligned}$$

Note. The taxpayer has the burden of establishing an acceptable method of allocating a lump-sum purchase price between depreciable and nondepreciable assets.

6. Treas. Reg. §1.1250-1(e)(3)(i).

7. Treas. Reg. §1.61-6(a).

Conversion of Principal Residence to Rental Property

When the taxpayer converts their principal residence to rental property, the basis of the property is the **lesser of:**

- The FMV of the property on the conversion date, **or**
- The taxpayer's original basis.[8]

For depreciation purposes, the property is treated as being placed in service on the conversion date. For the tax year in which the conversion takes place, the taxpayer must prorate deductible rental property expenses. This ensures that deductions are claimed only for the portion of the year during which the property was a rental property. The expenses attributable to the personal-use period within the year are not deductible as rental expenses but may be otherwise deductible. For example, the amount of mortgage interest and property taxes for the personal-use period may be included as part of the taxpayer's itemized deductions for the year.

Example 11. Maria purchased residential property on December 28, 2006. After using the property as her personal residence, she subsequently converted the residence into rental property on September 19, 2011. The relevant details are as follows.

At the time of the property purchase in 2006:

FMV allocable to land	$ 35,000
FMV allocable to building	100,000
Total purchase price	$135,000

At the time of conversion to rental in 2011:

FMV of land on conversion date	$10,000
FMV of building on conversion date	70,000
FMV of overall property on conversion date	$80,000

Maria's basis in the property is the lesser of her original basis ($135,000) or the FMV of the property on the conversion date ($80,000). Her basis in the property on the conversion date is therefore $80,000. Her basis in the building is $70,000 for depreciation purposes.

The expenses incurred before the conversion date are attributable to Maria's personal use of the property as her residence. She may be able to claim some of these expenses, such as those for mortgage interest and property taxes, as part of her overall itemized deductions for the year.

Example 12. Use the same facts as **Example 11,** except Maria sells the property on December 28, 2012, for $95,000. Maria's basis in the property is $80,000. Her realized gain is $15,000 ($95,000 − $80,000). Maria held the property for exactly six years (from December 28, 2006, to December 28, 2012). The 5-year period ending on the sale date is December 28, 2007, to December 28, 2012. During this 5-year period, Maria used and owned the property as her principal residence for at least two years. This meets the requirements of the principal residence exclusion under IRC §121. Even though Maria realized gain of $15,000 on the sale of the property, none of this gain is recognized because she can exclude this gain from income. The depreciation recapture gain is taxable to her because the §IRC 121 principal residence exclusion does not cover the exclusion of this gain.[9] It only permits the exclusion of capital gain on the sale of the property.

Note. Substantial guidance on the use of the principal residence exclusion is found in the regulations under IRC §121. Use of the principal residence exemption in connection with the sale of a residence later converted to rental property is covered in Chapter 6, Rental Activities, in the 2011 *Federal Tax Fundamentals* workbook. Nonqualified use may affect the amount of principal residence exclusion that may be used.[10]

8. Treas. Reg. §1.167(g)-1.
9. IRC §121(d)(6).
10. IRC §121(b)(5).

The Code provides a special de minimis rule for a short-term rental. If the property is rented for less than 15 days during the taxable year, no deduction of rental expenses is permitted. However, the rental income is not included in the taxpayer's gross income for the year.[11]

CAPITAL GAINS ON COLLECTIBLES

Collectibles include the following items.

- A work of art
- A rug or antique
- A metal or gem
- A stamp or coin
- Any alcoholic beverage[12]

Note. IRC §1(h)(5) refers to IRC §408(m) for the definition of "collectibles." IRC §408(m) addresses the tax treatment of IRA distributions of collectibles and provides the above list of items as the definition of collectibles. Regulations[13] under §408(m) state that "for purposes of this section" collectibles include the above items and add musical instruments and any historical objects (documents, clothes, etc.) to the list, as well as "any other tangible personal property." It is unclear whether the cross reference in §1(h)(5) to the collectibles definition of §408(m) includes musical instruments and historical objects as items subject to a 28% rate.

Gains on the sale of collectibles are taxed at a maximum rate of 28%.[14] The special 0% rate is not applicable to the sale of collectibles. However, lower-income taxpayers may benefit from a marginal tax rate that is less than the maximum 28% rate. In addition, taxpayers in the highest two brackets benefit from paying a lower 28% rate on collectibles gains rather than their higher marginal tax rate of either 33% or 35%.

Example 13. Jillian is single and has $14,000 of taxable income, which consists of $5,000 of employment income and a $9,000 gain she realized on the sale of her coin collection. Her employment income falls into the lowest tax bracket, which has a 10% tax rate and a ceiling of $8,700 for 2012. The tax liability on the employment income is therefore $5,000 × 10% = $500.

For the $9,000 collectibles gain, the first $3,700 ($8,700 − $5,000) falls into the lowest tax bracket and the remaining $5,300 ($9,000 – $3,700) falls into the next highest bracket with a 15% rate. Therefore, her tax liability on the collectibles gain is $1,165 (($3,700 ×10%) + ($5,300 × 15%)). Jillian's total tax bill on her employment income and collectibles gain is $1,665 ($500 + $1,165).

Example 14. Brett is single and has $200,000 of taxable income in 2012, which includes $9,000 realized on the sale of his coin collection. His regular income is $191,000 ($200,000 − $9,000). This regular income moves progressively through the first five tax brackets, triggering a tax liability of $47,557. Even though Brett's marginal tax rate is 33%, his collectibles gain of $9,000 is taxed at a maximum rate of 28%. The amount of tax on his collectibles gain is therefore $2,520 ($9,000 × 28%). Brett's total tax liability is $50,077 ($47,557 + $2,520).

11. IRC §280A(g).
12. IRC §§1(h)(5) and 408(m).
13. Treas. Reg. §1.408-10(b).
14. IRC §1(h)(1)(E).

SECTION 1202 STOCK

A taxpayer that disposes of **qualified small business stock** may be eligible to exclude part or all of the gain from income. In order to obtain the exclusion from income, the taxpayer must hold the qualified stock for **more than five years.** The 5-year holding period applies regardless of the acquisition date of the stock. Any amount of gain that is included in income is taxed at a maximum capital gains rate of 28%.

The general rule is that the taxpayer can exclude 50% of the gain from income.[15] However, this 50% exclusion was increased for certain stock acquisitions as follows.

- 75% gain exclusion for qualified stock acquired after February 17, 2009, and on or before September 27, 2010[16]
- 100% gain exclusion for qualified stock acquired after September 27, 2010, and before January 1, 2012[17]

Certain corporations such as domestic international sales corporations, regulated investment companies, real estate mortgage investment conduits, agricultural and business cooperatives, and certain others are not eligible for the §1202 exclusion.[18]

Qualified small business stock is stock in a C corporation that is engaged in an active business. "Engaged in an active business" means that at least 80% of the value of the corporation's assets are used in qualified trades or businesses.[19] A **qualified trade or business** is any business **except:[20]**

- Most types of professional services firms (law, accounting, engineering, architecture, and others in which the reputation or skill of employee(s) is a principal asset);
- Banking, insurance, financing, leasing, investing, or similar businesses;
- Any farming business (including a tree farm);
- Businesses that qualify for either the §§613 or 613A depletion deduction; and
- Hotels, motels, restaurants, and similar businesses.

In addition, the corporation's **gross assets cannot exceed $50 million.[21]**

SPECIAL CAPITAL GAINS ELECTION

An individual taxpayer may borrow money for the purpose of buying investment property. The interest paid on the debt is **investment interest,** which may be deductible.[22] In order for the interest to qualify for the deduction, **investment property** must be purchased, which is generally property that:

- Produces interest, dividends, annuities, or royalties not derived in the ordinary course of a trade or business;
- Produces a capital gain or loss from a sale of the property if held for investment; or
- Is a trade or business in which the taxpayer does not materially participate.

15. IRC §1202(a).

16. American Recovery and Reinvestment Act of 2009, PL 111-5.

17. Added by the Small Business Jobs Act of 2010, PL 111-240 (Sep. 27, 2010) and amended by the Tax Relief, Unemployment Insurance Reauthorization and Jobs Creation Act of 2010, PL 111-312 (Dec. 17, 2010).

18. IRC §§1202(c)(1) and 1202(e)(4).

19. IRC §1202(e).

20. IRC §§1202(e)(3)(A)–(E).

21. IRC §1202(d)(1).

22. IRC §§163(a) and (d).

The amount of interest the taxpayer can deduct within a given tax year depends on the amount of "net investment income" the taxpayer has within that year. Net investment income is determined by the following formula.[23]

Net investment income = Investment income – Investment expenses

Investment income consists of:

- Gross income from property held for investment, and
- Net gain from dispositions of property held for investment.

Investment expenses consist of deductions, other than interest, that are directly connected with the production of investment income.

Net investment income is the upper limit on the taxpayer's investment interest deduction for the year. Any excess amount not deductible carries forward for possible deduction in the following tax year[24] subject to the same limitation on deductibility. Therefore, the taxpayer can increase the amount of deductible investment interest paid in the year if the amount of investment income is increased. Increasing the amount of investment income results in higher net investment income and a higher upper limit on the year's deduction of investment interest. This can be accomplished by making a special tax election that can be used to:

- Treat some or all qualified dividend income recognized in the same year as investment income,[25] and
- Treat some or all net capital gains recognized in the year as investment income.[26]

If the election is made, the elected income is taxed at ordinary income rates rather than capital gain rates. This election is made using Form 4952, *Investment Interest Expense Deduction.* Once the election is made, it cannot be revoked without the IRS's consent.[27]

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> **Note.** The gain on §1202 stock does not qualify for the election.[28] In addition, this election must be made on or before the due date of the tax return.

23. IRC §163(d)(4)(A).

24. IRC §163(d)(2).

25. IRC §1(h)(11), as added by the Jobs and Growth Tax Relief Reconciliation Act of 2003, PL 108-27, §302(a) (May 28, 2003).

26. IRC §163(d)(4)(B)(ii).

27. Treas. Reg. §1.163(d)-1(c).

28. IRC §§1(h), 163(d)(4)(B), and 1202(a).

OFFSETTING LOSSES AGAINST GAINS

Under capital gains tax rules, capital losses can only be used to offset capital gains.[29] However, for taxpayers other than corporations, up to $3,000 of capital losses can be used as a deduction against ordinary income within each tax year.[30] Capital losses can be carried forward to future years for use against capital gains in those years.[31] Special tax calculations determine the amount of capital losses available for carry over to the succeeding tax year.[32]

> **Note.** Capital loss rules for **corporations** differ from those for individual taxpayers. A corporation **does not** have the ability to claim up to $3,000 of capital losses against ordinary income. In addition, a corporate capital loss not used within the current taxation year to offset capital gains must first be carried back and used against capital gains, if any, within the prior 3-year period. After this 3-year carryback, any remaining losses are carried over to subsequent tax years for use against future capital gains. There is a 5-year limit on the carryover to future years. Gains not used within the 3-year carryback or 5-year carryover periods expire.

TAXATION OF MUTUAL FUNDS AND STOCKS

It is essential to properly calculate an accurate **basis** figure for mutual fund shares and stock shares. This information is necessary to accurately calculate any gain or loss resulting from a sale of some or all of the shares held by the taxpayer. When a taxpayer has purchased various "batches" or "lots" of shares of the same stock or fund at different times and prices, various acceptable methods exist to arrive at a proper basis figure.

Taxpayers are generally responsible for developing, maintaining, and documenting accurate basis records. However, the IRS has been concerned about inaccuracies associated with taxpayer basis records and calculations. Accordingly, recent laws were enacted which shift this recordkeeping responsibility from the taxpayer to brokers and mutual fund companies.

DETERMINING BASIS

Generally, the taxpayer has two methods for determining basis in stocks or mutual fund shares.

1. The **single-category method**
2. The **double-category method**

Single-Category Method

The single-category method is calculated using the following two steps.

1. Add the total cost of all the shares held.
2. Divide the total cost by the number of shares held.

The single-category method places all shares of the mutual fund or stock in the same pool and results in an average per share basis.

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29. IRC §1211(b).
30. IRC §1211(b)(1).
31. IRC §1212(b).
32. IRC §1212(b)(2).

Example 15. Sam needs to know the basis in his shares of the Prudent Investor Fund because he sold 220 shares on August 17, 2011, for $8,800. Sam made the following share purchases in the Prudent Investor Fund.

Date	Number of Shares Purchased	Total Cost
Jan. 14, 2011	100	$ 2,700
Mar. 6, 2011	200	7,450
Nov. 11, 2011	150	5,600
Total	450	$15,750

On November 12, 2011, Sam's basis, using the single-category method, is calculated by dividing the total cost of all the shares he purchased in the fund ($15,750) by the number of shares held (450). This provides Sam's average per share basis. Sam's basis is $35 per share ($15,750 ÷ 450).

Also, on November 12, 2011, Sam sold 220 shares for $8,800. The proceeds per share are $40 ($8,800 ÷ 220). His capital gain per share is $5 ($40 proceeds − $35 basis). Total gain for the sale of 220 shares is $1,100 (220 shares sold × $5 per share gain). Because the shares were held for less than one year, this is a short-term capital gain. It is taxed at ordinary tax rates when Sam reports this gain on his return.

Note. IRC §1001(a) provides that the difference between proceeds and basis constitutes the gain or loss on the sale of property, which includes mutual fund shares and stocks.

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Example 16. Continuing with **Example 15,** Sam only has 230 shares remaining from the 2011 purchases. In addition, he purchases 140 shares on February 8, 2012, for $5,350 and 260 shares on July 6, 2012, for $6,840. He sells 100 shares on October 15, 2012, for $4,300. His 2011 and 2012 share purchases are as follows.

Date	Number of Shares Purchased	Total Cost
Jan. 14, 2011	100	$ 2,700
Mar. 6, 2011	200	7,450
Nov. 11, 2011	150	5,600
Nov. 12, 2011	(220)	(7,700)
Feb. 8, 2012	140	5,350
Jul. 6, 2012	260	6,840
Total	630	$20,240

Sam's per-share basis, calculated using the single-category method, is $32 ($20,240 total cost of shares purchased ÷ 630 shares). Per share proceeds from the 100 shares sold on October 15, 2012, are $43 ($4,300 proceeds ÷ 100 shares sold). The gain on the sale is $11 per share ($43 proceeds – $32 basis). Total gain on the sale of the 100 shares is $1,100 ($11 per share gain × 100 shares sold).

Note. Under the mutual fund tax rules that apply to the single-category method, Sam's $1,100 gain is characterized as an **$880 long-term gain and $220 short-term gain.** Shares are treated as sold on a "first-in, first-out" (FIFO) basis.[33] Accordingly, the 80 remaining shares he purchased on March 6, 2011, were held longer than one year prior to their October 15, 2012, sale. The remaining 20 shares are from the November 11, 2011, purchase and are short term.

33. Treas. Reg. §1.1012-1(e)(7)(ii).

Double-Category Method

The double-category method can also be used to determine basis. While the single-category method places all shares of a particular mutual fund into one pool and averages the basis, the double-category method uses **two** pools. Long-term shares (held for more than a year) are kept in one pool and short-term shares (held for one year or less) are kept in the other. Each pool's average per share basis is calculated in the same manner as the single-category method described in the previous section.

After one year and one day has elapsed since the acquisition of any shares in the short-term pool, those shares become long-term shares and are transferred to the long-term pool. The long-term pool's average basis is subsequently recalculated. Shares are sold from each pool on a FIFO basis. However, when the taxpayer sells shares, the sale of either long-term shares or short-term shares can be specified.

Other Methods

There are other methods that are often referred to as ways to determine basis. However, these methods are essentially **ordering rules** that reflect which shares are sold first if a taxpayer sells less than their entire holding of a particular mutual fund or stock. The actual basis in the shares is determined by the purchase price of those shares and any adjustments to that basis.

Specific Lot Identification. The taxpayer may purchase an initial "batch" (or "lot") of shares in a stock or mutual fund and subsequently purchase additional batches at later points in time. Because market prices continually change, each batch of shares purchased by the taxpayer is likely to have been purchased at different share prices. Specific lot identification (SLID) allows the shareholder to specifically identify which batch of shares they are selling. The basis used in any gain or loss calculation is the specific price paid for the batch of shares identified by the taxpayer as sold.

Example 17. Joseph makes separate lot purchases of stock in XYZ Diamond Mining, Inc., at the following times.

Purchase Date	Number of Shares	Total Price Paid	Price Per Share
Jan. 2, 2012	200	$2,000	$10
Jul. 6, 2012	100	1,100	11
Sep. 18, 2012	100	900	9
Nov. 22, 2012	100	800	8
Total	500	$4,800	

Joseph keeps records of the different dates and prices of each purchase. Shortly before the end of the year, Joseph needs some cash and decides to sell 100 XYZ Diamond Mining, Inc., shares which he bought earlier in the year. Because this involves the sale of capital property held for one year or less, Joseph knows that the sale results in a short-term gain taxable at ordinary rates. Under the SLID method, he can specifically designate the 100 shares purchased on July 6, 2012, as the 100 shares sold. He can use his basis of $1,100 (or $11 per share) against the proceeds. Joseph selects these higher-basis shares because it reduces his tax liability on the short-term capital gain.

FIFO. The first-in, first-out (FIFO) ordering rule requires the shares first purchased to be designated as those sold.

Example 18. Use the same facts as **Example 17,** except Joseph uses the FIFO method. Accordingly, the 100 shares he sold are taken from his initial lot purchase on January 2, 2012. He uses a basis of $10 per share (which is $1,000 on his 100 shares sold) in the calculation of the gain or loss.

LIFO. The last-in, first-out (LIFO) ordering rule requires the latest shares purchased to be designated as those sold.

Example 19. Use the same facts as **Example 17,** except Joseph uses the LIFO method. Accordingly, the 100 shares he purchased in November, which are the latest shares purchased, are designated as the shares sold. Joseph's basis used in the calculation of the gain or loss on the sale is $800.

Highest-In, First-Out. Under the highest-in, first-out method (HIFO), all shares purchased are ranked from highest basis to lowest basis. The highest-basis shares are designated as the shares sold first.

> **Example 20.** Use the same facts as **Example 17,** except Joseph sells 200 shares and uses the HIFO method for determining his basis. Of the 200 shares sold, the first 100 shares sold are designated as the shares Joseph purchased in July because these shares have the highest basis. These shares have a basis of $1,100.
>
> The remaining 100 shares sold are designated as taken from the lot Joseph purchased in January because these shares have the next highest basis. These 100 shares purchased in January have a basis of $1,000 ($10 per share × 100 shares). Joseph is left with the 100 remaining January shares and the other lots purchased in September and November.

Loss/Gain Utilization Method. This method strategically evaluates which shares are in a loss position and which shares are in a gain position based on the anticipated per share sale price. In order to minimize taxes, share lots with the largest loss positions are depleted first. Share lots with the largest gain positions are depleted last. To further minimize taxes under the capital gains tax rules, loss shares are depleted such that short-term loss lots are depleted before long-term lots. Long-term gain lots are depleted before short-term gain lots.

Wash Sales

A capital loss is not allowed when the taxpayer acquires the same (or substantially the same) security either:

- Within a 30 day "**look-back**" period before the date of a sale of that security, or
- Within a 30 day "**look-forward**" period after the date of a sale of that security.[34]

The look-back and look-forward periods consist of calendar days, not trading days. The 30-day duration prevails despite the intervening end of a calendar year or fiscal year. Entering into a contract or purchasing options to acquire the same, or substantially the same security also results in loss nonrecognition.[35] A capital gain from a sale within the 30-day look-back or look-forward period, however, is recognized.

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The amount of loss that is disallowed serves as an upward adjustment to the basis of the new shares acquired within the look-back or look-forward periods.[36]

> **Example 21.** On June 6, 2010, Melinda purchased 100 shares of Conservation Industries, Inc., for $100 per share. On December 15, 2011, she sells her 100 shares at $60 per share for a loss of $40 per share. However, she later hears good news about a major new project Conservation Industries is successfully implementing. She believes the stock has substantial growth potential again and purchases 100 shares on January 12, 2012. The purchase price is $83 per share.
>
> Melinda's January 12, 2012, share purchase was within the 30-day look-forward window under the wash sale rules. Her initial loss of $40 per share is not recognized. However, Melinda is allowed to add the $40 per share disallowed loss to her basis in the new stock she acquired on January 12, 2012. The newly acquired shares have an adjusted cost basis of $83 per share (the actual purchase price) plus the $40 per share disallowed loss, for a total of $123 per share. If Melinda later sells her Conservation Industries shares for $125, she will report only $2 per share of capital gain. The holding period of the stock on which the loss was disallowed is tacked onto Melinda's holding period of the new shares bought on January 12, 2012. Accordingly, the new shares are treated as being held since June 6, 2010.[37]

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34. IRC §1091(a).
35. Ibid.
36. IRC §1091(d).
37. IRC §1223(3).

For multiple loss sales, the wash sale loss disallowance provision is applied beginning with the earliest loss sale. The first loss sale is fully applied before the next loss sale is applied. If the number of newly acquired shares purchased within the look-back or look-forward period is less than the number of shares sold at a loss, the loss is disallowed to the extent of the number of the newly acquired shares.[38] If the number of newly acquired shares is greater than or equal to the number sold at a loss, the entire loss is disallowed.[39]

Example 22. Trevor made the following transactions with Oxford Steel Fabricating, Inc., stock during 2012.

Date	Transaction
February 6	Buy 500 shares
August 2	Buy 500 shares
August 15	Sell 200 shares at a loss
August 25	Sell 350 shares at a loss
August 30	Buy 60 shares

On August 15 and 25, Trevor sells 550 of the original 1,000 shares at a loss.

Step 1. The earliest loss sale on August 15 is applied first against any acquisitions made in the 30-day look-back and look-forward window. The August 15 sale of these 200 shares is matched against 200 of the August 2 shares purchased within the 30-day look-back window.

Step 2. The entire August 15 capital loss is therefore disallowed and 200 of the 500 shares purchased on August 2 receive an increased basis adjustment by the amount of the disallowed loss. This leaves the remaining 300 shares purchased on August 2 with an original basis that is unaffected.

Step 3. The August 25 loss is applied. Of the 350 August 25 shares sold at a loss, 300 of them are matched against the 300 August 2 shares that were unaffected from the first loss application.

Step 4. Accordingly, the remaining 300 August 2 shares have an increased basis adjustment by the amount of loss disallowed on the sale of 300 of the 350 shares sold on August 25.

Step 5. The remaining 50 August 25 shares that were sold at a loss are matched against 50 of the 60 shares purchased on August 30.

Step 6. Therefore, 50 of the August 30 shares have an increase in basis by the amount of disallowed loss on the 50 August 25 shares. The entire August 25 loss is disallowed.

If the newly acquired shares are purchased in a traditional or Roth IRA, a corresponding loss is disallowed but there is no increased basis adjustment in the newly acquired shares.[40]

38. IRC §1091(b).

39. IRC §1091(c).

40. Rev. Rul. 2008-5, 2008-3 IRB 271.

New Mandatory Basis Reporting

New basis rules for **stocks** and for **mutual fund shares** apply to tax years beginning after October 18, 2010. The new rules are phased in from 2011 through 2013. These rules are summarized as follows.

- **Stocks** purchased on or after **January 1, 2011,** are considered **covered securities**. Brokers must prepare an information return (typically a Form 1099-B) that reports gross sale proceeds, the customer's cost basis, and whether the gain is long- or short-term.
- **Mutual fund shares** purchased on or after **January 1, 2012,** are considered covered securities, and broker and mutual fund companies must prepare similar detailed information returns showing gross proceeds, cost basis, and whether any gain is long- or short-term.[41]
- **Other securities,** such as options and bonds, become covered on **January 1, 2013.**
- Qualified retirement accounts and money market funds are not considered covered under the new rules.
- The double-category method of calculating basis is **eliminated** for covered stocks and mutual fund shares.
- The broker or mutual fund company selects a default method for basis determination.[42]
- The taxpayer can elect to use one of several other methods to determine basis instead of the default method by notifying the agent or custodian holding the shares.[43]

Note. For stocks purchased before January 1, 2011, and mutual fund shares purchased before January 1, 2012 ("uncovered" securities, which do not fall under the new rules), taxpayers continue to be responsible for accurate basis information. The new rules address an IRS concern about inaccurate taxpayer basis records or calculations regarding investments and capital gain calculations. The new rules shift this responsibility to brokers and mutual fund companies for covered securities. **However, taxpayers should continue to maintain their own basis records.**

The taxpayer making an election to use a method other than the broker's default method must provide notice to the agent or custodian in writing. A range of methods are available to the taxpayer holding stocks or mutual fund shares. The particular methods offered may vary across brokerage firms. The methods available are those permissible for stock or mutual funds under IRC §1012. Such methods generally include average cost, FIFO, LIFO, HIFO, and SLID, as previously described.

Note. It is expected that most brokers and mutual fund companies will make either the single-category method or the FIFO method the default method for basis calculation because of the simplicity of these two methods. Brokerage firms may have different notice and time requirements for the selection of a specific basis method and should be contacted prior to an anticipated sale to ensure sufficient notice is given.

Basis is determined for each separate account.[44] Generally, stock acquired before January 1, 2012, that is eligible for the average cost method is treated as being in a separate account from stock acquired on or after that date. A mutual fund company, however, can elect to treat all shares as a single account regardless of the acquisition date.[45]

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41. IRC §6045(g), as added by the Emergency Economic Stabilization Act of 2008, PL 110-343 (Oct. 8, 2008).
42. Treas. Reg. §1.1012-1(e)(2)(i).
43. Treas. Reg. §1.1012-1(e)(1).
44. IRC §1012(c)(1).
45. IRC §1212(c)(2).

For stock shares for which the taxpayer has used the double-category method, a transition rule applies because of the elimination of the double-category method. The taxpayer must recalculate basis on such shares using the average cost method on **April 1, 2011,** regardless of the holding period of the shares.[46] The double-category method can no longer be used for shares sold, exchanged, or otherwise disposed of on or after April 1, 2011.

Note. The above summary of the new basis rules applies to mutual funds. The new rules regarding stock and mutual fund basis are complex. Further guidance is found in Treas. Reg. §1.1012-1.

Revised Form 1099-B for Mandatory Basis Reporting. In order to facilitate broker and mutual fund reporting of taxpayer basis for covered securities, the IRS has substantially revised Form 1099-B. The revised Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions,* has several boxes dedicated to mandatory basis reporting. This includes the taxpayer's basis (box 3), type of gain or loss (short-term or long-term) (box 1c), and any wash sale losses disallowed (box 5) for the tax year.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.	**1a** Date of sale or exchange **1b** Date of acquisition **1c** Type of gain or loss Short-term ☐ Long-term ☐	OMB No. 1545-0715 **2012** Form **1099-B**		**Proceeds From Broker and Barter Exchange Transactions**
		1d Stock or other symbol		**1e** Quantity sold
PAYER'S federal identification number / RECIPIENT'S identification number	**2a** Stocks, bonds, etc. $	Reported to IRS ☐ Sales price ☐ Sales price less commissions and option premiums		**2b** If box checked, loss based on amount in 2a is not allowed ☐
RECIPIENT'S name	**3** Cost or other basis $	**4** Federal income tax withheld $		**Copy B For Recipient**
Street address (including apt. no.)	**5** Wash sale loss disallowed $ **7** Bartering $	**6** Checked if: **a** ☐ Noncovered security **b** ☐ Basis reported to IRS		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.
City, state, and ZIP code	**8** Description			
Account number (see instructions) / 2nd TIN not. ☐	**9** Profit or (loss) realized in 2012 on closed contracts $	**10** Unrealized profit or (loss) on open contracts—12/31/2011 $		**13** State **14** State identification no.
CUSIP number	**11** Unrealized profit or (loss) on open contracts—12/31/2012 $	**12** Aggregate profit or (loss) on contracts $		**15** State tax withheld $

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46. Treas. Reg. §1.1012-1(e)(7)(iii).

BROKERAGE FEES, COMMISSIONS, AND OTHER COSTS

Generally, investment fees and expenses, tax advice fees, and other costs associated with the production or collection of investment income are deductible as itemized expenses. These fees and costs are subject to the 2%-of-adjusted-gross-income limit.[47] These costs include legal fees associated with investments and service charges associated with dividend reinvestment programs.[48]

However, commissions incurred on the sale or purchase of mutual fund shares are generally netted from the basis or proceeds amounts. Therefore, the commissions are already deducted when any gain or loss is calculated.

Example 23. Monica buys 100 Class A shares of the Large Cap Value mutual fund at $45 per share. Her total purchase price of $4,500 includes a 4% load (commission). She panics and sells the 100 shares for $35 per share one month later. The fund charges a 2% short-term trading fee if shares are not held at least 90 days. Monica's short-term capital loss on the sale is **$1,070** as shown below.

Gross sales price (100 shares × $35)	$3,500
Less: short-term trading fee ($3,500 × 2%)	(70)
Net sales price (Box 2a, Form 1099-B)	$3,430
Less: purchase price	(4,500)
Monica's short-term capital loss	**($1,070)**

Note. The deduction of brokerage fees and commissions in this netting fashion is commonly accepted and frequently reconciles transaction amounts with those shown on Form 1099-B. However, IRS Pub. 529, *Miscellaneous Deductions*, suggests that brokerage fees, commissions, and other service charges are deductible only on Schedule A and are subject to the 2%-of-AGI threshold.

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DIVIDEND REINVESTMENT PROGRAMS

Many mutual funds offer the investor the option of reinvesting the distributions received. Some publicly listed companies also offer such programs to stockholders. This is accomplished by using a dividend reinvestment program (DRP).

Even though some or all of a distribution is reinvested in the mutual fund to purchase additional shares, the distribution is still reported on Form 1099-DIV (or Form 1099-INT for any interest component of the distribution). The distribution is taxable to the investor despite the reinvestment of the distribution.

Example 24. Sarina invests $100 per month into the GreatFund Dow 30 Index Fund for 24 months. After 24 months, her regular $100 monthly investment has purchased a total of 324 shares in the fund. During the 24 months, the fund made a distribution to Sarina in the amount of $230. Sarina elected to participate in the fund's DRP. The $230 distribution is used to purchase an additional 30 shares. After 24 months, Sarina holds 354 shares (324 shares from regular monthly investment + 30 DRP shares).

Sarina's total basis in her 354 shares is $2,630. This is the total of her regular monthly investment of $2,400 ($100 per month × 24 months) plus the $230 distribution reinvested using the DRP. She is taxed on the $230 distribution in the year it is distributed to her. Sarina's per share basis is $7.43 ($2,630 ÷ 354) using the average basis method.

47. IRS Pub. 529, *Miscellaneous Deductions* pp. 8–9 (2010).

48. Ibid.

Fees, Charges, and Discounts

The terms and conditions of many DRP programs include the following.

- Discounts from the market price of shares
- Fees or charges are paid by the DRP
- The DRP charges the investor a fee or charge for purchases

The amount of any discount provided by the DRP is treated as a dividend and taxed to the DRP participant. Similarly, the amount of any fee or charge, such as a brokerage fee, that is paid by the DRP is treated as a taxable dividend.

The basis in DRP shares is calculated using the following formula:

	Amount paid for shares
+	Amount taxed to the investor as a dividend
−	Amount deducted as a service charge
	Basis in DRP shares

Brokerage fees and service charges, such as account fees, decrease basis because these are miscellaneous investment expenses that are subject to the 2%-of-AGI threshold and reported on Schedule A.

Example 25. Christophe owns stock in Associated Barcoding Company. He participates in the DRP. The DRP offers a 5% discount on stock purchases, because the DRP purchases stock directly from the company. The DRP does, however, assess an account fee of $10, which is charged with each quarterly stock purchase. Christophe receives a $100 dividend. The dividend is used to purchase additional company shares. Because there is a 5% discount, Christophe is credited with $105 of stock. He is taxed on the original dividend of $100. The additional $5 discount is also taxed as a dividend to Christophe.

The $10 fee reduces basis because it is an account fee that may be deductible to Christophe on Schedule A, subject to the 2%-of-AGI limitation, instead of being included in Christophe's basis. Christophe's total basis in these DRP shares is:

Price originally paid	$100
Plus: amount taxed as a dividend (discount amount)	5
Less: service charge	(10)
Basis	$ 95

MUTUAL FUND TAXATION

The annual taxation of **mutual funds** is determined by taxable activity that may occur at either or both of two levels.

- The **taxpayer level,** when the taxpayer buys and sells some or all of the shares held
- The **fund level,** when the fund manager makes changes with the various investments held within the fund and the tax ramifications of those changes flow through to the taxpayer-investor that holds shares

Taxpayer-Level Taxation

Taxation at the taxpayer level refers to the taxpayer purchasing and selling mutual fund units at various prices. This results in capital gains or losses as discussed in the earlier section regarding share basis determination. This level of taxation is analogous to the taxpayer's tax liability that arises from the purchase and sale of individual stocks. However, unlike individual stocks, mutual funds are pooled investments.

Fund-Level Taxation

It is common for a mutual fund manager to make changes within the particular mix of investments held by a particular mutual fund. When the fund manager disposes of investments within the fund, gains or losses are triggered that pass through to the investor. The fund can also make various types of distributions. These distributions may be taxable to the investor depending on the type of distribution the taxpayer receives.

These distributions are generally reported on Form 1099-DIV, *Dividends and Distributions*. The following Form 1099-DIV indicates the particular boxes in which most mutual fund distributions of various types are reported.

☐ CORRECTED (if checked)

PAYER'S name, street address, city, state, ZIP code, and telephone no.		**1a** Total ordinary dividends $ **1b** Qualified dividends $	OMB No. 1545-0110 2012 Form **1099-DIV**	**Dividends and Distributions**
		2a Total capital gain distr. $	**2b** Unrecap. Sec. 1250 gain $	**Copy B** **For Recipient**
PAYER'S federal identification number	RECIPIENT'S identification number	**2c** Section 1202 gain $	**2d** Collectibles (28%) gain $	
RECIPIENT'S name		**3** Nondividend distributions $	**4** Federal income tax withheld $	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.
			5 Investment expenses $	
Street address (including apt. no.)		**6** Foreign tax paid $	**7** Foreign country or U.S. possession	
City, state, and ZIP code		**8** Cash liquidation distributions $	**9** Noncash liquidation distributions $	
Account number (see instructions)		**10** Exempt-interest dividends $	**11** Specified private activity bond interest dividends $	
		12 State | **13** State identification no.	**14** State tax withheld $	

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Ordinary Dividends (Box 1a). The total of all taxable distributions that are **not** treated as **long-term** capital gains fall under this category. This includes distributions consisting of interest, qualified dividends, and nonqualified dividends. Short-term capital gains distributions are also reported in this total. Accordingly, the amount reported in **Box 1a** can constitute various types of distributions that are characterized differently for tax purposes.

Qualified Dividends (Box 1b). The portion of any dividend distribution that qualifies for the 0% or 15% tax rate is reported here. Although the amount of qualified dividends is part of the total distribution amount reported in **Box 1a,** the amount of qualified dividends is shown separately in **Box 1b.**

> **Note.** The favorable 0% and 15% tax rates for qualified dividends are scheduled to expire at the end of 2012.

A qualified dividend is a dividend that meets the following requirements.

- It is issued by either a U.S. corporation or a "qualified foreign corporation."
- The taxpayer meets the holding period requirements for the underlying shares.

A **qualified foreign corporation** is a corporation that meets any of the following criteria.

- The corporation is **incorporated in a U.S. possession.**
- The corporation is in a country that the IRS has determined has a satisfactory tax treaty.
- The dividend was paid in connection with stock that is listed on a **major U.S. stock exchange.**

The IRS publishes a list of acceptable U.S. stock exchanges and a list of countries that have tax treaties that are deemed sufficient for purposes of the qualified dividend rules. These lists are found in IRS Pub. 550, *Investment Income and Expenses.*

Note. Mutual funds that hold stocks issuing qualified dividends generally pass those dividends on to the individual mutual fund investors. When the individual investors receive the dividends, the dividends retain their character as qualified dividends as long as the investor meets the holding period requirements. The mutual fund company generally keeps a record of the amount of dividends received from U.S. or qualified foreign corporations that can be qualified dividends to investors who meet the holding period requirements.

In order for a dividend to be a qualified dividend and receive capital gains tax treatment, the taxpayer must hold the underlying shares for **more than** 60 days during the 121-day period that begins 60 days prior to the "ex-dividend date" of the stock.

The **ex-dividend date** is the first day that the stock can be sold by the holder without losing the right to receive the next upcoming dividend that has been declared by the corporation's board of directors. When the board of directors declares a dividend on corporate stock, the ex-dividend date is established. The ex-dividend date is normally two **business days** before the **record date,** which is the date the stockholder must be listed as a share owner in the corporation's records in order to receive the dividend.

Example 26. The fund manager of MegaDiversified Industrial Fund declares a dividend on May 17, 2012, and announces that all shareholders of record on the fund's books on or before April 17, 2012, are entitled to receive the dividend. Because April 17, 2012, is the record date, the ex-dividend date is two business days before April 17, 2012. April 17, 2012, is a Tuesday. Therefore, the ex-dividend date is the preceding Friday, which is April 13, 2012. Any shareholder purchasing MegaDiversified Industrial shares on April 13 or after does not receive the dividend.

Note. To calculate the shareholder's holding period, the share purchase date is not counted but the date that the shares are sold is counted.

Example 27. Use the same facts as **Example 26.** Seymour purchased his MegaDiversified Industrial Fund shares on March 15, 2012. He sells his shares on May 8, 2012. In order for the dividend to be a qualified dividend, the shareholder must hold the shares for more than 60 days within the 121-day period commencing 60 days before the ex-dividend date. This 121-day period begins on February 13, 2012, and ends on June 12, 2012. Because Seymour only held his shares for 54 days within this 121-day period, his dividend is not a qualified dividend. The dividend must be reported and taxed as an ordinary dividend.

In order for his dividend to be a qualified dividend, Seymour must hold his shares until May 15, 2012. On May 15, 2012, Seymour's holding period is 61 days. This fulfills the holding period requirement.

Example 28. Use the same facts as **Example 27.** Despite Seymour selling his shares on May 8, 2012, which precluded his dividend from being a qualified dividend, MegaDiversified Fund sends Seymour a letter indicating that the dividend declared on May 17, 2012 was $0.10 per share and that $0.08 per share of this dividend constituted a qualified dividend. Seymour's total dividend was $1,000. The letter was accompanied by Seymour's Form 1099-DIV for the 2012 taxation year, which shows total ordinary dividends of $1,000 and qualified dividends of $800. Even though Seymour's Form 1099-DIV shows qualified dividends, those dividends are not qualified because Seymour did not meet the holding period requirements. The entire $1,000 dividend is taxed as an ordinary dividend.

Capital Gains Distributions (Box 2a). A mutual fund may realize long-term capital gains from the sale of investments. To the extent that long-term capital gains are realized, the fund can designate part or all of a distribution to its investors as a "capital gain distribution." The taxpayer reports this capital gain distribution (sometimes called a "capital gain dividend") just like any other long-term capital gain.

The tax treatment of the long-term gain to the taxpayer depends on the application of the long-term capital gains taxation rules to that investor as discussed earlier in this chapter. If the taxpayer's income is in the lower two brackets, the favorable 0% tax rate applies as it would with other long-term capital gains. Capital gain distributions that qualify for this tax treatment are reported in Form 1099-DIV, **box 2a.**

Observation. Long-term capital gains received by the mutual fund are generally passed through to the investor as long-term capital gains. The nature of the income to the fund retains its character when it is passed through to the investor. This is also true with qualified dividends and other types of income that the mutual fund distributes to the investor.

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Unrecaptured §1250 Gain (Box 2b). Unrecaptured §1250 gain was discussed earlier in this chapter. A mutual fund may realize this type of gain on the sale of depreciated real estate. This gain is passed through from the mutual fund to individual investors. The investor pays any tax associated with this gain. Form 1099-DIV, **box 2b,** indicates the amount the investor must report.

Note. Depreciation recapture on §1250 property is discussed earlier in this chapter and was also covered in detail in Chapter 6 of the 2011 *Federal Tax Fundamentals* workbook.

Nondividend Distributions (Box 3). A nondividend distribution occurs when the mutual fund distributes to the investors some or all of the original amount invested in the fund. When this occurs, the taxpayer's share of the nondividend distribution (sometimes called a "return of capital" distribution) is reported on Form 1099-DIV in **box 3.** This amount is not taxable but does require the taxpayer to make a downward adjustment in share basis.

The steps required to make this downward adjustment in share basis depend on the method used by the taxpayer to track basis. For a taxpayer that uses the single-category averaging method, basis is adjusted by subtracting the amount shown in Form 1099-DIV, box 3, from the total basis in the mutual fund shares before the nondividend distribution.

Tax-Exempt Interest Distribution

A mutual fund that invests in municipal bonds is an example of a type of mutual fund that distributes tax-exempt interest to investors. Mutual funds report tax-exempt interest on Form 1099-INT, **box 8.** The taxpayer reports this amount on line 8b of Form 1040, *U.S. Individual Income Tax Return,* along with any other tax-exempt interest received during the year.

Note. Although the taxpayer does not pay federal tax on this exempt income, it counts as income in the calculations for tax liability on social security income. Moreover, the taxpayer cannot deduct expenses associated with generating tax-exempt interest.

January Dividends

A mutual fund dividend paid in January is deemed to have been paid to investors on December 31 of the immediately preceding tax year if:

- The dividend is declared in the last three months of the preceding tax year,
- The record date is in the last three months of the preceding tax year, and
- The dividend is actually paid before January 31 of the tax year.

Because these "January dividends" relate to December 31 of the preceding tax year, they are reported on the investor's Form 1099-DIV for that preceding tax year along with any other dividends received in that year.

SCHEDULE D OVERVIEW

The new mandatory basis reporting rules mentioned earlier in this chapter resulted in a substantial 2011 revision of Form 1099-B. In addition, the following major changes were made for the 2011 taxation year onward.

- The IRS created the new Form 8949, *Sales and Other Dispositions of Capital Assets.*
- Schedule D, *Capital Gains and Losses,* was substantially revised.

For the 2011 taxation year and subsequent years, all security sales fall into one of three categories that reflect the new mandatory basis reporting rules.

1. Sales of covered securities for which cost basis is provided
2. Sales of noncovered securities for which no cost basis information is provided on a Form 1099-B that was issued in connection with the sale
3. Sales of an investment for which there is no Form 1099-B

Detailed information on investment sales is no longer provided on Schedule D. Details are instead shown on the new Form 8949. A separate, 2-page Form 8949 is used by the taxpayer for each of the above categories of transactions.

Form **8949**

Department of the Treasury
Internal Revenue Service (99)

Sales and Other Dispositions of Capital Assets

▶ See Instructions for Schedule D (Form 1040).
▶ For more information about Form 8949, see *www.irs.gov/form8949*
▶ Attach to Schedule D to list your transactions for lines 1, 2, 3, 8, 9, and 10.

OMB No. 1545-0074
2011
Attachment Sequence No. **12A**

Name(s) shown on return | **Your social security number**

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

Note: You **must** check **one** of the boxes below. Complete a *separate* Form 8949, page 1, for **each** box that is checked.

***Caution.** Do not complete column (b) or (g) until you have read the instructions for those columns (see the Instructions for Schedule D (Form 1040)). Columns (b) and (g) do not apply for most transactions and should generally be left blank.

☐ **(A)** Short-term transactions reported on Form 1099-B with basis reported to the IRS ☐ **(B)** Short-term transactions reported on Form 1099-B but basis not reported to the IRS ☐ **(C)** Short-term transactions for which you cannot check box A or B

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Code, if any, for column (g)*	(c) Date acquired (Mo., day, yr.)	(d) Date sold (Mo., day, yr.)	(e) Sales price (see instructions)	(f) Cost or other basis (see instructions)	(g) Adjustments to gain or loss, if any*
1							

Form 8949 (2011) Attachment Sequence No. **12A** Page **2**

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

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

Note: You **must** check **one** of the boxes below. Complete a *separate* Form 8949, page 2, for **each** box that is checked.

***Caution.** Do not complete column (b) or (g) until you have read the instructions for those columns (see the Instructions for Schedule D (Form 1040)). Columns (b) and (g) do not apply for most transactions and should generally be left blank.

☐ **(A)** Long-term transactions reported on Form 1099-B with basis reported to the IRS ☐ **(B)** Long-term transactions reported on Form 1099-B but basis not reported to the IRS ☐ **(C)** Long-term transactions for which you cannot check box A or B

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Code, if any, for column (g)*	(c) Date acquired (Mo., day, yr.)	(d) Date sold (Mo., day, yr.)	(e) Sales price (see instructions)	(f) Cost or other basis (see instructions)	(g) Adjustments to gain or loss, if any*
3							

The results shown on the taxpayer's Forms 8949 then flow to Schedule D, which was revised to accommodate and summarize the detailed data from the taxpayer's Forms 8949.

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 Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.

OMB No. 1545-0074
2011
Attachment Sequence No. 12

Name(s) shown on return | Your social security number

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

Complete Form 8949 before completing line 1, 2, or 3. This form may be easier to complete if you round off cents to whole dollars.	(e) Sales price from Form(s) 8949, line 2, column (e)	(f) Cost or other basis from Form(s) 8949, line 2, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 2, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
1 Short-term totals from all Forms 8949 with box A checked in Part I		( )		
2 Short-term totals from all Forms 8949 with box B checked in Part I		( )		
3 Short-term totals from all Forms 8949 with box C checked in Part I		( )		

4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4	
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5	
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your **Capital Loss Carryover Worksheet** in the instructions	6	( )
7 **Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back	7	

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

Complete Form 8949 before completing line 8, 9, or 10. This form may be easier to complete if you round off cents to whole dollars.	(e) Sales price from Form(s) 8949, line 4, column (e)	(f) Cost or other basis from Form(s) 8949, line 4, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 4, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
8 Long-term totals from all Forms 8949 with box A checked in Part II		( )		
9 Long-term totals from all Forms 8949 with box B checked in Part II		( )		
10 Long-term totals from all Forms 8949 with box C checked in Part II		( )		

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 the instructions	13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (h). Then go to Part III on the back	15	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H **Schedule D (Form 1040) 2011**

Note. For more detailed information on Form 8949 and Schedule D, see 2012 Volume B, Chapter 4: Information Reporting. That chapter includes an example with filled-in forms.

STATE AND LOCAL BOND INTEREST

Interest earned on a state or local bond is generally excluded from income.[49] However, there are some exceptions to this general rule as explained below.

PRIVATE ACTIVITY BONDS

When proceeds of a state or local bond are used to finance a **private project** rather than a public project, the bond is called a **private activity bond.** Bonds that meet one of three tests outlined in IRC §141 are deemed private activity bonds.

There are two types of private activity bonds.

- **Taxable —** Interest from private activity bonds is taxable[50] as regular interest income because the proceeds are not being used for a traditional public purpose.
- **Tax exempt —** A private activity bond may be a **qualified** private activity bond which **allows** for tax-exempt interest income.[51]

The types of private activity bonds that can be qualified are listed in IRC §141(e)(1). These types of bonds include exempt facility bonds, qualified mortgage bonds, and veteran's mortgage bonds. In order for these types of private activity bonds to be qualified, they must also meet the volume cap limitations of IRC §146 and other requirements outlined in IRC §147.

> **Note**. Each state and U.S. possession has an annual limit on the maximum amount of tax-exempt bonds that can be issued. This amount, calculated annually for each state, is based on each state's population. This limitation is referred to as the **"volume cap."** Under IRC §146, bonds issued in excess of the volume cap do not receive tax-exempt status.

ARBITRAGE BONDS

If at the time a state or local bond is issued it is reasonably expected that part or all of the proceeds will be used directly or indirectly to acquire higher yielding investments or replace funds already used to do so, then the bond is called an **arbitrage bond.**[52] A bond is also classified as an arbitrage bond if any of the proceeds are intentionally used for these purposes.[53] The exclusion for tax-exempt interest for state and local bonds does not apply to an arbitrage bond.[54]

49. IRC §103(a).
50. IRC §103(b)(1).
51. Ibid.
52. IRC §148(a).
53. Ibid.
54. IRC §103(b)(2).

BONDS NOT IN REGISTERED FORM

Bonds that meet any of the following three criteria are not **registration-required** bonds.

- Bonds that are not of a type offered to the public[55]
- Bonds that have a maturity of one year or less[56]
- Bonds that have reasonable arrangements in place ensuring sales only to non-U.S persons (Interest must be paid only outside the United States and the bonds must have a notation on the bond's face indicating that a U.S. person holding the bond is subject to U.S. tax law limitations.[57])

State or local bonds that do not meet at least one of the above three criteria are registration-required bonds and must be in **registered form** in order for the interest to be tax exempt.[58] Bonds are in registered form if the issuer meets certain issuing or book-entry requirements to sufficiently identify bondholders through initial and secondary sales.[59]

FEDERALLY GUARANTEED BONDS

Interest income is **taxable** if generated from bonds that carry a federal guarantee.[60] If the proceeds of a bond issue are invested directly or indirectly into federally insured deposits or accounts, the bond issue is treated as having a federal guarantee.[61] However, the Code provides some exceptions to this general rule,[62] which include guarantees by the Federal Housing Administration,[63] federal student loan guarantees,[64] temporary investment of proceeds,[65] and bonds used in specific housing programs.[66]

SUBCHAPTER S CORPORATE DISTRIBUTIONS

8

An accurate basis amount is needed in order to prepare tax returns for corporate shareholders. When transactions occur throughout the year, the basis figure from the prior year must be adjusted to arrive at an appropriate basis figure for the current year. It is the taxpayer's responsibility to calculate accurate basis amounts and maintain appropriate documentation of those calculations.

Basis is important because it is used to determine:

- How a distribution from a corporation is taxed to the shareholder,
- How much of an S corporation loss allocated to the taxpayer on a Schedule K-1 can be deducted by that taxpayer within the taxation year, and
- How the taxpayer is taxed on disposition of part or all of their corporate shares.

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55. IRC §149(a)(2)(A).
56. IRC §149(a)(2)(B).
57. IRC §149(a)(2)(C).
58. IRC §149(a)(1).
59. See Temp. Treas. Reg. §5f.103-1(c).
60. IRC §149(b).
61. The Deficit Reduction Act of 1984, PL 98-369, §631(c)(2).
62. IRC §149(b)(3).
63. IRC §149(b)(3)(A)(i).
64. IRC §149(b)(3)(A)(ii).
65. IRC §149(b)(3)(B)(i).
66. IRC §149(b)(3)(C).

Note. For a detailed discussion on initial shareholder basis at the inception of the business and the annual adjustments necessary to update the basis figure for each year, see Chapter 5, Schedule K-1, in the 2011 *Federal Tax Fundamentals* workbook. A discussion of basis, the at-risk and passive activity loss rules, and their impact on the taxpayer's annual loss deduction are also covered.

Note. See pages 182–190 in the 2009 *University of Illinois Federal Tax Workbook* for a thorough discussion of how to calculate basis of stock for closely-held corporate shareholders. This can be found at **www.TaxSchool.illinois.edu/taxbookarchive.**

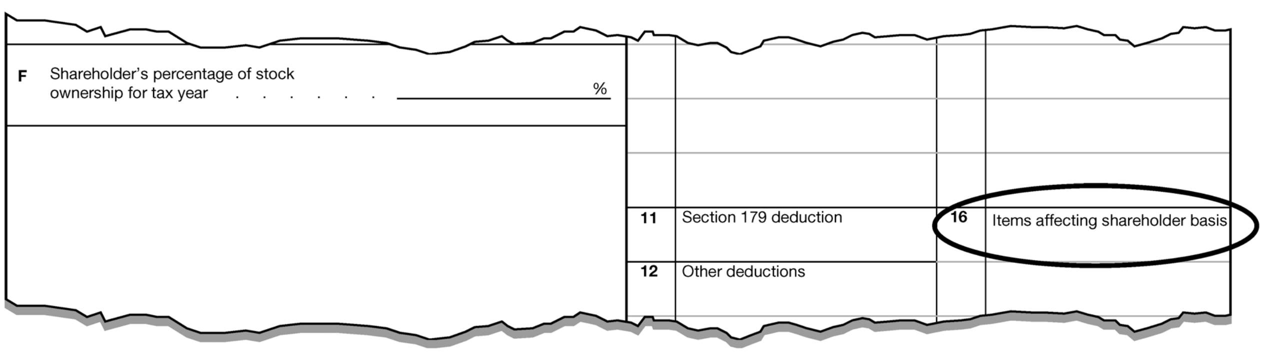
SHARE BASIS AND LOAN BASIS

The relevant time at which basis is calculated for the tax year is generally at the end of the corporation's tax year.[67] The shareholder's total basis is comprised of both stock basis and loan basis.

Note. The rules for reducing and restoring share and loan basis are found in Chapter 5, Schedule K-1, of the 2011 *Federal Tax Fundamentals* workbook. In addition, Treas. Regs. §§1.1367-1 and 1.1367-2 provide guidance on adjustments to stock and loan basis, respectively.

BASIS ADJUSTMENTS FROM FORM 1120S, SCHEDULE K-1

For a taxpayer with an interest in an **S corporation,** Schedule K-1 reports several amounts that serve as adjustments to basis. Box 16, as shown below, is specifically used for amounts that do not appear elsewhere on Schedule K-1.



Box 16 of a taxpayer's Schedule K-1 may be encoded for one or more of five different items requiring an adjustment to basis. The following table provides an explanation of what each of the five codes indicates and the corresponding required basis adjustment necessary for each.

Box 16 Code	Explanation	Required Basis Adjustment
A	Tax-exempt interest income	Increase
B	Other tax-exempt income	Increase
C	Nondeductible expenses	Decrease
D	Property distributions	Decrease
E	Repayment of shareholder loans	Decrease

67. Treas. Reg. §1.1367-1(d)(1).

Code D includes distributions of money or property that are not reported on Form 1099-DIV, *Dividends and Distributions*.

Note. Further guidance on how to adjust loan basis is provided by Treas. Reg. §1.1367-2, Rev. Rul. 64-162, and Rev. Rul. 68-537.

Example 29. Sabrina is sole shareholder of Sabrina's Stables and Tack Shop, Inc. The business is an S corporation with a December 31 tax yearend. Sabrina has given Marshall, her tax preparer, all the details and information on the corporate activity for **2011.** Upon reviewing Sabrina's **2011** information regarding S corporation activity, Marshall notes the following.

- Sabrina's stock basis at the end of 2010 is $17,000.
- Sabrina's debt basis at the end of 2010 is zero.
- With Sabrina's guarantee, the S corporation borrowed $10,000 in 2011 to purchase office equipment.
- The S corporation's ordinary business income for 2011 is $9,400.
- The S corporation received tax-exempt bond interest of $300.
- Sabrina wishes to claim a $5,000 §179 deduction in connection with some of the office equipment purchased.
- The nondeductible portion of the S corporation's meals and entertainment expenses for 2011 is $1,200.
- Sabrina received a distribution of antique office furniture from the S corporation that has a $4,300 appraised value.

As tax preparer, Marshall must do the following.

- Complete a Schedule K-1 for Sabrina to reflect the relevant activity in 2011.
- Calculate Sabrina's 2011 basis amount.

Marshall prepares the following Schedule K-1 to appropriately reflect the above items.

For Example 29

671111

☐ Final K-1 ☐ Amended K-1 OMB No. 1545-0130

Schedule K-1 (Form 1120S) 2011
Department of the Treasury
Internal Revenue Service

For calendar year 2011, or tax year beginning ____________, 2011 ending ____________, 20____

Shareholder's Share of Income, Deductions, Credits, etc. ▶ See back of form and separate instructions.

Part I Information About the Corporation

A Corporation's employer identification number
38-8989898

B Corporation's name, address, city, state, and ZIP code
Sabrina's Stables and Tack Shop Inc.
2 Prospect Hill Drive
Stockbridge, MA 01263

C IRS Center where corporation filed return
Cincinnati, OH

Part II Information About the Shareholder

D Shareholder's identifying number
984-76-5432

E Shareholder's name, address, city, state, and ZIP code
Sabrina Wexford
334 Main Street
Great Barrington, MA 01230

F Shareholder's percentage of stock ownership for tax year . . . . 100 %

For IRS Use Only

Part III Shareholder's Share of Current Year Income, Deductions, Credits, and Other Items

1	Ordinary business income (loss)	9,400	13	Credits	
2	Net rental real estate income (loss)				
3	Other net rental income (loss)				
4	Interest income				
5a	Ordinary dividends				
5b	Qualified dividends		14	Foreign transactions	
6	Royalties				
7	Net short-term capital gain (loss)				
8a	Net long-term capital gain (loss)				
8b	Collectibles (28%) gain (loss)				
8c	Unrecaptured section 1250 gain				
9	Net section 1231 gain (loss)				
10	Other income (loss)		15	Alternative minimum tax (AMT) items	
11	Section 179 deduction	5,000	16	Items affecting shareholder basis	
			A		300
12	Other deductions		C		1,200
			D		4,300
			17	Other information	

* See attached statement for additional information.

For Paperwork Reduction Act Notice, see Instructions for Form 1120S. Cat. No. 11520D **Schedule K-1 (Form 1120S) 2011**

After referring to Treas. Reg. §1.1367-1(f) and becoming familiar with the necessary basis adjustments and ordering rules for such adjustments, Marshall calculates Sabrina's **2011 stock basis.** Sabrina's $17,000 stock basis at the end of the 2010 taxation year is used as the 2011 beginning stock basis. Marshall calculates Sabrina's stock basis at the end of the S corporation's 2011 tax year as follows.

Beginning stock basis from 2010	$17,000
Plus: ordinary income	9,400
Plus: tax-exempt income	300
Subtotal	$26,700
Less: property distribution	(4,300)
Less: nondeductible expense	(1,200)
Less: §179 deduction	(5,000)
Ending stock basis for 2011	**$16,200**

Although Sabrina's 2011 stock basis is $16,200, Sabrina has no loan basis. Her loan basis at the end of 2010 is zero. A $10,000 loan was initiated during 2011. However, this loan does not provide Sabrina with any loan basis because it was initiated in the name of the corporation. If the loan originated in Sabrina's name, the loan would provide her with $10,000 in loan basis.

IMPUTED INTEREST

Imputed interest refers to interest that is **deemed** to have been paid on a transaction when interest in fact was not paid. Any imputed interest is taxable interest income to the lender and may be deductible to the borrower, depending on the borrower's use of the loan proceeds.

Loans may be structured by related parties with interest rates that are "below market." Under certain circumstances, the Code restructures these loans as "arm's length" transactions by imposing a market rate of interest on a **below-market loan (BML)** arrangement. Generally the imputed interest amount is the additional interest the IRS requires the parties to recognize that is in excess of the amount of interest they used in their loan agreement. This may have tax consequences to either the lender, the borrowers, or both.

There are specific rules on the types of loans subject to the BML rules and how the IRS tests a loan to determine whether it is a BML subject to the benchmark market interest rate provisions.

LOANS SUBJECT TO THE BELOW-MARKET RULES

Under the BML rules of IRC §7872, the concept of a **loan** is interpreted very broadly to facilitate the anti-abuse purpose of the BML rules.[68] A loan includes any extension of credit or transfer of money between one party to another party when one party uses the money and later returns it.[69] IRC §7872 recharacterizes the following types of BMLs.[70]

- Gift loans
- Compensation-related loans
- Corporation-shareholder loans
- Tax-avoidance loans
- Loans to qualified continuing care facilities
- Certain other below-market rate loans

Note. Several of the above types of loans are defined in Treas. Reg. §1.7872-4.

68. Prop. Treas. Reg. §1.7872-2(a)(1).

69. Ibid.

70. IRC §7872(c).

Some loans are specifically **exempt** from the BML rules as long as the loan does **not** have tax avoidance as its principal purpose.[71] Following are some of the loans that the IRS classifies as **exempt** because they are regarded as not having any significant effect on the tax liability of either the borrower or the lender.[72]

- Loans, consistent with the lender's customary business practice, that are made available to the general public using the same terms and conditions
- Accounts or withdrawable shares provided by financial institutions in the ordinary course of business
- Certain public debt acquisition arrangements
- A life insurance policyholder loan that uses the policy's cash value as collateral
- Loans subsidized by the federal, state, or municipal government agency made available under a public program
- Employee relocation loans that meet certain requirements[73]
- Most loans under $250,000 made to a charitable organization
- Loans meeting certain requirements with a lender or borrower that is a foreign person[74]
- Other loans that **do not have any significant effect on the tax liability** of either the lender or borrower

All facts and circumstances are considered in determining if a loan has any significant effect on the tax liability of either the borrower or lender.[75] Some of the following factors are considered.

- Whether any income and deduction aspects of the loan offset each other
- The amounts of any income inclusions and deductions from the loan
- The cost to the taxpayer of complying with the BML rules if the loan were subject to those rules
- The nontax reasons for using a below-market rate instead of the market rate under the BML rules

Demand Loans and Term Loans

Under the BML rules, there are two categories of loans: **demand loans** and **term loans.** It is important to determine which category a particular loan falls under because the applicable BML rules are different for each category.

A **demand loan** is a loan:

- That is payable in full at the request of the lender at any time,[76] or
- That is defined under regulations and has an indefinite maturity date.[77]

> **Note.** While an existing demand loan may be structured with an indefinite maturity date, there is presently no regulatory guidance on how to treat such a loan under the demand loan rules.

71. Temp. Treas. Reg. §1.7872-5T(a)(2).
72. Temp. Treas. Reg. §1.7872-5T(b).
73. See Temp. Treas. Reg. §1.7872-5T(c)(1) for the requirements.
74. See Temp. Treas. Reg. §1.7872-5T(c)(2) for the requirements.
75. Temp. Treas. Reg. §1.7872-5T(c)(3).
76. IRC §7872(f)(5).
77. Ibid.

A compensation-related term loan may be treated as a demand loan if the benefits of the loan's interest arrangement:

- Are not transferrable, and
- Are conditioned on the future performance of substantial services by the borrower.[78]

A **term loan** is defined as any loan that is not a demand loan.[79]

Term Loans

Generally, the applicable federal rate (AFR) is the IRS benchmark **market rate of interest** that is compared to the actual rate of interest the taxpayer used in a term loan arrangement. If the taxpayer used an interest rate **less** than the IRS benchmark, the term loan is considered a BML and is subject to the BML tax rules.

Because taxpayers can structure term loans with various maturities, it is necessary to have **short-term, mid-term, and long-term benchmarks** for appropriate comparisons in determining whether the taxpayer's loan is a BML. The following table indicates which AFR is used for the various maturity dates on a loan that a taxpayer may use in a term loan arrangement.[80]

Type of Loan Used by the Taxpayer	Maturity Term	Appropriate AFR for Comparison Purposes
Short-term	Up to 3 years	Short-term AFR
Mid-term	Over 3 years but less than 9 years	Mid-term AFR
Long-term	Over 9 years	Long-term AFR

Accordingly, there are three categories of AFRs published in the Internal Revenue Bulletin each month. AFR rates are subject to change from month to month because they are based on prevailing interest rates on U.S. government obligations such as Treasury notes and Treasury bonds.

The following table contains the AFRs for February 2012 as shown in Rev. Rul. 2012-7.

REV. RUL. 2012-7 TABLE 1
Applicable Federal Rates (AFR) for February 2012

	Period for Compounding			
	Annual	Semiannual	Quarterly	Monthly
Short term:				
AFR	.19%	.19%	.19%	.19%
110% AFR	.21%	.21%	.21%	.21%
120% AFR	.23%	.23%	.23%	.23%
130% AFR	.25%	.25%	.25%	.25%
Mid term:				
AFR	1.12%	1.12%	1.12%	1.12%
110% AFR	1.23%	1.23%	1.23%	1.23%
120% AFR	1.34%	1.34%	1.34%	1.34%
130% AFR	1.47%	1.46%	1.46%	1.46%
150% AFR	1.69%	1.68%	1.68%	1.67%
175% AFR	1.97%	1.96%	1.96%	1.95%
Long term:				
AFR	2.58%	2.56%	2.55%	2.55%
110% AFR	2.84%	2.82%	2.81%	2.80%
120% AFR	3.09%	3.07%	3.06%	3.05%
130% AFR	3.36%	3.33%	3.32%	3.31%

78. Ibid.

79. IRC §7872(f)(6).

80. IRC §1274(d)(1)(A); Treas. Reg. §1.1274-4(b).

In addition to the short-, mid-, and long-term AFRs, there are also AFRs for various interest compounding frequencies (annual, semiannual, quarterly, or monthly) that a taxpayer may use within an actual loan arrangement. Most common BML arrangements use the rates labeled AFR in the above table as their benchmark.

The other rates, calculated at 110%, 120%, or more are used for other special situations. For example, seller financed sale-and-leaseback arrangements use the 110% AFR rates. Valuation of remainder and reversionary interests use actuarial tables provided by the IRS that are based on the 120% AFR rates.

Below-Market Term Loans. The BML rules do **not** apply to any loan with a stated interest rate that is **equal to or greater** than the AFR for that loan. The appropriate AFR is the rate that must be used for the loan's maturity term and compounding frequency.

A term loan is a BML if the amount loaned exceeds the present value of all payments due under the terms of the loan.[81] The following rules determine whether a term loan is a BML.

- To discount the payments, the AFR with the appropriate compounding period and maturity term is used.
- The AFR schedule in effect the day the loan originated is used.
- Later AFR changes do not affect the status of the original loan for the life of the loan.

Example 30. Cynthia is sole shareholder of Cynthetic Enterprises, Inc. On February 15, 2012, the corporation makes a 1-year term loan to Cynthia, with interest compounding annually. Cynthia plans to repay the loan on February 15, 2013. She decides to make the loan a zero-interest loan, so her repayment will be a lump sum of $100,000.

Cynthia uses the AFR rates for **February 2012** because this is the schedule in effect on the day the loan originated. The appropriate AFR benchmark is for **annual compounding** because Cynthia's loan specified annual compounding (despite the zero percent interest rate). Moreover, Cynthia's loan is for a 1-year term. The short-term AFRs must be used for term loans with maturity terms of up to three years.

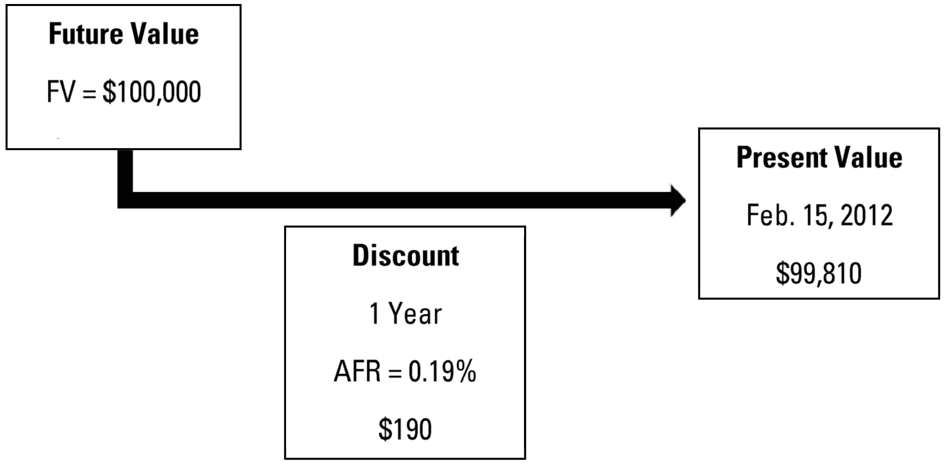
The February 2012 short-term annual compounding AFR is 0.19%. The AFR of 0.19% is higher than Cynthia's zero interest rate. The loan is therefore a BML subject to the rules of IRC §7872.

Note. In the table from Rev. Rul. 2012-7, the short-term AFRs used with semiannual, quarterly, and monthly compounding also are 0.19%. This is because AFR rates are presently very low. Typically, these other rates are slightly lower than the annual compounding AFR.

To calculate the amount of imputed interest on Cynthia's zero interest loan, her $100,000 loan repayment, due on February 15, 2013, must be discounted exactly one year to the February 15, 2012, origination date. The discount rate used is the short term 0.19% AFR for annual compounding.

In essence, the value of the $100,000 repayment amount due in the future (one year later in February 2013) must be "reduced" by the appropriate AFR of 0.19% to determine the **present value** (PV) of that amount on the loan origination date of February 15, 2012. This discounting process is illustrated by the following diagram.

81. IRC §7872(b).



This PV is calculated from the **future value** (FV) using the following formula, where *n* is the number of years in the duration of the loan.

$$\text{PV} = \frac{\text{FV}}{(1 + \text{AFR})^{n}}$$

The AFR of 0.19% expressed as a decimal is 0.0019. The PV of $100,000 one year in the future, discounted at 0.19%, is:

$$\begin{aligned}\text{PV} &= \frac{\$100{,}000}{(1 + 0.0019)^{1}} \\ &= \frac{\$100{,}000}{1.0019} \\ &= \$99{,}810\end{aligned}$$

The amount loaned ($100,000) is **higher** than the PV of the payments due under the terms of the loan ($99,810). The difference between the FV of $100,000 and the PV of $99,810 is the AFR interest discount of $190. Therefore, the corporation's zero interest loan to Cynthia has **$190** of imputed interest.

Recharacterizing the Term Loan. Forgone interest is the amount of market rate interest (under the BML rules using the appropriate AFR for the loan) less any actual interest that was paid on the taxpayer's loan.[82] In **Example 30,** the forgone interest amount is equal to the imputed interest amount of $190 because no interest was charged by the corporation on the term loan it made to Cynthia.

The application of the BML rules on a term loan results in the following **deemed transfers** of the forgone interest amount.

1. The amount of forgone interest is deemed transferred by the lender to the borrower **on the date of the loan.**
2. The borrower is deemed to pay the forgone interest back to the lender **over the term of the loan.**

With a below-market term loan, the forgone interest amount is deemed transferred from the lender to the borrower on the date the loan was made (or the first date §7872 applies to the loan if later).[83] The forgone interest amount is treated in a manner consistent with the parties' respective accounting methods.[84]

82. IRC §7872(e)(2).
83. IRC §7872(b) and Treas. Reg. §1.7872-7(a)(1).
84. Ibid.

The forgone interest amount on a term loan is considered **original issue discount (OID)**[85] and is in addition to any other OID that the loan transaction has under IRC §1273.[86]

> **Note**. OID is simply another type of interest income.

The transfer of forgone interest from lender to borrower may be in the form of a **gift, charitable donation, dividend, compensation, or other form of payment** in keeping with the relationship between borrower and lender and the substance of the transaction.[87]

Example 31. Use the same facts as **Example 30.** The zero interest loan from the corporation to Cynthia is recharacterized by the BML rules in a manner in keeping with Cynthia's relationship with the corporation.

On February 15, 2012, the loan origination date, the corporation is deemed to have made a distribution to Cynthia in the amount of $190. The corporation reports this distribution in 2012. This distribution could be taxed as either a return of basis, capital gain, or dividend depending on Cynthia's basis in the corporation.

Cynthia is deemed to pay the corporation $190 interest on the loan. This amount is treated as OID under the Code. This interest may be deductible to Cynthia depending on the purpose of the loan.

The corporation must report the $190 of interest income in accordance with the terms of the loan. The payment of interest is due February 15, 2013. The corporation therefore reports $190 of interest income as received in 2013.

> **Note.** The tax treatment of the imputed interest depends on the nature of the loan transaction and relationship of the parties involved. This is discussed under "Reporting Imputed Interest" later in this section.

Example 32. Use the same facts as **Example 31,** except the corporation loans Cynthia the $100,000 on interest-free terms for **five** years. The analysis is as follows.

Referring to the February 2012 AFR table, the appropriate AFR benchmark is the one corresponding with annual compounding for a 5-year term. A 5-year term requires a mid-term AFR. The mid-term AFR used for annual compounding is 1.12%.

The AFR of 1.12% expressed as a decimal is 0.0112. The PV of $100,000 five years in the future, discounted at 1.12% is:

$$\begin{aligned} PV &= \frac{\$100{,}000}{(1 + 0.0112)^5} \\ &= \frac{\$100{,}000}{(1.0112)^5} \\ &= \frac{\$100{,}000}{1.057268} \\ &= \$94{,}583 \end{aligned}$$

85. IRC §7872(b)(2)(A).

86. IRC §7872(b)(2)(B).

87. Prop. Treas. Reg. §1.7872-1(a).

The amount loaned ($100,000) exceeds the PV of the repayment under the terms of the loan ($94,583). The difference of **$5,417** ($100,000 − $94,583) is the imputed interest on this BML.

Under the BML rules for term loans, Cynthia is deemed to receive a $5,417 distribution from the corporation on the loan origination date of February 15, 2012. The corporation must report this distribution for 2012.

Cynthia is deemed to pay the corporation $5,417 of interest over the term of the loan. The Code treats this amount as OID received by the corporation. The corporation must report the interest income in accordance with the terms of the loan. Therefore, each year, the corporation reports the year's interest amount as taxable income. If the interest is deductible to Cynthia, she can deduct the same interest amount reported by the corporation in each of the five years of the loan term.

Example 33. Use the same facts as **Example 30,** except Cynthia makes a zero-interest loan **to the corporation.** The transfer of the imputed interest amount is characterized in accordance with the relationship and nature of the parties to the loan.[88]

The $190 imputed interest is deemed a **capital contribution** from Cynthia to the corporation. The corporation is deemed to pay Cynthia an equal amount back in the form of interest, which the corporation may deduct and which Cynthia must report.

Demand Loans

While most of the rules for term loans also apply to demand loans, there are several key differences.

Below Market Demand Loans. For a demand loan, the appropriate AFR benchmark at the loan's inception to compare with the actual stated loan rate is the **lower** of:

- The short-term, semiannual compounding AFR in effect for the semiannual period (January through June or July through December) within the year in which the loan originated, or
- The short-term AFR that uses the same compounding frequency as the actual loan effective for the month in which the loan is made (if the loan originated in a month other than January or July)[89]

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Example 34. Consolidated Corporation makes a 3% loan to Franco, a longtime employee of the company. The loan is a demand loan and is made on March 16. Under the terms of this loan, it remains in place for approximately 21.5 months until December 31 of the following year.

The January short-term, semiannual compounding AFR (which prevails for the semiannual compounding period from January 1 to June 30) is 2.85%. The short-term semiannual compounding AFR for the month of March is 4.55%. The appropriate benchmark is the lower of these two rates, which is 2.85%. For the first semiannual period in the year (through June 30), the loan is not subject to the BML rules. This is because the stated loan rate of 3% is higher than the 2.85% benchmark.

After inception, the demand loan must be retested to ensure it is still not a BML. The demand loan must be retested every January 1 and July 1 (the beginning of each semiannual period within each calendar year) that the loan is in effect. Accordingly, on an ongoing basis after inception, the stated loan rate must be at least equal to the short-term AFR for the shorter of:

- The compounding interval or payment interval of the actual loan, or
- The next semiannual period commencing January 1 or July 1.

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88. Prop. Treas. Reg. §1.7872-1(a)(1).

89. Prop. Treas. Reg. §1.7872-3(b)(3).

Example 35. Use the same facts as **Example 34.** The demand loan must be retested for the second semiannual period from July 1 to December 31 within the year the loan is made. Assuming the semiannual compounding AFR for July is 4.75%, the stated 3% loan rate is not equal to or greater than this 4.75% AFR benchmark. Franco's loan becomes a BML and there is imputed interest for the second half of the year.

Note. A demand loan not initially subject to BML rules at origination may become a BML if AFR rates increase above the stated rate in the demand loan.

Because a demand loan is retested against an AFR benchmark every semiannual period, a demand loan in place for a year or longer is viewed as a series of smaller, sequential 6-month loans, with each loan retested for the next 6-month semiannual period.

To simplify this cumbersome process, IRC §7872(e)(2) permits the use of a "blended annual rate" for a demand loan that has a fixed principal amount outstanding for an entire calendar year. The blended annual rate is an average of the semiannual rates for January and July.[90] The **blended annual rate** for the year is published with the AFRs for the month of July.

If the blended annual rate is used as a benchmark, the imputed interest amount is calculated as follows.[91]

(Blended annual rate × Loan principal) – Sum of all interest payments allocable to the calendar year

Example 36. C corporation makes a $100,000 loan to Shareholder. It is a demand loan with an interest rate of 2% and is in effect for the entire calendar year. Shareholder is obligated to make semiannual interest payments. Shareholder makes an interest payment on June 30 of $1,000 and another $1,000 interest payment on December 31, as scheduled under the terms of the loan. Using the 2.5% blended interest rate for the year, the imputed interest amount is calculated as follows.

$$\begin{aligned} \textbf{Imputed interest} &= (\$100{,}000 \times 2.5\%) - \$2{,}000 \\ &= \$2{,}500 - \$2{,}000 \\ &= \$500 \end{aligned}$$

Accordingly, the imputed interest on the loan for the year is $500. Shareholder is deemed to have received a $500 distribution for the tax year and to have paid the $500 to the corporation in interest. The corporation must report this interest income.

Note. With a **term loan,** the deemed transfers between lender and borrower are deemed to occur on the inception date of the loan. However, with **a demand loan,** these transfers are deemed to occur each **December 31** for the amount of imputed interest allocable for the year.

Special Exceptions and Limitations

There are several loan arrangements that have been given statutory or regulatory **exemption** from the imputed interest rules of §7872.

90. Rev. Rul. 86-17, 1986-1 CB 377.

91. Prop. Treas. Reg. §1.7872-13(a)(1).

De Minimis Rule for Gift Loans. A gift loan of **$10,000 or less between individuals** that is not directly attributable to the purchase or carrying of income-producing assets is exempt from the application of IRC §7872.[92] This exception applies even if the loan has tax-avoidance purposes.[93]

In addition, for gift loans between individuals in the amount of **$100,000 or less,** the imputed interest amount at the end of the year is limited to the amount of the borrower's annual net investment income.[94] This imputed interest limitation applies as long as the loan does not have a tax-avoidance purpose[95] and the lender does not have the ability to manipulate the timing of investment income recognized for tax purposes from year to year.[96] The imputed interest income inclusion is zero if the lender's other investment income is $1,000 or less.[97]

De Minimis Rule for Shareholder Loans and Compensation-Related Loans. Loans of $10,000 or less made by a shareholder to their corporation and compensation-related loans are also exempt from IRC §7872 if tax avoidance was not a principal purpose for the arrangement.[98]

Tax-Neutral Loans. Several types of loans or transactions are exempt from the application of §7872 because the interest arrangements do not have a significant effect on the federal tax liability of the borrower or lender. These loans were mentioned earlier in this chapter.

Several other exempt loans and transactions are listed in Temp. Treas. Reg. §1.7872-5T. Certain transactions or loans with continuing care facilities that meet required guidelines are also exempt from the application of §7872.[99]

Reporting Imputed Interest

The substance of the actual loan arrangement between parties determines how a loan is characterized. It is difficult to determine how every potential BML arrangement will be characterized. However, the following table shows the **probable** treatment by the IRS of various types of BMLs.

Lender and Borrower	Characterization of Deemed Payment from Lender to Borrower (Forgone Interest Amount)	Tax Reporting Result
Employee to employer	Various, depending on the substance of the loan arrangement	Depends on character of payment
Employer to employee	Compensation	Form W-2
Parent to child	Gift	Possible Form 709 (if gift not exempt)
Child to parent	Gift	Possible Form 709 (if gift not exempt)
Corporation to shareholder	Distribution, dividend, or compensation	Schedule K-1, Form 1099-DIV, or Form W-2
Shareholder to corporation	Capital contribution	Increase in shareholder basis
Partnership to partner	Compensation	Guaranteed payments
Partner to partnership	Capital contribution	Increase in partner basis
Unrelated individuals	Various, depending on parties' relationship and substance of the loan arrangement (e.g. gift, compensation, etc.)	Depends on character of payment

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92. IRC §7872(c)(2).
93. Prop. Treas. Reg. §1.7872-8(b)(1).
94. IRC §7872(d).
95. Prop. Treas. Reg. §1.7872-8(c)(2).
96. Prop. Treas. Reg. §1.7872-8(c)(3).
97. Prop. Treas. Reg. §1.7872-8(c)(4).
98. IRC §7872(c)(3).
99. IRC §7872(g).

With a BML, once the forgone interest is appropriately characterized and deemed transferred from the lender to the borrower, the borrower is deemed to repay that same amount back to the lender in the form of interest. There are differences between term loans and demand loans in how the Code addresses this interest payback.

Term Loans. The recharacterization of a term loan involves **two** deemed payments.

The **first** deemed payment is from the lender to the borrower. This payment may be characterized as outlined in the previous table. The amount of this deemed payment is the amount of forgone interest, calculated as follows.

Total loan amount – Present value of all required loan payments using the appropriate AFR

Depending on how this amount is characterized, it may be includible in the gross income of the borrower and/or deductible by the lender.

The **second** deemed payment is from the borrower to the lender and is considered an interest payment on the loan.

With a term loan, the excess of the loan amount over the present value of all required loan payments (the forgone interest amount) is **OID.** Under OID rules, the lender and borrower recognize the interest over the life of the loan.[100] In most cases, the interest amount reported annually is calculated using the constant yield method.[101] This calculation serves to allocate the taxable interest reported annually over the life of the loan.[102]

> **Note.** Treas. Reg. §1.1272-1(b)(1) provides the step-by-step method for calculating the annual OID to report each year over the life of a loan.

Because this interest amount is considered OID, a Form 1099-OID, *Original Issue Discount,* is used each year to document the deemed interest payment from the borrower to the lender. This interest serves to make the loan a market-rate loan between the parties. Depending on how the transaction is characterized, the borrower may be able to deduct some or all of the interest that the lender reports each year.

Demand Loans. With a demand loan, the deemed payment from the lender to the borrower and the interest repayment from the borrower to the lender is deemed to occur on **December 31** for each year that the loan exists.[103] The amount of each year's deemed transfer is the amount attributable to that year. Each year's amount is the amount that is payable using AFR rates minus any interest actually paid by the borrower.[104]

> **Note.** Treas. Reg. §1.7872-13 provides guidance on methods to calculate the forgone interest amounts on various demand loans. Prop. Treas. Reg. §1.7872-6 provides guidance on calculating the annual amounts reportable for each year the demand loan is outstanding.

A demand loan is not subject to OID rules.[105] Accordingly, Form 1099-INT, *Interest Income,* is used to report the deemed interest payment from the borrower to the lender.

> **Note.** See pages 383–85 in the 2007 *University of Illinois Federal Tax Workbook* for more information regarding the imputed interest rules for loans between business entities and closely-held business owners. This can be found at **www.TaxSchool.illinois.edu/taxbookarchive.**

100. IRC §7872(b).
101. Treas. Reg. §1.1272-1.
102. Treas. Reg. §1.1272-1(b)(1).
103. IRC §7872(a)(2).
104. Prop. Treas. Reg. §1.7872-6(c).
105. Treas. Reg. §1.1274-1(b)(3)(ii).

Information Reporting. Under proposed regulations,[106] a lender that either reports imputed interest income or claims a deduction for a deemed payment to the borrower must attach an informational statement to the annual tax return filed. The statement must indicate the following information.

- That there is a BML arrangement
- The name, address, and tax identification number of each borrower
- The amount and character of the imputed items
- Any mathematical assumptions used for the computations
- Any other information required by the return or instructions[107]

The borrower has a similar reporting requirement under the same proposed regulation.[108]

OFFSHORE ASSET REPORTING REQUIREMENTS

Taxpayers are subject to worldwide income-reporting requirements. This means all income from all sources must be reported,[109] whether from inside or outside the United States. In addition to reporting income from foreign sources, taxpayers must also comply with requirements to disclose foreign assets. There are two reporting requirements that affect individual taxpayers.

- Form TD F 90-22.1, *Report of Foreign Bank and Financial Accounts* (FBAR)
- Foreign Account Tax Compliance Act (FATCA)

A thorough knowledge of both reporting requirements is vital in order to avoid substantial IRS noncompliance penalties.

REPORT OF FOREIGN BANK AND FINANCIAL ACCOUNTS (FBAR)

A **U.S. person** with a financial interest in or signature authority over one or more **foreign financial accounts** is required to file **Form TD F 90-22.1 (FBAR)** if the aggregate value of such assets **at any point** during the calendar year exceeds $10,000.[110] The official exchange rate at the end of the year is used to convert foreign currencies to U.S. dollars for purposes of determining whether the $10,000 requirement was met. Taxpayers subject to this reporting requirement must also retain records showing details of the offshore accounts maintained.[111]

A "U.S. person" includes a citizen or resident of the United States, a partnership or corporation formed in the United States, an estate, and certain trusts.[112]

106. Prop. Treas. Reg. §1.7872-11(g)(1).

107. Ibid.

108. Prop. Treas. Reg. §1.7872-11(g)(2).

109. IRC §61.

110. Instructions for Form TD F 90-22.1.

111. 31 CFR §1010.420.

112. IRC §7701(a)(30).

A "foreign financial account" is broadly defined to include the following types of accounts if located **outside** the United States.

- Savings or checking account
- CD or time deposit
- Securities or brokerage account
- Commodity futures or options account
- Insurance or annuity policy with a cash value
- Mutual or segregated fund holding[113]

Filing the FBAR is a requirement under the Bank Secrecy Act. The FBAR is due June 30 in connection with the prior calendar year. It is not filed with the taxpayer's income tax return; instead, it is filed by mailing the form to the Department of the Treasury office in Detroit, Michigan.[114] For each foreign financial account, the FBAR form discloses details such as the following.

- The name and mailing address of the financial institution with which the foreign financial account is maintained
- The maximum value of the account that was reached during the calendar year
- The type of account

Substantial civil and criminal penalties can result from failure to file the FBAR or filing a fraudulent FBAR form.

> **Note.** Form TD F 90-22.1 can be downloaded from the IRS website at **www.irs.gov/pub/irs-pdf/f90221.pdf.**

FOREIGN ACCOUNT TAX COMPLIANCE ACT (FATCA)

The FATCA reporting requirements are effective for tax years beginning on or after January 1, 2011. FATCA is broad legislation requiring foreign financial entities to provide information on U.S. accountholders. FATCA also has a filing requirement for individual taxpayers.

Taxpayers who hold **specified foreign financial assets** may be required to file Form 8938, *Statement of Specified Foreign Financial Assets,* with their Form 1040. A blank Form 8938 is included at the end of this chapter. The filing requirement is triggered if the total amount of specified foreign financial assets is either:

- More than **$50,000 ($100,000 MFJ)** on the **last day** of the tax year, **or**
- More than **$75,000 ($150,000 MFJ)** at **any time** during the tax year.[115]

113. 31 CFR §1010.350(c).

114. The mailing address can be found in the instructions included in Form TD F 90-22.1.

115. Draft instructions, Form 8938, *Statement of Specified Foreign Financial Assets*.

Specified foreign financial assets include the following.

- Any account held at a foreign financial institution
- Any of the following assets not held at a financial institution:
  - A foreign-issued stock or security
  - Any financial instrument or contract held for investment having a non-U.S. issuer or counterparty
  - An interest in a foreign entity[116]

Note. IRS Notice 2011-55 suspends the Form 8938 filing requirement for individuals for the 2011 tax year. Individual taxpayers must attach any required 2011 and 2012 Form 8938 to their **2012** tax returns.

There are substantial penalties for noncompliance with the FATCA filing requirements. Failure to properly furnish the required information subjects the taxpayer to a $10,000 penalty. If proper disclosure is not corrected within 90 days after the IRS subsequently mails a noncompliance notice to the taxpayer, a further $10,000 penalty is assessed for each 30-day period of continued noncompliance. The total penalty is limited to a maximum of $50,000.

Note. See pages 236–245 in the 2011 *University of Illinois Federal Tax Workbook* for a thorough discussion of these two offshore asset reporting requirements.

116. IRC §6038D(b).

Form **8938** (November 2011) Department of the Treasury Internal Revenue Service

Statement of Specified Foreign Financial Assets

▶ See separate instructions ▶ Attach to your tax return

OMB No. 1545-2195

Attachment Sequence No. **175**

If you have attached additional sheets, check here ☐

Name(s) shown on return	Identifying number
Number, street, and room or suite no. (if a P.O. box, see instructions)	
City or town, province or state, and country (including postal code)	

For tax year beginning , 20 , and ending , 20

Note. All information must be in English. Show all amounts in U.S. dollars. Show currency conversion rates in Part I, line 6(2), or Part II, line 6(2).

Type of filer

a Specified individual **(1)** ☐ Married filing a joint return **(2)** ☐ Other individual

b Specified domestic entity **(1)** ☐ Partnership **(2)** ☐ Corporation **(3)** ☐ Trust **(4)** ☐ Estate

Check this box if this is an original, amended, or supplemental Form 8938 for attachment to a previously filed return . . . . . . ☐

Part I Foreign Deposit and Custodial Accounts (see instructions)

If you have more than one account to report, attach a continuation sheet with the same information for each additional account (see instructions).

1 Type of account ☐ Deposit ☐ Custodial | **2** Account number or other designation

3 Check all that apply **a** ☐ Account opened during tax year **b** ☐ Account closed during tax year
c ☐ Account jointly owned with spouse **d** ☐ No tax item reported in Part III with respect to this asset

4 Maximum value of account during tax year . . . . $

5 Did you use a foreign currency exchange rate to convert the value of the account into U.S. dollars? . . ☐ Yes ☐ No

6 If you answered "Yes" to line 5, complete all that apply.

(1) Foreign currency in which account is maintained	**(2)** Foreign currency exchange rate used to convert to U.S. dollars	**(3)** Source of exchange rate used if not from U.S. Treasury Financial Management Service

7 Name of financial institution in which account is maintained

8 Mailing address of financial institution in which account is maintained. Number, street, and room or suite no.

9 City or town, province or state, and country (including postal code)

Part II Other Foreign Assets (see instructions)

Note. *If you reported specified foreign financial assets on Forms 3520, 3520-A, 5471, 8621, or 8865, you do not have to include the assets on Form 8938. You must complete Part IV. See instructions.*

If you have more than one asset to report, attach a continuation sheet with the same information for each additional asset (see instructions).

1 Description of asset | **2** Identifying number or other designation

3 Complete all that apply

a Date asset acquired during tax year, if applicable . . . . ________

b Date asset disposed of during tax year, if applicable . . . . ________

c ☐ Check if asset jointly owned with spouse **d** ☐ Check if no tax item reported in Part III with respect to this asset

4 Maximum value of asset during tax year (check box that applies)

a ☐ $0 - $50,000 **b** ☐ $50,001 - $100,000 **c** ☐ $100,001 - $150,000 **d** ☐ $150,001 - $200,000

e If more than $200,000, list value . . . . $

5 Did you use a foreign currency exchange rate to convert the value of the asset into U.S. dollars? . . . ☐ Yes ☐ No

For Paperwork Reduction Act Notice, see the separate instructions. Cat. No. 37753A Form **8938** (11-2011)

Part II Other Foreign Assets *(continued)*

6 If you answered "Yes" to line 5, complete all that apply.

(1) Foreign currency in which asset is denominated	**(2)** Foreign currency exchange rate used to convert to U.S. dollars	**(3)** Source of exchange rate used if not from U.S. Treasury Financial Management Service

7 If asset reported in Part II, line 1, is stock of a foreign entity or an interest in a foreign entity, report the following information.

a Name of foreign entity

b Type of foreign entity **(1)** ☐ Partnership **(2)** ☐ Corporation **(3)** ☐ Trust **(4)** ☐ Estate

c ☐ Check if foreign entity is a PFIC

d Mailing address of foreign entity. Number, street, and room or suite no.

e City or town, province or state, and country (including postal code)

8 If asset reported in Part II, line 1, is not stock of a foreign entity or an interest in a foreign entity, enter the following information for the asset.

Note. If this asset has more than one issuer or counterparty, attach a continuation sheet with the same information for each additional issuer or counterparty (see instructions).

a Name of issuer or counterparty

Check if information is for ☐ Issuer ☐ Counterparty

b Type of issuer or counterparty

(1) ☐ Individual **(2)** ☐ Partnership **(3)** ☐ Corporation **(4)** ☐ Trust **(5)** ☐ Estate

c Check if issuer or counterparty is a ☐ U.S. person ☐ Foreign person

d Mailing address of issuer or counterparty. Number, street, and room or suite no.

e City or town, province or state, and country (including postal code)

Part III Summary of Tax Items Attributable to Specified Foreign Financial Assets (see instructions)

Asset Category	Tax item	Amount reported on form or schedule	Where reported	
			Form and line	Schedule and line
I. Foreign Deposit and Custodial Accounts	**a** Interest	$		
	b Dividends	$		
	c Royalties	$		
	d Other income	$		
	e Gains (losses)	$		
	f Deductions	$		
	g Credits	$		
II. Other Foreign Assets	**a** Interest	$		
	b Dividends	$		
	c Royalties	$		
	d Other income	$		
	e Gains (losses)	$		
	f Deductions	$		
	g Credits	$		

Part IV Excepted Specified Foreign Financial Assets (see instructions)

If you reported specified foreign financial assets on the following forms, check the appropriate box(es). Indicate number of forms filed. You do not need to include these assets on Form 8938 for the tax year.

☐ 3520 Number of forms ________ ☐ 3520-A Number of forms ________ ☐ 5471 Number of forms ________

☐ 8621 Number of forms ________ ☐ 8865 Number of forms ________

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