Chapter 1: Investments

Please note. Corrections were made to this workbook through January of 2018. No subsequent modifications were made. For clarification about acronyms used throughout this chapter, see the Acronym Glossary at the end of the Index.

For your convenience, in-text website links are also provided as short URLs. Anywhere you see **uofi.tax/xxx**, the link points to the address immediately following in brackets.

About the Author

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Chapter Summary

This chapter focuses on tax return reporting of investment income and gains from stocks, bonds, and more complex investments. Advice is also provided about handling supplemental information included by investment companies in consolidated Forms 1099.

Brokers are only required to provide cost basis reporting for covered securities. Specific reporting requirements depend on the type of security and when it was acquired.

Determining the cost basis of bonds requires the tracking of adjustments to basis (e.g., bond premiums paid, market discounts received, or original issue discount). For covered securities, the IRS requires that brokers report these adjustments annually.

Entries on Forms 1099-DIV are generally straightforward. However, certain information cannot be easily ascertained from these forms. This chapter explains the tax treatment of such items.

Brokers must report proceeds from (and in some cases, basis for) securities sales on Form 1099-B. Various tax reporting issues are explained, including summary reporting, cost basis corrections, and options for determining cost basis of mutual fund shares.

Below-market loans charge interest rates lower than the applicable federal rate (AFR). Certain taxpayers must report interest of at least the AFR. The rules for reporting below-market loans are described.

An option is the right to buy or sell property in the future at a stated price. Publicly traded nonequity options are IRC §1256 contracts, which requires that any gain or loss be allocated 40% short-term and 60% long-term, regardless of the holding period. Tax treatment for equity options depends on whether the option was exercised, expired, or the subject of a closing transaction.

The sale of property the investor does not own (or owns but does not wish to sell) is a short sale. Typically, the investor "sells short" by borrowing the property and delivering it to a buyer, then "closes the sale" by either buying substantially identical property and delivering it to the lender, or delivering property held at the time of the sale. This chapter also includes information about broker-reported substitute payments to taxpayers who loan their securities for use in a short sale.

An employee stock ownership plan (ESOP) is a retirement plan to which a company contributes its stock (or money to buy its stock) for the benefit of company employees. Shares of stock vest over time before an employee is entitled to them. Employees can make before- or after-tax contributions into the plan. The net unrealized appreciation (NUA) of shares in a lump-sum ESOP distribution is taxed as long-term gain. Gain in excess of NUA is short-term or long-term depending on the holding period.

Taxpayers participate in many types of investment vehicles, such as stocks and mutual funds. Most of these types of investments are fairly straightforward and easy to report on tax returns. However, practitioners occasionally encounter sophisticated situations that require more complex tax reporting. This chapter addresses some of the more complicated types of investment income and reporting.

INFORMATION REPORTING ON CONSOLIDATED STATEMENTS

Most investment companies issue consolidated tax-reporting statements that include all tax information that the company is required to report to the IRS and the taxpayer. The consolidated statements often include all of the following information returns in one multi-page document.

1. Form 1099-INT, *Interest Income*
2. Form 1099-OID, *Original Issue Discount*
3. Form 1099-DIV, *Dividends and Distributions*
4. Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*
5. Form 1099-MISC, *Miscellaneous Income*

The information provided in these formats is usually straightforward and easy to report on the tax return. Occasionally, taxpayers have complicated investment situations. Some of these situations are discussed in this chapter.

The consolidated statements often provide information that the taxpayer needs in order to properly report their investment activity on their tax return even if the investment company is **not required** to report the information to the IRS or to the taxpayer. Such information may include the following.

1. Accrued interest paid on purchases
2. Bond premiums on noncovered bonds (bonds acquired before 2014)[1]
3. Acquisition premiums[2] on noncovered debt instruments (acquired before 2014)[3]
4. Market discounts on noncovered bonds/debt instruments (acquired before 2014)[4]
5. Tax-exempt original issue discount (OID) on noncovered bonds/debt instruments acquired before 2017[5]
6. Cost-basis information for sales when basis is not required to be reported to the IRS
7. Investment expenses

The supplemental information is often buried within the multiple pages of the consolidated statements. Moreover, it is not always clear how (or if) the supplemental information should be reported. This chapter includes information about what tax practitioners need to know to properly report the supplemental information.

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1. Treas. Reg. §1.6049-9(a).
2. "Acquisition premium" is the phrase used by the IRS to describe market premiums paid for OID instruments. See Treas. Reg. §1.6049-9(c).
3. Ibid.
4. Treas. Reg. §1.6045-1(n).
5. Treas. Reg. §1.6049-10(c).

COVERED AND NONCOVERED SECURITIES

The Energy Improvement and Extension Act of 2008[6] required that brokers provide **cost basis** information for reportable dispositions of covered securities.[7] No securities were subject to the provision until after 2011, which gave the industry time to comply with the new requirement. In addition, the effective dates of the requirement were incrementally implemented for various types of holdings. Accordingly, the term "covered securities" includes different holdings depending on the year they were acquired. Each year that a new type of holding was added to the basis-reporting requirement, new acquisitions of those types of investments became "covered securities," while the existing holdings remained "noncovered securities."

Covered securities generally include the following.

1. Corporate stock acquired after 2010[8]
2. Mutual fund shares acquired after 2011[9]
3. Options,[10] securities futures,[11] and certain debt obligations acquired after 2013[12]
4. Most remaining debt obligations acquired after 2015[13] (This includes more complicated debt instruments, such as zero-coupon bonds, OID bonds, variable rate instruments, convertible notes, etc.)
5. Tax-exempt OID bonds acquired after 2016[14]

In 1962, Congress passed The Revenue Act of 1962,[15] which first established the requirement to report interest, dividend, and patronage dividend payments of $10 or more during the year.

> **Note.** Adjusted for inflation, $10 in 1962 is equivalent to about $80 in 2016.[16]

In 1962, the interest-reporting requirement applied mainly to corporations, insurance companies, stockbrokers, and financial institutions such as banks and credit unions. It did not apply to other types of businesses or tax-exempt bonds.[17] OID interest on most corporate bonds became subject to interest reporting requirements in 1968.[18]

For nearly 40 years, very little changed with these information reporting requirements until Congress extended the requirement to tax-exempt interest in 2005.[19] As mentioned previously, the IRS began to require more information reporting for various debt obligations starting in 2014.

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6. PL 110-343.
7. IRC §6045(g).
8. Treas. Reg. §1.6045-1(a)(15).
9. Ibid.
10. Treas. Reg. §1.6045-1(m)(2).
11. Treas. Reg. §1.6045-1(a)(15).
12. Treas. Reg. §1.6045-1(n)(2).
13. Treas. Reg. §1.6045-1(n)(3).
14. Treas. Reg. §1.6049-10.
15. PL 87-834.
16. Calculated using: *US Inflation Calculator. Coinnews Media Group*. [www.usinflationcalculator.com] Accessed on Dec. 28, 2016.
17. PL 87-834.
18. TD 7154, 1972-1 CB 236.
19. The Tax Increase Prevention and Reconciliation Act of 2005 (PL 109-222).

Many brokerage companies reported some or all of the information even before it was required. However, the distinction between covered and noncovered securities made the consolidated Forms 1099 more difficult to decipher. Interest information typically included on Forms 1099-INT, 1099-OID, and related supplemental statements may need additional practitioner attention.

> **Note.** For purposes of simplification, the word bond in this section refers to any bond, note, or debt instrument.

BOND INTEREST INCOME AND OID ISSUES

In order to properly track basis on bonds and other debt obligations, it is necessary to know the amount of any adjustments that must be made to basis because a portion of the purchase price is attributable to factors other than the face amount of the debt. Such factors may include bond premiums paid, market discounts received, or OID.

It is also necessary to know if the taxpayer made any elections with respect to the premiums or discounts. For OID obligations, it is necessary to know the amount of the OID that accrued while the taxpayer held the instrument.

Therefore, beginning on the dates that the various debt obligations became covered securities, the IRS requires that the brokers report these adjustments each year. The regulations specify that brokers assume the taxpayer made certain elections. They also specify the prescribed methods for calculating the annual adjustments.

Original Issue Discount Calculation

OID is equal to the difference between a bond's (or other debt instrument's) cost when it is issued and the stated redemption price.[20] The interest accumulates and is paid when the bond matures.

Example 1. Dale's grandfather bought him a U.S. Government Series E Savings Bond on his birthday in 1970. The bond's original cost was $75. The face value of the bond was $100, and it matured in 1980. The $25 difference between the cost and the redemption value is the OID. Each year from 1970 to 1980, the bond earned interest; the interest compounded until the $75 investment was worth $100 in 1980.

> **Note.** Most taxpayers do not elect to report interest as it accrues on U.S. bonds. However, a taxpayer may make an election under IRC §454 to report all interest accrued to date on certain U.S. bonds and all future interest as it accrues each year. This can be a helpful tool for a decedent's final tax return when the decedent's tax bracket is lower than that of the heirs.

OID bonds are most commonly issued by the U.S. government and state and local governments. However, corporations may also issue OID bonds.

20. *Original Issue Discount — OID.* Investopedia. [www.investopedia.com/terms/o/oid.asp] Accessed on Dec. 29, 2016.

Tax-Exempt Interest from State and Local Governments

Bonds issued by states, local governments, and other state or local government-sponsored ventures are often called "municipal bonds" or "muni-bonds." Although interest earned on these bonds is generally excluded from federal taxable income,[21] it **must be reported** on a taxpayer's return for the following reasons.

1. Tax-exempt interest (and dividends) received may be used as part of a calculation that determines how much of another type of income will be taxed (e.g., calculating modified adjusted gross income (MAGI) to determine taxable social security).[22]
2. Other governmental services may use the information reported on the tax return to determine the benefits or cost of benefits available to the taxpayer (e.g., certain high-income taxpayers are charged higher Medicare Part B premiums based on the MAGI reported on their tax returns).[23]
3. Some tax-exempt private activity bonds are subject to alternative minimum tax (AMT).

Note. Private activity bonds are bonds issued as part of a combined state and private party effort that benefits nongovernmental persons such as private businesses, charitable organizations, or individuals.[24] For example, private and governmental agencies may cooperate to build and maintain a local airport. As part of funding the effort, they issue tax-exempt bonds. Congress defines the conditions that must be met for the bonds to be tax-exempt[25] and for the bonds to be subject to AMT.[26] The amount of tax-exempt interest that is subject to AMT must be reported in box 9 ("specified private activity bond interest") on Form 1099-INT.[27]

Double-Exempt Bonds

Municipal Bonds. In addition to being excluded from federal taxation, some state and local bond interest is excluded from state taxation. Bond interest excluded from both federal and state taxation is often referred to as "double-exempt."

The exclusion from state income taxation depends on state law. Most states do not tax their residents on tax-exempt bond interest from bonds issued by the state or its local governments. However, they typically do tax their residents on tax-exempt interest earned on bonds issued outside of the state.[28]

Some states also tax selected in-state bonds. These states include Illinois,[29] Iowa,[30] Oklahoma,[31] and Wisconsin.[32]

21. IRC §103(a).
22. Instructions for Form 1040.
23. *Medicare Premiums: Rules for Higher-Income Beneficiaries.* Social Security Administration. [www.ssa.gov/pubs/EN-05-10536.pdf] Accessed on Jan. 10, 2017.
24. *Glossary of Municipal Securities Terms.* Municipal Securities Rulemaking Board. [www.msrb.org/glossary/definition/private-activity-bond-_pab_.aspx] Accessed on Feb. 12, 2017.
25. IRC §141.
26. IRC §57(a)(5)(C).
27. Instructions for Form 1099-INT.
28. *Are Municipal Bonds Exempt from State Taxes?* Pylypczak-Wasylyszyn, Daniela. Jun. 24, 2015. MunicipalBonds.com. [www.municipalbonds.com/tax-education/tax-exemption-from-state-income-taxes/] Accessed on Dec. 29, 2016.
29. See IL Pub. 101, *Income Exempt from Tax,* for more information on the specific types of state bonds excluded from Illinois taxation.
30. *Taxable Interest Income.* Iowa Department of Revenue. [tax.iowa.gov/expanded-instructions/taxable-interest-income-0] Accessed on Feb. 12, 2017.
31. *Oklahoma and Municipal Obligations.* Oklahoma Tax Commission. [www.ok.gov/tax/Individuals/Income_Tax/Filing_Information/Tax_Exempt_Bonds/Oklahoma_and_Municipal_Obligations.html] Accessed on Feb. 12, 2017.
32. *Individual Income Tax State and Municipal Bond Interest.* State of Wisconsin Department of Revenue. [www.revenue.wi.gov/Pages/faqs/pcs-munifaq.aspx#mun4] Accessed on Feb. 12, 2017.

U.S. Territories. Federal law exempts interest from bonds issued by federal territories from both federal and state income tax. These territories are Guam, Puerto Rico, Virgin Islands, American Samoa, and the Northern Mariana Islands.[33]

> **Note.** All direct obligations of the U.S. government are exempt from state taxation under the "Borrowing" and "Supremacy" clauses of the U.S. Constitution. Federal law also exempts other specific types of income from state income tax. This can be confusing because interest from Federal Home Loan Banks is excluded, but interest from similarly named entities such as the Federal Home Loan Mortgage Corporation is not excluded.[34] Practitioners are advised to consult state department of revenue publications for a complete list of all state-excludable interest.

Accrued Interest Included When Bonds are Sold or Purchased

Typically, when a person buys a bond between interest payment dates, the buyer pays the seller the interest that accrued between the last interest payment and the date of the sale. Proper identification of this interest affects interest reporting, the seller's capital gain or loss, and the buyer's basis. Accordingly, **brokerage companies are required to adjust the information reported to the seller.** However, they are **not** required to report the information to the buyer.

Seller's Reporting. Brokers are required to report the interest income the seller receives as part of the sale on Form 1099-INT. They are also required to adjust the sales price of the bond on Form 1099-B.[35] The proper classification of this interest essentially ensures that the interest portion is reported as ordinary income instead of capital gain income.

Buyer's Reporting. The issuer of the bond pays the entire amount of interest due from the last payment to the next payment to the holder as of the date of record. Therefore, the entity that pays the interest reports the entire payment as interest income to the taxpayer who receives the payment. The price the buyer pays for the bond includes the accrued interest.

The entire amount reported on Form 1099-INT must be included on the recipient's Schedule B, *Interest and Ordinary Dividends*. However, the buyer is allowed to deduct the accrued interest that was paid to the seller. The amount subtracted is identified as "accrued interest" on Schedule B.[36]

Premiums on Bonds

When the interest rate stated on a bond is **higher than** other publicly traded bonds with similar risk factors and similar taxable or tax-exempt status, the market price of the bond is higher than the outstanding principal of the bond. This occurs when interest rates fall after the bond was issued. The premium is the difference between the outstanding principal and the market price.

Example 2. In December 2013, U.S. Treasury 10-year notes paid a stated interest rate of approximately 3%.[37] In July 2016, the interest rate was about 1.5%.[38] In July 2016, Shelly bought a $10,000 December 2013 T-note on the open market and paid $11,000 for it. The $1,000 difference between the outstanding principal and the market price was the market premium paid for the note.

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33. IL Pub. 101, *Income Exempt from Tax.*

34. Ibid.

35. Instructions for Form 1099-B.

36. Instructions for Schedule B.

37. *Daily Treasury Yield Curve Rates (2013).* U.S. Dept. of the Treasury. [www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2013] Accessed on Feb. 12, 2017.

38. *Daily Treasury Yield Curve Rates (2016).* U.S. Dept. of the Treasury. [www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2016] Accessed on Feb. 12, 2017.

The tax treatment of bond premiums is determined by the following factors.

1. Whether the bonds are taxable or tax-exempt
2. For taxable bond premiums, if the taxpayer has made any (intentional or unintentional) elections regarding amortization of the premium

Premiums on Taxable Bonds. A taxpayer may elect to amortize the premium over the life of a taxable bond or may leave the premium as part of the basis in the taxable bond. The election allows taxable interest income to be reduced each year by the portion of the premium allocable to each year. It also reduces the bond's basis. When reporting the disposition of covered bonds on Form 1099-B, investment companies are required to treat the premiums as having been amortized unless they received notification that the taxpayer **did not make** the election.[39]

The election applies to all taxable bonds held during and after the tax year for which the taxpayer makes the election.[40] It applies to both ordinary bonds and OID bonds.[41]

The bondholder makes the election by offsetting interest income with the bond premium amortization in the holder's timely filed federal income tax return for the first tax year to which the holder desires the election to apply.[42] According to the regulations, the taxpayer should attach a statement that the holder is making the election under Treas. Reg. §1.171-4.[43] However, the regulations do not state that the statement is required. Accordingly, it is very easy to make the election inadvertently.

The taxpayer cannot revoke the election without the IRS's consent. Form 3115, *Application for Change in Accounting Method,* must be used to request consent to revoke the election.[44]

Form 1099-INT Reporting for Premium Amortization on Taxable Bonds. In most cases, brokers must calculate and report amortization of premiums paid for **taxable bonds acquired after 2013.**[45] An exception applies if the person holding the bonds notifies the broker in writing that they do not want to amortize bond premiums under IRC §171.[46]

For U.S. Treasury bonds and other taxable bonds, interest income and premium amortization are reported in different boxes on Form 1099-INT, as shown in the following example. The investment companies have the option to report the amortization separately or reduce the interest income reported.[47]

> **Example 3.** In 2016, Trish purchased various bonds on the open market and paid premiums as part of the purchases. For reasons having to do with her designated beneficiaries, she holds the bonds with two local investment companies, Eddie Jones and Chuck Swab. She always buys the same investments at each company. She did not notify either company that she was not electing to amortize the premiums.
>
> Eddie Jones reports the premium amortizations separately. Trish's Form 1099-INT from them shows that she received $3,000 of interest income from ordinary bonds (box 1) and $4,000 of interest from U.S. government bonds (box 3). It also shows that the amortization of her bond premiums paid is $130 on the ordinary bonds (box 11) and $200 on the U.S. government bonds (box 12). Her Form 1099-INT follows.

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39. Treas. Reg. §1.6045-1(n)(7).
40. Treas. Reg. §1.171-4(b).
41. Treas. Reg. §1.171-4(a)(2).
42. Treas. Reg. §1.171-4(a)(1).
43. Ibid.
44. Treas. Reg. §1.171-4(d).
45. Treas. Reg. §1.6049-9(c).
46. Ibid.
47. Instructions for Form 1099-INT.

For Example 3

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. **Eddie Jones** **293 Main St.** **Local, IL 60000**	Payer's RTN (optional) **1** Interest income $ **3000.00**	OMB No. 1545-0112 **2016** Form **1099-INT**	**Interest Income**
	2 Early withdrawal penalty $		**Copy B** **For Recipient**
PAYER'S federal identification number: **111-11-1111** RECIPIENT'S identification number: **123-12-1234**	**3** Interest on U.S. Savings Bonds and Treas. obligations $ **4000.00**		
RECIPIENT'S name **Trish Shaw** Street address (including apt. no.) **238 Herman St.** City or town, state or province, country, and ZIP or foreign postal code **Local, IL 60000**	**4** Federal income tax withheld $ **6** Foreign tax paid $ **8** Tax-exempt interest $ **10** Market discount $	**5** Investment expenses $ **7** Foreign country or U.S. possession **9** Specified private activity bond interest $ **11** Bond premium $ **130.00**	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.
FATCA filing requirement ☐	**12** Bond premium on Treasury obligations $ **200.00**	**13** Bond premium on tax-exempt bond $	
Account number (see instructions)	**14** Tax-exempt and tax credit bond CUSIP no.	**15** State / **16** State identification no.	**17** State tax withheld $ $

Form **1099-INT** (keep for your records) www.irs.gov/form1099int Department of the Treasury - Internal Revenue Service

Chuck Swab reports the interest income net of premium amortizations. The same bonds were purchased through them as through Eddie Jones, but the Form 1099-INT shows only the net amount of $2,870 ($3,000 – $130) in box 1 and $3,800 ($4,000 – $200) in box 3.

Note. Most taxpayers who acquired bonds in 2014, 2015, and 2016 probably did not notify their investment companies that they were not making the election to amortize the bond premiums. If their investment companies reported the net amounts in box 1 or box 3, the taxpayers made the election to amortize the premiums simply by reporting the amounts presented on Forms 1099-INT.

If their investment companies reported the amounts in box 11 or box 12, the taxpayer identifies the amount subtracted on Schedule B as "ABP Adjustment."[48] If the taxpayer chose not to take the deduction, when the bonds are disposed of, they will have to adjust the basis from the amounts reported by the broker on Form 1099-B.

48. Instructions for Schedule B.

Form 1099-OID Reporting for Premium Amortization on Taxable Bonds. The rules that brokers must follow for premiums paid on **taxable OID bonds acquired after 2013** mirror those for non-OID bonds as explained earlier.[49] An investment company must calculate and report the amount of any acquisition premium amortization **unless** they were notified in writing that the holder does not want to amortize bond premiums under IRC §171.[50]

On Form 1099-OID, brokers may report the gross amount for OID in box 1 and acquisition premium amortization in box 6. Alternatively, brokers may report a net amount of OID in box 1 that reflects the offset of the OID includable in the bondholder's income by the amount of acquisition premium allocable to the bond for the year.[51]

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no.	**1** Original issue discount for 2017* $ * This may not be the correct figure to report on your income tax return. See instructions on the back. **2** Other periodic interest $	OMB No. 1545-0117 **2017** Form **1099-OID**	**Original Issue Discount**
PAYER'S federal identification number / RECIPIENT'S identification number	**3** Early withdrawal penalty $	**4** Federal income tax withheld $	**Copy B**
	5 Market discount $	**6** Acquisition premium $	**For Recipient**
RECIPIENT'S name Street address (including apt. no.) City or town, state or province, country, and ZIP or foreign postal code	**7** Description		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.
	8 Original issue discount on U.S. Treasury obligations* $	**9** Investment expenses $	
FATCA filing requirement ☐	**10** Bond premium $	**11** Tax-exempt OID $	
Account number (see instructions)	**12** State / **13** State identification no.	**14** State tax withheld $ $	

Form **1099-OID** (keep for your records) www.irs.gov/form1099oid Department of the Treasury - Internal Revenue Service

Supplemental Reporting for Premium Amortization on Noncovered Taxable Bonds. Taxable bonds, U.S. bonds, and taxable OID bonds acquired before 2014 are noncovered securities.[52] Therefore, the current year's amortization of bond premiums for bonds acquired before 2014 is reported in the supplemental information **if** the investment company chooses to provide the amortization amount.

> **Caution.** Because the election to amortize bond premiums applies to all taxable bonds, the amortization on noncovered bonds is deducted when the amortization on covered bonds is deducted. Accordingly, **practitioners should thoroughly review the investment company's supplemental information for this amortization.** In addition, they may need to request more information from the brokers if it appears that bond premium amortization on noncovered bonds is missing from the supplemental information provided.

49. Treas. Reg. §1.6049-9(c).
50. Ibid.
51. Ibid.
52. Treas. Reg. §1.6045-1(n)(2).

Reporting Premium Amortization on Tax-Exempt Bonds. Taxpayers **must** amortize premiums on tax-exempt obligations.[53] This is not an election.

Starting with the 2015 Form 1099-INT, brokers could report the amortization of premiums paid for tax-exempt bonds separately in box 13 ("bond premium on tax-exempt bond").[54] (See **Example 3** for Form 1099-INT.) However, brokers have the option to report only the net tax-exempt interest in box 8 ("tax-exempt interest").[55]

For tax-exempt OID bonds acquired after 2016, brokers must calculate and report the amortization of premiums paid for tax-exempt OID bonds on Form 1099-OID.[56]

Discounts on Bonds

When the interest rate stated on a bond is **lower than** other publicly traded bonds with similar risk factors and the same status as taxable or tax-exempt, the market price of the bond is lower than the outstanding bond principal. This occurs when interest rates rise after the bond was issued. The difference between the price paid for the bond on the open market and the outstanding bond principal is the market discount. Essentially, this is the opposite of a market premium.

> **Example 4.** In July 2012, U.S. Treasury 10-year notes paid a stated interest rate of approximately 1.5%.[57] In December 2014, the interest rate was approximately 3%.[58] In December 2014, Shelly bought a $10,000 July 2012 T-note on the open market and paid $9,000. The $1,000 difference between the principal and the purchase price was the market discount for the note.

Unless the taxpayer makes an IRC §1278(b) election to include the accrued portion of the market discount in current income each year, the following consequences apply.

1. Any gain on the disposition of a market discount bond is treated as ordinary income to the extent of the portion of the market discount accrued at the time of the disposition.[59] The taxpayer reports this gain as interest income.[60]

2. The deduction for interest paid on money specifically borrowed to buy the bonds is generally limited to the amount that the interest paid exceeds the accrued discount for that year. The disallowed interest expense is deferred until the year the bond is disposed of and is deductible at that time to the extent of the gain recognized on the disposition.[61]

IRC §1278(b) Election. This election applies to all bonds acquired by the taxpayer during the year the election is made and thereafter. It cannot be revoked without the IRS's consent. The taxpayer increases the bases of their market discount bonds by the amount included in income under this election.[62]

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53. Treas. Reg. §1.171-1(c)(1).

54. Comparison of 1099-INT for 2014 and 2015. Found at *Prior Year Products.* IRS. [apps.irs.gov/app/picklist/list/priorFormPublication.html?value=1099-INT&criteria=formNumber&submitSearch=Find] Accessed on Dec. 30, 2016.

55. Instructions for Forms 1099-INT and 1099-OID.

56. Treas. Reg. §1.6049-10.

57. *Daily Treasury Yield Curve Rates (2012).* U.S. Dept. of the Treasury. [www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2012] Accessed on Feb. 12, 2017.

58. *Daily Treasury Yield Curve Rates (2014).* U.S. Dept. of the Treasury. [www.treasury.gov/resource-center/data-chart-center/interest-rates/Pages/TextView.aspx?data=yieldYear&year=2014] Accessed on Feb. 12, 2017.

59. IRC §1276(a)(1).

60. IRC §1276(a)(4).

61. IRC §1277.

62. IRC §§1278(b)(2)-(4).

The taxpayer makes the election by attaching a statement to the timely filed income tax return for the election year.[63] The attachment must state that the market discount was included in the gross income of the taxpayer under IRC §1278(b). **The statement must also describe the method used by the taxpayer to determine the market discount attributable to the tax year covered by the tax return.** Either of the following methods may be used.

1. The default method of calculating the portion of the discount attributable to a tax year is the **ratable accrual** method.[64] This method calculates the accrued market discount based on the ratio of the number of days the taxpayer held the bond compared to the number of days between acquisition and maturity.[65]

2. Taxpayers may elect to use a **constant interest rate** method[66] (sometimes referred to as the **constant yield** method). The constant interest rate method essentially calculates the accrual on a compounding basis.[67] The election to use this method is irrevocable.[68]

Regardless of whether the market discounts are accrued or recovered upon disposition of the bonds, the discount portion is treated as interest. However, the income is **not** treated as interest income for the following purposes.[69]

1. Classification as tax-exempt state and local bond interest (IRC §103) (Accordingly, the market discount portion of tax-exempt bonds is not treated as taxable interest income.)

2. Taxation of nonresident alien individuals and foreign corporations under IRC §§871(a), 881, 1441, and 1442

Forms 1099-INT and 1099-OID Reporting for Market Discounts. If notified that a customer made an IRC §1278(b) election for **taxable or tax-exempt** covered bonds, brokers are required to calculate and report the market discount accrued each year.[70] Brokers must use the **constant yield method** unless they were notified that the customer did **not** make the election to use the constant yield method.[71]

On Form 1099-INT, the market discount is reported in box 10 ("market discount"). On Form 1099-OID, it is reported in box 5 ("market discount"). For tax-exempt covered securities acquired between 2013 and 2017, brokers are not required to report the accruals of market discounts.[72]

Form 1099-B Reporting for Market Discounts. Brokers must report basis information for covered bonds by assuming that a customer did **not** make an IRC §1278(b) election unless notified of the election.[73] Accordingly, absent any notifications, the basis information reported on Form 1099-B is the amount actually paid for the bond without accounting for any accruals reported by the taxpayer.[74] The broker must also report the amount of the gain that must be treated as interest instead of capital gain.[75] The allocation between ordinary interest income and capital gain must be made using the **constant yield method** unless the taxpayer notified the broker of their election during the year the covered bond was purchased.[76] The ordinary income portion is reported on Form 1099-B in box 1f ("accrued market discount").

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63. Rev. Proc. 92-67, 1992-2 CB 429.
64. IRC §1278(b)(1)(B) referencing IRC §1276(b). See also Rev. Proc. 92-67, 1992-2 CB 429.
65. IRC §1276(b)(1).
66. IRC §1276(b)(2).
67. IRC §1276(b)(2) directs that the calculation be done using the method found at IRC §1272(a).
68. Rev. Proc. 92-67, IRB 1992-36.
69. IRC §§1276(a)(4) and 1278(b)(1)(B).
70. Treas. Reg. §1.6045-1(n)(6)(ii).
71. Instructions for Forms 1099-INT and 1099-OID.
72. Ibid.
73. Treas. Reg. §1.6045-1(n)(5).
74. Treas. Reg. §1.6045-1(d)(6)(i).
75. Treas. Reg. §1.6045-1(n)(6)(i).
76. Treas. Reg. §1.6045-1(n)(11)(i)(B).

Example 5. Frank purchased a bond in 2014 with a maturity date in 2016. The bond's principal amount was $20,000 and it paid interest semi-annually. However, because of the bond's low interest rate, he was able to acquire it on the open market for only $19,000. Frank did not notify his broker of any elections concerning the market discount. He received the following Form 1099-B for the redemption of the bond. Because Frank held the bond to maturity, the entire $1,000 market discount had accrued as of the redemption date.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. **Brokers R We** **2536 Applegate Lane** **La Crosse, WI 54601**	Applicable check box on Form 8949 **D**	OMB No. 1545-0715 **2016** Form **1099-B** **Proceeds From Broker and Barter Exchange Transactions**
	1a Description of property (Example 100 sh. XYZ Co.) **Bond**	
	1b Date acquired **01/15/2014**	**1c** Date sold or disposed **11/30/2016**
PAYER'S federal identification number **89-4111111**	RECIPIENT'S identification number **123-99-9999**	
	1d Proceeds $ **20000.00**	**1e** Cost or other basis $ **19000.00**
	1f Accrued market discount $ **1000.00**	**1g** Wash sale loss disallowed $
RECIPIENT'S name **Frank Lee**	**2** Short-term gain or loss ☐ Long-term gain or loss ☒ Ordinary ☒	**3** If checked, basis reported to IRS ☒
Street address (including apt. no.) **3624 Illinois St.**	**4** Federal income tax withheld $	**5** If checked, noncovered security ☐
City or town, state or province, country, and ZIP or foreign postal code **La Crosse, WI 54601**	**6** Reported to IRS: Gross proceeds ☒ Net proceeds ☐	**7** If checked, loss is not allowed based on amount in 1d ☐
Account number (see instructions)	**8** Profit or (loss) realized in 2016 on closed contracts $	**9** Unrealized profit or (loss) on open contracts—12/31/2015 $
CUSIP number / FATCA filing requirement ☐	**10** Unrealized profit or (loss) on open contracts—12/31/2016 $	**11** Aggregate profit or (loss) on contracts $
14 State name **WI** / **15** State identification no / **16** State tax withheld $ $	**12** Check if proceeds from collectibles ☐	**13** Bartering $

Copy B For Recipient

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-B** (Keep for your records) www.irs.gov/form1099b Department of the Treasury - Internal Revenue Service

Frank reported the disposition in part II of Form 8949, *Sales and Other Dispositions of Capital Assets,* which follows. In box 1f, he used code D to indicate that the $1,000 difference in the purchase price and redemption price was attributable to the market discount.[77] Note that Form 8949 does not show a capital gain or loss. He reported the $1,000 market discount on his 2016 Schedule B as ordinary interest income (not shown).

77. Instructions for Form 8949.

For Example 5

Form 8949 (2016) Attachment Sequence No. **12A** Page **2**

Name(s) shown on return. Name and SSN or taxpayer identification no. not required if shown on other side	Social security number or taxpayer identification number
Frank Lee	123-99-9999

Before you check Box D, E, or F below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part II **Long-Term.** Transactions involving capital assets you held more than 1 year are long term. For short-term transactions, see page 1.

Note: You may aggregate all long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 8a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box D, E, *or* F below. Check only one box. If more than one box applies for your long-term transactions, complete a separate Form 8949, page 2, for each applicable box. If you have more long-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☒ **(D)** Long-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(E)** Long-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
☐ **(F)** Long-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
Bond	1/15/14	11/30/16	20,000	19,000	D	(1,000)	0
2 Totals. Add the amounts in columns (d), (e), (g), and (h) (subtract negative amounts). Enter each total here and include on your Schedule D, **line 8b** (if **Box D** above is checked), **line 9** (if **Box E** above is checked), or **line 10** (if **Box F** above is checked) ▶			20,000	19,000		(1,000)	0

Note: If you checked Box D above but the basis reported to the IRS was incorrect, enter in column (e) the basis as reported to the IRS, and enter an adjustment in column (g) to correct the basis. See *Column (g)* in the separate instructions for how to figure the amount of the adjustment.

Form **8949** (2016)

Form 1099-B Reporting for Market Discounts After Customer Notifications. When brokers are notified of taxpayer elections, they must take the elections into account when reporting the basis information for dispositions of covered bonds.[78] Accordingly, the basis is increased by any accrued market discount through the date of disposition. Furthermore, no allocation of the gain is necessary and nothing is reported in box 1(f) of Form 1099-B.

Caution. Some brokers provide the amount of market discount accrual in the supplemental information they provide to the taxpayers. Some practitioners have reported the provided market discount accruals without verifying that the taxpayers made the IRC §1278(b) and constant yield method elections. Furthermore, if taxpayers switched practitioners, the various practitioners may have reported the accrued market discounts differently. Practitioners should review basis information provided for noncovered bonds carefully.

FORM 1099-DIV

A sophisticated investor, or an investor with a sophisticated financial advisor, may receive a Form 1099-DIV from their investment company with income in nearly all of the boxes on the form. Most of these entries are straightforward, and tax preparation software easily manages proper reporting and taxation of the income when the preparer properly enters the data presented.

However, proper treatment of the income may not be easily ascertained from the information on the Form 1099-DIV. This section covers the tax treatment of income reported on Form 1099-DIV.

Note. Mutual funds are a subcategory of regulated investment companies (RIC). Other regulated investment companies include exchange-traded funds (ETF), real estate investment trusts (REIT), and unit investment trusts (UIT). The distinguishing feature of such companies is the eligibility to pass through the taxes on interest, dividends, and capital gains to individual investors.[79]

78. Treas. Regs. §§1.6045-1(n)(5)(ii)(B) and (6)(ii).

79. *Regulated Investment Company – RIC.* Investopedia. [www.investopedia.com/terms/r/ric.asp] Accessed on Jan. 1, 2017.

Example 6. Orlando's investments are held with Springs Cobbler, an investment advisory company. Among his holdings are traditional stocks, mutual funds, REITs, UITs, and municipal bond funds. He received the following Form 1099-DIV for 2016.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. **Springs Cobbler** **69 Well Court** **Fargo, ND 58125**	**1a** Total ordinary dividends $ **45000.00** **1b** Qualified dividends $ **30000.00**	OMB No. 1545-0110 20**16** Form **1099-DIV**	**Dividends and Distributions**
	2a Total capital gain distr. $ **16000.00**	**2b** Unrecap. Sec. 1250 gain $ **1000.00**	**Copy B** **For Recipient**
PAYER'S federal identification number **89-5812511** | RECIPIENT'S identification number **555-44-1099**	**2c** Section 1202 gain $ **2000.00**	**2d** Collectibles (28%) gain $	
RECIPIENT'S name **Orlando Bay**	**3** Nondividend distributions $ **19000.00**	**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.
Street address (including apt. no.) **26 Marigold Blvd**		**5** Investment expenses $ **10.00**	
City or town, state or province, country, and ZIP or foreign postal code **Davis, CA 95616**	**6** Foreign tax paid $ **600.00**	**7** Foreign country or U.S. possession **Various**	
	8 Cash liquidation distributions $	**9** Noncash liquidation distributions $	
FATCA filing requirement ☐	**10** Exempt-interest dividends $ **8000.00**	**11** Specified private activity bond interest dividends $ **2500.00**	
Account number (see instructions) **YOLO1099**	**12** State | **13** State identification no.	**14** State tax withheld $ $	

Form **1099-DIV** (keep for your records) www.irs.gov/form1099div Department of the Treasury - Internal Revenue Service

HOW TO REPORT INCOME SHOWN ON FORM 1099-DIV[80]

Box 1a, Total Ordinary Dividends

The amount in box 1a is the total of all dividends paid to the taxpayer, including dividends from stocks, money market funds, the taxable portion of dividends from municipal funds, reinvested dividends, and dividends from employee stock ownership plans (ESOP).[81] This box also includes short-term capital gains from mutual funds and RICs.

Note. The Code allows shareholders of RICs who receive capital gain distributions to treat the income as long-term capital gains on their returns.[82] Similar provisions apply to the tax attributes of qualified dividends[83] and tax-exempt dividends.[84] There are no Code provisions that allow shareholders to recharacterize the short-term capital gains included in dividends as capital gains on their personal returns. Accordingly, a taxpayer with unused capital losses may not offset the short-term gains included in ordinary dividends by the RIC against the unused capital losses.

80. Instructions for Form 1099-DIV.

81. IRC §404(k).

82. IRC §852(b)(3)(B).

83. IRC §854(b).

84. IRC §852(b)(5)(B).

Box 1b, Qualified Dividends

Qualified dividends are reported in box 1b of Form 1099-DIV. These are dividends paid by certain types of corporations that meet various requirements under the Code.[85] Qualified dividends are taxed at lower rates than other dividends; these rates are the same as the long-term capital gains rates. Box 1b shows the amount of dividends that qualify for the reduced rates.[86]

In addition to the requirements imposed at the corporate level, shareholders must also satisfy certain requirements to qualify for the reduced rates. Such requirements include the length of time the taxpayer holds the stock prior to the dividend distributions. The issuer of the Form 1099-DIV is not required to adjust the amounts they report as qualified when it is impractical for them to determine if the taxpayer meets the holding-period requirements.[87]

Shareholder Requirements.[88] Taxpayers may **not** treat dividends as qualified in the following circumstances.

1. The taxpayer held the stock for less than 61 days during the 121-day period that began 60 days before the ex-dividend date. The ex-dividend date is usually two business days before the record date.[89] The record date is the date that companies use to determine who the shareholders were when they issue declared dividends. Additional requirements apply if the ownership risk was reduced because of outstanding options and similar holdings.[90]
2. For preferred stock when the dividends are associated with periods totaling more than 366 days, the taxpayers held the stock for less than 91 days during the 181-day period that began 90 days before the ex-dividend rate.
3. The taxpayer was under an obligation (whether pursuant to a short sale or otherwise) to make related payments with respect to positions in substantially similar or related property.
4. The taxpayer takes the dividends into account when determining their investment income for purposes of deducting investment interest expense.

> **Note.** The first two tests apply to the time the investor held shares in a mutual fund, but the investor does not have to know the periods attributable to the stocks within the RICs.[91]

Box 2a, Total Capital Gain Distributions[92]

Capital gain distributions are paid by RICs and REITs. They are the capital gains realized by the fund that the fund elects to distribute to its shareholders.[93] Capital gain distributions are treated as long-term capital gains, regardless of how long the taxpayer owned the shares in the fund. However, box 2a also includes distributions that are subject to different rates or special rules. The nonstandard distributions are reported in box 2b ("unrecap. sec. 1250 gain"), box 2c ("section 1202 gain"), and box 2d ("collectibles (28%) gain"), which are explained later.

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85. IRC §1(h).
86. Instructions for Recipient Form 1099-DIV.
87. Instructions for Form 1099-DIV.
88. IRC §1(h)(11)(B)(iii); IRS Pub. 550, *Investment Income and Expenses.*
89. *Ex-Dividend Dates: When Are You Entitled to Dividends.* Oct. 23, 2014. U.S. Securities and Exchange Commission. [www.sec.gov/answers/dividen.htm] Accessed on Jan. 1, 2017.
90. See Treas. Reg. §1.246-5.
91. IRC §854(b)(1)(B)(i).
92. IRS Pub. 550, *Investment Income and Expenses.*
93. Treas. Regs. §§1.852-4(c) and 1.857-6(e).

A special rule applies to RIC and REIT shares that the taxpayer held for six months or less if they realized a loss on the sale of the shares. In such case, only the loss in excess of the capital gain distribution is treated as short-term. The remainder of the loss is treated as a long-term capital loss. The holding period is extended when the taxpayer holds offsetting options or other risk-negating positions.[94]

Box 2b, Unrecaptured §1250 Gain[95]

The portion of gains on certain types of real estate that is attributable to depreciation allowed or allowable is taxed differently than the depreciation component of other dispositions of property. Typically, only REITs or RICS that hold investments in REITs use box 2b on Form 1099-DIV. This is the case because only REITs pass-through capital gains attributable to depreciable real estate.

The amount shown in box 2b is not entered on the tax return. The taxpayer uses this amount in the calculation of tax on the Unrecaptured Section 1250 Gain Worksheet, which is part of the series of Schedule D tax worksheets included in the instructions for Form 1040, *U.S. Individual Income Tax Return.*

> **Note.** For more information about recaptured and unrecaptured IRC §1250 gains, see the 2014 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 3: Capital Gains and Losses. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Box 2c, §1202 Gain[96]

Box 2c of Form 1099-DIV shows the portion of the amount in box 2a that is IRC §1202 gain from certain stock that may qualify for exclusion from income. Qualified stock includes certain small business stock that may be subject to an exclusion of 50–100% from income and certain empowerment zone business stock that may be subject to a 60% exclusion.

An investment company reporting capital gain distributions in this category must also include a statement that includes information identifying the corporation that issued the stock that was sold and the exclusion percentage applicable (among other information).[97] If the stock was held by a pass-through entity such as a mutual fund, the taxpayer must have held stock when the entity acquired the qualified small business stock (QSBS) and at all times thereafter until the stock was sold.

Qualified Small Business Stock. Only stocks in C corporations that operate primarily in certain industries, such as manufacturing and retailing, qualify for this exclusion. In addition, the investor must have acquired the stock at its original issue, or acquired it by gift or inheritance, and must hold the stock for more than five years. A number of other requirements apply under the Code.

> **Note.** Theoretically, an investment company has vetted all of the requirements before reporting any gains as qualified for IRC §1202. However, an investor who transfers QSBS to a brokerage firm must notify the firm that the stock meets the requirements for QSBS in order for a subsequent sale to be properly reported by the firm.

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94. IRC §§852(b)(4) and 857(b)(8)(A).

95. Instructions for Recipient Form 1099-DIV.

96. Instructions for Schedule D.

97. Instructions for Form 1099-DIV.

The amount of excludable gain is based on the date the taxpayer acquired the QSBS.

Acquisition Date	Applicable Exclusion
September 28, 2010, and later	100%
February 18, 2009, through September 27, 2010	75%
August 11, 1993, through February 17, 2009	50%

Any gain remaining after applying the exclusion is taxed at the lower of 28% or the taxpayer's ordinary income rate. Therefore, although a portion of the gain is excluded, the remaining portion is taxed at a higher rate than would otherwise apply to the long-term capital gain.

The taxpayer reports the exclusion amount on Form 8949 with the name of the corporation whose stock was sold and the adjustment code "Q." If less than 100% of the gain is excluded, the remaining gain is included on the 28% rate gain worksheet, which is part of the series of Schedule D tax worksheets included in the Form 1040 instructions.

Empowerment Zone Business Stock. Only gains from stocks in corporations that meet the requirements of QSBS and are **also** qualified business entities operating in empowerment zones (see IRC §1397C(b) for qualifications) are eligible for this special tax treatment. The applicable exclusion rates are shown in the following table.

Acquisition Date	Applicable Exclusion
September 28, 2010, and later	100%
February 18, 2009, through September 27, 2010	75%
December 22, 2000, through February 17, 2009	60%

The reporting requirements for empowerment zone stocks are the same as for QSBS.

Box 2d, Collectibles (28%) Gain

Long-term capital gains on collectibles do not qualify for the lower capital gains rates, although the maximum rate is 28% of the gain.[98] Items categorized as collectibles include antiques, metals, coins, and gems. Accordingly, investors may hold shares in RICs that invest in precious metals like gold or silver, which can have reportable distributions in this category. The amount shown in box 2d is not entered on the tax return. It is included in the calculation of tax on the 28% rate gain worksheet.

Box 3, Nondividend Distributions[99]

Nondividend distributions are a return of capital. Typically, they are not taxable. However, the distributions reduce the basis in the taxpayer's holdings; therefore, they must be tracked. If the distributions exceed the taxpayer's basis in the stock, they are taxable as capital gains.

98. IRC §1(h).

99. IRS Pub. 550, *Investment Income and Expenses.*

If the taxpayer purchases investments in a stock that issued nondividend distributions at different times and cannot definitely identify the shares subject to the nondividend distribution, the taxpayer reduces the basis of the earliest purchases first.

Caution. Brokerage firms must track these distributions for investments made after the investment became a covered security; however, they are not required to report distributions in excess of basis if the investment is not sold or otherwise disposed of during the year.[100] UITs are often structured to return a portion of capital each year. Basis in UITs and other RICs issuing substantial nondividend distributions should be updated annually.

Nondividend distributions can also include stock and other noncash distributions. The value of noncash distributions also reduces the shareholder's basis in the stock. If the basis is reduced to zero, the taxpayer reports any excess distribution as a capital gain.

Example 7. In 2016, Orlando received $19,000 in nondividend distributions according to the Form 1099-DIV he received (as shown in **Example 6).** Review of the supplemental information (not shown) provided by Springs Cobbler showed that $5,000 of the nondividend distribution was from a UIT and $14,000 was a noncash distribution from Vallow, Inc.

Orlando purchased the UIT units in January 2016 for $60,000. The $5,000 nondividend distribution reduced his basis to $55,000. Because Orlando's basis was not reduced below zero, he did not have to report anything related to this distribution on his 2016 return.

Orlando purchased 200 shares of Vallow, Inc. in 1967 for $10 each. To his knowledge, this is the first nondividend distribution, and there have been no stock splits, spin-offs, or split-offs.

The noncash, nondividend distribution from Vallow consisted of 100 shares of Titanium Plastics, Inc. (TP), another publicly traded company, as part of a special dividend. On the date of the distribution, the shares of TP traded for $130 each. Orlando reported a capital gain of $12,000 ($14,000 – ($10 basis per share × 200 shares)) from this distribution.

Box 5, Investment Expenses

Amounts reported in box 5 do **not** represent investment fees paid to the broker issuing the Form 1099-DIV. Only the investor's pro rata share of certain expenses passed through by a nonpublicly offered RIC are reported in this box.[101]

Caution. Practitioners should look in the supplemental information provided by the brokers for other investment expenses.

Boxes 6, Foreign Tax Paid, and 7, Foreign Country or U.S. Possession[102]

Box 6 represents the foreign taxes withheld from dividends before the corporations paid the dividends.[103] Typically, brokers include a breakdown of the amount withheld from each investment's payouts and the country the foreign taxes were paid to in the supplemental information. Box 7 shows the specific country for which the foreign taxes were paid. Forms 1099-DIV from brokers often show "various" in box 7.

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100. IRC §6045(g).

101. Instructions for Form 1099-DIV.

102. Instructions for Form 1116.

103. Instructions for Form 1099-DIV.

Taxpayers use Form 1116, *Foreign Tax Credit,* to calculate the amount of credit that they may claim for foreign taxes withheld from interest and dividends. However, for many investors, this form is not required. In the following circumstances, individual taxpayers may claim the credit directly on line 48 ("foreign tax credit") of Form 1040 instead of filing Form 1116.

1. The total foreign taxes withheld are not more than $300 ($600 if married filing jointly).
2. All of the withholding is from passive category income, which includes interest and dividends except those received from controlled foreign corporations in which the taxpayer owns 10% or more of the voting power of the company.
3. All of the income and related foreign taxes paid were reported on a qualified payee statement, such as Form 1099-DIV, Form 1099-INT, or a Schedule K-1.

The taxpayer makes the election to forgo filing Form 1116 by not filing the form if it is not required and instead entering the amount directly on Form 1040. This election is not available to estates and trusts.

In lieu of claiming the foreign taxes as a credit, the taxes may be deductible on Schedule A. This strategy is only advantageous in rare circumstances. Therefore, it is not covered here.

With or without the election, the credit is **limited** to the ratio of net foreign source taxable income to modified taxable income, multiplied by the taxpayer's total income tax. Therefore, the calculations on Form 1116 must be completed. Absent the election, any foreign taxes in excess of the current year's credit may be carried back one year and then forward 10 years. With the election, the current year excess is lost, but carryovers from and to other years are unaffected. In addition, **with the election**, the AMT foreign tax credit is the same as calculated for regular tax purposes.[104]

Completing Form 1116. Form 1116 can be very complicated when the taxpayer has foreign taxes related to non-investment income. Such intricacies are outside the scope of this chapter.

The first task in completing Form 1116 is to categorize the source of the interest and dividends by country. **However, all foreign taxes passed through by RICs are grouped into a single category**.

High-income taxpayers whose **qualified** foreign dividends are $20,000 or greater must adjust the amount of foreign income reported on Form 1116. Essentially, a portion of the foreign investment income that was taxed at lower rates is excluded from foreign source income. This requirement only applies to taxpayers whose taxable ordinary income exceeds certain thresholds based on filing status ($191,650 for single taxpayers, $233,350 for MFJ or qualifying widow(er) taxpayers, $116,675 for MFS taxpayers, and $212,500 for head of household taxpayers in 2017).

The second task is to allocate expenses related to earning the foreign income to the applicable income.[105] Expenses may be allocated to a class of gross income (e.g., dividends) consisting of one or more items of gross income (e.g., dividends from multiple sources).

IRS Pub. 514, *Foreign Tax Credit for Individuals*, explains that expenses are definitely related to a specific class of gross income if they are incurred either:

- As a result of, or incident to, an activity from which that income is derived; or
- In connection with property from which that income is derived.

If the taxpayer itemizes, certain itemized deductions that are not specifically related to earning the foreign income are prorated based on total gross income from foreign sources and all sources.

104. Instructions for Form 6251.

105. Treas. Reg. §1.861-8(b).

Next, the foreign taxes paid are entered in part II of Form 1116. The instructions indicate that "1099 taxes" may be entered in column (j) if the foreign taxes paid on passive income are reported on Form 1099-DIV, Form 1099-INT, or a similar statement. However, if the preparer's software will not accept an entry other than a date, it is standard practice to use the last day of the taxpayer's year.

Columns (k) through (n), which are used to report the taxes in the originating foreign currencies by category, are not required for foreign taxes reported on Form 1099-DIV, Form 1099-INT, or similar statement. The foreign tax withheld expressed in U.S. currency is entered in columns (o) through (r).

Any carryback (on an amended return) or carryover (from prior years) of unused foreign tax credits is reported on line 10.

Example 8. Orlando's 2016 Form 1099-DIV (see **Example 6)** showed $600 of foreign tax paid. A review of the supplementary information provided by the brokerage firm (not shown) revealed that the entire $600 was withheld from mutual fund dividends.

Orlando's completed Form 1116 follows. Orlando was required to file Form 1116 because his foreign tax withheld exceeded $300. His 2016 credit was limited because the foreign taxes paid were higher than the proportional amount of federal taxes attributable to his foreign investment income.

For Example 8

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

Foreign Tax Credit

(Individual, Estate, or Trust)

▶ Attach to Form 1040, 1040NR, 1041, or 990-T.

▶ Information about Form 1116 and its separate instructions is at *www.irs.gov/form1116*.

OMB No. 1545-0121 — 2016 — Attachment Sequence No. 19

Name	Identifying number as shown on page 1 of your tax return
Orlando Bay	555-44-1099

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

a ☒ Passive category income
b ☐ General category income
c ☐ Section 901(j) income
d ☐ Certain income re-sourced by treaty
e ☐ Lump-sum distributions

f Resident of (name of country) ▶ USA

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

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

Line	Description	A	B	C		Total (Add cols. A, B, and C.)
g	Enter the name of the foreign country or U.S. possession ▶	RIC				
1a	Gross income from sources within country shown above and of the type checked above (see instructions): Form 1099s	6,000			1a	6,000
b	Check if line 1a is compensation for personal services as an employee, your total compensation from all sources is $250,000 or more, and you used an alternative basis to determine its source (see instructions) ▶ ☐					
	Deductions and losses (Caution: See instructions.):					
2	Expenses **definitely related** to the income on line 1a (attach statement)					
3	Pro rata share of other deductions **not definitely related:**					
a	Certain itemized deductions or standard deduction (see instructions)	16,625				
b	Other deductions (attach statement)					
c	Add lines 3a and 3b	16,625				
d	Gross foreign source income (see instructions)	6,000				
e	Gross income from all sources (see instructions)	100,750				
f	Divide line 3d by line 3e (see instructions)	0.0596				
g	Multiply line 3c by line 3f	991				
4	Pro rata share of interest expense (see instructions):					
a	Home mortgage interest (use the Worksheet for Home Mortgage Interest in the instructions)					
b	Other interest expense					
5	Losses from foreign sources					
6	Add lines 2, 3g, 4a, 4b, and 5	991			6	991
7	Subtract line 6 from line 1a. Enter the result here and on line 15, page 2 ▶				7	5,009

Part II Foreign Taxes Paid or Accrued (see instructions)

Country	Credit is claimed for taxes (you must check one): (h) ☒ Paid (i) ☐ Accrued — (j) Date paid or accrued	In foreign currency — Taxes withheld at source on: (k) Dividends	(l) Rents and royalties	(m) Interest	(n) Other foreign taxes paid or accrued	In U.S. dollars — Taxes withheld at source on: (o) Dividends	(p) Rents and royalties	(q) Interest	(r) Other foreign taxes paid or accrued	(s) Total foreign taxes paid or accrued (add cols. (o) through (r))
A	12/31/2016					600				600
B										
C										

8 **Add lines A through C, column (s). Enter the total here and on line 9, page 2** ▶ 8 600

For Paperwork Reduction Act Notice, see instructions. Cat. No. 11440U Form **1116** (2016)

For Example 8

Form 1116 (2016) Page **2**

Part III Figuring the Credit

9	Enter the amount from line 8. These are your total foreign taxes paid or accrued for the category of income checked above Part I	9	600
10	Carryback or carryover (attach detailed computation)	10	
11	Add lines 9 and 10	11	600
12	Reduction in foreign taxes (see instructions)	12	( )
13	Taxes reclassified under high tax kickout (see instructions)	13	
14	Combine lines 11, 12, and 13. This is the total amount of foreign taxes available for credit	14	600
15	Enter the amount from line 7. This is your taxable income or (loss) from sources outside the United States (before adjustments) for the category of income checked above Part I (see instructions)	15	5,009
16	Adjustments to line 15 (see instructions)	16	
17	Combine the amounts on lines 15 and 16. This is your net foreign source taxable income. (If the result is zero or less, you have no foreign tax credit for the category of income you checked above Part I. Skip lines 18 through 22. However, if you are filing more than one Form 1116, you must complete line 20.)	17	5,009
18	**Individuals:** Enter the amount from Form 1040, line 41; or Form 1040NR, line 39. **Estates and trusts:** Enter your taxable income without the deduction for your exemption	18	82,625
	Caution: If you figured your tax using the lower rates on qualified dividends or capital gains, see instructions.		
19	Divide line 17 by line 18. If line 17 is more than line 18, enter "1"	19	0.0606
20	**Individuals:** Enter the amounts from Form 1040, lines 44 and 46. If you are a nonresident alien, enter the amounts from Form 1040NR, lines 42 and 44. **Estates and trusts:** Enter the amount from Form 1041, Schedule G, line 1a; or the total of Form 990-T, lines 36, 37, and 39	20	9,362
	Caution: If you are completing line 20 for separate category **e** (lump-sum distributions), see instructions.		
21	Multiply line 20 by line 19 (maximum amount of credit)	21	567
22	Enter the **smaller** of line 14 or line 21. If this is the only Form 1116 you are filing, skip lines 23 through 27 and enter this amount on line 28. Otherwise, complete the appropriate line in Part IV (see instructions) ▶	22	567

Part IV Summary of Credits From Separate Parts III (see instructions)

23	Credit for taxes on passive category income	23	
24	Credit for taxes on general category income	24	
25	Credit for taxes on certain income re-sourced by treaty	25	
26	Credit for taxes on lump-sum distributions	26	
27	Add lines 23 through 26	27	
28	Enter the **smaller** of line 20 or line 27	28	567
29	Reduction of credit for international boycott operations. See instructions for line 12	29	
30	Subtract line 29 from line 28. This is your **foreign tax credit.** Enter here and on Form 1040, line 48; Form 1040NR, line 46; Form 1041, Schedule G, line 2a; or Form 990-T, line 41a ▶	30	567

Form **1116** (2016)

Box 8, Cash Liquidation Distributions, and Box 9, Noncash Liquidation Distributions[106]

A corporation that makes distributions as part of a partial or complete liquidation reports the liquidating distributions on Form 1099-DIV in box 8 if the distribution is in cash and box 9 if the distribution is noncash. These distributions are essentially a return of capital. Accordingly, the distribution first reduces the stockholder's basis in their shares.

If the stock was acquired in more than one transaction, each purchase is considered a block. Liquidating distributions reduce basis in proportion to each block's number of shares. Partial liquidations are prorated among the part of the stock redeemed in the partial liquidation.

After the basis in any block of stocks is reduced to zero, the excess is reported as a capital gain. This may occur before the year of the final liquidating distribution. If the taxpayer has basis remaining after the final liquidating distribution, the taxpayer may claim a capital loss for the unrecovered basis. These transactions are reported on Form 8949.

> **Caution.** Even though the liquidation involves a disposition of the shares of the corporation, Form 1099-B does not typically show the disposition. Brokerage companies are only required to report transactions involving sales or dispositions.[107] Even if the stock in the liquidated company is a covered security, the redemption or cancellation of the stock may not trigger Form 1099-B reporting. Careful review of the supplemental information supplied by brokerage companies may yield the necessary information to properly report liquidation distributions.

Box 10, Exempt-Interest Dividends, and Box 11, Specified Private Activity Bond Interest Dividends[108]

Boxes 10 and 11 are used by RICs that invest in municipal bonds to report the tax-exempt interest received by the funds that was passed through to the shareholders. These dividends are reported the same way as tax-exempt interest that the taxpayer received directly from municipal bonds. (See the subsection titled "Tax-Exempt Interest from State and Local Governments" earlier in this chapter.)

FORM 1099-B, SCHEDULE D, AND FORM 8949 ISSUES

Brokers are required to report cost basis information for covered securities on Form 1099-B for transactions involving sales or dispositions.[109] As explained previously, the effective dates that brokers are required to track basis varies depending on the type of security. Basis in noncovered securities may be provided in the supplemental information if the broker has the information needed to determine basis.

REPORTING FORM 1099-B TOTALS ONLY ON SCHEDULE D[110]

Sales and exchanges of capital assets are reported on Form 8949. A separate form is required for each category of sales.

1. Transactions for which the basis **was** reported to the IRS on Form 1099-B
2. Transactions reported to the IRS on Form 1099-B for which the basis was **not** reported to the IRS
3. Transactions which were not reported on Form 1099-B

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106. IRS Pub. 550, *Investment Income and Expenses*.

107. IRC §6045(g).

108. IRS Pub. 550, *Investment Income and Expenses;* Instructions for Form 1099-DIV.

109. IRC §6045(g).

110. Instructions for Form 8949.

The IRS simplified reporting for certain taxpayers who receive Forms 1099-B that include basis. To qualify, all the following conditions must be met.

1. The taxpayer received a Form 1099-B that does **not** show any adjustments in box 1f or 1g. (Box 1f of Form 1099-B shows adjustments for accrued market discounts (see **Example 5)** and box 1g shows losses disallowed due to wash sale rules.)

2. The "ordinary" box in box 2 of Form 1099-B must **not** be checked.

3. The taxpayer is **not** required to make any adjustments to the basis or the type of gain or loss reported on the Form 1099-B.

If the taxpayer uses this method, all Forms 1099-B with basis may be aggregated on two lines of Schedule D. Total proceeds and cost basis for **short-term** transactions are entered on line 1a of Schedule D and totals for **long-term** transactions are entered on line 8a. A taxpayer who uses this method is not required to attach the detail of the transactions to the return. In addition, the taxpayer is not required to send the detail to the IRS attached to Form 8453, *U.S. Individual Income Tax Transmittal for an IRS e-file Return.*

Example 9. Dan began dabbling in the stock market in 2016. He used an online brokerage account to make numerous trades. He bought and sold stocks over 100 times during the year. The Form 1099-B he received from the brokerage company included the basis in all of his trades. Dan opted to report the information on line 1a of his 2016 Schedule D, which follows.

For Example 9

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR.
▶ Information about Schedule D and its separate instructions is at *www.irs.gov/scheduled*.
▶ Use Form 8949 to list your transactions for lines 1b, 2, 3, 8b, 9, and 10.

OMB No. 1545-0074
2016
Attachment Sequence No. 12

Name(s) shown on return	Your social security number
Dan Harden	222-12-2016

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

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part I, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
1a Totals for all short-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 1b	75,000	60,000		15,000
1b Totals for all transactions reported on Form(s) 8949 with **Box A** checked				
2 Totals for all transactions reported on Form(s) 8949 with **Box B** checked				
3 Totals for all transactions reported on Form(s) 8949 with **Box C** checked				

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 1a 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	15,000

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

See instructions for how to figure the amounts to enter on the lines below. This form may be easier to complete if you round off cents to whole dollars.	(d) Proceeds (sales price)	(e) Cost (or other basis)	(g) Adjustments to gain or loss from Form(s) 8949, Part II, line 2, column (g)	(h) Gain or (loss) Subtract column (e) from column (d) and combine the result with column (g)
8a Totals for all long-term transactions reported on Form 1099-B for which basis was reported to the IRS and for which you have no adjustments (see instructions). However, if you choose to report all these transactions on Form 8949, leave this line blank and go to line 8b				
8b Totals for all transactions reported on Form(s) 8949 with **Box D** checked				
9 Totals for all transactions reported on Form(s) 8949 with **Box E** checked				
10 Totals for all transactions reported on Form(s) 8949 with **Box F** checked				

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 8a 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) 2016**

REPORTING ONLY SUMMARY TOTALS ON FORM 8949[111]

Instead of reporting each transaction on a separate row of Form 8949, they can be reported on an attached statement containing all of the same information in a similar format (i.e., description of property, dates of acquisition and disposition, proceeds, basis, adjustment and code(s), and gain or loss).

This method can be particularly useful when the brokerage company has provided the cost basis information for noncovered securities in supplemental statements, which can be electronically attached to e-filed returns. Each broker's statements must be reported separately so that the IRS can match the taxpayer's return to the amounts reported on Form 1099-B. Thus, even with this method, there could be four entries on the return for each brokerage company (short-term with basis reported to the IRS, short-term without basis reported, long-term with basis reported, long-term without basis reported).

The tax preparer makes the following entries to indicate that statements are attached rather than reporting individual transactions.

1. The name of the broker on the Form 1099-B is entered instead of a description of property sold. "See attached statement" follows the name of the broker.
2. The date acquired and date sold columns are left blank. (However, some software enters "See Stmnt.")
3. The total of the sales proceeds reported by the broker is entered in the proceeds column for each category of sale. The corresponding cost basis, as shown in the statement attached to the return, is reported in the basis column.
4. Code "M" is entered in column (f) to indicate to the IRS that the details of the reportable transactions are attached to the return.

These entries are shown on the following Form 8949.

111. Ibid.

Form **8949**

Department of the Treasury
Internal Revenue Service

Sales and Other Dispositions of Capital Assets

▶ Information about Form 8949 and its separate instructions is at *www.irs.gov/form8949.*
▶ File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074
2016
Attachment Sequence No. **12A**

Name(s) shown on return: Taxpayer
Social security number or taxpayer identification number: TAX ID #

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are short term. For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☒ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)
☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS
☐ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions. (f) Code(s) from instructions	(g) Amount of adjustment	(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
Broker name: See attached statement			Proceeds	Basis	M		Gain/(Loss)

Note. Practitioners need to be aware of their software's limitations and how it handles such transactions.

REPORTING CORRECTIONS TO FORM 1099-B ON FORM 8949[112]

The basis amounts reported by brokers are not always correct. The IRS allows taxpayers to report an adjustment to the basis reported by the brokerage company on Form 8949. The instructions for Form 8949 include a list of codes to use to indicate which type of adjustment applies. If the basis reported on Form 1099-B is incorrect, code B is used in column (f).

Note. See **Example 23** for a common situation in which the basis reported on Form 1099-B must be adjusted.

112. Ibid.

MUTUAL FUND BASIS METHODS[113]

When mutual fund shares are sold, gain or loss is measured by the difference between the amount realized from the sale of the fund shares and the basis of those shares. If all the shares in a fund are disposed of in a single transaction, the basis determination is not complex. However, the basis calculation is more difficult when only a portion of a taxpayer's interest in a fund is disposed of and the shares were acquired at different times and at difference prices. In this situation, a taxpayer can choose any of the following three methods to determine the basis of their mutual fund shares when the taxpayer sells the shares.

1. **Specific share identification** is the best way for a taxpayer to plan the amount of gain/loss that they will realize upon the sale of some (but not all) of their shares in a particular investment. The taxpayer must indicate to the broker at the time of the sale exactly which shares or lots that they are selling. The taxpayer also must receive confirmation of their specification in writing from the broker.

> **Note.** See the 2016 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 5: Wealth Accumulation and Preservation, for a discussion of the methods of calculating basis to determine which specific stocks to sell.

2. The **first-in, first-out (FIFO) method** is the default method when the taxpayer does not specifically identify the shares sold. Under this method, the shares acquired first are the shares treated as sold first.

3. The **average basis method** averages the basis of all of the shares of an identical stock in an account regardless of the holding period. This method is explained in detail next.

> **Note.** Unlike the first two methods, the average basis method can also be used for shares held in connection with a DRP as well as shares held in a mutual fund. Shares held in a DRP plan are not identical to shares held outside of the DRP even if they have the identical committee on uniform securities identification procedures (CUSIP) number.

The basis of mutual fund shares that were acquired by reinvesting distributions from the fund is calculated using the amount of the distributions that were used to purchase each full and fractional share. This rule applies even if the distribution is an exempt-interest dividend that was not taxed.

Average Basis

The taxpayer can only use the average basis method for the following types of investments.

- Mutual funds and other RICs
- Shares held in connection with a DRP if all shares in the account are covered securities
- Shares acquired after 2011 in connection with a DRP

Although the basis is determined using the average cost of the investment, the character of the gain/loss as short- or long-term is determined using the FIFO method.

113. IRS Pub. 550, *Investment Income and Expenses.*

Example 10. Shawn inherited 1,000 shares of Blitz Small Markets Equity and Income Fund (BSMX) in 2014. Dividends and capital gains are distributed annually. Shawn elected to reinvest both types of distributions. The following table shows his acquisition and basis history.

Date	Type of Acquisition	Number of Shares	Price Per Share	Basis
September 9, 2014	Inheritance (FMV)	1,000	$20	$20,000
December 1, 2014	Dividends	50	15	750
December 1, 2014	Capital gain distributions (CGD)	150	15	2,250
December 1, 2015	Dividends	30	35	1,050
December 1, 2015	CGD	170	35	5,950
Totals		1,400		$30,000
Divided by number of shares				÷ 1,400
Average cost per share				$ 21.43

On September 18, 2016, Shawn sold 700 shares of BSMX for $40 per share, realizing $28,000. Using the average basis method, his basis was $15,001 ($21.43 × 700) and his gain was $12,999 ($28,000 – $15,001). He reported the sale as a long-term capital gain on his 2016 return because the shares disposed of are considered to be those acquired first (i.e., on September 9, 2014).

Observations for Example 10

1. **Shawn's ordinary marginal tax rate was 25%**, so his capital gain tax rate was 15%. Using the **average basis method**, his total federal income tax on the sale was **$1,950** ($12,999 × 15%).
2. If Shawn had used the **FIFO method**, his basis would have been $14,000 (700 shares × $20 price per share of oldest shares) and his long-term capital gain would have been $14,000 ($28,000 – $14,000). His total federal income tax on the sale would be **$2,100** ($14,000 × 15%).
3. If Shawn had used the specific identification method, he could have identified the shares to be sold as those that had the highest basis. Using this method, he would have sold the 200 shares acquired in 2015 and 500 of the inherited shares.

   The 200 (170 + 30) shares acquired in 2015 had a combined basis of $7,000 ($1,050 + $5,950). The sales proceeds for these 200 shares was $8,000 (200 shares × $40 sales price per share) and his short-term capital gain would have been $1,000 ($8,000 – $7,000).

   The 500 inherited shares had a basis of $10,000 (500 × $20). The sales proceeds for these 500 shares was $20,000 (500 × $40). His net long-term capital gain would have been $10,000 ($20,000 – $10,000).

   By **identifying** the shares to sell using the highest-cost method, Shawn's tax would be **$1,750** (($1,000 × 25% ordinary income tax rate) + ($10,000 × 15% long-term capital gain rate)).
4. These results would be different if Shawn's **marginal ordinary income tax rate was 15%.** Assuming that the entire gain fell within the 15% bracket, Shawn would pay 0% federal income tax on long-term capital gains. In that case, the average cost and FIFO methods would yield no federal tax cost. However, the federal income tax using the specific identification highest-cost method would be **$150** ($1,000 × 15% ordinary tax rate).

Making the Election to Use Average Basis Method

Covered Securities. To make the election to use the average basis method for covered securities, the taxpayer must send written notice to the custodian or agent who keeps the account. The taxpayer can send the written notice electronically. The taxpayer must also notify their broker of the election if the custodian and broker are different agents. Generally, mutual funds and DRP shares are covered securities if acquired after 2011, as explained previously.

A taxpayer may make the election to use the average basis method at any time. The election is effective for sales or other dispositions of stocks that occur after the taxpayer notifies the custodian or agent of the election. The election must identify each account with that custodian or agent and each stock in that account to which the election applies. However, the election can also indicate that it applies to all accounts with a custodian or agent, including accounts later established with the custodian or agent.

The taxpayer can revoke the election to use the average basis method for **covered securities** by sending written notice to the custodian or agent holding the stock. The taxpayer must generally revoke the election by the earlier of the following dates.

- One year after the election is made
- The date of the first sale, transfer, or disposition of the stock following the election

The revocation applies to all the stock in an account that is identical to the shares of stock for which the taxpayer is revoking the election.

Noncovered Securities. For noncovered securities, a taxpayer elects to use the average basis method on their income tax return for the first tax year that the election applies. The taxpayer makes the election by indicating on the return that the average basis method was used in reporting gain or loss on the sale or other disposition. The taxpayer can also make the election on an amended return filed no later than the due date (including extensions) for filing the original return for the tax year for which the election applies.[114]

INTEREST INCOME FROM LOANS

IMPUTED INTEREST ON BELOW-MARKET LOANS[115]

Below-market loans are loans that charge interest at a rate lower than the applicable federal rate (AFR) at the time the loan was issued. In certain circumstances, taxpayers are required to report the imputed interest, which is the interest they would have received if they had charged at least the AFR instead of the lower interest rate.

Applicable Federal Rates

The IRS is required to calculate the AFRs each month for a variety of tax purposes. These rates are published each month in revenue rulings.

There are five tables of AFRs published by the IRS each month. Each table is required by certain Code sections.[116] However, other Code sections often use these AFRs as the starting point for rates related to the requirements of that section. For example, the IRS interest rate for late payments of tax is determined under IRC §6621. Subsection (b)(3) describes the short-term rate calculated under IRC §1274(d) as the starting point for the calculation of the interest rate for late payments. **Table 1 is used for determining the AFR on below-market loans.[117]** Although the other tables do not apply to loan interest income, a description of their uses is provided for information purposes only.

114. Treas. Reg. §1.1012-1(e)(9).

115. IRS Pub. 550, *Investment Income and Expenses.*

116. Rev. Rul. 2016-26, 2016-45 IRB 538.

117. IRC §7872(f)(2), referencing IRC §1274(d).

- **Table 1** is required by IRC §1274(d) in order to determine the minimum interest rate charged for debt related to the sale or exchange of property. The rates are based on the average market yield of U.S. marketable obligations (e.g., U.S. Savings Bonds).[118] The table is divided into subcategories based on the **term of the loan** and the period for compounding.
  - **Short-term:** three years or less
  - **Mid-term**: Over three years but not over nine years
  - **Long-term**: Over nine years
- **Table 2** is required by IRC §1288(b) in order to determine the OID on tax-exempt obligations.
- **Table 3** is required by IRC §382(f) as part of determining the limitation on net operating loss carryforwards and certain built-in losses following corporate ownership changes.
- **Table 4** is required by IRC §42(b) as part of determining the low-income housing credit for qualified buildings placed in service during the month.
- **Table 5** is required by IRC §7520 to determine the present value of:
  - An annuity,
  - An interest for life or for a term of years, or
  - A remainder or a reversionary interest.

Loans Subject to the Below-Market Loan Rules[119]

The rules for below-market loans apply to the following.

1. Gift loans — loans in which the forgone interest is in the nature of a gift
2. Pay-related loans — loans between an employer and an employee or between an independent contractor and a person for whom the contractor provides services
3. Corporation-shareholder loans — loans to and from shareholders of the corporation
4. Tax avoidance loans — loans in which the avoidance of federal tax is one of the main purposes of the interest arrangement
5. Certain loans made to qualified continuing care facilities under a continuing care contract — applies when neither the lender nor the lender's spouse is age 62 or older at the end of the year
6. Gift loans to qualified charitable organizations of **more than** $250,000

The rules do not apply to loans without any significant tax effect. (For examples, see IRS Pub. 550, *Investment Income and Expenses*.)

The rules for below-market loans do **not** apply if the total outstanding amount of loans between the borrower and lender is $10,000 or less. This exception applies to the following types of loans.

1. Gift loans between individuals not directly used to buy or carry income-producing assets
2. Pay-related loans or corporate-shareholder loans if the principal purpose of the interest arrangement is not to avoid federal tax (This does not apply to a term loan that was previously subject to the below-market rules.)

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118. IRC §1274(d)(1)(C)(i).

119. IRS Pub. 550, *Investment Income and Expenses.*

Demand Versus Term Loans[120]

A **demand loan** is a loan payable in full at any time the lender demands it. A demand loan is a below-market loan if no interest is stated or if interest is stated at a rate below the short-term AFR.[121]

A **term loan** is any loan that is not a demand loan. A term loan is a below-market loan if the amount of the loan is more than the present value of all payments due under the loan. The present value of the loan is calculated using the AFR on the date of the loan for the appropriate compounding period and maturity term.[122] The difference between the present value and the face amount of the loan is the OID. The lender must report the annual part of the OID as interest income. The borrower may be able to deduct the OID as interest expense.

Rules for Demand and Gift Loans[123]

A below-market demand or gift loan is generally treated as an arm's-length transaction in which the **lender** makes:

1. A loan to the borrower in exchange for a note that requires the payment of interest at the AFR, and
2. A payment **to the borrower** in an amount equal to the forgone interest.

Generally, the borrower is treated as having transferred the forgone interest back to the lender as interest. The lender must report this as interest income. These interest transfers are considered to occur annually, generally on December 31.

Example 11. On November 18, 2016, Peg loaned Elinor $500,000 for personal purposes. Elinor signed a note payable promising to repay the principal to Peg on demand. The note also stated that the interest rate on the loan is 0%.

If the interest rate on the loan were equal to the AFR, the rate would have been 0.68%.[124] Using the AFR, the interest due on December 31, 2016, would have been $399 ($500,000 × 0.68% × (43 days ÷ 366 days in 2016)).

For tax purposes, Peg is treated as having made a $399 gift to Elinor, which Elinor immediately used to pay the interest due on the loan. Peg claimed $399 of interest income on her 2016 return.

Elinor did not claim the gift as income on her 2016 return. Additionally, she cannot deduct the interest payment because the loan was used for personal purposes.

Note. Depending on the transaction's substance, the lender's "payment" to the borrower is treated as a gift, dividend, contribution to capital, compensation, or other payment. Depending on its classification, the borrower may have to report it as taxable income.

Forgone Interest for Gift Loans of $100,000 or Less. For gift loans between individuals, if the outstanding loans between the lender and borrower total $100,000 or less, the forgone interest included in income by the lender and deducted by the borrower is limited to the amount of the borrower's net investment income (NII).[125] If the borrower's NII does not exceed $1,000, the forgone interest is treated as zero. This limit does not apply to a loan if federal tax avoidance is one of the main purposes of the interest arrangement.

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120. IRC §7872.

121. IRC §7872(f)(2)(B).

122. IRC §7872(f).

123. IRS Pub. 550, *Investment Income and Expenses.*

124. Rev. Rul. 2016-26, 2016-45 IRB 538.

125. As defined in IRC §163(d)(4).

Rules for Pay-Related Loans and Corporation-Shareholder Loans

As stated previously, the rules for below-market loans generally do not apply to pay-related and corporation-shareholder loans if the total outstanding amount of loans between the borrower and lender is $10,000 or less. However, the rules **do apply** to loans of $10,000 or less in either of the following circumstances.

1. Avoidance of federal tax is the principal purpose of the arrangement.
2. The loan is a term loan that was previously subject to the below-market loan rules.

Pay-Related Loans.[126] For loans between an employer and an employee over $10,000, the employer is treated as transferring the forgone interest to the employee as additional compensation (subject to social security, Medicare, and FUTA taxes).[127] The employee is treated as paying interest back to the employer.

Different rules apply to demand loans and term loans. For demand loans, the imputed interest payments and deemed transfer of additional compensation are treated as being made annually. For term loans, the lender is treated at the time of the loans as transferring the difference between the loan amount and the present value of all the future payments under the loan as additional compensation. The term loan is then treated as having OID equal to the amount of the deemed transfer of additional compensation and is subject to the OID provisions of IRC §1272 *et. seq.*

Corporation-Shareholder Loans.[128] For loans to shareholders over $10,000, the corporation is treated as transferring the forgone interest to the shareholder as a distribution of property. For C corporations, the distribution is generally treated as a dividend.[129] For S corporations, the distribution generally reduces basis. However, if the corporation was a C corporation prior to electing S status, it might have accumulated earnings and profits that could affect the characterization of the distribution.[130]

For most loans over $10,000 to shareholders who are also employees, the loan is presumed to be a corporation-shareholder loan absent other evidence. This applies to shareholders directly or indirectly owning more than 0.5% of the stock of publicly held corporations or more than 5% of the stock of closely held corporations.

For below-market loans over $10,000 from shareholders to corporations, the forgone interest is treated as a contribution to capital. Shareholders recognize income to the extent of the forgone interest. The corporations increase contributed capital and interest expense.

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126. *Executive Compensation - Fringe Benefits Audit Techniques Guide (02-2005).* Jan. 4, 2017. IRS. [www.irs.gov/businesses/corporations/executive-compensation-fringe-benefits-audit-techniques-guide-02-2005] Accessed on Jan. 13, 2017.

127. Prop. Treas. Reg. §1.7872-11(d). See also Rev. Proc. 81-48, 1981-2 CB 623, and Rev. Rul. 86-14, 1986-1 CB 304, for the formula for calculating an employee's FICA wages when the employer pays the FICA tax without deducting the amount of the tax from the employee's pay. See also IRS Pub. 15-A, *Employer's Supplemental Tax Guide.*

128. Prop. Treas. Reg. §1.7872-4(d).

129. IRC §301.

130. See IRC §1368.

SELF-CHARGED LOAN INTEREST[131]

Special passive-activity rules apply to loans between taxpayers and pass-through entities in which the taxpayers holds a direct or qualifying indirect interest. These rules also apply to identically owned pass-through entities. Under these rules, interest income is classified as passive income on Form 8582, *Passive Activity Loss Limitations.*

In general, passive activity income does not include interest income.[132] If a taxpayer loans money to a passive activity with pass-through losses, this could result in the taxpayer claiming portfolio interest income and not being allowed to deduct the related pass-through loss from the entity. Similarly, interest income reported by passive activities is treated as portfolio income, but the interest expense incurred by the taxpayer from investments in passive activities could be limited under the passive activity rules.

> **Note.** For a thorough explanation of the passive activity rules, see the 2014 *University of Illinois Federal Tax Workbook,* Volume B, Chapter 4: Passive Activities. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

Taxpayer Loans to Pass-Through Entity

Generally, these special passive-activity rules apply if a taxpayer's share of a borrowing entity's self-charged interest deduction passes through to the taxpayer as a passive deduction. In such case, the applicable percentage of interest charged to the entity is treated as passive activity gross income from the activity. The **applicable percentage** is obtained by dividing the taxpayer's share of the borrowing entity's self-charged interest deductions that are treated as passive activity deductions for the tax year by **the greater** of the following.[133]

1. The taxpayer's share of the borrowing entity's aggregate self-charged interest deductions for all activities for the tax year (both passive and nonpassive)
2. The taxpayer's aggregate interest income from the borrowing entity for all activities of the entity

Example 12. Neha owns 50% of a partnership in which she actively participates. In 2016, she received $10,000 of interest income on a loan she made to the partnership.

The partnership used 75% of the loan for passive rental real estate purposes and 25% of the loan for a business activity.

The $10,000 is the only self-charged interest the partnership paid in 2016. The partnership deducted $7,500 of self-charged interest expense from its passive rental real estate income and $2,500 from the business activity.

Neha's share of the passive activity interest deduction was $3,750 (50% × $7,500). This is divided by the greater of the following.

1. Her share of all of the self-charged interest, which is $5,000 (50% × $10,000).
2. Her total interest income from the partnership, which is $10,000.

Therefore, Neha's applicable percentage is 37.5% ($3,750 ÷ $10,000). Accordingly, $3,750 ($10,000 × 37.5%) of her interest income was recharacterized as passive income for purposes of determining her allowed passive losses on Form 8582.

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131. TD 9013, 2002-2 CB 542; Treas. Regs. §§1.469-7 and 1.469-11.

132. IRC §469(e)(1).

133. TD 9013, 2002-2 CB 542.

Pass-Through Entity Loans to Taxpayer

Generally, the special passive-activity rules apply when interest paid to an entity from a loan to the taxpayer passes through to the taxpayer as interest income. In addition, the taxpayer must have used the loan proceeds in a passive activity. In such case, the taxpayer treats the applicable percentage of interest passed through by the entity as passive activity gross income on Form 8582. The applicable percentage is determined by the following formula.

The taxpayer's deductions for the tax year for interest charged by the lending entity, to the extent treated as passive activity deductions from the passive activity, divided by **the greater** of the following.[134]

1. The taxpayer's aggregate deductions for all activities for the tax year for interest charged by the lending entity, regardless of whether these deductions are treated as passive activity deductions
2. The taxpayer's aggregate share for the tax year of the lending entity's self-charged interest income for all the lending entity's activities

Example 13. Emily and Fred each own 50% of the stock of TriX, Inc., an S corporation. Emily borrowed $40,000 from TriX, and paid TriX $2,000 of interest in 2016. Emily used $10,000 of the loan proceeds to make a personal expenditure and used $30,000 of the loan proceeds to invest in rental real estate. (This real estate is not rented to TriX.) Thus, 75% of the loan ($30,000 ÷ $40,000) was used for deductible purposes.

Emily and Fred each received $1,000 as their pro rata share of TriX's interest income from the loan for the tax year. Accordingly, Emily's self-charged interest income for the year was $1,000.

Emily incurred a $6,000 loss on the rental property in 2016. Her income was too high in 2016 for the $25,000 rental real estate allowance under IRC §469(i) to apply. The $6,000 loss included a deduction for $1,500 (75% × $2,000) of interest paid on the loan.

Emily's applicable percentage is 75%, which is calculated by dividing $1,500 by $2,000 (the greater of $2,000 or $1,000). She included $750 of interest income (75% of the $1,000 interest income passed through from TriX) as passive income on Form 8582.

Note. For more information on the $25,000 rental real estate allowance, see the 2014 *University of Illinois Federal Tax Workbook*, Volume B, Chapter 4: Passive Activities. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

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134. Ibid.

Exclusion of Self-Charged Interest from Net Investment Income Tax[135]

Under the self-charged interest rules, pass-through interest income is recharacterized as non-passive income derived from the ordinary course of a trade or business and thereby excluded from the definition of NII. The regulations refer to the passive activity rules only for determining the amount of self-charged interest income that the taxpayer can reclassify and thus exclude from the net investment income tax (NIIT). However, the taxpayer may not exclude interest income if the related interest deduction reduced the amount of the taxpayer's self-employment (SE) income.

Example 14. Justin is the 100% shareholder in an S corporation. In 2016, he materially participated in the activities of the corporation, none of which were passive. He paid the corporation $5,000 in interest on a loan he owed the company. The S corporation passed through the interest income to Justin on his 2016 Schedule K-1, *Shareholder's Share of Income, Deductions, Credits, etc.*

Justin's 2016 filing status was single. His adjusted gross income (AGI) consisted of the following.

Wages	$100,000
S corporation income	100,000
Qualified dividends from mutual funds	15,000
Interest income passed through from the S corporation	5,000
Total adjusted gross income	$220,000

Because Justin's AGI was over $200,000, his investment income is subject to the NIIT. However, he can subtract the $5,000 of self-charged interest from investment income on his Form 8960, *Net Investment Income Tax,* which follows.

Note. Justin's pass-through income from the S corporation is subtracted on line 4b because he materially participated in the S corporation's activities.[136]

135. Instructions for Form 8960. See also Treas. Reg. §1.1411-4(g)(5).

136. Instructions for Form 8960. See also the 2016 *University of Illinois Federal Tax Workbook*, Volume A, Chapter 2: S Corporation Shareholder Issues (p. A79).

For Example 14

Form **8960**

Department of the Treasury
Internal Revenue Service (99)

Net Investment Income Tax— Individuals, Estates, and Trusts

▶ Attach to your tax return.

▶ Information about Form 8960 and its separate instructions is at *www.irs.gov/form8960.*

OMB No. 1545-2227

2016

Attachment Sequence No. **72**

Name(s) shown on your tax return: **Justin Fits**

Your social security number or EIN: **123-45-8960**

Part I Investment Income

☐ Section 6013(g) election (see instructions)
☐ Section 6013(h) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (see instructions)			1	5,000
2	Ordinary dividends (see instructions)			2	15,000
3	Annuities (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (see instructions)	4a	100,000		
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b	(100,000)		
c	Combine lines 4a and 4b			4c	0
5a	Net gain or loss from disposition of property (see instructions)	5a			
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	(5,000)
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	15,000
Part II	**Investment Expenses Allocable to Investment Income and Modifications**				
9a	Investment interest expenses (see instructions)	9a			
b	State, local, and foreign income tax (see instructions)	9b			
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	
10	Additional modifications (see instructions)			10	
11	Total deductions and modifications. Add lines 9d and 10			11	
Part III	**Tax Computation**				
12	Net investment income. Subtract Part II, line 11 from Part I, line 8. Individuals complete lines 13–17. Estates and trusts complete lines 18a–21. If zero or less, enter -0-			12	15,000
	Individuals:				
13	Modified adjusted gross income (see instructions)	13	220,000		
14	Threshold based on filing status (see instructions)	14	200,000		
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	20,000		
16	Enter the smaller of line 12 or line 15			16	15,000
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (.038). **Enter here and include on your tax return** (see instructions)			17	570
	Estates and Trusts:				
18a	Net investment income (line 12 above)	18a			
b	Deductions for distributions of net investment income and deductions under section 642(c) (see instructions)	18b			
c	Undistributed net investment income. Subtract line 18b from 18a (see instructions). If zero or less, enter -0-	18c			
19a	Adjusted gross income (see instructions)	19a			
b	Highest tax bracket for estates and trusts for the year (see instructions)	19b			
c	Subtract line 19b from line 19a. If zero or less, enter -0-	19c			
20	Enter the smaller of line 18c or line 19c			20	
21	Net investment income tax for estates and trusts. Multiply line 20 by 3.8% (.038). **Enter here and include on your tax return** (see instructions)			21	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 59474M Form **8960** (2016)

Example 15. Jaritt is a 50% partner in an LLC which is taxed as a partnership. In 2016, he materially participated in the activities of the LLC, none of which were passive. He paid the company $5,000 in interest on a loan he owed the company. The LLC passed through half of the interest ($2,500) as interest income to Jarritt on his 2016 Schedule K-1.

Jaritt's 2016 filing status was single. His AGI was composed of the following.

Guaranteed payments from LLC	$100,000
Net ordinary income from LLC	100,000
Qualified dividends from mutual funds	27,525
Interest income passed through from LLC	2,500
Deduction for 50% of self-employment tax	(10,025)
Total adjusted gross income	$220,000

Because Jarritt's AGI was over $200,000, his investment income is subject to the NIIT. Jarritt may not subtract the $2,500 interest from his income subject to the NIIT, because his income from the LLC was subject to SE tax. His Form 8960 follows.

Note. Both Justin in **Example 14** and Jarritt in **Example 15** had $20,000 in income above the $200,000 threshold for NIIT. However, Jarritt paid $760 in NIIT and Justin paid only $570.

For Example 15

Form **8960** | Department of the Treasury Internal Revenue Service (99)

Net Investment Income Tax— Individuals, Estates, and Trusts

▶ Attach to your tax return.

▶ Information about Form 8960 and its separate instructions is at *www.irs.gov/form8960.*

OMB No. 1545-2227 | **2016** | Attachment Sequence No. **72**

Name(s) shown on your tax return	Your social security number or EIN
Jarritt Fits	543-21-8960

Part I Investment Income

☐ Section 6013(g) election (see instructions)
☐ Section 6013(h) election (see instructions)
☐ Regulations section 1.1411-10(g) election (see instructions)

1	Taxable interest (see instructions)			1	2,500
2	Ordinary dividends (see instructions)			2	27,525
3	Annuities (see instructions)			3	
4a	Rental real estate, royalties, partnerships, S corporations, trusts, etc. (see instructions)	4a	200,000		
b	Adjustment for net income or loss derived in the ordinary course of a non-section 1411 trade or business (see instructions)	4b	(200,000)		
c	Combine lines 4a and 4b			4c	0
5a	Net gain or loss from disposition of property (see instructions)	5a			
b	Net gain or loss from disposition of property that is not subject to net investment income tax (see instructions)	5b			
c	Adjustment from disposition of partnership interest or S corporation stock (see instructions)	5c			
d	Combine lines 5a through 5c			5d	
6	Adjustments to investment income for certain CFCs and PFICs (see instructions)			6	
7	Other modifications to investment income (see instructions)			7	
8	Total investment income. Combine lines 1, 2, 3, 4c, 5d, 6, and 7			8	30,025

Part II Investment Expenses Allocable to Investment Income and Modifications

9a	Investment interest expenses (see instructions)	9a			
b	State, local, and foreign income tax (see instructions)	9b			
c	Miscellaneous investment expenses (see instructions)	9c			
d	Add lines 9a, 9b, and 9c			9d	
10	Additional modifications (see instructions)			10	
11	Total deductions and modifications. Add lines 9d and 10			11	

Part III Tax Computation

12	Net investment income. Subtract Part II, line 11 from Part I, line 8. Individuals complete lines 13–17. Estates and trusts complete lines 18a–21. If zero or less, enter -0-			12	30,025
	Individuals:				
13	Modified adjusted gross income (see instructions)	13	220,000		
14	Threshold based on filing status (see instructions)	14	200,000		
15	Subtract line 14 from line 13. If zero or less, enter -0-	15	20,000		
16	Enter the smaller of line 12 or line 15			16	20,000
17	Net investment income tax for individuals. Multiply line 16 by 3.8% (.038). **Enter here and include on your tax return** (see instructions)			17	760
	Estates and Trusts:				
18a	Net investment income (line 12 above)	18a			
b	Deductions for distributions of net investment income and deductions under section 642(c) (see instructions)	18b			
c	Undistributed net investment income. Subtract line 18b from 18a (see instructions). If zero or less, enter -0-	18c			
19a	Adjusted gross income (see instructions)	19a			
b	Highest tax bracket for estates and trusts for the year (see instructions)	19b			
c	Subtract line 19b from line 19a. If zero or less, enter -0-	19c			
20	Enter the smaller of line 18c or line 19c			20	
21	Net investment income tax for estates and trusts. Multiply line 20 by 3.8% (.038). **Enter here and include on your tax return** (see instructions)			21	

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 59474M Form **8960** (2016)

PUT AND CALL OPTIONS

An **option** is an investment that gives the owner the right to buy or sell property (usually stock or other securities) in the future at a stated price. Options represent the right to buy or sell shares of the underlying stock. They can be used to protect gains in stocks with an uncertain outlook. The stated price is often called the **strike** price or **exercise** price.

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

> **Example 16.** Cari believes that the price of shares of PTS Inc. stock will increase soon. It is currently trading at $75 per share. She buys a call option for $200. The option gives her the right to purchase 100 shares at $75 per share at any time within 30 days from the date of issuance. If she is right and the market value increases, she can purchase the shares at $75 each and immediately sell them for the new higher price. If she is wrong, she only loses the $200 she invested in the option, as opposed to investing $7,500 in a stock that did not perform as she expected.

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

> **Example 17.** Krissy believes that the price of shares of stock in GMG, Inc. will drop soon. It is currently trading at $75 per share. She buys a put option for $200. The option gives her the right to sell 100 shares at $75 per share at any time within 30 days from the date of issuance. If she is right and the market value decreases, she can purchase the shares on the open market at the lower price and immediately sell the shares at $75, realizing an immediate profit. If she is wrong, she only loses the $200 she invested in the option.

The tax rules applicable to **nonequity options** are different than the rules for **equity options.** Essentially, equity options are related to specific stocks or certain security indexes. Nonequity options are related to all other types of property.[137] Both types of options are covered in this section.

NONEQUITY OPTIONS[138]

Nonequity puts and calls include the following.

1. Broad-based stock index options (e.g., Standard and Poor's 500 Index option contract)
2. Debt options (e.g., U.S. Treasury bonds option contracts)
3. Commodity futures options (e.g., corn or wheat option contracts)
4. Currency options (e.g., Japanese Yen option contracts)

> **Note.** A nonequity option may be purchased as a **hedge** against business risks instead of as a market investment strategy. For example, a farmer may purchase an **option to buy** anhydrous ammonia (a commodity) at a certain price in the future as a hedge against the cost of the chemical increasing. Gains and losses from hedging transactions are reported as ordinary income or loss on the applicable business schedule.[139]

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137. IRS Pub. 550, *Investment Income and Expenses.*

138. Ibid.

139. Treas. Reg. §1.1221-2.

Broad-Based Stock Index Options Defined

Market indexes are designed to gauge the overall condition of the stock market or a particular type of publicly traded stock.[140] For example, the Standard & Poor's 500 Index is a composite based on 500 large U.S. companies that are primarily listed on NASDAQ or the New York Stock Exchange.[141] In contrast, the Russell 2000 Index monitors the stock prices of 2,000 smaller companies.[142]

The Securities and Exchange Commission (SEC) determines which indexes are **broad-based** and which are narrow-based.[143] Based on the SEC's determination, an index fund is taxed under the rules for nonequity options (broad-based) or the rules for equity options (narrow-based).

An **index fund** is a mutual fund or exchange-traded fund (ETF) established to hold investments similar to the ones tracked by a particular index. Accordingly, a **stock index option** is an option to purchase/sell shares in the underlying index fund.

A broad-based stock index option is an option to buy/sell shares of an index fund that is based on an index that the SEC has determined is broad-based. These options are subject to special rules under IRC §1256 (discussed next).[144] A narrow-based stock index option is taxed as an equity option (discussed later).

Rules For Nonequity Options

Nonequity options that are traded on (or subject to the rules of) a qualified board or exchange[145] (e.g., the Chicago Board of Trade) are included in the category of §1256 contracts.[146] IRC §1256(a) requires that any gain or loss from these contracts be allocated 40% to short-term gains/losses and 60% to long-term gains/losses **regardless of the holding period.**[147] In addition, it requires that all §1256 contracts held at yearend be treated **as if they were sold** at fair market value (FMV) on the last business day of the tax year. This treatment is called being marked-to-market. (The wash sale rules do not apply.[148])

The gains and losses from nonequity options and from marking the options to market are reported on Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles*. Brokers are required to report the necessary information to the taxpayer and the IRS using Form 1099-B.[149]

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140. *Market Indices.* Oct. 15, 2012. U.S. Securities and Exchange Commission. [www.sec.gov/answers/indices.htm] Accessed on Feb. 27, 2017.

141. Report titled "S&P U.S. Indices, *Methodology*," found at the website S&P 500. [us.spindices.com/indices/equity/sp-500] (by clicking the Methodology dropdown button) Accessed on Feb. 13, 2017.

142. *Russell U.S. Equity Indexes.* Dec. 2016. FTSE Russell. [www.ftse.com/products/downloads/Russell-US-indexes.pdf?150] Accessed on Feb. 13, 2017.

143. IRS Pub. 550, *Investment Income and Expenses.*

144. Ibid.

145. IRC §1256(g).

146. Instructions for Form 6781.

147. Ibid.

148. Ibid.

149. Instructions for Form 1099-B.

Example 18. Terri started trading options on the EFT commonly known as "The Spider" (or Spyder) in 2016. During the year, she bought and sold 60 options (without exercising them) for a net gain of $1,200. She also held 10 unexpired options at the end of the year. She purchased the open options for $250 each and they were worth $200 each on December 30, 2016 (the last business day of 2016). Her net loss on the open options after marking the options to market at yearend was $500 (10 options × ($250 – $200)).

She received a Form 1099-B from her broker for the transactions. Her tax preparer completed Form 6781, which reflects her $700 net gain ($1,200 – $500). Note that none of the boxes above Part I need to be checked. These forms follow.

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, ZIP or foreign postal code, and telephone no. **Scottytrade** **555 Commercial Ave.** **Tyler, TX 75701**	Applicable check box on Form 8949	OMB No. 1545-0715 **2016** Form **1099-B**	**Proceeds From Broker and Barter Exchange Transactions**
	1a Description of property (Example 100 sh. XYZ Co.) **Sec. 1256 Option Contracts**		
	1b Date acquired	**1c** Date sold or disposed	
PAYER'S federal identification number **37-9999999** / RECIPIENT'S identification number **124-59-7858**	**1d** Proceeds $	**1e** Cost or other basis $	**Copy B** **For Recipient**
	1f Accrued market discount $	**1g** Wash sale loss disallowed $	
RECIPIENT'S name **Terri Cobalt**	**2** Short-term gain or loss ☐ Long-term gain or loss ☐ Ordinary ☐	**3** If checked, 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.
Street address (including apt. no.) **123 Ling St.**	**4** Federal income tax withheld $	**5** If checked, noncovered security ☐	
City or town, state or province, country, and ZIP or foreign postal code **Bourbonnais, IL 60914**	**6** Reported to IRS: Gross proceeds ☐ Net proceeds ☐	**7** If checked, loss is not allowed based on amount in 1d ☐	
Account number (see instructions)	**8** Profit or (loss) realized in 2016 on closed contracts $ **1200.00**	**9** Unrealized profit or (loss) on open contracts—12/31/2015 $	
CUSIP number / FATCA filing requirement ☐	**10** Unrealized profit or (loss) on open contracts—12/31/2016 $ **(500.00)**	**11** Aggregate profit or (loss) on contracts $ **700.00**	
14 State name / **15** State identification no. / **16** State tax withheld $ $	**12** Check if proceeds from collectibles ☐	**13** Bartering $	

Form **1099-B** (Keep for your records) www.irs.gov/form1099b Department of the Treasury - Internal Revenue Service

For Example 18

Form **6781**

Department of the Treasury
Internal Revenue Service

Gains and Losses From Section 1256 Contracts and Straddles

▶ Information about Form 6781 and its instructions is at *www.irs.gov/form6781.*
▶ Attach to your tax return.

OMB No. 1545-0644
2015
Attachment Sequence No. 82

Name(s) shown on tax return	Identifying number
Terri Cobalt	124-59-7858

Check all applicable boxes (see instructions). A ☐ Mixed straddle election B ☐ Straddle-by-straddle identification election C ☐ Mixed straddle account election D ☐ Net section 1256 contracts loss election

Part I Section 1256 Contracts Marked to Market

	(a) Identification of account	(b) (Loss)	(c) Gain	
1	Form 1099-B Scottytrade		700	
2	Add the amounts on line 1 in columns (b) and (c) 2	( )	700	
3	Net gain or (loss). Combine line 2, columns (b) and (c)		3	700
4	Form 1099-B adjustments. See instructions and attach statement		4	
5	Combine lines 3 and 4		5	700
	Note: If line 5 shows a net gain, skip line 6 and enter the gain on line 7. Partnerships and S corporations, see instructions.			
6	If you have a net section 1256 contracts loss and checked box D above, enter the amount of loss to be carried back. Enter the loss as a positive number. If you did not check box D, enter -0-		6	0
7	Combine lines 5 and 6		7	700
8	**Short-term capital gain or (loss).** Multiply line 7 by 40% (.40). Enter here and include on line 4 of Schedule D or on Form 8949 (see instructions)		8	280
9	**Long-term capital gain or (loss).** Multiply line 7 by 60% (.60). Enter here and include on line 11 of Schedule D or on Form 8949 (see instructions)		9	420

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

Section A—Losses From Straddles

	(a) Description of property	(b) Date entered into or acquired	(c) Date closed out or sold	(d) Gross sales price	(e) Cost or other basis plus expense of sale	(f) Loss. If column (e) is more than (d), enter difference. Otherwise, enter -0-	(g) Unrecognized gain on offsetting positions	(h) Recognized loss. If column (f) is more than (g), enter difference. Otherwise, enter -0-
10								

11a	Enter the short-term portion of losses from line 10, column (h), here and include on line 4 of Schedule D or on Form 8949 (see instructions)	11a	( )
b	Enter the long-term portion of losses from line 10, column (h), here and include on line 11 of Schedule D or on Form 8949 (see instructions)	11b	( )

Section B—Gains From Straddles

	(a) Description of property	(b) Date entered into or acquired	(c) Date closed out or sold	(d) Gross sales price	(e) Cost or other basis plus expense of sale	(f) Gain. If column (d) is more than (e), enter difference. Otherwise, enter -0-
12						

13a	Enter the short-term portion of gains from line 12, column (f), here and include on line 4 of Schedule D or on Form 8949 (see instructions)	13a	
b	Enter the long-term portion of gains from line 12, column (f), here and include on line 11 of Schedule D or on Form 8949 (see instructions)	13b	

Part III Unrecognized Gains From Positions Held on Last Day of Tax Year. Memo Entry Only (see instructions)

	(a) Description of property	(b) Date acquired	(c) Fair market value on last business day of tax year	(d) Cost or other basis as adjusted	(e) Unrecognized gain. If column (c) is more than (d), enter difference. Otherwise, enter -0-
14					

For Paperwork Reduction Act Notice, see instructions. Cat. No. 13715G Form **6781** (2015)

Carryback of Losses from §1256 Contracts[150]

Typically, excess losses on capital gains may only be carried forward. However, excess losses on IRC §1256 contracts can be carried back three years at the election of the taxpayer. This makes sense because the mark-to-market rules may have caused the taxpayer to pay taxes on phantom gains in the prior years. The carryback is limited to the IRC §1256 gains actually taxed in the prior years after all capital gains and losses are netted. In addition, the amount of loss carried back to an earlier tax year cannot increase or produce a net operating loss for that year.

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

If only a portion of the net §1256 contracts loss is absorbed by carrying the loss back, the unabsorbed portion can be carried forward, under the capital loss carryover rules, to the year following the loss. In the carryover year, any capital loss carryover from losses on §1256 contracts is treated as if it were a loss from §1256 contracts for that year.

Net §1256 Contracts Loss. The net §1256 contracts loss is the lesser of:

- The net capital loss for the tax year determined by taking into account only the gains and losses from §1256 contracts, or
- The capital loss carryover to the next tax year determined before the carryback election is made.

Net §1256 Contracts Gain. The net §1256 contracts gain is the lesser of:

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

Loss Carryback Election. The loss carryback election is made by checking box D on Form 6781 filed with the loss year return. Form 1040X, *Amended U.S. Individual Income Tax Return*, or Form 1045, *Application for Tentative Refund*, may be used to carry back the loss. An amended Form 6781 and an amended Schedule D must be attached to the carryback return.

> **Example 19.** Phil trades commodity options. In 2016, he had a net loss of $17,000 from §1256 contracts. He did not have any other capital gains or losses in 2016. If he did not make an election to carry the loss back, he would have been allowed a deduction of $3,000 on the 2016 return, and $14,000 of the loss would have been carried forward to 2017.
>
> Because Phil had gains in prior years from §1256 contracts, he decided to make the election to carry the loss back. On his 2016 return, he checked box D on the top of Form 6781 to make the election. The maximum loss that he could carry back was the lesser of his §1256 contracts loss of $17,000 or the amount of the carryover to 2017 of $14,000. Accordingly, his carryback was limited to $14,000 before considering the actual amounts he was able to absorb in the carryback years.
>
> The loss was first carried back to 2013. In 2013, his total capital gains were $4,000, including his net gain from §1256 contracts of $1,000. His carryback to 2013 was limited to $1,000, the lesser of his net capital gains ($4,000) and his §1256 contracts gain ($1,000).
>
> His remaining carryback to 2014 was $13,000 ($14,000 from 2016 – $1,000 used for 2013). In 2014, his total capital gains were $5,000, including his net gains from §1256 contracts of $10,000. His carryback to 2014 was limited to $5,000.

150. IRS Pub. 550, *Investment Income and Expenses.* See also IRC §1212(c).

His remaining carryback to 2015 was $8,000 ($13,000 remaining after 2013 – $5,000 used for 2014). In 2015, he had a net capital loss of $6,000. Therefore, none of the carryback was applied to 2015. The remaining $8,000 was carried forward to 2017, retaining its character as a §1256 loss.

In total, Phil was able to claim $6,000 of §1256 losses in the carryback years ($1,000 from 2013 + $5,000 from 2014). Accordingly, $6,000 was entered on line 6 of his 2016 Form 6781, which follows.

Form **6781** | **Gains and Losses From Section 1256 Contracts and Straddles** | OMB No. 1545-0644 | **2016**

Department of the Treasury Internal Revenue Service

▶ Information about Form 6781 and its instructions is at *www.irs.gov/form6781.*
▶ Attach to your tax return.

Attachment Sequence No. 82

Name(s) shown on tax return: **Phil Spitz** — Identifying number: **456-87-8686**

Check all applicable boxes (see instructions).
- **A** ☐ Mixed straddle election
- **B** ☐ Straddle-by-straddle identification election
- **C** ☐ Mixed straddle account election
- **D** ☒ Net section 1256 contracts loss election

Part I — Section 1256 Contracts Marked to Market

(a) Identification of account	(b) (Loss)	(c) Gain
1 Form 1099-B ITradedit	(17,000)	
2 Add the amounts on line 1 in columns (b) and (c) 2	(17,000)	

3	Net gain or (loss). Combine line 2, columns (b) and (c)	3	(17,000)
4	Form 1099-B adjustments. See instructions and attach statement	4	
5	Combine lines 3 and 4	5	(17,000)
	Note: If line 5 shows a net gain, skip line 6 and enter the gain on line 7. Partnerships and S corporations, see instructions.		
6	If you have a net section 1256 contracts loss and checked box D above, enter the amount of loss to be carried back. Enter the loss as a positive number. If you didn't check box D, enter -0-	6	6,000
7	Combine lines 5 and 6	7	(11,000)
8	**Short-term capital gain or (loss).** Multiply line 7 by 40% (0.40). Enter here and include on line 4 of Schedule D or on Form 8949 (see instructions)	8	(4,400)
9	**Long-term capital gain or (loss).** Multiply line 7 by 60% (0.60). Enter here and include on line 11 of Schedule D or on Form 8949 (see instructions)	9	(6,600)

Gains and Losses From Straddles. Attach a separate statement listing each straddle and ... nts.

EQUITY OPTIONS[151]

Buyers of Puts and Calls

A **buyer** of a put or call stock option may not deduct its cost. It is a capital expenditure. Once the option is terminated, the cost of the options should be reflected on Form 1099-B according to the following rules.

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

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

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

151. IRS Pub. 550, *Investment Income and Expenses.*

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

> **Note.** The 2016 instructions for Schedule D state that the word "expired" should be used on Form 8949 as the sales price of expired puts and calls by buyers and as the cost basis of expired puts and calls by sellers. However, this cannot be entered on electronically filed returns. Returns that are electronically filed must use zero instead.

Sellers of Puts and Calls

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

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

The sales price of the option should be reflected on Form 1099-B according to the following rules.

1. **Exercise of a Call.** If a buyer exercises a call, the seller of the call must sell the underlying stock at the agreed strike price to the buyer of the call. The seller adds the amount received from the sale of the call to the amount received from the sale of the stock. The gain or loss is long-term or short-term depending on the holding period of the underlying stock.
2. **Exercise of a Put.** If a buyer exercises a put, the seller of the put must buy the underlying stock at the agreed strike (or option) price from the buyer of the put. The amount received from the sale of the put reduces the basis in the seller's shares that they acquired when the buyer exercised the put. The seller's holding period for the acquired shares begins on the day after they were purchased.
3. **Expiration of a Put or Call.** If the buyer of a put or call lets the option expire, the seller must report the income in the year the option expired as a short-term capital gain.[152]

SHORT SALES OF SECURITIES[153]

A short sale occurs when an investor agrees to sell property they do not own (or own but do not wish to sell). The investor makes this type of sale in two steps.

1. They "sell short" by borrowing the property and delivering the borrowed property to a buyer.
2. They "close the sale" at a later date, by either:
   - Buying substantially identical property and delivering it to the lender, or
   - Delivering property held at the time of the sale.

   Delivering property borrowed from another lender does not satisfy this requirement.

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152. Treas. Reg. §1.1234-1(b).

153. IRS Pub. 550, *Investment Income and Expenses.*

The taxpayer generally recognizes gain or loss when they deliver the property. There are two exceptions to this rule.

1. If the property becomes worthless, the taxpayer recognizes gain as if the short sale were closed at the time the property became substantially worthless.
2. The short sale may cause the taxpayer to be treated as having made a constructive sale of property. A constructive sale is one that does not really occur but is taxed as if it did. Taxpayers must recognize a gain on a **constructive sale of marketable securities** when they sell marketable securities in a short sale that are substantially similar to appreciated property they hold at the time of the sale. The phantom gain is recognized on the date of the short sale.

Example 20. On May 7, 2016, Mary Theresa bought 100 shares of RoyBoy Corporation stock for $1,000. On September 10, 2016, she sold short 100 shares of similar RoyBoy stock for $1,600. She did not enter into any other transactions involving RoyBoy stock for the rest of 2016 and the first 30 days of 2017. Her short sale is treated as a constructive sale of an appreciated financial position because a sale of her RoyBoy stock on the date of the short sale would have resulted in a gain. She recognized a $600 short-term capital gain from the constructive sale, and her new holding period in the RoyBoy stock began on September 10, 2016.

Note. See IRS Pub. 550, *Investment Income and Expenses,* for more information on constructive sales.

SHORT-TERM OR LONG-TERM CAPITAL GAIN OR LOSS

As a general rule, taxpayers determine whether they have short-term or long-term capital gains or losses on a short sale by the length of time they actually hold the property that is eventually delivered to the lender to close the short sale.

The constructive sale rules apply to gains and losses from short sales of stocks, securities, and commodity and securities futures (other than certain straddles) if the taxpayer held or acquired property substantially identical to property that sold short. If the number of shares the taxpayer held is less than the number they sold short, the constructive sale rules do not apply to the gain or loss on the excess shares.

Gains and Holding Period

Special rules apply in the following situations.

1. The taxpayer holds the substantially identical property for one year or less on the date of the short sale.
2. The taxpayer acquired the substantially identical property after the short sale and by the date of closing the short sale.

These special rules are as follows.

Rule 1. Any gain when the taxpayer closes the short sale is a short-term capital gain.

Rule 2. The holding period of the substantially identical property begins on the date of the closing of the short sale or on the date of the sale of this property, whichever comes first.

Losses

If, on the date of the short sale, a taxpayer held substantially identical property for more than one year, any loss they realize on the short sale is a long-term capital loss, even if they held the property used to close the sale for one year or less. These losses on short sales of stock or securities may also be subject to wash sale treatment.

Note. For more information on wash sales, see the 2014 *University of Illinois Federal Tax Workbook*, Volume C, Chapter 3: Capital Gains and Losses and Chapter 4: Special Taxpayers. This can be found at **uofi.tax/arc** [taxschool.illinois.edu/taxbookarchive].

For positions that are part of a **mixed straddle**, taxpayers may make certain elections to avoid this treatment of losses from short sales. Mixed straddles are beyond the scope of this chapter.

Note. See IRS Pub. 550 for more information on mixed straddles.

Substitute Payments

If a taxpayer loans their securities for use in a short sale and the broker receives certain payments on the taxpayer's behalf while the short sale is open, that broker must give the taxpayer a Form 1099-MISC (or similar statement) reporting the amount of these payments. The taxpayer does not treat these substitute payments as dividends or interest; instead, they are reported as "other income" on line 21 of Form 1040.

A substitute payment is a payment in lieu of:

- Tax-exempt interest (including OID) accrued while the short sale was open; and
- A dividend, if the ex-dividend date is after the transfer of stock for use in a short sale and before the closing of the short sale.

If the taxpayer borrows stock to make a short sale, they may receive distributions that they have to remit to the lender while they maintain their short position. These payments are only deductible if the taxpayer holds the short sale open at least 46 days (more than one year in the case of an extraordinary dividend) and the taxpayer itemizes their deductions. The taxpayer treats the payments as investment interest on Schedule A.

If the taxpayer closes the short sale before the 46th day after the date of the short sale (one year or less in the case of an extraordinary dividend), they must increase the basis of the stock used to close the short sale by the amount of the payments remitted to the lender.

Note. If the amount of any dividend the taxpayer received on a share of preferred stock is at least 5% (10% in the case of other stock) of the amount realized on the short sale, the dividend is an extraordinary dividend.

Certain periods are disregarded when determining how long a short sale is kept open for purposes of the 46-day period. The testing period is suspended during any days that the taxpayer holds, has an option to buy, or is under a contractual obligation to buy substantially identical stock or securities.

If the taxpayer makes the remittance for a liquidating distribution or nontaxable stock distribution, or if the taxpayer buys more shares equal to a stock distribution issued on the borrowed stock during their short position, they have a capital expense. The taxpayer must add the payment to the cost of the stock sold short.

ISSUES RELATED TO EMPLOYER SECURITIES

NONSTATUTORY STOCK OPTIONS[154] — CASHLESS EXERCISE

Corporations may grant stock options to individuals who provide services to the company. Stock options that are granted under plans that meet the requirements of IRC §§421 through 424 are called **statutory stock options**. Stock options that are granted under plans that do not meet these requirements may be called **nonstatutory** or **nonqualified** stock options. The stock options give the holder the right to buy shares in the company at a stated price after a certain date or after the price of the stock reaches a certain level.

154. Treas. Reg. §1.83-7.

The excess of the FMV of stock received upon exercise of a nonstatutory stock option over the amount paid for the stock under the option is often called the **spread**. An employer must report this spread on Form W-2 in boxes 1, 3 (up to the social security wage base), 5, and in box 12 using the code "V."[155]

Example 21. Darian is an executive at Centipede, Inc. (CET). She was granted a nonstatutory stock option in 2006 to purchase up to 1,200 shares of CET stock for $45 after January 1, 2016. On January 21, 2016, she exercised the option and purchased 1,200 shares. The price of CET stock at the time of the exercise was $85. The spread is $40 ($85 FMV – $45 cost). This $40 spread per share is taxable income subject to withholding and FICA taxes. The taxable gain from the exercise was $48,000 (1,200 shares × $40). This was added to her taxable wages in boxes 1, 3, and 5 of Form W-2. It is also shown in box 12 of the Form W-2 with code V.

It is very common for taxpayers to sell some or all of the shares acquired with the exercise at the same time that the options are exercised. Because the taxpayer provides no cash to purchase the shares, this is called a **cashless exercise.**

Example 22. Use the same facts as **Example 21.** In order to complete the transaction, Darian needed $54,000 to purchase the 1,200 shares of stock at $45 each. She also needed $17,592 to cover the following taxes.

Federal withholding ($48,000 × 25%)	$12,000
FICA taxes ($48,000 × 7.65%)	3,672
State withholding ($48,000 × 4%)	1,920
Total taxes	$17,592

If she did not sell any shares, Darian would have to provide **$71,592** ($54,000 + $17,592) plus transaction fees to acquire the shares. Instead, Darian arranges to sell 843 shares at the same time that she exercises the options.

The total proceeds from the sale were $71,655 ($85 market price × 843 shares). She was charged $35 in transaction fees. After the sale, Darian received $28 ($71,655 proceeds – $71,592 acquisition costs – $35 fee) and 357 (1,200 – 843) shares of CET stock.

The stock sold in a cashless exercise is usually reported on Form 1099-B. Unfortunately, the Form 1099-B frequently shows the stock basis at the option price without adjusting the basis for the spread related to the shares sold that was also included on the taxpayer's Form W-2. In order to prevent the spread from being taxed twice, the basis must be adjusted for the amount previously included in the taxpayer's income. If the basis reported on the Form 1099-B is reported to the IRS, the taxpayer reports the correct basis and indicates that the basis is corrected by entering code B in column (f) of Form 8949.

Example 23. Use the same facts as **Example 21** and **Example 22.** Darian received the following Form 1099-B from the clearing house that processed the sale of the 843 shares used to cover the exercise of the shares. The cost basis of $37,970 shown on the Form 1099-B equals 843 shares at $45 each plus the $35 in transaction fees. The $40 per share spread is not reported on the form.

To adjust her basis for the $40 per share spread, Darian reported the $33,720 (843 × $40) adjustment as a subtraction in column (g) of Form 8949 with code B in column (f). The $35 loss shown in column (h) on the following Form 8949 is equal to the transaction fee.

155. IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits.*

For Example 23

F*TRADE CLEARING
PO BOX 123
JERSEY SHORE, NJ 17740

Account No: 123456
Account Name: DARIAN
Taxpayer Identification Number: ***–**–1234

Account Executive No: ET1

ORIGINAL: 12/31/2016

RECIPIENT'S Name, Street Address, City, State, and Zip Code
DARIAN
824 ANYWHERE ST.
ANYTOWN, IL 61144

Copy B for recipient ☐ 2nd TIN Notice

Payer's Federal Identification Number: 12–3456789
Payer's Name, Street, City, State, Zip Code:
F*TRADE CLEARING
PO BOX 123
JERSEY SHORE, NJ 17740
Telephone Number: (800) 555– 9999

2016 GROSS PROCEEDS

1099–B Proceeds from Broker and Barter Exchange Transactions **OMB No. 9999–9999**

Short Term Gains/Losses – Report on Form 8949, Part I with Box A checked

Box 2: Type of Gain or Loss – Short Term
Box 3: Basis Reported to the IRS
Box 5: Box not Checked (Covered Security)

The 1099–B data referenced by a Box Number is reported to the IRS. The additional information not referenced by a Box Number is not reported to the IRS, but may be helpful to complete your return.

Description CUSIP (Box 1a)	Quantity Sold	Date Acquired (Box 1b)	Date Sold or Disposed (Box 1c)	Proceeds (Box 1d)	Cost or Other Basis (Box 1e)	Code (Box 1f)	Adjustments (Box 1g)	Gain/Loss Amount	Additional Information
CENTIPEDE, INC	843.00000	01/21/2016	01/21/2016	$71,655.00	$37,970.00		$0.00	$33,685.00	
Totals (8949, Part I with Box A checked)				**$71,655.00**	**$37,970.00**		**$0.00**	**$33,685.00**	

Page 2 of 6

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

For Example 23

Form **8949** Department of the Treasury Internal Revenue Service

Sales and Other Dispositions of Capital Assets

▶ Information about Form 8949 and its separate instructions is at *www.irs.gov/form8949.*

▶ File with your Schedule D to list your transactions for lines 1b, 2, 3, 8b, 9, and 10 of Schedule D.

OMB No. 1545-0074 2016 Attachment Sequence No. 12A

Name(s) shown on return	Social security number or taxpayer identification number
Darian	222-33-1234

Before you check Box A, B, or C below, see whether you received any Form(s) 1099-B or substitute statement(s) from your broker. A substitute statement will have the same information as Form 1099-B. Either will show whether your basis (usually your cost) was reported to the IRS by your broker and may even tell you which box to check.

Part I **Short-Term.** Transactions involving capital assets you held 1 year or less are short term. For long-term transactions, see page 2.

Note: You may aggregate all short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS and for which no adjustments or codes are required. Enter the totals directly on Schedule D, line 1a; you aren't required to report these transactions on Form 8949 (see instructions).

You *must* check Box A, B, *or* C below. Check only one box. If more than one box applies for your short-term transactions, complete a separate Form 8949, page 1, for each applicable box. If you have more short-term transactions than will fit on this page for one or more of the boxes, complete as many forms with the same box checked as you need.

☒ **(A)** Short-term transactions reported on Form(s) 1099-B showing basis was reported to the IRS (see **Note** above)

☐ **(B)** Short-term transactions reported on Form(s) 1099-B showing basis **wasn't** reported to the IRS

☐ **(C)** Short-term transactions not reported to you on Form 1099-B

1 (a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold or disposed of (Mo., day, yr.)	(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the **Note** below and see *Column (e)* in the separate instructions	**Adjustment, if any, to gain or loss.** If you enter an amount in column (g), enter a code in column (f). **See the separate instructions.** (f) Code(s) from instructions	(g) Amount of adjustment	(h) **Gain or (loss).** Subtract column (e) from column (d) and combine the result with column (g)
Centipede, Inc.	01/21/2016	01/21/2016	71,655	37,970	B	(33,720)	(35)

EMPLOYER SECURITIES ACQUIRED VIA ESOP DISTRIBUTIONS[156]

Employers may offer their employees the option of investing in the employer's securities through a qualified retirement plan. An employee stock ownership plan (ESOP) is a retirement plan in which a company contributes its stock (or money to buy its stock) to the plan for the benefit of the company's employees. The plan maintains an account for each employee who participates in the plan. Shares of stock vest over time before an employee is entitled to them.[157]

An ESOP can be established as a qualified retirement plan under IRC §401. ESOPs are stock bonus plans and/or money purchase plans that invest primarily in employer securities.[158] Employees may contribute before- or after-tax money into the plan. Distributions of cash from the plan are generally taxed the same as distributions from other qualified retirement plans.[159]

The net unrealized appreciation (NUA) related to ESOP shares may qualify for special tax treatment. NUA is the net increase in the securities' value during the time they were in the retirement plan.

156. IRS Pub. 575, *Pensions and Annuity Income.*

157. *Employee Stock Ownership Plans (ESOPs).* SEC. [www.sec.gov/answers/esops.htm] Accessed on Mar. 2, 2017.

158. *Employee Stock Ownership Plans (ESOPs).* Feb. 15, 2017. IRS. [www.irs.gov/retirement-plans/employee-stock-ownership-plans-esops] Accessed on Feb. 17, 2017.

159. IRC §402.

The NUA of shares distributed from an ESOP in a **lump-sum distribution** is not taxed until the stock is sold unless the taxpayer chooses to include it in income for the year of distribution. To qualify as a **lump-sum distribution,** the employee's entire balance in the plan must be distributed. In addition, the distribution must be made after the employee has:[160]

- Attained age 59½,
- Separated from service,
- Become disabled, or
- Died.

As long as the **entire** balance of the shares in the ESOP is distributed to the employee **within one tax year**, multiple distributions may qualify as a lump-sum distribution. Distributions in which part of the balance is rolled over may also qualify.[161] If the employee participates in other employer-sponsored retirement plans, the balances in the other plans do **not** have to be included in the ESOP distribution as long as the other retirement plans are not ESOPs. For example, profit sharing plans and stock bonus plans are considered different types of plans when determining if the employee's entire plan balance has been distributed.[162]

Any gain on the sale of the ESOP stock, up to the amount of the NUA, is treated as a **long-term capital gain regardless of when the stock was distributed to the employee.** Any gain in excess of NUA is short-term or long-term depending on the length of time the employee held the stock after the distribution.

160. IRC §402(e)(4)(D).

161. Ltr. Rul. 200003058 (Jan. 2000); Ltr. Rul. 200038057 (Jun. 2000).

162. Prop. Treas. Regs. §§1.402(e)-2(d)(1)(v) and (e)(1)(i).

Example 24. Kevin Bird, age 60, is single and works at Aviary, Inc. He is a participant in the employees' investment plan, which is a qualified ESOP. He has purchased stock with after-tax money over the years. On April 20, 2016, he withdrew 337 shares from the plan in a lump-sum distribution. He received the following letter shortly after the shares were distributed to him. In January 2017, he received the Form 1099-R shown immediately after the letter.

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

APRIL 2016
SSN 999-00-0000

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

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

If this distribution results in taxable income, you will also receive, after the end of the year, a Form 1099-R showing the amount of taxable income you should report when preparing your tax return for **2016**. The following information and the enclosed information notes are provided for your use in preparing your federal income tax return and for determining your cost basis per share so that on subsequent sale of the stock you will be able to calculate any gain or loss:

A.	VALUE OF DISTRIBUTION	$17,946.00
B.	DEDUCT NONTAXABLE PORTION	$14,274.00
C.	DEDUCT NET UNREALIZED APPRECIATION	$2,779.00
	d. ORDINARY INCOME	$893.00
	e. CAPITAL GAIN	$0.00
F.	FEDERAL INCOME TAX BASIS PER SHARE	$44.95
G.	MARKET VALUE PER SHARE FOR 337 SHARES	$53.1950
H.	DATE HOLDING PERIOD BEGAN FOR 337 SHARES	04/20/16
I.	CONTRIBUTION BALANCE AFTER DISTRIBUTION	0

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

AVIARY, INC.
AUTHORIZED REPRESENTATIVE

☐ CORRECTED (if checked)

PAYER'S name, street address, city or town, state or province, country, and ZIP or foreign postal code **Aviary, Inc.** **999 NE Adams Street** **Peoria, IL 61629**	1 Gross distribution $ **17946.00** 2a Taxable amount $ **893.00**	OMB No. 1545-0119 2016 Form **1099-R**	**Distributions From Pensions, Annuities, Retirement or Profit-Sharing Plans, IRAs, Insurance Contracts, etc.**
	2b Taxable amount not determined ☐	Total distribution ☐	**Copy B**
PAYER'S federal identification number: **36-1234567** RECIPIENT'S identification number: **999-00-0000**	3 Capital gain (included in box 2a) $	4 Federal income tax withheld $	**Report this income on your federal tax return. If this form shows federal income tax withheld in box 4, attach this copy to your return.**
RECIPIENT'S name **Kevin I. Bird**	5 Employee contributions /Designated Roth contributions or insurance premiums $ **14274.00**	6 Net unrealized appreciation in employer's securities $ **2779.00**	
Street address (including apt. no.) **293 Herman Street**	7 Distribution code(s) **7** — IRA/ SEP/ SIMPLE ☐	8 Other $ %	This information is being furnished to the Internal Revenue Service.
City or town, state or province, country, and ZIP or foreign postal code **Pekin, IL 61554**	9a Your percentage of total distribution %	9b Total employee contributions $	
10 Amount allocable to IRR within 5 years $ 11 1st year of desig. Roth contrib. FATCA filing requirement ☐	12 State tax withheld $ $	13 State/Payer's state no.	14 State distribution $ $
Account number (see instructions)	15 Local tax withheld $ $	16 Name of locality	17 Local distribution $ $

Form **1099-R** www.irs.gov/form1099r Department of the Treasury - Internal Revenue Service

On his 2016 Form 1040, Kevin reported gross distributions from pensions and annuities of $17,946 and taxable distributions of $893.

Example 25. Gain Less than NUA: Use the same facts as **Example 24.** Kevin sold his 337 shares of ESOP stock on May 2, 2016, for **$17,148**. His gain on the sale is $2,000, which is calculated as follows.

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

Because the $2,000 gain is **less** than the NUA of $2,779 (line C of the letter), the entire gain is afforded long-term treatment on Kevin's 2016 return. Kevin's gain is long-term even though he held the ESOP stock for less than one month.

Example 26. Gain Greater than NUA: Use the same facts as **Example 24.** Kevin sold the shares for **$19,148** on May 2, 2016. His gain of $4,000 is more than his NUA of $2,779. Therefore, $2,779 of his gain is taxed as long-term, and the remaining $1,221 of his gain is taxed as short-term capital gain.

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

Observations for Example 26.

1. Kevin's holding period for post-distribution appreciation begins on April 21, 2016, the day after the ESOP shares were distributed to him.
2. If Kevin held the shares until April 22, 2017, all of the post-distribution gain would be taxed as long-term.