CapTions

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CapTions
Capital Gains & Losses - Making Sense of Investment Transactions & Options

Summary

In today's economy where clients are seeking to maximize portfolio gains and investment returns, where a simple CD or Treasury bond no longer offers a satisfactory return, our clients are engaging in ever-more complex financial transactions. This course will introduce the tax professional to the world of finance to ensure that capital gains and losses, qualified dividends, capital gain distributions, option premiums, depreciation recapture, closing transactions, sales and exchanges are properly reported and taxed at the more favorable rate.

A choice of options: What are they? Who has them? What do you do with them? How are they taxed? These and other questions will be answered in plain English, giving tax professionals a better understanding of the investment world. Topics will include puts, calls, rights, warrants, futures, forwards, foreign currency transactions, employee stock options, incentive stock options, as well as the trading methodologies and tax treatments of each—basis, income recognition under IRC §83(b), and (of course!) AMT.

The information contained herein is for educational use only and should not be construed as tax, financial, or legal advice. Each individual's situation is unique and may require specialized treatment. It is, therefore, imperative that you consult with tax and legal professionals prior to implementation of any strategies discussed.

Instructor

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Part I: Capital Transactions

I. A Quick Review

A. Capital Transactions Defined

A capital asset is defined as everything owned for personal or investment purposes, except inventory held for resale to customers; depreciable property when used in a trade or business; copyrights and other intellectual property; and accounts receivable.[1]

Capital transactions typically involve the receipt and disposition of assets, such as securities, real property, inventory, or intangible items. Examples include, but are not limited to:

- A purchase of stock, followed by its sale
- A purchase of a bond, followed by its maturity
- A purchase of a bond, followed by its redemption
- A purchase of preferred stock, followed by conversion to common stock
- A purchase of a stock option, followed by its exercise
- A receipt of a stock option, followed by its expiration
- A short sale of stock, followed by a purchase used to cover the obligation
- An exchange of one property for another

In other words, any time a taxpayer can first claim to *have the* asset and then later claim that *he no longer does*, it is said to involve a transaction. In the case of a short sale, the order of *have* and *have not* are reversed, but again the taxpayer may figuratively hold open his hand and see that at one time it is full and at another time, it is not.

A capital transaction may be either a sale or an exchange:

- A *sale* is defined as a transfer of property for money. (Some leases may in fact be conditional sales.)
- An *exchange* is a transfer of property for other property or services.

Common to both is the "realization" requirement.[2] The oft-quoted 16th Amendment authorizing the taxation of "income *from* whatever source derived" has been interpreted to equate "from" with "realization." Used to establish with certainty that a benefit has in fact been derived by separating the taxpayer from his property, the definition of realization has, however, been litigated frequently.

[1] "For purposes of this subtitle [A: Income Taxes], the term "capital asset" means property held by the taxpayer (whether or not connected with his trade or business), but does not include…" IRC § 1221(a).

[2] "The gain from the sale or other disposition of property shall be the excess of the amount *realized* [emphasis added] therefrom over the adjusted basis…" IRC § 1001(a).

In 1991, it was held that a mere exchange of property may not be sufficient to meet the standard, and that instead the taxpayer must also transfer the benefits and burdens of legal ownership.[3] Codified, an exchange for realization purposes now requires a "significant modification."[4] For example, loans which have been renegotiated or refinanced are now deemed to have been significantly modified if enough terms of the contract are changed to affect the borrowers' decision. A mere conversion from a variable to a fixed rate mortgage is not adequate.[5]

Realization helps to reduce the administrative burden of tax enforcement by allowing the fair market value of an asset to be objectively established. Furthermore, once the proceeds of a transaction have been received (realized), the taxpayer has funds with which to pay the resulting tax. By choosing to enter into a closing transaction at his discretion, the taxpayer can control the timing of the realization event and manage his tax liability.

B. Historical Rates[6]

Years	Maximum Rate (%)	Holding Periods	Year of Enactment
1916	15	Same as prevailing income tax rates	
1917	67		
1918	77		
1919-1921	73		
1922-1933	12.5	2 years	1921
1934-1935	31.5	2, 5 and 10 years	1934
1936-1937	39		
1938-1941	30	18 months and 2 years	1938
1942-1967	25	6 months	1942
1968	26.9		
1969	27.5		
1970	32.3		
1971	34.3		
1972-1975	36.5		1976
1976-1977	39.9	9 months	
1978	39	1 year	
1979-1980	28		
1981	23.7		
1982-1986	20	6 months	1984
1987	28		
1988-1990	33	1 year	1988
1991-5/6/97	28	18 months (in 1997)	1997
5/7/97-2002	20	1 year	2001
2003-2008	15*		

* Qualified Dividends are taxed at Ordinary Income rates hereafter.

[3] *Cottage Savings Association v Commissioner*, 499 US 554.

[4] Treas. Reg. § 1.1001-3(b).

[5] Significant modifications include changing the annual yield by more than 0.25% or the timing of payments, substituting a new obligor, altering the collateral, or switching from recourse to non-recourse financing or vice versa.

[6] Available at http://www.cch.com/wbot2012/029CapitalGains.asp [last accessed May 17, 2013].

Despite the frequency and apparent whim with which capital gains rates have changed, several explanations have been given:[7]

1. Bunching of Income

Capital assets are often held long-term, thereby accruing gains that ordinarily might be realized annually. When these assets are in fact sold, the gains which have accrued are often substantial and force taxpayers into higher marginal tax brackets.

However, gains of this sort are often realized by high-net worth taxpayers who are already subject to the highest rates and therefore do not suffer from the supposed bracket creep. Instead, income averaging might better be used to mitigate the tax liabilities of those truly affected by income bunching.

2. Inflationary Effects

Since current tax law measures gains in nominal (not real or inflation-adjusted) dollars, reduced capital gains rates may be intended to mitigate the tax effect of profits attributable to the rising dollar rather than to economic profits inherent to the asset sold.

Although applied uniformly across the taxpayer spectrum, preferential capital gain rates offer disproportionate savings to those taxpayers who realize gains well in excess of inflationary effects. Taxpayers whose investments have merely kept pace with inflation realize no benefit from the favorable rates.

Example

Taxpayer	Amount Invested [A]	Today's Inflated Value [B]	Sales Proceeds [C]	Nominal Gain [C – A]	Inflation-adj. Gain [C – B]	35% tax on Inflation-adj Gain	15% tax on Nominal Gain	Tax Savings
1	$100	$200	$100	$0	($100)	$0	$0	$0
2	$100	$200	$200	$100	$0	$0	$15K	($15)
3	$100	$200	$900	$800	$700	$245	$120	$125

3. Economic Incentive

By offering favorable rates on capital gains, it is argued that investment in capital assets is stimulated, thereby encouraging economic investment which benefits society as a whole through its trickle-down effect.

[7] McDaniel, et al, *Federal Income Taxation*, 5 ed., Foundation Press (2004).

However, the capital gains incentive illogically favors growth over income-producing investments and may ultimately encourage an inefficient allocation of assets.

4. Counter the Lock-in Effect

Since only realized gains are taxed under current law, unrealized gains remain locked within attendant assets escaping taxation until some future event occurs. As a result, taxpayers often choose to hold assets indefinitely, potentially reducing the mobility of capital.

While lower capital gain rates may serve to persuade investors to liquidate their holdings, equity and efficient allocation might just as easily be established by taxing accrued gains annually, whether realized or not.

C. Favorable Long-term Treatment

Capital transactions can be categorized into short- and long-term, depending on how long the asset was in the taxpayer's possession. Under current law, the distinction is made at the one-year mark. If the asset was held for *one year or less*, the transaction is considered to be short-term (ST). If the asset was held for *more than one year* (one year and one day beyond), the transaction is categorized as long-term (LT).

This classification becomes important as different tax rates are applied to short-term versus long-term transactions. The table below summarizes the rates currently in effect:

Taxpayer's Tax Bracket	STCG ≤ 1 year	LTCG > 1 year & Qualified Dividends	§ 1250 Deprec. Recapture	Collectibles & § 1202 Sm Bus Stk
10 & 15%	10 or 15%	0% *(through 12/31/12)*	25%	28%
25 to 35%	25 to 35%	15% *(through 12/31/12)*	25%	28%

Zero Rate[8]

Through December 31, 2012, LTCGs will be taxed at 0% (!) if the taxpayer is a non-corporate taxpayer with a net capital gain or qualified dividends (but NOT collectibles, § 1202 gain, or § 1250 recapture) that does not exceed the excess of:

- The amount of income that would otherwise be taxed at a rate below 25%, over
- The total taxable income reduced by the adjusted net capital gain.

Any LTCGs in excess of this limitation will be taxed at 15%. Although regular taxable income effectively absorbs the 0% rate before it is applied to LTCGs, the rate is potentially available to all taxpayers regardless of whether they are in fact in high-income marginal tax brackets. Presuming that the bulk of the high income – that amount that pushes them into the tax brackets of 25% or

[8] Previously a temporary provisions scheduled to expire December 31, 2012, the zero-tax rate was extended permanently under the American Taxpayer Relief Act of 2012 [ATRA 2012].

more – consists of LTCGs only, taxpayers will benefit at least partially from the new capital gains rates.

An easy formula[9] to determine how many capital gains will be taxed at 0% is:

Top end of 15% marginal bracket – Taxable inc. less adjusted net capital gain

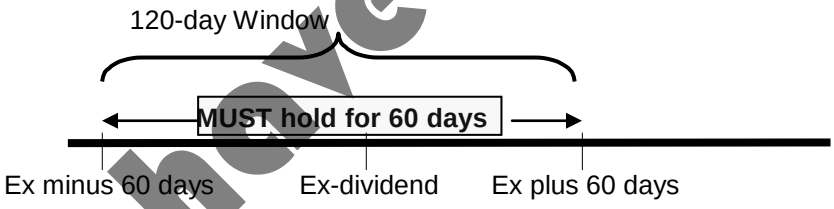
Children not subject to the Kiddie Tax may, of course, benefit from the 0% rate. However, those (under the age of 18 with incomes in excess of $1,900) whose parents are in higher tax brackets will find their LTCGs taxed at 15%, just as the parents' gains would be taxed. Intended to dissuade parents from gifting appreciated securities to their offspring who could then sell them tax-free, the Kiddie Tax Rule will apply unless the child's earned income provides more than one-half of his support.

D. Special Rates

1. Qualified Dividends[10]

Affected by ATRA 2012

The favorable long-term capital gain rate is also applied to qualified dividends paid by most domestic and foreign corporations. To be eligible, the investor must have held the income-producing common or preferred stock for at least 60 days during a 120-day period that began 60 days before the ex-dividend date.



Several additional rules apply:

- Dividends from most REITs and S-Corps, as well as STCG distributions from mutual funds do not qualify for this special treatment.
- Qualified dividends are combined with net capital gains and taxed at the favorable rates.
- You must affirmatively elect (using **Form 4952**) to treat qualified dividends as investment income, which is taxable as ordinary income and can be used to offset investment expenses.

NOTE: The Qualified Dividend provision was made permanent under the American Taxpayer Relief Act of 2012 [ATRA 2012].

[9] Formula and examples excerpted from RIA Newsstand, *Federal Taxes Weekly Alert*, Vol. 3, No. 54 (January 17, 2008).

[10] IRC § 1(h)(11).

2. Collectibles

Collectibles include artwork, rugs, antiques, metals,[11] gems, stamps, coins, alcoholic beverages, musical instruments (not used in the course of a trade or business), historical objects and documents, and any other tangible personal property specified by the IRS.[12] Although gain on sale of these items is taxed at a maximum of 28%,[13] some newly minted gold and silver coins issued by the US government are eligible for 20% treatment.

Losses from sales of collectibles may be used to offset short- and long-term capital gains from other sources in the same familiar manner as all gains and losses are netted. However, because net collectible gains are subject to the 28% rate, they must first be totaled with §1202 Small Business Stock gains and then reduced by net short-term losses realized in the current taxable year as well as net long-term loss carry-forwards (if any).[14]

NOTE: Investors should be aware that certain investments may be subject to collectible tax treatments, including Exchange-traded Funds (ETFs) that directly invest in precious metals.[15] Taxpayers should further note that IRAs may not invest in collectibles;[16] but if purchased, the acquisition costs will be treated as a distribution subject to tax and early distribution penalties (if applicable).[17]

[11] Gold is considered a "collectible" by the IRS for income tax purposes.

[12] Treas. Reg. § 1.408.10.

[13] IRC § 1(h)(4)(A)(i).

[14] See *Ordering of Losses* covered later in the text.

[15] Office of Chief Counsel Memorandum PMTA-2008-01809 [available at http://www.irs.gov/file_source/pub/lanoa/pmta01809_7431.pdf, last accessed May 16, 2013].

[16] Items specifically exempt from the definition of "collectible" for IRA (but not income tax) purposes include US gold coins under one ounce, one ounce silver coins minted by the Treasury Department, specified platinum coins and certain gold, silver, platinum or palladium bullion. (Rodda, *Beware of special taxation of collectibles*, Elder Client Planner, Spidell Publishing Inc., November 1, 2009).

[17] IRC § 408(m)(1).

E. Surtax on Investment Income[18]

Affected by ATRA 2012

Beginning January 1, 2013, certain high-income taxpayers (as well as some estates and trusts)[19] will be required to pay a 3.8% surtax on the lesser of (1) net investment income or (2) the amount of modified adjusted gross income (MAGI) which exceeds the applicable threshold ($200,000 for Single; $250,000 for Married-filing-Joint).[20] Estates and trusts are subject to the surtax on the lesser of undistributed net investment income or AGI which exceeds the dollar amount at which the highest marginal tax bracket begins ($11,650 in 2012).

Example: Single taxpayer has net investment income of $50,000 and MAGI of $180,000. No surtax is due since MAGI is less than $200,000 threshold.

Example: Single taxpayer has net investment income of $100,000 and MAGI of $220,000. A surtax of $760 would be due on the $20,000 by which his MAGI exceeds the applicable threshold amount.[21]

MAGI is adjusted gross income increased by any Foreign Earned Income Exclusion claimed. The surtax will only apply to the entire amount of net investment income if the taxpayer's MAGI exceeds the applicable threshold by the amount of net investment income. In other words, a single taxpayer with net investment income of $100,000 would be subject to $3,800 surtax only if his MAGI totaled at least $300,000.

Net investment income is defined as the sum of gross income from interest, dividends, annuities, royalties and rents (not derived from the ordinary course of a trade or business) plus business income derived from the trading of financial instruments or commodities and net gains on the disposition of property not held for trade or business. Investment income does not include amounts subject to self-employment tax (i.e. trades or businesses conducted by sole proprietors, partnerships or S-corporations) or income from tax-favored retirement plans.[22]

NOTE: The sale of a personal residence may trigger the surtax since gains in excess of the § 121 Exclusion are added to net investment income.

[18] IRC § 1411.

[19] The surtax does not apply to non-resident aliens or charitable trusts. US citizens or resident aliens married to non-resident aliens must file Married-Filing-Single and are subject to a threshold amount of only $125,000 unless the couple makes a §6013 election to file jointly.

[20] These threshold amounts are not indexed for inflation; therefore, more taxpayers will be subject to the tax in future years.

[21] Examples provided by Thompson Reuters in *Checkpoint Newsstand*, "Year End Planning: Reduce Exposure to Higher Post-2012 Taxes on Investment Income & Gains–Part I," August 22, 2012.

[22] Additional exclusions include tax-exempt bond interest and veterans' benefits.

Additionally gains on home sales will increase MAGI which may, in turn, trigger the surtax. As a result, a taxpayer who anticipates a gain on sale of his principal residence in excess of the §121 Exclusion should sell before year-end.

Deductions allowed against investment income include: [23]

- Deductions allowed under IRC §62 against rental and royalty income,
- Penalties for the early withdrawal of savings,
- Investment interest expense,[24] and
- State, local and foreign income taxes allocable to net investment income.

NOTE: Neither the $3,000 capital loss deduction allowed for regular income tax purposes nor net operating loss carry-forwards are deductible against net investment income.

F. Non-resident Aliens

U.S. citizens and resident aliens (Green Card holders) are taxed on capital gains as described above. However, Non-resident Aliens (NRAs) are tax differently.

Defined as those individuals who are not US citizens or residents and do not meet the Green Card or Substantial Presence Tests, NRAs are taxed only on US-sourced income.

1. Taxpayer is present in the US

   If the NRA is present in the US for more the 183 days during the tax year, net capital gains from the sale or exchange of all capital assets is taxed at a 30% rate (unless a lower rate applies due to a tax treaty with another country).

   Net gains are determined by offsetting capital losses against gains without considering:

   - Any capital loss carryovers from previous years
   - The § 1202 Small Business Stock Exclusion
   - Any loss on sale or exchange of property held for personal use (including casualty losses)
   - Gains from not effectively connected sources listed below

   If the NRA is in the US for less than 183 days, all capital gains from sources not effectively connected to a US trade or business are tax-exempt.

[23] Proposed Treas. Reg. § 1.1411-4(f).

[24] Investment interest expense may not be used to reduce net investment income below zero; therefore, excess deductions may be carried forward for reduction of net investment income in future years.

Presence in U.S.	U.S. Source Income	Worldwide Income
Less than 183 days	Taxed	NOT taxed
183 days or longer	Taxed	Taxed

2. Not effectively connected sources

However, gains and losses from sources that are not effectively connected with a US trade or business are taxed under different rules than those applicable to US citizens and residents.

The following gains are subject to a 30% tax (unless a lower treaty rate applies) whether the taxpayer is or is not in the US for more than 183 days:

- Gains on sale or disposal of timber, coal or iron unless taxpayer elects to treat these items as effectively connected income
- Gains on sale of all patents and copyrights after October 4, 1966 and some patent transfers prior to October 5, 1966
- Gains on sale or exchange of original issue discount obligations

Taxpayers may refer to IRS *Publication 519: US Tax Guide for Aliens.*

II. Reporting Capital Transactions

The taxpayer will find that he has only two alternatives by which to report his capital transactions, depending on whether the property was used for business or personal purposes.

A. Personal Use

Whether short- or long-term, personal asset dispositions must be reported on **Schedule D** [see below for new reporting requirements]. Part I of this Schedule is used to report short-term transactions, while Part II is used for long-term.

A few exceptions apply:

- If the disposition was due to a casualty, theft, accident or an act of nature, the loss is reported on **Form 4684 Casualties and Thefts**, Section A subject to a $100 deductible.
- If the property was partially used for business, such as rental property, the gains and losses attributable to the business portion are reported on **Form 4797 Sales of Business Property**, Parts I and II.
- If the personal property was condemned, the transaction is reported on **Form 4797**, Part I.
- Securities traders, who have qualified to take the mark-to-market election, may use **Form 4797**, Part II.

Sadly, losses incurred on personal property are non-deductible.

New Forms for 2011 and Beyond…

Throughout this text, I will refer to **Schedule D** for purposes of reporting gains and losses resulting from capital transactions. Of course, we already know that Schedule D has been significantly revised and now serves merely to summarize capital transactions reported on the new **Form 8949, Sales and Other Dispositions of Capital Assets**.

Form 8949 is still divided into short- and long-term sections and used to report transactions with holding periods less than or more than one year, respectively. However, this form further segregates all transactions into three categories:

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

Taxpayers will check off the appropriate box depending on whether or not their brokers have included cost basis information on Form **1099-B**. Mandated by the Energy Improvement and Extension Act of 2008, brokerage firms are required to report adjusted basis information as well as quantities sold, sales prices, commissions, holding periods, short sales, disallowed losses due to wash sales, and corporate mergers for all "covered securities".[25]

Securities currently subject to these new reporting requirements include stock, and other financial instruments as designated by the Department of Treasury which were purchased on or after January 1, 2011. Therefore, only a limited number of transactions are required to be categorized as "A" on 2011 tax returns. Sales of regulated investment companies and shares acquired through dividend reinvestment plans (if acquired on or after January 1, 2012) will be added to the new reporting requirements on 2012 returns and beyond; reporting of options and debt instruments has recently been delayed from January 1, 2013 to January 1, 2014.[26] In this manner, the onus of cost basis tracking is shifted from the taxpayer to the broker in hopes of simplifying the IRS' verification tasks. But the process is intended to be implemented incrementally and promises to be cumbersome during the phase-in period.

Nevertheless, it is important to note that all securities discussed in this text fall within the new mandate and are, therefore, reportable first on **Forms 4797** (if interbank transactions or subject to the mark-to-market election) and **8949** (all others) rather than directly on **Schedule D**.

[25] Instructions for **Form 1099-B**, Department of the Treasury, Internal Revenue Service, Cat. No. 64171A.

[26] IRS Notice 2012-34.

e-File Requirements

In the good ole days when practitioners were still filing paper returns for their clients, it was common practice to simply attach copies of the year-end brokerage statement rather than individually type (or hand-write) every transaction a client made throughout the year. The came e-file!

Today, IRS instructions for **Form 8949** state:

Instead of reporting each of your transactions on a separate line of Form 8949, you can report them on an attached statement containing all the same information as Form 8949 and in a similar format. Use as many attached statements as you need. Enter the combined totals from all your attached statements on a Form 8949 with the appropriate box checked. For example, report on line 3 of a Form 8949 with box A checked all long-term gains and losses from transactions your broker reported to you on a statement showing that the basis of the property sold was reported to the IRS. If you have statements from more than one broker, report the totals from each broker on a separate line.

Do not enter "available upon request" and summary totals in lieu of reporting the details of each transaction on Form(s) 8949 or attached statements.

If you e-file *your return but choose not to include your transactions on the electronic short-term capital gain (or loss) or long-term capital gain (or loss) records, you must attach Form 8949 (or a statement with the same information) to Form 8453 and mail the forms to the IRS.*

B. Business Use

All gains and losses resulting from dispositions of business property are reported on **Form 4797**.

- Long-term transactions are reported on Part I; short-term on Part II.
- Transactions involving depreciable assets are reported on Part III to allow for the recapture of depreciation taken or allowable.
- Part IV is used to calculate the depreciation recapture on listed property where business use has fallen below 50% or on property for which the §179 expense was taken.
- Casualty losses are reported on **Form 4684**, Part B.

Again, a few exceptions apply: Livestock used in a farm activity but not held primarily for resale to customers is considered §1231 property and thus reported on **Form 4797**.

- Part II is used to report the sale of cattle and horses held for *less than 24 months* and other livestock held for less than 12 months.
- Part I is used to report long-term losses.
- Part III is used to report long-term gains.

Self-created musical works and copyrights in such works were previously subject to ordinary income treatment; however, the Tax Prevention and

Reconciliation Act of 2005 allowed sellers of such works to treat the assets as capital when sold.[27]

To make the election, the seller must simply report the sale or exchange on **Schedule D**. IRS consent is required to revoke the election, or automatically if an amended return is filed within 6 months after a tax return is timely filed.

C. Holding Period

Although the Code once was different, holding periods for capital transactions are now recognized on the trade rather than settlement date. In the past, a taxpayer could elect which date to use, but Rev Rul 93-84[28] now specifies that the holding period for determining whether the transaction qualifies for long-term treatment begins on the day after acquisition and ends on the day of disposition. Thus, an asset purchased on January 15th must be held until January 16th of the following year to qualify for the favorable tax rates.

D. Capital Losses

The Tax Code was never intended to be equitable and so it is not surprising that while gains are fully reportable and taxable, losses may not always be. In fact, capital losses can only be used to offset capital gains. Should the taxpayer have additional or excess capital losses, he may only deduct $3000/year against ordinary income. The unused balance may be carried forward into the following year and if still unused, may be carried forward indefinitely.

<u>Year of Death</u>

Capital losses, including capital loss carry-forwards, in the year of death may be taken on the decedent's final tax return; but those losses not used in that year are lost forever and may not be carried forward.

<u>Related Party Transactions</u>

Losses resulting from sales to related parties—including a spouse, child, grandchild, parent, grandparent, great-grandparent, or sibling—are disallowed.[29] Although losses resulting from sales to more distant relatives can be made, the related party rule cannot be circumvented if the transaction involves a sale to one of these individuals when they are acting on behalf (as a nominee for) a closer relative. Similarly, losses from sales to related corporations—those in which the taxpayer owns more than 50% of the

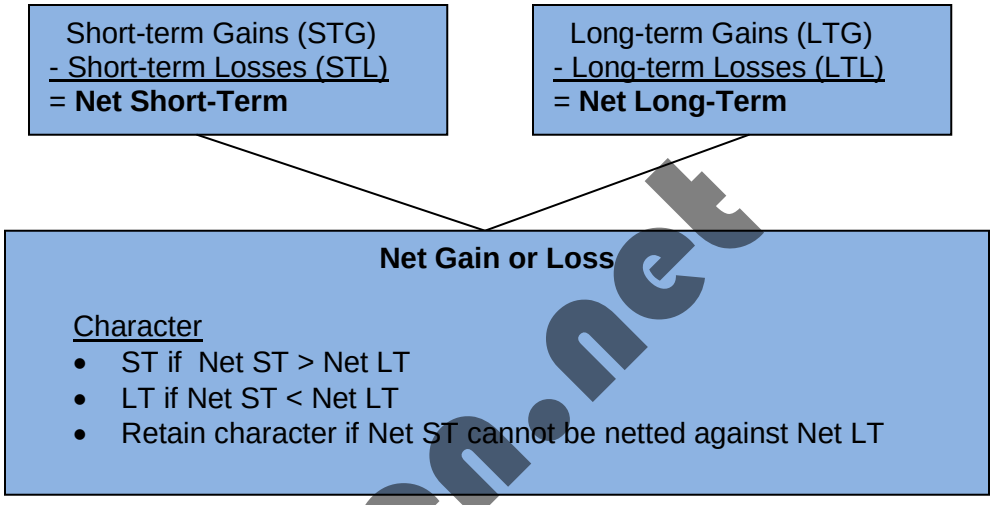
[27] The election became effective in 2007 and was scheduled to expire in 2010, but has now been made permanent with the enactment of the Tax Relief and Health Care Act of 2006.

[28] "[T]he year of disposition of a regular-way sale of stock or securities traded on an established securities market is the year that includes the trade date."

[29] IRC § 267.

stock—and other controlled entities such as trusts and estates may also not be deducted.

Capital losses are further categorized into short- (ST) and long-term (LT). Next, STCLs are netted against STCGs while LTCLs are netted against LTCGs. Only after this netting process is complete, will the resulting short- and long-term gains and losses be netted against each other. The combined result is reported on Line 17 and retains the character (short- or long-term) of the predominant gains and losses.



Once again, the government is teaching the taxpayer a valuable lesson: *It is best to have short-term losses and long-term gains.* In this manner, the gains are taxed at the lower rates while the STCLs can be used to offset the "expensive" STCGs.

Ordering of Losses[30]

While gains are eagerly taxed by federal and state governments, losses (as seen above) may only be used to offset gains. However, these losses must be applied in the following order:

1. Short-Term Capital Losses
   - Reduce short-term capital gains
   - Reduce net long-term capital gains taxed at 28% (collectibles & small business stock)
   - Reduce net long-term gains taxed at 25% (recapture property)
   - Reduce net capital gains taxed at 0 or 15% (depending upon the taxpayer's marginal bracket)

[30] IRC § 1(h).

2. Long-Term Capital Losses

- Net capital losses from the 28% rate assets reduce long-term gains taxed at 25%, then long-term gains taxed at 0 or 15%
- Net capital losses from 0 or 15% rate assets reduce long-term gains taxed at 28% and then long-term gains taxed at 25%
- In other words, losses are always applied to highest-rate gains first, then sequentially to lesser-rate gains from 28% down

NOTE: Capital losses carried over retain their character as long-term or short-term.

E. Claim of Right Doctrine

While it is undisputed that a tax liability arises upon receipt of income, it is often the timing that is in question—when exactly did the taxpayer have the right to the earnings? Such was the case in *North American Oil v. Burnet*[31] wherein the Supreme Court held that income was taxable at the time that the taxpayer had a "claim of right" to it.

The taxpayer's oil properties were embroiled in an ownership dispute. As a result, the income that was earned in 1916 from these particular properties was put into receivership pending the outcome of litigation. The funds were released to the taxpayer the following year. Pending appeal, the court's decision was finally reaffirmed 5 years later.

The taxpayer attempted to postpone income recognition (when tax rates were coincidentally lower), arguing that his rights to the earnings had not been definitively established until 1922. Yet, the Supreme Court found that the taxpayer had actually received the disputed funds (in 1917), that he had treated them as his own, and that he had not entered into any offsetting obligation in the interim. Although the income was subject to dispute, it was nevertheless includible.

Aside from the fact that the IRS would always prefer to tax income sooner rather than later to boost its collections, earlier income inclusion helps to preclude the risk that a taxpayer might become insolvent in future years before the tax is paid. Additionally, it would be administratively difficult to ascertain when, if ever, earned income is finally free from potential dispute—thus, the occurrence of actual receipt is more readily identifiable than the final resolution of all possible controversies.

But claim of right can also create great hardship for a taxpayer whose claim is ultimately resolved unfavorably, forcing him to disgorge moneys that he thought were his and, of course, had already been taxed upon. In such instance, the taxpayer may of course deduct the court-ordered repayment. But when and how?

[31] 286 U.S. 417 (1932).

Until enactment of IRC §1341, taxpayers were required to treat the income inclusion and subsequent deduction as separate events, reportable in the respective tax years. The new code section continued to require income inclusion based on a claim of right, but the offsetting deduction in the later year would be allowed to decrease that year's tax to the lower of:

- The tax in the later year computed with the deduction, or
- The tax in the later year—computed without the deduction, but reduced by the amount that the tax in the earlier year would have been reduced had the disputed income not been included.

Additionally, the character of the deduction must correspond to the character of the income previous included.

Example: Taxpayers liquidate and divide the proceeds of a corporation in which each owned 50% of the stock. Partial distributions were made in 4 subsequent years; the profits thereon were reported as "capital gains." Later, a judgment was rendered against the corporation—each of the two taxpayers paid his half of the judgment and (erroneously) deducted the amount paid as an ordinary business loss in the year of payment. The court held that these losses should have been treated as "capital losses," since they were paid because of liability imposed on the taxpayers as transferees of liquidation distribution assets. The transaction could not be viewed independently even though each taxable year may otherwise be viewed as a separate unit for accounting purposes. Thus, the deduction in the later must be treated as a LTCL—of course, subject to attendant capital loss limitations.[32]

Taxpayers seeking to avoid an unfavorable outcome resulting from this mirror-image treatment must argue that the initial and subsequent transactions are unrelated. For example, *Arrowsmith* was found to be inapplicable where the original gain from the sale of stock *acquired in lieu of*

[32] *Arrowsmith v. Commissioner*, 346 U.S. 6 (1952).

Similarly, a taxpayer was forced to recognize the gain on a forced buy-out transaction of his S-Corp shares in year of receipt even though he continued to fight his former partner and the disposition of his shares in court. Although there remained the possibility that the buyout transaction would be unwound retroactively, the Court held that the taxpayer had no current fixed legal obligation to restore the proceeds to the buyer at the time of receipt. *Hightower v. Comm.*, 101 AFTR 2d (2008).

And in current news, *Forbes* author Tony Nitti speculates that dethroned Tour de France winner Lance Armstrong may be compelled to return as much as $5 million of bonuses received for each of his victories during his seven-year reign as champion. These winnings, of course, were previously included as taxable compensation subject to the highest applicable ordinary income rate. Should Armstrong be forced to disgorge these earnings in the coming tax year, he would be eligible to claim the payments as ordinary and necessary business expenses. If, however, his repayments exceed next year's income – very possible since his sponsors have abandoned him – "he may not be able to reap the full tax benefit of the deductions". Additionally, any potential tax benefit will likely be less valuable now than when the income was originally earned and taxed "during the pre-Bush tax cut years of 1999-2001." [Nitti, *The Potential Tax Implications of Lance Armstrong's Banishment from Cycling*, available at http://finance.yahoo.com/news/potential-tax-implications-lance-armstrongs-113039311.html, last accessed October 26, 2012.]

employee compensation was held to be unconnected to the loss later realized on the sale of stock *acquired through the exercise of options.*

III. Computation of Gains and Losses

In its most simplistic form, gains and losses are calculated by subtracting the cost of the asset from the sales proceeds. While sales proceeds may be readily determined and are in fact reported on such forms as **1099-A**, **1099-B**, **1099-C** and **1099-S**, amongst others, it is often harder to determine the cost of an asset acquired. Significant time may have passed, records may have been lost or misplaced, and a variety of events may have transpired which would have affected the cost in the interim. Thus, adjustment to original cost may have to be made to determine the cost basis.

A. Determination of Cost Basis

Depending on the item or the transaction involved, cost basis will be equal to the original acquisition cost plus or minus appropriate adjustments.[33] **NOTE:** Lacking substantiation by the taxpayer, the IRS will always assume a zero cost basis.

<u>Examples of Increases and Decreases to Basis:</u>

Increases to Basis	Decreases to Basis
Capital improvements: • Building an addition • Replacing the roof • Paving the driveway • Installing central A/C • Rewiring your home	Exclusion from income of subsidies for energy conservation measures
Assessments for local improvements, such as water connections, sidewalks, and roads	Credit for qualified electric vehicles
Casualty losses and restoration of damaged property	Deduction for clean-fuel vehicles and clean-fuel vehicle refueling property
Legal fees to defend or protect title	Nontaxable corporate distributions
Zoning costs	Casualty or theft loss deductions and insurance reimbursements
	Section 179 and depreciation deductions

Taxpayers may refer to IRS *Publication 551: Basis of Assets*.

<u>Routine Safe Harbor Maintenance Rule</u>

In the past, taxpayers have been required to capitalize repair costs that would otherwise be deductible if the repairs were incurred as part of a general plan

[33] Resident aliens with real property held abroad are subject to special rules: Basis of the property equals the cost of acquisition in US dollars computed on the exchange rate in effect on the date of acquisition. The basis does not receive a step-up to FMV on the date that an NRA becomes a resident alien or US citizen. Foreign currency sales proceeds must be converted to US dollars using the exchange rate in effect on the date of sale. As a result, the resident alien may realize a taxable gain from the difference between sales and purchase prices as well as from an unrealized exchange rate gain.

of renovation or rehabilitation. A proposed IRS regulation[34] would introduce a safe harbor rule that would *allow repairs made at the same time as an improvement—but not directly related to that improvement—to be deducted as current expenditures*.

The safe harbor rule would apply only if, at the time the property is placed in service, the taxpayer expects to perform the maintenance activities more than once during the asset's lifetime. Factors to be considered when determining whether maintenance is "routine" would include such items as the nature of the activity and industry practice.

Example: A company which owns a fleet of trucks decides to replace the existing engine, cab, and storage tank on each truck. These costs must, of course, be capitalized as they serve to restore the fleet to prime operating condition. However, the company also decides to paint each truck cab and have all broken taillights fixed—both deductible repairs if made independently—but because they are completed when the new components are installed,

- *the cost of the taillights may be expensed since these repairs do not directly benefit and are not incurred by reason of the truck restoration, BUT*
- *the painting cost must be capitalized (!).*

On the other hand, "betterment costs" must now be capitalized. This new term applies to amounts paid to repair a material defect that existed before the taxpayer acquired the property, as well as outlays for material additions and expansions. Again, facts and circumstances will determine whether an expenditure results in betterment, but will typically hinge upon a comparison of the property's condition before and after the expense was incurred. Where a shop suffered storm damage, the examples given in the proposed regulation distinguish between re-doing an entire roof with wood shingles (NO betterment), re-doing the roof with asbestos shingles when wood shingles are unavailable (NO betterment), and re-roofing with a maintenance-free, non-absorptive composite material (betterment).

Restoration costs—including those costs necessary to restore property to its ordinarily efficient operating condition because it is no longer functional for its intended purpose or adapting the property to a new and different use—must also be capitalized. Again, the regulation's example helps as much as it hurts: The owner of a building with 20 retail spaces converts 3 spaces into one large one by knocking out walls. This would *not* be treated as a new use since the use of space is still consistent with the owner's original intent.

<u>Uniform Capitalization Rules</u>

These rules must be applied when determining cost basis if you produce real or tangible personal property for use in your business or for sale to customers, or if you acquire business property for resale. All direct costs and

[34] Prop. Treas. Reg. § 1.263(a)-3 (March 7, 2008).

an allocable part of most indirect costs incurred during production or resale must be capitalized and thus added to your cost basis rather than deducted in the year incurred. These costs can be recovered later through depreciation and amortization or upon disposition of the asset.

As always, there are exceptions to these rules, such as:

- Qualified creative expenses incurred as a free-lance writer, photographer or artist (these expenses do not include outlays for printing, photographic plates, motion picture films, or videotapes)
- Property produced under long-term contract
- Research and experimental costs

Allocation of Basis

If multiple assets are acquired simultaneously, the purchase price must be allocated equitably amongst all of the assets. For acquisitions after January 5, 2000, the allocation must be made in proportion to, but not more than their fair market value (FMV) on the date of acquisition date of CDs, foreign currencies, actively traded securities; accounts receivable and mortgages; inventories; §197 intangibles; and goodwill.

Buyers and sellers of business assets must agree to the allocation and ensuing valuations and use **Form 8594** to report this information to the tax authorities. Taxpayers may wish to engage the services of a cost segregation expert to expertly assign values to specific assets, thereby accelerating allowable depreciation deductions and decreasing tax liabilities over periods of years.

Here are the results of a sample study[35] which shows that significant tax savings can be achieved by re-allocating the cost of construction or purchase amongst various asset classes. Assume that an asset consisting of a building (27½-year property), improvements (15-year property) and equipment (5-year property) was purchased for $10,273,796. If the purchase cost is allocated to the real property in its entirety, the purchaser will be limited to depreciation deductions based on straight-line depreciation of over a useful life of 27½ years. If, instead, cost segregation was employed and the purchase price allocated amongst the building ($6,590,865), improvements ($1,721,773) and equipment ($1,961,158), the following tax savings could be achieved by claiming accelerated depreciation where allowed:

	2006	2007	2008	2009	Total 2006-09
Additional Depreciation	1,085,313	389,843	224,591	211,333	1,911,080
Total Taxes Deferred	480,794	172,700	99,494	93,621	846,609
Present Value of Cumulative Taxes Deferred (after 27½ years)	445,180	593,242	672,224	741,038	552,871

[35] As prepared by Cost Segregation Partners. Sample Report available at www.costsegregationpartners.com [last accessed October 25, 2012].

Basis other than Cost

In some cases, cost cannot be determined or used to establish basis and so other methods must be used…

Type of Transaction	Cost Basis	Amount Includable as Income
Property received for services rendered	FMV	FMV or agreed-upon value
Bargain Purchase	FMV	FMV – purchase price
Bargain Sale to Charity	Total Basis × FMV of Item Sold ÷ Total FMV	FMV – prorata basis
Restricted Property	FMV upon vesting	FMV – price paid (if any) when vested
Insurance Policies and Annuities	N/A	No gain or loss recognized if §1035 exchange done (life policy or annuity for another annuity) If cash is received, gain must be recognized
Involuntary Conversions and Repossessions	Basis of old property – recognized loss – moneys received + recognized gain + moneys spent	Recognized gain = proceeds received – money's spent to replace property
Cancelled Debt	N/A	Amount of debt forgiven
Taxable Exchanges	FMV	FMV – basis of property relinquished
Nontaxable Exchanges	Basis of the old property traded in + boot paid	No gain or loss recognized at time of exchange
Partially Nontaxable Exchange	Basis of old property – moneys received – loss recognized + moneys spent + gain recognized	Recognized gain = FMV of the new property + cash spent – basis of old property Loss is never deductible if you receive unlike property or cash
Easement	FMV – amount received for easement	Amount received for easement
Related Parties	FMV of item relinquished + cash paid	Gain must be recognized if either party disposes of asset before 2 years (except death or involuntary conversion) Gain is ordinary income if sale of depreciable property is involved Losses are not recognized
Transfers Between Spouses	Spouse's adjusted basis	No gain or loss recognized
Gifts	If later sold at a gain, use donor's basis If later sold at a loss, use lesser of donor's basis or FMV Adjust basis for the amount of gift tax paid, if any	No gain or loss recognized
Inheritance	FMV on date of death or alternate valuation date	No gain or loss recognized
Personal Property Converted to Business Use	If later sold at a gain, use purchase price + acquisition costs If later sold at a loss, use lesser of FMV on date of conversion or adjusted basis	No gain or loss recognized
Property Contributed to a Partnership	Original cost + recognized gain	
Property Contributed to a Corporation in Exchange for Stock	Original cost + recognized gain – recognized loss	No gain or loss recognized If services are rendered, then stock received for these services is considered compensation
Timber	Adjusted basis for depletion (§611)	Capital gain or loss is recognized if the timber is held for investment If held for resale, gain or loss is ordinary
Collectibles	Purchase price	Capital gain or loss unless taxpayer is a dealer of coins, stamps or stones

NOTE: Basis is often, but not always the FMV at the time of the transaction.

B. Special Basis Rules for Certain Transactions

Stock Rights

Investor bought 200 shares of XYZ at $2,000 and then received 20 rights allowing him to purchase an additional 20 shares at $3/share. The FMV of the stock is $1,900 on the date of distribution and the FMV of the rights is $80. Basis is allocated as follows:

Basis of Stock = $1900 ÷ ($1900 + $80) × $2000 = $1919
Basis of Rights = ($80 ÷ $1980) × $2000 = $81

Fractional Shares

Investor owns 125 shares of XYZ which she bought for $25/share. The company declared a 2% stock dividend, entitling Investor to an additional 2.5 shares. The company elected to sell, rather than offer Investor a cash dividend (in lieu of the ½-share), and reported the sales proceeds of $15 on ***Form 1099-B****.*

Basis of Fractional Share = $3125 ÷ 127.5 x 0.5 = $12.25
Gain on Sale = $15 – 12.25 = 2.75 (reported on ***Schedule D****)*
Basis of Remaining Shares = ($3125 – 12.25) ÷ 127 = $24.51

Corporate Spin-offs

In 1996, AT&T spun-off Lucent Technologies and NCR Corporation and distributed shares of these subsidiary companies to its existing shareholders. Since this transaction is not a taxable event for the shareholder, his basis in the new shares must now be allocated between the stock of the original company and the stock in the spin-offs based on the ratio of their fair market values on the date of the spin-off. The issuing company will provide a worksheet to assist shareholders in making the proper computations and will also provide a statement which the shareholder must sign and attach to his tax return referring to IRC §355.

Liquidation Distribution

100 shares were purchased in 1995 at $3,000 and another 100 shares were purchased in 1996 for $4,000. In 2000, investor received a liquidation distribution of $7,000 which must be allocated amongst the two blocks of stock previously purchased.

(100 shares ÷ 200 shares) × $7,000 = $3,500

Thus, the taxpayer realizes a $500 LTCG on the first block of stock (= $3,500 - $3,000) and the basis of the second block is reduced to $3,500 (= $7,000 - $3,500).

If yet another distribution were to occur, it too, would have to be allocated. Therefore, the taxpayer would realize a capital gain on the first block of stock,

reduce the basis of the second block to zero and then realize a capital gain on any amounts which are now distributed in excess of that basis.

Demutualization of Life Insurance Companies

Although other entities may do so as well, a recent industry trend has led numerous insurance companies to convert from member- to shareholder-ownership. In that manner, the company's policy holders and annuitants receive stock or cash in exchange for their equity interests. These transactions must be reported for tax purposes, keeping in mind that the basis in the original equity interest is deemed to have been zero.[36]

Tax-free Reorganization: No gain or loss will be recognized by the policyholder (shareholder). The zero-basis from the equity interest prior to demutualization will carry over to the new shares of stock received after demutualization. The holding period of the stock will be tacked on to the period that the equity interest was held in the mutual company. If the shareholder receives cash in addition or in lieu of shares, a capital gain must be recognized equal to the amount of cash received—its short- or long-term character will be determined by the length of time that the taxpayer had an equity interest in the mutual company.

Non-qualified Demutualization: If the transaction does not qualify as a tax-free reorganization—the insurance company will notify its policy holders—a capital gain must be recognized equal to the amount of cash and/or stock received. Once again, the holding period will be determined by the length of time that the taxpayer had an equity interest in the mutual company. The holding period for the new stock is *not* tacked on to the prior period and begins on the day *after* the stock is received.

Worthless Securities[37]

Securities—defined as corporate stock, stock rights, or bonds—which have no value may be reported as capital losses upon the occurrence of an identifiable event that establishes their worthlessness, such as the

[36] Rev. Rul. 71-233: "Payment by each policyholder of the premiums… represents payment for the cost of insurance and an investment in his contract but not an investment in the assets of [the insurance company]. His proprietary interest in the assets [of the insurance company] arises solely by virtue of the fact that he is a policyholder of [the insurance company]. Therefore, the basis of each policyholder's proprietary interest in the [insurance company] is zero."

The US Court of Federal Claims has recently sided with the taxpayer in *Eugene Fisher, Trustee of the Seymour Nagan Irrevocable Trust v. US* (August 6, 2008) who claimed that the costs of his insurance and his investment in the mutual company were inseparable. Because the valuation of the taxpayer's ownership rights was indiscernible, the court compared the relatively small amount received from the demutualization to the *total* cost of the policy and found that no income was realized. While the IRS has not (yet) acceded to this view, many practitioners have filed protective claims on behalf of their clients.

[37] IRC § 165(g).

bankruptcy of the issuing corporation. However, if a security retains even a minute value, a loss deduction is not allowed.

In that case, a taxpayer has two choices: (1) He can sell the securities for the nominal value that they have retained and thereby fix the dates and amounts of the attendant losses, or (2) he can abandon the assets. While the first option indeed allows the taxpayer to claim the difference between his minimal sales price and his original purchase price as a capital loss, he may be unable to find a buyer for what is essentially a "worthless" security.

On the other hand, by relinquishing title to his security, permanently surrendering his rights, and receiving no consideration in exchange, he can abandon the asset. Aggressive taxpayers have then argued that abandonment is eligible for ordinary loss treatment; however, the IRS has proposed a regulation[38] requiring that abandoned securities be treated in the same manner as worthless securities; thus, they are eligible for capital loss treatment only.

In any case, worthless securities are deemed to have become worthless on the *last* day of the year in which the identifying event occurs. This date, then, determines whether the attendant loss is long- or short-term.

[38]Prop. Treas. Reg. § 1.165-5, Fed. Reg.1001-05 (September 4, 2007).

C. Summary of Cost Basis and Holding Periods for Investment Transactions

Type of Event	Cost Basis	Holding Period Begins
Purchased Stock	FIFO will be assumed unless the taxpayer can identify the specific shares sold and receives a trade confirmation with the identification	On date of purchase
Dividend Income	Original cost of stock is increased by amount of dividends reinvested. If plan allows investor to reinvest at a discount from FMV, then this discount will be treated as reportable dividend income.	On day after dividend is issued
Return of Capital	Nontaxable distributions in excess of original basis are considered capital gain	Original purchase date
Stock Split	Basis of original shares is prorated amongst the original and newly received shares	Original purchase date
Stock Dividends	Basis of original shares is prorated amongst the original and newly received shares unless Shareholder elects cash in lieu of stock dividends or receives an increased ownership percentage (in this case, he will be taxed on the FMV at the time of the distribution and receive a new holding period for the new stock)	Original purchase date
Stock Rights	FMV on distribution date if the rights are taxable—otherwise, the basis must be allocated between the original stock and the rights received or basis is zero if the rights are allowed to expire	Original purchase date for the unexercised rights or date of exercise if new shares are acquired
Warrants	Purchase price of the stock + cost of the warrant + cost to exercise warrant	Date of exercise
Convertible Bonds	Purchase price of the stock + cost of the convertible bond	Date of purchase of the convertible bond
Bond Premiums	Reduce basis by the amount of amortization deducted Post-1998: Taxpayer may elect to amortize and reduce taxable interest income by the amount of amortization--§171 requires amortization for tax exempt bonds	Date of purchase
Bond Discounts	Increase basis by the amount of accretion claimed Taxpayer may elect to accrete and include amounts accreted as taxable interest income--§1272 requires a basis adjustment for OIDs	Date of purchase
Liquidation Distributions	Reduce basis by the amount of the distribution—if more is distributed than available basis, a capital gain is realized. Upon final dissolution of the corporation, taxpayer may claim a capital loss if less than basis is recovered	Original purchase date
Fractional Shares	Basis is allocated between the original stock and the fractional shares received	Original purchase date
Worthless Securities	Considered sold on the last day of the tax year	Original purchase date
Spin-offs	Basis is allocated between the original stock and the fractional shares received on the basis of the relative FMV of the old and new company stock (taxpayer must attach a statement provided by the company as per §355 to his tax return)	Original purchase date

IV. Investment Companies

A. Closed-end or Publicly Traded Funds

A fixed number of shares of these funds are typically issued on a one-time basis (IPO) and then traded on the secondary market in the same manner as stocks are traded. Thus, the treatment of their distributions is comparable to that of the Corporate Distributions mentioned above.

B. Open-end or Mutual Funds

These shares are issued on a continuous basis. No finite number of shares is issued. The shares are purchased from and redeemed by the issuing fund company. The treatment of mutual fund transactions differs from that of other issuing corporations.

Summary of Tax Treatment

In addition to interest and dividend income generated by the fund and taxed to the investor, various forms of capital gains may be realized.

Triggering Event	Tax Treatment
Fund Distribution: • Qualified Dividend • Capital Gain Distribution	LTCG (Declared by fund manager)
Share Redemption • Automatic Withdrawal • Sale • Exchange w/i Fund Family	ST or LTCG (Gain = NAV – Basis)

1. Distributions

Reinvested Dividends and Interest

Depending on the underlying assets in the fund portfolio, dividend and interest income may be earned by the fund. However, if this income is passed on to the investor, the fund avoids taxation and only the investor will have to report the income as ordinary income on his personal tax return. If the dividends are reinvested, the income is taxable in the year of receipt by the mutual fund company, but the basis of the shares is then adjusted by the amounts reinvested.

Presuming that the mutual fund has complied with the requisite holding period, some of the dividends it receives will be eligible for favorable LTCG treatment as qualified dividends. This benefit will be passed on to the investor who will be notified on **Form 1099-DIV**.

Tax-exempt Dividends

Tax-exempt dividends are not subject to taxation but must be reported on Line 8b of **Form 1040**.

A special rule applies if these shares are then sold at a loss within six months from the date of purchase.

Example: On February 1st the investor purchased 100 shares of a State Tax-Free Fund for $1000 and sold the same shares on April 30th for $960. Although he realized a $40 loss, he may only recognize the portion in excess of the tax-exempt dividends he received. In this case, he received $24 during the time he held the shares and so only $16 loss (= $40 - $24) may be recognized.

Capital Gain Distributions

Throughout the lifetime of the portfolio, the fund manager will buy and sell securities within the portfolio, realizing attendant gains and losses. As per Subchapter M of the Code[39] which employs the Pipeline or Conduit Theory, the manager must distribute the gains annually to the shareholders to avoid taxation at the fund level. These capital gain distributions (CGDs) are reported as LTCGs regardless of the investor's holding period and the fund's portfolio turnover. If the taxpayer has no other gains and losses to report, he may report the CGDs directly on **Form 1040**, Line 13 rather than on **Schedule D**.

Occasionally, a mutual fund company may choose not to distribute some of the LTCGs and instead, the company will pay the tax on these amounts. The amounts of the undistributed gains and the tax paid by the fund on behalf of the taxpayer are reported to the taxpayer on **Form 2439**. The LTCGs (**Form 2439**, Box 1a) will then be reported by the taxpayer on **Schedule D**, Line 11 and the taxes withheld will be entered as a payment on **Form 1040**, Line 68 as a Credit from **Form 2439**. The basis of the investment may be increased for any excess of LTCG included on the return over the amount of tax credit claimed.

2. Redemptions

Should an investor choose to liquidate his mutual fund position, he will sell his shares back to the fund at the Net Asset Value (NAV) at the close of the next business day. The gain or loss will be computed based on the sales proceeds less the adjusted cost basis which can be determined in a number of ways.

If the investor participates in an automatic withdrawal plan whereby a fixed number of shares or a fixed dollar amount is regularly redeemed and delivered to the investor, the transaction is once again treated as a sale and gain or loss must be recognized.

Most mutual funds offer a selection of portfolios within their family of funds. The investor may at any time make an exchange between these funds without incurring any transactional costs. However, the IRS considers the transaction to be a taxable event as though the shares of the first fund had been sold and then new shares of the second fund had been bought. The resulting gain or loss must be reported and the holding period of the new shares begins on the date of the exchange.

Gain or loss must be recognized even on a tax-free fund. These funds typically invest in municipal bonds. Although the interest on these bonds is free from federal (and sometimes even state) taxation,

[39] IRC § 852.

the resulting capital gains and losses from redemptions or exchanges must be recognized.

3. Basis of Shares

Since mutual fund shares are often purchased at different times and prices, cost basis may be determined in a variety of ways:

- FIFO
- Specific Identification
- Average Cost

The taxpayer may elect one of the basis calculation methods mentioned above. If no election is made, the IRS will presume FIFO. Thus, it will be assumed that the first shares purchased, are now the first shares sold.

Alternatively, the taxpayer may specifically identify the shares to be sold, but he must receive a trade confirmation stating the purchase date of the shares he selected and now redeemed.[40]

Finally, the investor may use average cost. Nowadays, many mutual fund companies supply this information automatically to their shareholders at year-end, so this is often the method of choice and used for ease and convenience. There are two ways to calculate average cost: Single-category Method or Double-Category Method. In the latter case, the average cost is determined separately for shares held short- and long-term. Upon election of this method, the taxpayer should indicate his choice by attaching a statement to his tax return. Although the election applies to only one fund at a time (and a different basis calculation method may be used for other funds in the portfolio), the election is irrevocable and applies to all shares of the same fund for as long as the investor holds that fund.

If the investor has received any of his mutual fund shares as a gift when the FMV of these shares was equal to or less than the donor's basis, special basis rules apply. Average cost may only be used if a statement is submitted when the election is first made, ensuring that the basis of the gifted shares will equal the FMV at the time of the gift.

Regardless of the method selected, the investor may add the sales load paid at time the shares were purchased to his cost UNLESS *all* three of the conditions listed below are met:

- The investor may reinvest or exchange his shares without incurring a sales load again in the future AND
- The investor redeems his shares within 90 days of the purchase date AND

[40] Reg. 1.1012-1(c)(1).

- The investor acquires new shares in this or a sister fund as a result of the reinvestment right granted to him.

Mutual Fund Basis Calculations—Comparison of Methods

FACTS:

Date of Purchase	# of Shares	Cost/Share	Total Cost	Transaction Type	Holding Period thru 1/02
3/00	500	10.00	5,000	Orig. purchase	LT
12/00	30	10.50	315	Div. & CGD Reinv.	LT
5/01	200	9.75	1,950	Addtl. Contrib.	ST
12/01	40	10.25	410	Div. & CGD Reinv.	ST
Totals	*770*		*7,675*		

Investor sells 600 shares on 1/02 at $10.30/sh for a total of $6,180. Of these 600 shares, 530 were held for the long-term and 70 shares for the short-term. Thus, $5,459 of the total sales price is attributable to the long-term and $721 to the short-term.

FIFO: Assume that the first shares sold are the first ones purchased.

Date of Purchase	# of Shares	Cost/Share	Total Cost	Sales Proceeds ($10.30/sh)	Net Gain
3/00	500	10.00	5,000		LT
12/00	30	10.50	315		LT
Subtotal	*530*		*5,315*	*5,459*	*144 LTCG*
5/01	70	9.75	683		
Subtotal	*70*		*683*	*721*	*38 STCG*

Although the LTCG and STCG would have to be reported separately on Schedule D, for comparison purposes, the **net gain would be $182**.

Specific Identification: To minimize his current tax liability, taxpayer will select shares with highest cost.

Date of Purchase	# of Shares	Cost/Share	Total Cost	Sales Proceeds ($10.30/sh)	Net Gain
12/00	30	10.50	315		LT
3/00	500	10.00	5,000		LT
Subtotal	*530*		*5,315*	*5,459*	*144 LTCG*
12/01	40	10.25	410		
5/01	30	9.75	293		
Subtotal	*70*		*703*	*721*	*18 STCG*

Although the LTCG and STCG would have to be reported separately on Schedule D, for comparison purposes, the **net gain would be $162**.

Average Cost—Single-Category: Basis will be calculated by dividing total cost of shares bought ($7,675) by total number of shares bought (770 shares) & determining that average cost was $9.97/share. Shares are then sold in the order they were originally purchased.

Date of Purchase	# of Shares	Avg Cost/Sh	Total Cost	Sales Proceeds ($10.30/sh)	Net Gain
3/00	500	9.97	4,985		LT
12/00	30	9.97	299		LT
Subtotal	*530*		*5,284*	*5,459*	*175 LTCG*
5/01	70	9.97	698		
Subtotal	*70*		*698*	*721*	*23 STCG*

Although the LTCG and STCG would have to be reported separately on Schedule D, for comparison purposes, the **net gain would be $198**.

Average Cost—Double-Category: Taxpayer calculates separate average costs for each category of ST & LT holding periods → average cost for ST would be $9.83/share (= $2,360 purchase price ÷ 240 shares) & $10.03/share (= $5,315 ÷ 530 shares) for the LT.

Date of Purchase	# of Shares	Cost/Share	Total Cost	Sales Proceeds ($10.30/sh)	Net Gain
3/00	500	10.03	5,015		LT
12/00	30	10.03	301		LT
Subtotal	*530*		*5,316*	*5,459*	*143 LTCG*
5/01	70	9.83	688		
Subtotal	*70*		*688*	*721*	*33 STCG*

Although the LTCG and STCG would have to be reported separately on Schedule D, for comparison purposes, the **net gain would be $177**.

CONCLUSION:

Under the given circumstances, the taxpayer would receive the most favorable tax treatment if he applied the methods ranked in the following order:

(1) Specific Identification
(2) Average Cost: Double-Category
(3) FIFO
(4) Average Cost: Single-Category

4. Advantages of Mutual Funds over Alternative Investments

In addition to some of the obvious advantages such as portfolio diversification and professional management, mutual funds also offer the following benefits:

- CGDs are treated as LTCGs regardless of the investor's actual holding period.
- The fund's capital losses do not flow through to the investor and thus do not affect the $3,000 limitation on net capital losses.
- The average cost methods of determining basis cannot be applied to any other investment.

V. Short Sales[41]

Although an investor always seeks to make a profit by buying low and selling high, he may sometimes reverse the order of the two transactions. For example, if he believes that the stock will decline, he may first sell and then buy back the same stock at a later time. Of course, he cannot sell what he does not own. Thus, he must begin by borrowing the shares of stock from his broker/dealer (B/D) with the promise to re-pay this debt in the future. Then, he sells the borrowed shares at a high price. Sometime later, he purchases the shares—hopefully at a lower price—in an attempt to cover his debt to the B/D.

Example: Say your neighbor has a beautiful red Corvette in his driveway and has given you permission to borrow the car any time you would like. So, you do. And then you sell his car for $25,000. Of course, your neighbor will eventually realize that his car is missing and will ask you to return it. He will not care if you say that you no

[41] IRC § 1233.

longer have it. Thus, you will be forced to repurchase the same car (or one that looks very similar), anticipating that your neighbor can be made whole. Naturally you hope that car prices have declined and that you'll be able to buy the Corvette for less than $25,000. You return the car to your neighbor and pocket the resulting profit.

Short selling, as this investment strategy is known, is obviously a bearish course of action. For this to work, the market *must* decline. If the market should move upward (and there is no telling how high it might go), the debt may have to be covered with stock purchased at a very high price and the potential loss could be unlimited.

Holding Period

Gains and losses for tax purposes will be computed in the same manner as for all stock transactions, but the holding period is determined by the length of time that the short seller (borrower) actually holds the stock between the time he purchases it and delivers it to the lender (B/D).

Example: The investor borrows the stock on March 15, 2000 and sells it short. On April 3, 2001 he re-purchases the shares but does not deliver them to the lender until April 5, 2001. Although he was short for more than one year, he only held the asset for 2 days. Therefore, the gain on this transaction will be classified as short-term.

Constructive Sale Rule[42]

Often times an investor may own substantially identical stock to the shares borrowed and sold short (engaging in a transaction known as "Short-Against-the-Box"). In this case, the stock is treated as though it had been sold and immediately repurchased, resulting in a STCG.

Example: The investor owns 100 shares of XYZ on March 15, 2000 (purchased March 1, 2000 for $30/share) when he also borrows another 100 shares to make his short sale for $37/share). He will have to recognize a STCG of $700 (= $3,700 - $3,000) on March 15th. If he later uses his own shares to cover his short position, he will have no further gain or loss, but if he purchases new shares on March 3, 2001 for $35/share, he will recognize a $200 STCG (= $3,700 - $3,500). His holding period will begin on March 16, 2000—one day after the constructive sale.

Prior to 1997[43], the taxpayer could elect to enter into the short sale in one year and then close his position in another, thereby effectively deferring the recognition of income. But this is no longer allowed unless:

[42] IRC § 1259.

[43] Excerpt of article published in *New York Times*, November 27, 1997, available at http://query.nytimes.com/gst/fullpage.html?res=9504E1DE153AF934A15752C1A961958260&n=Top%2fReference%2fTimes%20Topics%2fPeople%2fL%2fLauder%2c%20Estee [last accessed September 28, 2007]: Congress made such tax-deferral strategies far more costly in the tax bill signed into law in August, in large part because of a 1995 transaction by the trust for Mrs. Lauder, a founder of the cosmetics business that bears her name. The stock deal allowed the trust to defer large capital gains taxes when the Estee Lauder Company went public. In the transaction, Mrs. Lauder's trust sold 5.5 million borrowed shares to profit from the gains in price of shares that it already held. But the trust kept its original holdings to defer capital gains taxes. The strategy is known as "shorting against the box." In this case, Mrs. Lauder's trust was able to defer capital gains taxes on

- The position is marked-to-market
- The position is straight debt
- The position involves non-publicly traded securities

Income received while position is open: As the stock sold short is only borrowed, the investor may receive dividend income to which he is not entitled. He will be asked to repay that amount to the lender (B/D). He may only deduct these payments as investment interest if his short position is open longer than 46 days. Otherwise, he must add these expenses to the basis of the stock used to close the short sale.

Collateral: The lender (B/D) will require that the investor place moneys on deposit with the firm to guarantee future performance and be assured that the investor will some day repay his debt on the short sale. The money on deposit may earn interest. If the interest earned on the deposit is less than the dividends repaid to the B/D, the investor may deduct his payments as investment interest. Any excess repayments are not deductible.

VI. Margin Trading

Brokerage firms typically offer two types of trading accounts – the plain vanilla account and the margin account required whenever borrowing is involved. As you can see from the prior discussion, short selling involves the sale of *borrowed* securities and can, therefore, only be done in a margin account.

But trading on margin can also involve the purchase of securities using borrowed money. Similar to a home purchase, an investor borrows money from his broker to purchase securities with a minimal down-payment. But unlike a home purchase in which the down-payment can be negotiated between buyer and seller, the down payment in a margin account is set by regulatory authorities. Currently fixed at 50% (in comparison to the 20% typically mandated for real estate loans), the margin down payment offers the broker greater protection than the mortgage broker in the event of default. But like the mortgage on a primary residence, the securities loan is a non-recourse loan which means that the lender cannot pursue the borrower for additional funds if the market value of the collateral proves insufficient at the time of default.

By using borrowed funds – whether to purchase a home or stock – the investor is benefitting from leverage with allows him to magnify his gains.

Transaction	All Cash Purchase	Leveraged Purchase (10% Down)
Buy house for $500K	$500K	$50K
Market Value increases to $525K	$25/500 = 5% Return	$25/50 = 50% Return
Market Value decreases to $450K	-$50/500 = 10% Loss	-$50/50 = 100% Loss

$135 million in proceeds from the stock sale until after her death. The strategy would have enabled the family to inherit the shares at the current market price, instead of at the much lower original cost; at the same time, it would have lowered the potential estate taxes.

NOTE: If the market turns against the investor, leverage will also magnify his losses. As a result, an investor who chooses to buy on margin must believe that the market will go his way!

A. Definitions

Comparing once again to familiar concepts, we see that investors like homeowners have equity (net worth). In the real estate market, we know that the homeowner's equity is the difference between the market value of the home and the loan balance wed to the mortgage company. While equity typically starts out at about 20%, equity will increase as the value of the home rises and/or as the mortgage principal is slowly repaid. Of course, we all have clients who, in recent years, have found themselves under-water, a term used to describe the situation where the homeowner has zero or even negative equity because the value of the home is actually less than the balance owed to the lender. Often, foreclosures and short sales[44] result.

In a margin account, the investor's equity is calculated using this formula:

$$MV - DB = EQ$$

The terms are defined as:

- Market Value (MV)
  All securities are automatically marked-to-market at the end of each business day.
- Debit Balance (DB)
  This represents the amount of money borrowed from and owed to the broker.
- Equity (EQ)
  This, then, is the investor's resulting net worth.

B. Transactions

Investors may engage in various types of transactions in a margin account but must always keep a close eye on equity. While equity must always start out at 50%, various account activities will cause equity to increase [a good thing for the investor] while other activities could cause a decline. Brokerage firms set minimum equity limits in hopes of ensuring their position as lenders. Should equity fall below this level, the brokerage firm will issue a margin call – a notice to the investor that he must *immediately* bring his account into good standing. Margin calls can be met by depositing more cash or securities. Failure to meet the call, allows the broker [with prior standing

[44] This is not the same type of short sale we encountered when we sold borrowed stock. Short sales in the real estate market involve sales of property that will yield proceeds which fall short of the property owner's debt obligations. In these transactions, the lien holder must agree to accept less than the amount that is actually owed to him. Any deficiency from the unpaid balance due may be forgiven by the lender by agreement between the parties or by operation of state law. A short sale is often used as an alternative to foreclosure because it mitigates additional fees and costs to both creditor and borrower, although the borrower's credit rating is typically negatively affected.

authorizations given at the time of account opening] to sell some of all of the holdings in the account until the call is satisfied or no assets remain.

Listed below are the effects of various account activities on investor's equity:

1. Equity is increased when:
   - Market Value increases
   - Debit Balance is reduced
   - Cash or securities are added to the account
   - Dividends or interest are received

2. Equity is decreased & can fall below minimum allowable levels when:
   - Cash is withdrawn from the account
   - Interest is charged on the Debit Balance
   - Market Value decreases

3. If equity falls below the 25% minimum allowable amount, the investor will receive a margin call which must be met immediately by:
   - Adding cash to the account
   - Adding fully paid securities to the account
   - Liquidating assets in the account

C. Dangers

Trading on margin offers the potential for sizeable profits, exponentially magnified through the power of leverage. But this type of trading also carries inherent risks which may result in dire consequences. Legends of investors jumping from high-rise offices during the Crash of '29 are sadly true.[45] But remember that a market downturn generates only a paper loss unless the investor sells into the panic out of fear or ignorance or because he received a margin call he could not satisfy.

Being over-extended is never a good thing. Borrowing more than you could comfortably repay when times are bad is a danger common to real estate and securities markets. But margin traders face dangers inherent and peculiar to the investment world alone, including:

- Sudden market downturns – even if recovery is imminent, a margin call will be issued and if not satisfied immediately, securities will be liquidated.
- The broker will not select assets for liquidation with care or due diligence.
- Transactional costs and tax consequences may magnify losses forced to be realized.
- Forced liquidations may cause the market to drop further, thereby exacerbating the downslide.

[45] In *1929: The Year of the Great Crash* (1989) historian William K. Klingaman says asphyxiation by gas was the most common method of doing oneself in, although there was considerable variety, reported by The Straight Dope [available at http://www.straightdope.com/columns/read/2412/after-the-1929-stock-market-crash-did-investors-really-jump-out-of-windows, last accessed November7, 2012].

- Excess equity built up during market advances is preserved in a special account (known as "SMA") – this may be used to purchase additional securities even if actual equity is dangerously low and could cause the investor to become dangerously over-leveraged.

VII. Wash Sale Rule[46]

This rule was established to prevent investors from making illusionary sales for the purpose of converting paper losses into recognized losses on the tax return. The rule states that an investor, who sells a security at a loss, may not repurchase substantially the same security within 30 days before and 30 days after the date of the sale.

Example: On June 30, 2001 the investor bought 100 shares of XYZ for $4,000. On August 4, 2001 he sells the shares for $3,300 but repurchases another 100 shares of XYZ for $3,900 the next day. Although the investor realized a loss on the sale of $700, he may not deduct it since he repurchased the same security before the expiration of the window. Instead, he must add the non-deductible loss to the cost basis of the new shares ($4,600 = $3,900 + $700).

Clearly, the taxpayer had hoped to deduct the loss on his return which otherwise would have remained unrealized. By repurchasing the same security, he had hoped to retain his position and benefit from future appreciation of the stock.

The government cannot prevent an investor from buying and selling, but this rule is designed to discourage sales if done only to recognize losses rather than for viable financial reasons. Taxes should never be the sole or even the primary motivation for making investment decisions.

On the other hand, if the investor had waited until September 5, 2001 to repurchase the stock, his loss would have been deductible. It is assumed that if someone were to sell a security and then willingly wait for one month to repurchase it, he would be exposed to market fluctuations just like any other investor. If he were willing to take that kind of risk, the rule will not prevent his actions.

Some taxpayers try to circumvent the rule by purchasing other securities. For example, the investor may hope to sell XYZ common stock and replace it with XYZ preferred stock. Sadly, this will not "fool" the tax authorities as the rule clearly stipulates *substantially the same* securities. Thus, the following transactions would all fail under the rule:

- XYZ common stock for XYZ call option
- XYZ preferred stock for XYZ convertible bond
- XYZ bearer bond for XYZ registered bond

Typically, if the securities are issued by the same corporation, they will likely be deemed as being substantially the same. In fact, the Wash Sale Rule may even apply to bonds of different issuers, if the terms (coupon, maturity, and rating) of the

[46] IRC §1091.

bonds are substantially similar. Mutual funds of similar nature and objective may also fall within the rule. Thus, investment advisors who tout timing services ought to be aware.

Additional points to note

- Husband and Wife are treated as one taxpayer for purposes of this rule.
- The holding period of the repurchased stock (with its adjusted basis) will include the holding period of the original stock.
- If unequal amounts of shares are sold and repurchased, the shares sold are matched with an equal number of shares bought using FIFO.
- Wash sale losses incurred on one block of stock may not be used to offset gains on another block of identical stock.
- Reinvested dividends in a mutual fund will also trigger the rule for a 60-day period.

Nevertheless, several techniques may be used to establish a tax loss and still preserve the investment position without running afoul of the Wash Sale Rule, including:

- The investor could buy more of the same security and sell the original holding at least 31 days later. Of course, the investor would risk any price decline in the interim period.
- The investor could sell the asset at a loss and instead buy the security of a company within the same line of business or industry, trading on the prospects of the industry as a whole rather than on one company alone.
- Similarly, the investor could sell shares of one mutual fund and buy shares in another that employs a comparable investment strategy.

Wash Sale transactions are reported on **Schedule D** in the normal manner, but a second line entry will be required to remove the disallowed loss by entering it as a positive number as an offset to the loss claimed on the line above.

BEWARE: This rule applies to *all* accounts held by a taxpayer. Rev. Rul. 2008-05 applied the Wash Sale Rule to transactions made by the same taxpayer in two different accounts, even where one of these accounts was a tax-exempt retirement account.

Example: Taxpayer owns 100 shares of XYZ Company in his regular brokerage account, which he sells at a loss on December 20th. The following day, Taxpayer buys 100 shares of XYZ in his IRA account. Much like Security First National Bank, *28 BTA 289 (1933), wherein the court held that "the difference between acquisition by [the individual] personally and acquisition by the trust amount[ed] only to a refinement of title and [should] be disregarded," Chief Counsel found that a taxpayer who buys and sells securities—whether in one account or several—is essential transacting on his own behalf. Therefore, the taxpayer must allow enough time to pass when trading the same security in only one and/or in multiple accounts.*

NOTE: The basis of an IRA cannot be increased by the loss that is disallowed under the Wash Sale Rule. This loss is lost forever!

VIII. Favored Tax Treatments under the IRC

Affected by ATRA 2012

A. Gain on Sale of Small Business Stock (§1202)

This Code change, introduced in 1993, allows individual taxpayers to exclude up to 50% of a realized gain from the sale of qualified small business stock.[47] To be eligible, the following conditions must be met:

- The stock must have been issued by a C-Corporation and acquired as a new issue or as compensation for services rendered to the company.
- The corporation must be a qualified small business on the date the stock was issued and must maintain that status throughout the period that the stock was held.
- The corporation's gross assets cannot exceed $50 million.
- At least 80% of the company's assets must be used in the conduct of a qualified trade or business involving the performance of personal services, banking, financing, leasing, insurance, farming, hotel, or restaurant operations, or a business for which depletion deductions are allowed.
- The company cannot be organized as a REIT or REMIC.
- The corporation cannot have repurchased stock issued to the taxpayer 2 years before or after issuing its stock and cannot repurchase more than 5% of the total shares outstanding from any shareholder within one year prior to issuing its stock.

Presuming that the stock is indeed eligible for §1202 treatment, there are two limitations on the excludable gain:

- The maximum allowable exclusion for any one issuer's stock is $5 million/year.[48] If the company is within an Empowerment Zone, that exclusion is raised to $6 million.
- The taxpayer's excludable gain is limited to ten times the adjusted basis of his stock.

The non-excludable gain on sale of the stock is then subject to tax at a maximum rate of 28%[49]--the effective rate on the entire gain thereby

[47] The Small Business Jobs Act of 2010 temporarily raised the exclusion to 100% for eligible stock purchased between September 27 and December 31, 2010. The Tax Relief Unemployment Insurance Reauthorization and Job Creation Act of 2010 then extended the deadline through December 31, 2011. The American Taxpayer Relief Act of 2012 extended the 100% exclusion yet again to include tax years 2012 and 2013. The qualified stock must be held five years.

[48] Increased to $10 million/year ATRA 2012.

[49] Non-excludable gains are also subject to the 3.8% Medicare surtax that applies to capital gains from the sales of stock after December 31, 2012. Any gain excluded under §1202 is not added when computing "net investment income" subject to the Medicare surtax. Since §1202 applies only to C-corporations, taxpayers seeking to avoid the surtax (as well as, of course, the gain on sale of company stock) may prefer to incorporate rather than elect another form of business entity. Some tax advisors predict that C-corporations already favored under §1202 my enjoy still more legislative preferences such as reduced corporate tax rates and territorial (rather than worldwide) taxation. [Gordon & Quihuis, *Congress Extends 100% Gain Exclusion For Small Business Stock*, Morgan, Lewis & Bockius LLP, January 21, 2013].

becomes 14% (= 50% of 28%). Finally, 42% of the excluded gain is considered a tax preference item for AMT purposes.[50]

B. Loss on Sale of Small Business Stock (§1244)

Although losses on sales of stock are typically considered capital losses and thus limited to $3,000 of net capital losses/year, this Code section enables an investor to claim these losses as ordinary and deduct them in full against other ordinary income.

Losses incurred on §1244 stock may be treated as ordinary losses up to $50,000/ year on separate returns or $100,000/year on joint returns. To qualify, less than one half of the corporation's gross receipts must be derived from royalties, rents, or investment income.

These losses may be deducted against ordinary income on **Form 4797**, Part II and could produce an NOL. If the taxpayer has losses in excess of the allowable limits, he may deduct them as capital losses on **Schedule D**.

Qualifying stock must meet the following criteria:

- It must be issued by a domestic corporation and must be common stock
- It must be issued by a small business corporation with $1 million or less in contributed capital at the time that the stock is issued
- It must be identified as §1244 stock
- It must be issued in exchange for money or other property, but cannot be issued in exchange for other stock or securities
- The company's gross receipts from royalties, rents and investment income cannot exceed 50% of the total receipts for the most recent 5 years prior to the time of the loss

C. Rollover of Gain on Sale of Small Business Stock (§1045)

If the investor has held the stock of a small business company for more than six months and then sells it at a gain and reinvests the proceeds within 60 days into another small business stock, he may defer that gain. Any amounts not rolled over will be taxed to the extent of the gains realized. The basis of the new stock will be decreased by the amount of the gain rolled over and the holding period of the new stock will include that of the old stock. **NOTE:** Both the old and the new stock must satisfy the definition of §1202 small business stock.

Example: On January 8, 2000 Investor purchased qualifying small business stock for $90,000 and sold the stock on February 12, 2001 for $120,000. On March 7, 2001 Investor then purchased another qualifying small business stock for $110,000. As all of the requirements have been met, Investor may roll the $20,000 (= $110,000 - $90,000) capital gain realized on the first stock into the second stock. The excess capital gain of $10,000 ($30,000 realized -

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[50] As per ATRA 2012, gains excluded under §1202 are non-preference items for AMT.

$20,000 rolled over) must be recognized. The basis of the new stock is now $90,000 (= $110,000 - $20,000) and the holding period is considered to have begun with the purchase in January 2000.

NOTE: Any small business stock sold under §1202, §1244 or §1045 will lose the benefit of the estate tax exclusion afforded under §2057.

State Tax Treatment of Small Business Stock in California[51]

1. Gains (comparable to IRC §1202)[52]

   Although California also offers a 50% exclusion of gain on eligible small business stock, a few differences should be noted:
   - The stock must have been held 5 or more years
   - The maximum exclusion cannot exceed $5 million or 10 times the taxpayer's aggregate adjusted basis in the stock

   Example: The taxpayer sells $16 million of qualified stock. Up to $5 million may be excluded; the remaining $11 million is taxable. If filing Married-Filing-Separately, only $2.5 million may be excluded.

2. Rollover (comparable to IRC §1045)[53]

   Again, attention to detail will reveal federal and state distinctions: To be eligible for the tax deferral, California requires reinvestment of all of the sales proceeds—not merely the gain.

   Example: The taxpayer sells qualified stock with a basis of $500,000 for $3 million. If he wishes to defer recognition of his gain on sale, the IRS requires that he reinvest his $250,000 profit; whereas the FTB requires that he reinvest the full $3 million.

3. Further Differences

   California requires that small business companies meet the following criteria in addition to those mandated by the federal government:
   - ≥ 80% of the corporate payroll must be attributable to employment within California
   - ≥ 80% of the corporate assets must be used for business in California

ALERT: On December 21, 2012, The California tax authority released FTB Notice 2012-03 which clarifies the Franchise Tax Board's position based on

[51] Invalidated by the August 2012 decision in *Cutler v. Franchise Tax Board*. **NOTE explanation that follows CA differences.**

[52] CA Rev & Tax Code § 18152.5.

[53] CA Rev & Tax Code § 18038.5.

the legal outcome of the Court of Appeal ruling in *Cutler.*[54] The Court held that the provisions in the law favoring California-based corporations were discriminatory, violated the interstate commerce clause of the U.S. Constitution, and were therefore invalid and unenforceable.[55] Although the remaining provisions – and, in fact, the federal rules – were left unaffected, the FTB "found no lawful option"[56] but to deny the small business exclusion in its entirety. This ruling of course applies prospectively as well as retroactively to all open years as early as 2008. Affected taxpayers have to choice to (1) wait for notification from the FTB denying a previously claimed exclusion or (2) can voluntarily amend their tax returns.[57]

It is estimated that roughly 2500 taxpayers who were once covered by the exclusion may now owe back taxes and that elimination of the exclusion "would likely deplete investment in California's startups by at least 2% per year – a drop of at least $100 million annually."[58] A newly organized group called the California Business Defense is currently working with state legislators to prevent collection of back taxes that the FTB estimates may total as much as $120 million.

TIP: While each taxpayer's situation is unique and should be addressed on an individual basis, some may wish to file a protective claim for refund pending the release of the *Cutler* trial court's opinion on remand or regulatory change.[59]

NOTE: Only California requirements have been listed here. Taxpayers should be made aware that other differences may apply in other jurisdictions.

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[54] 208 Cal. App. 4th 1247 (2012).

[55] Mulak, *California Small Business Stock Exclusion Declared Invalid*, CA Enrolled Agent, March/April 2013, p.8.

[56] Qualified Small Business Stock (QSBS) Gains – FAQs [available at https://www.ftb.ca.gov/law/Qualified_Small_Business_Stock_and_Cutler_Decision.shtml, last accessed May 15, 2013].

[57] Taxpayers should note that the penalty exception that applies when rules change due to the enactment of new legislation, the exception does not apply when rules change due to court decisions [CA Rev & Tax Code § 19104].

NOTE: While it may be advisable to amend newer returns to limit the accrual of penalties and interest, it is best to await the FTB Notice of Assessment for the 2008 tax year since interest may be suspended when such a notice is not issued within 36 months after the original due date of the return.

[58] Karp, *Back-Tax Hit Sparks Fury*, US News, April 12, 2013 [available at http://online.wsj.com/article/SB10001412788, last accessed May 15, 2013].

[59] Herbst & Porinoff, *FTB Retroactively Denies "Qualified Small Business Stock" Personal Income Tax Benefits*, Manatt, Phelps & Phillips LLP, January 8, 2013.

D. Property Used in Trade or Business (§1231)

This Code section applies to depreciable personal or real property used in a trade or business and *held for more than one year*. It does not include inventory, property held for resale to customers, or intellectual property such as copyrights and literary or musical compositions.

The following sales or exchanges would result in §1231 gain or loss treatment:

- Real property
- §197 intangibles, including goodwill, going concern value, books and records, patents, copyrights, formulas, customer records, supplier records, licenses, permits, covenants-not-to-compete, franchises and trademarks, if purchased after August 10, 1993
- Leaseholds
- Cattle or horses used for breeding, dairy, draft or sporting
- Livestock, not including poultry
- Un-harvested crops, if sold or exchange in conjunction with the land upon which it is grown
- Timber, coal or iron ore
- Condemnation of business property
- Casualty or theft of business property

<u>Tax Treatment</u>

Gains in excess of depreciation deductions taken or allowed are taxed as LTCGs while losses are treated as ordinary losses. §1231 gains and losses are first netted. If taxpayer realizes a net §1231 loss, it is considered an ordinary loss, reportable on **Form 4797**, Part I. If the taxpayer realizes a net §1231 gain, it is considered ordinary income up to the amount of any unrecaptured §1231 losses from the previous 5 years and reported on **Form 4797**, Part I. The remaining net §1231 gain is taxed as a LTCG and reported on **Schedule D**.

Example: Taxpayer has a net §1231 loss of $7,000 in 1999 and net §1231 gains of $4,000 in 2000 and $5,000 in 2001. The loss in 1999 can first be applied against the gain in 2000 which is therefore treated as ordinary income. In 2001, the balance of the unrecaptured loss ($3,000 = $7,000 - $4,000) can be offset against the gain. Thus, $3,000 of the §1231 gain will be reported as ordinary income; the remaining $2,000 reported as LTCG.

NOTE: Tax practitioners should make it a habit to "ascertain the history of business property sales for the prior five years" to determine how much §1231 loss has previously been recaptured and how much now remains to be recaptured on the current return or is left to expire.[60]

[60] Weldon, *Nonrecaptured §1231 Losses – A closer look at Form 4794*, NATP *TAX*PRO Monthly, November 2012.

E. Gain on Sale of Depreciable Property (§1245)

§1245 property includes depreciable personal property, certain tangible assets, and certain real property (not including buildings or structural components). These properties have been or are currently subject to depreciation and/or amortization allowances. Examples include:

- Tangible or intangible personal property
- Property used in the manufacture, production or extraction of transportation, communications, electricity, gas, water or sewage disposal services
- Real property subject to amortization deductions such as pollution control and child care facilities
- Petroleum storage facilities

Gains typically result from depreciation allowed or allowable and will also include any §179 expense claimed. The amount recognized is the lesser of either the depreciation previously deducted or the realized gain (= Sales Proceeds – Adjusted Basis). These gains are treated as ordinary income and are reported on **Form 4797**, Part III.

Example: Five-year business property was purchased in 1999 for $10,000. The property was sold in 2001 for $4,500. Depreciation deductions taken through 2001 totaled $6,000. The gain is calculated as follows:

Amount Realized		*$4,500*
Original Cost	*$10,000*	
Depreciation	*6,000*	
Adjusted Basis		*4,000*
Gain Realized		*$500*

The reportable §1245 is the lesser of the depreciation claimed or the realized gain. Here, $500 would be treated as ordinary income.

The amounts of depreciation and amortization expenses that must be recaptured include:

- Ordinary depreciation deductions taken
- Amortization of lease acquisitions, lessee improvements, pollution control facilities, reforestation expenses, §197 intangibles, pre-1982 child care facility expenses and pre-1993 franchises and trademarks
- §179 expense deduction

NOTE: If depreciation deductions were not actually taken on previous years' tax returns, the §1245 is nevertheless computed based on the depreciation that would have been allowable under the straight-line method.

F. Gain on Sale of Depreciable Real Property (§1250)

§1250 property includes most depreciable real property. The gains in question generally result from the depreciation allowed or allowable in excess of straight-line. However, since straight-line depreciation has been mandated

for most buildings since 1986, the importance of §1250 has diminished. Previously, gains realized due to the straight-line depreciation deductions were reported as capital gains on **Schedule D**. Gains realized due to accelerated depreciation deductions taken were treated as ordinary income on **Form 4797**, Part III.

Code §	Topic	Special Provisions	Tax Treatment	Tax Form
1202	Gain on Sm. Bus. Stk.	50% exclusion	Capital	D, Column g
1244	Loss on Sm. Bus. Stk.	$100K/yr = ordinary	Capital	4797, Part II
1045	Rollover of Sm. Bus. Stk.	w/i 60 days	N/A	N/A
1231	Trade or Bus. Prop.	Held > 1 year	Capital Gain Ordinary Loss	D 4797, Part I
1245	Gain on Depr. Prop.	Recapture Depreciation	Ordinary	4797, Part III
1250	Gain on Depr. Real	Recapture Excess Depreciation	Ordinary (if accelerated) Capital (if straight-line)	4797, Part III D

IX. Intangibles

A. Trade Secrets

Trade secrets are capital assets; proceeds from their sale are taxed as capital gains only if "all substantial rights to a patent, or an undivided interest therein" have been transferred. [61] Where taxpayers received a settlement in a case involving the misappropriation of a secret meat-processing method, the Court held that damages were paid to reimburse the plaintiff for lost profits not the sale of a patent since the secret was exchanged between third parties without the developer's (owner's) knowledge or permission.[62]

B. Whistleblower Awards

In an attempt to recover a $5 million federal tax refund, taxpayer sought to reclassify "information" provided to the government as a capital asset, arguing that the documents and expertise that he shared with federal prosecutors were in fact "sold".[63] However, the Ninth Circuit Court of Appeals held that the whistleblower could not sell or exchange information which he was statutorily required to provide as a condition of his qui tam suit.[64]

[61] IRC § 1235(a).

[62] C&F Packing developed a proprietary process to make and freeze pre-cooked sausage which it used to supply Pizza Hut with 200,000 pounds/week. Despite contractual provisions, Pizza Hut shared the methodology with another supplier (IPB, Inc.) who, in turn, undercut C&F's price. *Freda, et al v Comm*, 108 AFTR 2d (2011).

[63] *Alderson v. US*, 110 AFTR 2d (2012).

[64] A qui tam suit may be filed by a private citizen on behalf of the US government under the False Claims Act. In exchange for bringing to light egregious violations involving fraudulent or criminal acts, the informer is entitled to receive a portion – sometimes as much as 15 to 25% - of the government's eventual recovery.

In 2010, former US Postal team mate of Lance Armstrong has filed a qui tam suit against the infamous cyclist alleging that he defrauded the US government by using performance-enhancing drugs throughout the term of his six-year contract. Just recently, the US department of Justice announced that it will join the suit and seek

Furthermore, the whistleblower's information was not a capital assets since it was not property to which he had the legal right to exclude others from its use[65] and because it could not appreciate in value without the substantial efforts required by the informant to uncover facts in support of his lawsuit.

C. Website Costs

As internet usage continues to expand, tax treatment of associated costs continues to evolve. Since the IRS has not yet issued guidance how to distinguish between website costs that should be capitalized or currently deductible, guidance – however minimal – must be elicited from case law.

Business Acquisition versus Expansion

At the outset, it must be ascertained whether the website under development will be used to expand an existing business (deductible expense as per IRC §162) or acquire a new or unrelated business (capitalized expense as per IRC §195).

Example:[66] *XYZ Company wants to develop a website and hires a consultant to locate an existing internet-based business available for purchase. The consultant's fees must be capitalized but fees paid to existing employees who spend part of their workday assisting the consultant in his search for a suitable merger candidate may be deducted.*

Once an acquisition target is identified and the merger is in process, fees paid to outside auditors and attorneys must be capitalized but internal costs continue to be currently deductible.[67]

Example: XYZ has purchased ABC, Inc. During the merger process, XYZ has shut down ABC's website and asked its new employees (formerly of ABC) to redesign the website to advertise XYZ's product line as well as develop integration software. Since the website is devoted to selling products, the cost of adding content is deductible as an advertising expense.

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recovery of the "more than $30 million [that Armstrong and his team took] from the U.S. Postal Service based on their contractual promise to play fair and abide by the rules - including the rules against doping," as per District of Columbia U.S. Attorney Ronald C. Machen Jr. quoted by Thompson, Red and O'Keeffe in *U.S. Department of Justice going after Lance Armstrong as government joins Floyd Landis' whistleblower lawsuit against disgraced cyclist* [available at http://www.nydailynews.com/sports/i-team/department-justice-joins-suit-armstrong-article-1.1270884, last accessed May 17, 2013].

[65] *International News Service v. Associated Press,* 248 U.S. 215, 250 (1918).

[66] All examples in this section of the text are loosely based on the examples provided by Hardesty, *Telling the difference between capital and deductible website costs*, excerpted from Electronic Commerce: Taxation and Planning © Thomson-Reuters/WG&L, 2012.

[67] *Wells Fargo v. Comm.* ,86 AFTR 2d (2000).

XYZ may capitalize or make an election to deduct the software development costs currently. [68]

Training Costs

Employee training costs to familiarize newly acquired employees with the product line and operation methods of the acquiring company are generally deducted currently[69] and do not , in and of themselves, create or enhance a separate and distinct intangible asset.[70]

Database Development

If a website database is designed to deliver non-product specific information requiring continual update, revisions and deletions, the database will generally be considered to be a separate and distinct asset[71] – all associated costs will have to be capitalized.

Capitalization will not be required if the developer's rights to the contents of the database are not legally protected under federal or state law or the database does not have an independent measurable value. For example, the database is likely not legally protected if its contents was derived from public sources rather than proprietary information.

X. Real Property

A. Home Sales

The sale of a principal residence is generally not reportable unless the homeowner has realized a gain which cannot be excluded or the taxpayer elects not to exclude[72]. If the following tests are satisfied, a taxpayer may exclude up to $250,000 of his realized gain[73] ($500,000 if filing jointly; *either or both* have owned the residence for at least 2 years; and *both* have lived in the home for at least 2 years):

[68] Rev Proc 2000-50.

[69] Start-up companies must mortise these costs under IRC §195.

[70] Treas. Reg. § 1.263(a).

[71] A "separate and distinct" intangible is "a property interest of ascertainable and measurable value in money's worth that is subject to protection under applicable State, Federal or foreign law and the possession and control of which is intrinsically capable of being sold, transferred or pledged (ignoring any restrictions imposed on assignability) separate and apart from a trade or business." (Treas. Reg. § 1.263(a)-4(b)(3))

[72] The election is made by reporting the sale on **Schedule D**. The election can be made (or revoked) at any time prior to the expiration of the three-year period beginning on the due date of the taxpayer's return (not including extensions) for the year of the sale.

[73] IRC § 121.

Ownership and Use

The taxpayer must have owned and used the home as a principal residence for at least 2 of 5 years prior to the sale, although the 2 years need not be consecutive. The ownership test generally requires that the taxpayer own his residence directly and not through any entity, except a grantor trust.[74]

Under certain circumstances, special rules apply:

- Rentals: Qualifying use of a property as a principal residence may occur while the taxpayer does not own, but merely rents the property.[75]
- Members of the Armed Services: Military personnel and their spouses may suspend the 5-year test period for any period of time in which either spouse serve on qualified duty, defined as any period during which the taxpayer (or spouse) is on active duty for a period of more than 90 days while serving at least 50 miles from home or residing in government housing. The suspension cannot last more than 10 years and may be applied to only one property at a time.
- Divorce: If the jointly-owned principal residence is sold and separate returns are filed, the house is divided into two, allowing each spouse to exclude $250,000 of their portion of the gain provided that all other conditions for exclusion are met. §121 allows a spouse who does not actually use the home as a residence to meet the use test during any period that: (1) he owned the home, and (2) the occupant spouse uses the home as a personal residence under a divorce or separation decree. If a home is transferred to a taxpayer by a former spouse incident to divorce, the taxpayer is considered to have owned the house during any period of time that the spouse owned it.
- Like-kind Exchanges: §121 does not apply if the taxpayer sells his residence within five years of acquiring it through a like-kind exchange.[76]

NOTE: Since 2009, the gain on sale allocable to the non-qualified use period is no longer excludable.

Example: Taxpayer owns his home since 2005, used it as a primary residence until 2008 when he converted it to a rental, and then sold the home in 2010. While he did use the home as a primary residence for 3 of the 5 years, the rental use in 2009 (not 2008) is considered non-qualified and so the taxpayer must reduce his allowable exclusion by 1/5 to $200K.

Non-qualified use is any period after December 31, 2008 during which the home was not used a primary residence but does not include:

[74] Letter Rul. 200029046.

[75] Treas. Reg. § 1-121-1(c). Additionally, property received by gift or inheritance is not considered "owned" by the taxpayer.

[76] IRC § 1031.

- Any portion of the 5-year qualifying period after the taxpayer has moved out of his primary residence prior to its sale
- Any period (up to 10 years) during which the taxpayer served on qualified extended duty[77]
- Any period (up to 2 years) that the taxpayer is temporarily absent due to a change of health, employment, or unforeseen circumstances

Example: If a taxpayer buys a principal residence in 2010, moves out in 2020 and then sells the property in 2022, he will be eligible for the § 121 Exclusion. If, instead, the taxpayer moves out in 2020 but waits to sell the property until 2024, he will be ineligible for the § 121 Exclusion since the 2-out-of-5 test cannot be satisfied.

NOTE: The exclusion can only be applied once every two years.

Reduced Exclusion Rules

Taxpayers who do not meet the 2-year ownership and use test, or use the §121 exclusion more than once in a 2-year period, may qualify for a reduced exclusion if the sale of the taxpayer's home was primarily due to a change in place of employment, or for health reasons, or due to unforeseen circumstances.

The reduced exclusion is prorated for the smaller of the time period the homeowner meets the ownership and use requirements or the time period between the most recent sale of a home using the § 121 exclusion and the current sale.

Example: Husband and Wife purchased their home on September 1, 2005 and lived in it for 13 months. Due to a change of employment, they sell the home and relocate to another state. Because the move was job-related, they qualify for a reduced exclusion.

Number of months owned and used as main home	*13*
Divided by 24 months	*0.542*
Multiplied by $500,000 (max. exclusion)	*$ 271,000*

Thus, H & W may exclude up to $271,000 of gain on a house they owned for only 13 months.

Business or Rental Use of the Residence

- If the part of the home used for business or rental is *within the same dwelling unit* as the residential part of the home, the taxpayer is treated as having used the **entire** home as a principal residence for the home gain exclusion rules. No allocation of basis and amount realized from the sale is required. However, the taxpayer must recognize gain to the extent of depreciation deductions allowed or allowable after May 6, 1997.

[77] IRC § 121(d)(9)(C)

- The taxpayer cannot use the home for business in at least two of the five years prior to the sale in order to exclude gain on the business-use portion.
- If the part of the home used for business purposes is not within the same dwelling unit as the residential part of the home, the taxpayer must treat the sale of the home as a sale of two properties and allocate gain between the properties.

B. Like-kind Exchanges

IRC §1031 allows a taxpayer to defer recognition of gain on sale of business or investment property if the sales proceeds are reinvested in similar property as part of a qualifying like-kind exchange. If, however, the taxpayer receives cash, debt-relief, or property that is not like-kind ("boot") as part of the transaction, some taxable gain may be triggered in the year of the exchange.

Eligible taxpayers include individuals as well as taxable entities. Exchanges of like-kind property may be simultaneous or deferred—if deferred, specific rules regarding the timing and handling of the transactions must be followed:

- Both properties—the one given up and the one received in exchange—must be held by the taxpayer for business or investment purposes and cannot be acquired immediately before or disposed of immediately after the exchange.
- Neither property may be held for sale to customers, such as inventory or merchandise.[78]
- The new property to be received must be similar (like-kind) to the old property relinquished. In general, any real property in the U.S.—whether improved or not—is treated as like-kind with other real estate in, but not outside of the U.S. By contrast, different kinds of personal property (for example, equipment and vehicles) are not treated as like-kind. Tangible and depreciable personal property may be like-kind, depending upon individual facts and circumstances.
- Exchanges of intangible personal property depend on the nature or character of the rights involved. Stocks, bonds, notes and other securities do not qualify for a like-kind exchange, nor does the goodwill of any business.
- The property to be received in a non-simultaneous exchange must be identified *in writing* within 45 days after the transferred property is surrendered.
- The property in the non-simultaneous exchange must be received on or before the earlier of 180 days after the transfer of the property given up or the due date (including extensions) for the tax return year in which the transfer of the property given up occurs.

An exchange may also occur in reverse—whereby the replacement property is bought before the original property is sold—although the taxpayer must be

[78] Goodwill is not like-kind property eligible for § 1031 exchange treatment [Reg. § 1.1031(a)-2(c)(2)]. Goodwill is broadly defined to include trademarks and subscriber lists.

careful not to take control of cash or other proceeds before the exchange is complete. Regardless of the sequence, most taxpayers employ a qualified intermediary (QI) to facilitate a deferred exchange to ensure that the rules are satisfied. The taxpayer may not act as his own intermediary, nor may any individual who has worked for the taxpayer in the prior 2 years as his real estate agent, investment banker, accountant, or attorney.[79]

Since the recognition of realized gain is only postponed under this provision, the basis of the acquired property must be adjusted to ensure later recognition of the taxable gain. This, of course, means that an exchanged asset's basis for depreciation will be lower than if gain deferral had not been invoked.

Like-kind exchanges are reported on **Form 8824** which must be filed with the tax return in the year in which the exchange occurred.

Because the rule requires that the properties exchanged must be held for productive use in a trade or business or for investment purpose, the IRS has issued a safe harbor ruling for property that is used as the taxpayer's personal dwelling.[80] Prior procedural and judicial rulings have made it clear that the gain on the exchange of a personal residence may not be deferred under §1031; however, the IRS now will not challenge like-kind treatment if the taxpayer's residence given up in the exchange was owned by the taxpayer for at least 2 years immediately prior to the exchange *and* the taxpayer rented his home to others for at least 14 days in each of the prior 2 years or the taxpayer's personal use did not exceed 14 days (or 10% of the rental days) in each of the prior 2 years.

The replacement property must meet the same qualifications in the ensuing 2 years after the exchange. If the taxpayer has filed a tax return reporting a like-kind exchange but later discovers that the replacement property does not satisfy the safe harbor provisions, he must file an amended return.

C. Foreclosures

A lender may foreclose on the mortgage or repossess the property when the borrower defaults on his obligation to repay the borrowed funds. In this situation, the taxpayer must generally report the transaction as if it were a sale. The amount realized is determined by type of financing:

[79] The IRS has issued Rev Proc 2010-14 that provides a safe harbor method for like-kind exchanges that are not completed due to the failure of the QI to acquire and transfer the replacement property to the taxpayer. If the taxpayer otherwise meets the provisions of § 1031, the IRS will not treat him as being in actual or constructive receipt of the exchange proceeds. He may, instead, report his gain on the disposition of the relinquished property as he receives payments.

[80] Rev. Proc. 2008-16, effective March 10, 2008.

Non-recourse Debt

Where the borrower is not personally liable to repay the debt even if the value of the property is less than the outstanding debt, *the full amount of the principle of the canceled debt is considered the "amount realized"* when computing gain or loss. However, there is no COD income.[81]

Recourse Debt

Where the borrower is personally liable to pay any amount of the debt not covered by the value of the property, *the amount realized is the smaller of the debt canceled or the fair market value (FMV) of the transferred property*. The borrower recognizes ordinary income from the canceled debt for the part of the debt that is more than the fair market value of the transferred property – this is COD income. Additionally, the borrower must recognize gain or loss on the difference between the fair market value of the property and its adjusted basis.[82]

The form used to report the "sale" depends on the type of property repossessed: Business or rental property is reported on **Form 4797**, any investment-use or personal-use property (including a personal residence repossessed after 1997) is reported on **Schedule D**. Any losses from personal-use property are not deductible.

Income from cancellation of business debt is reported as business or rental income. Income from cancellation of a non-business debt is reported as Miscellaneous Income on line 21 of **Form 1040**.

COD Exclusions

While generally taxable, income from cancellation of debt (COD) is excluded if the forgiveness occurs under Title 11 bankruptcy; or when the taxpayer is insolvent;[83] or where the debt is qualified farm or qualified real property business indebtedness (other than C corporations).[84] Other exclusions include:

[81] *Comm. V. Tufts*, 461 US 300 (1983).

[82] *Frazier v. Comm.*, 111 TC 243 (1998).

[83] While exempt from creditor claims, retirement plan assets as well as the present value of monthly benefits from pensions, annuities and Social Security must be counted as assets when determining whether a taxpayer is insolvent. On the other hand, only the portion of a non-recourse debt that exceeds the fair market value of the property must be included in the insolvency calculation. (Fogel, *Ten More Myths About the Tax Consequences of Foreclosures and Short Sales*, California Enrolled Agent, Spidell Publishing Inc., May/June 2012).

[84] IRC § 108.

1. Deductible Interest

Another exception is afforded to the cash-basis taxpayer who would otherwise have enjoyed a tax deduction had the debt been repaid.[85] Even though **Form 1099-C** may have been issued to the taxpayer to report the amount of debt forgiven, IRS instructions specifically state that the income is not reportable. This means that even a taxpayer who is otherwise not insolvent may obtain at least partial relief.

*Example: After losing their vacation home to foreclosure, Taxpayers received **Form 1099-C** reporting $275,000 of Canceled Debt in Box 2. Normally, they would have to include this amount in full on **Form 1040**, Line 21 as Other Income. However, because Form **1099-C** Box 3 also reports that $75,000 of interest was included in the canceled debt, Taxpayers need only include the difference ($200,000) on Form 1040 as taxable income.*

2. Rental Property

COD Income may be excluded if the debt is Qualified Real Property Business Indebtedness (QRPBI) and can meet the following criteria:[86]

- The debt must have been incurred or assumed in connection with real property used in a trade or business. Rental real estate is not automatically presumed to rise to the stature of a "business." Despite the IRS position[87] that rental of real property does not constitute a trade or business, courts have routinely relied upon a facts-and-circumstances test to decide the issue.
- The debt must be secured by the rental property.
- The debt must have been incurred or assumed to acquire, construct, or substantially improve the property. Refinanced debt may also qualify in limited circumstances.
- An election is timely made by the due (including extensions) of the tax return for the year in which the taxpayer has COD income. The taxpayer must file **Form 982 Reduction of Tax Attributes Due to Discharge of Indebtedness**.

NOTE: Any COD income excluded from gross income under this exception must be used to reduce the taxpayer's adjusted basis in the property.

[85] IRC § 108(e)(2).

[86] IRC § 108(c)(3).

[87] TAM 8350008 (August 23, 1983).

3. Personal Residence Debt

Affected by ATRA 2012

For tax years 2007 – 2012,[88] a new exception has been introduced allowing taxpayers to also exclude up to $2 million ($1 million if MFS) on the cancellation of "qualified principal residence indebtedness". The debt must have been incurred to acquire, construct, or substantially improve the taxpayer's principal residence—refinanced debt is also eligible, although mortgages on second or vacation homes do not qualify. Even second mortgages and home equity loans on the primary residence do not qualify unless the loan proceeds once again were used to acquire, construct, or substantially improve the property. The basis of the residence is reduced by the amount of cancelled debt excluded from income.

The debt cancellation must be the result of a loan modification and not a foreclosure or short sale[89], which may create a gain or loss on sale in addition cancellation of debt ("COD") income.

- If the property is subject to a recourse loan, the transaction is treated as though the home had been sold for the lesser of the FMV or the debt cancelled. The taxpayer may claim a gain (or loss) on the difference between this deemed sales price and his adjusted basis. **NOTE:** Any amount of COD income—equal to the cancelled debt in excess of the property's FMV—may be excluded under the new exclusion rules.
- If the property is subject to a non-recourse debt, the entire transaction will be treated as though the home had been sold for the amount of debt satisfied and so *no COD income will be realized*. Any realized gain may be excluded under IRC §121—a loss, of course, is non-deductible on a personal residence.

Example # 1: Foreclosure

Taxpayer bought his primary residence for $250,000, subject to a $200,000 recourse mortgage which is qualified principal residence indebtedness. Although neither bankrupt nor insolvent, Taxpayer loses his home in a foreclosure proceeding. The home is sold for $180,000. Taxpayer realizes a non-deductible personal loss of $70,000 (= $250,000 basis - $180,000 foreclosure proceeds) and $20,000 COD income ($200,000 mortgage - $180,000 FMV), but this COD income may be excluded under the new law.

[88] Extended to the end of 2013 under ATRA 2012.

[89] In a foreclosure, the lender takes back the mortgaged property; whereas, in a short sale the borrower—with the lender's approval—sells his property for less than the mortgage balance and the lender, now satisfied, cancels the remaining debt. The amount of debt canceled is COD income.

Alternatively, the lender may elect to reduce the outstanding balance of the mortgage. In this case, no COD income would be recognized.

Example # 2: Loan Restructure

If the lender in the above example, instead, reduces the loan amount to $180,000, Taxpayer would have $20,000 excludible COD income, but his basis in the home would be reduced to $230,000 (= $250,000 basis – 20,000 excludible COD)

Example # 3: Non-recourse Loan

If the mortgage had instead been a non-recourse loan, Taxpayer would have a $50,000 non-deductible personal loss (= $250,000 basis - $200,000 deemed sales price). No COD income would be recognized.

Example# 4: Partially Non-qualified Mortgage

Taxpayer's home is subject to $1 million recourse debt, of which only $800,000 is qualified principal residence indebtedness. If the home sold for $700,000 and $300,000 of the debt is discharged, only $100,000 is excludable (= $300,000 cancelled debt - $200,000 non-qualified debt).

Special Circumstances

Multiple Loans: The Personal Residence Exclusion may be applied against the second mortgage on a principal residence if the loan proceeds were used to buy build or improve the home.[90]

Multiple Borrowers: **Form 1099-C** will likely be issued to *each* of the co-signers reporting the *full amount* of canceled debt since all parties were considered jointly and severally liable for the loan. Taxpayers may use a reasonable method to allocate the amount of COD income amongst themselves.[91]

Example: Parents co-signed loan for Son who later defaulted

If Parents did not live in home and Son had made all loan payments prior to default, it would be reasonable to allocate all (not 1/3) of COD income to Son so that he could then exclude the income from taxation under the Personal Residence Exclusion.

Investment Property: COD income resulting from the foreclosure or short sale to investment property may be used to increase the limitation for deducting investment interest.[92]

[90] IRC § 108(h)(2).

[91] Chief Counsel Advice 200023001 (February 4, 1999).

[92] IRS Letter Ruling 200952018 (September 17, 2009).

XI. Secondary Life Insurance

This burgeoning new market involves transactions in which ownership of a life insurance policy is sold to a third party who does not have an insurable interest in the insured but now acquires a financial interest in the insured's life [or more precisely, his *death*]. Many concerns—not the least of which are questionable tax consequences—have been raised including:

- Because the life insurance policy is sold to an individual who does not have the requisite insurable interest in the insured's life, the insured may find that the insurance company will later challenge the death-claim and not pay out. In that event, the third-party investor may then seek to recover the forfeited insurance proceeds from the insured's estate.
- Insurance carriers dislike these sorts of transactions[93] and have therefore included questions in their applications in an attempt to establish whether the policy being purchased will be sold. Presuming that such a question is asked and the applicant answers in the negative but then sells his policy anyway, he may be guilty of fraud. This would once again give the insurance company a valid excuse to deny a future death-claim, as well as pursue legal action against the insured.
- Since every individual who applies for life insurance has a maximum threshold of coverage that may be issued, the purchase of a policy with the intent of sale to a third party may in fact use up the insured's maximum amount of insurability. Thus, the applicant may be unable to buy additional coverage should he wish to do so in the future.
- Then there's always the risk of foul play if the third party investor knows the identity of the insured and chooses to hasten his death for a quicker return on his investment.

Looking at the tax issues…

While the insured and the investor have entered into an agreement whereby the investor has *loaned funds* to the insured so that he may purchase the insurance policy, it is not clear whether the IRS will in fact view the transaction as intended. This would mean that the tax authority may apply split dollar regulations, ultimately assessing tax on the economic benefits accrued to the insured. On the other hand, if the transaction is viewed as the *purchase and sale of an option*, the "loaned" funds received and used to pay the insurance premium may be deemed to be and taxed as an option payment. Furthermore, if this theory is applied, the transaction may also be subject to the scrutiny of the SEC.

[93] "Life insurance companies… rely on policies lapsing before the policyholder dies. Last year,… insurance companies reduced their financial exposure by $1.1 trillion when 19.8 million policyholders stopped paying premiums… In comparison, the industry paid death benefits on only 2.2 million policies. If those lapsed policies had been sold to investors rather than canceled, insurance companies could have eventually paid out as much as a trillion dollars." *Late in Life, Finding a Bonanza in Life Insurance*, Charles Duhigg, The New York Times, December 17, 2006 [available at http://www.nytimes.com/2006/12/17/business/17life.html, last accessed September 23, 2009].

Since life insurance is a capital asset, the insured's gain from sale of the policy may be treated as a STCG, since the holding period will typically have been less than one year. Alternatively, if the transaction is treated under the option theory, the gain will be taxed as ordinary income.[94]

Unfortunately, these types of transactions are still relatively infrequent and no clear rulings have established the tax treatment to be applied. In a recent policy paper entitled *Taxation of Life Insurance Policies in an Evolving Secondary Marketplace* published by the Insurance Studies Institute (3/3/08), the authors concluded that a

> "bifurcated approach for the sales proceeds of a life settlement is the proper tax treatment, even if the policy premium was financed. Under such an approach, gains recognized between the tax basis and the cash surrender value in the policy would be deemed ordinary income, and gains recognized above the cash surrender value (or, if the policy has no cash surrender value, above the tax basis of the policy) would be given capital gains treatment. In the matter of complete non-recourse premium finance, the transfer of the policy to the lender in discharge of the note constitutes gain and not COD [cancellation of debt] income. Any gain recognized through the discharge of a non-recourse premium finance loan should be treated as ordinary taxable income as no part of the loan debt represents an increase in the market value of the policy."

To summarize, the life settlement transaction will likely involve three levels of taxation as per The Journal of Accountancy, *New Value in Old Policies* by Neil Alexander:

- Zero tax—up to the basis in the policy, since it is a return of capital
- Ordinary income—from the basis to the policy's cash surrender value
- Capital gains—from the higher of either the cash surrender value or the federal income tax basis to the net settlement proceeds, since the policy is a capital asset

BEWARE: This is still a matter of unsettled law. Clients wishing to engage in this sort of transaction should consult a tax attorney to be sure that the contract is in fact well-drafted and enforceable, and that the tax consequences of the transaction will be properly reported.

XII. Capital Gains Treatment under Alternative Minimum Tax

So far, we have discussed the treatment of capital transactions under regular income tax provisions. Now, we must turn to the rates and rules of the parallel system known as the Alternative Minimum Tax (AMT).

A. ISOs

Although the exercise of an ISO is generally not a taxable event, the bargain element is includible in Alternative Minimum Taxable Income (AMTI).

[94] As an aside, it should be noted that the gain recognized from the *surrender* of a life insurance policy is treated as ordinary income. *Barr v. Comm.*, TC Memo 2009-250.

Defined as the difference between the fair market value of the stock on the date of exercise and the actual purchase price of the stock using the option, the bargain element represents the savings enjoyed by the option holder who has the opportunity—due to his option—to purchase the stock for less than the prevailing market price. The taxpayer must include this "savings" as an AMT tax preference item.[95]

Due to the varying treatment under the regular and the AMT tax systems, a taxpayer may well have two different bases for the same shares of stock: His regular tax basis will be the exercise price at which he purchased the stock with the help of the ISO. His AMT basis, on the other hand, will be the exercise price plus the includible AMTI income.

B. Net Operating Losses

A Net Operating Loss (NOL) results when allowable deductions exceed gross income.[96] However, capital losses in excess of capital gains are excluded from NOL computations. (Of course, $3,000 of these excess capital losses may still be deducted against ordinary income and any remaining losses may be carried forward indefinitely, but not back).

For AMT purposes, taxpayers must recompute the NOL to arrive at the Alternative Tax Net Operating Loss (ATNOL), beginning with the regularly computed NOL and making adjustments as mandated by IRS §§ 56, 57, and 58.

While the Code does not specifically address the issue of an AMT capital loss, the Tax and 5th Circuit Courts have concluded that because ATNOL is merely a modified NOL, capital loss limitations remain unchanged. As a result, ATNOLs resulting from capital losses may—like their regular capital loss counter-parts—not be carried back to offset AMT capital gains in earlier years (as learned the hard way by a California taxpayer).[97]

Although Merlo lost, a provision of the Tax Relief and Health Care Act of 2006[98] now grants relief to similarly situated taxpayers by offering a refundable AMT credit [99] for 2007 through 2012.

[95] IRC §56(b)(3).

[96] IRC §172.

[97] *Merlo*, 100 AFTR 2d: Saddled with a huge AMT tax liability in 2000 (due to the exercise of an ISO), the taxpayer sought to offset this liability with an ATNOL incurred in 2001 when his stock became worthless as the high-tech bubble burst.

[98] Enacted December 20, 2006.

[99] IRC §53(e)(1).

XIII. Tax Strategies

A. Mark-to-Market Election[100]

Normally an investor is bound by the rules regarding Wash Sales[101] and Capital Loss Limitations[102] when engaging in the purchase and sale of securities. However, the IRS allows active traders to make an election to report all securities transactions as ordinary income on **Form 4797**, Part II—rather than on **Schedule D**.

The §475 election requires that all securities be treated as sold and repurchased at FMV on the last day of the tax year. Unfortunately, the election for the current year must be made by attaching a statement to the previous year's tax return or the extension request by no later than the filing date (excluding extensions). In other words, to make the election for 2012, the taxpayer must make the election by no later than April 15, 2012. Then, when filing the 2012 return in 2013, **Form 3115 Application to Change Accounting Method** must be attached to the return. NOTE: The deadline for making the election for the 2012 tax year has already passed![103]

TIP: Create a new pass-through entity, such as a partnership or S Corporation, to conduct the trading activity. The §475 Election must be recorded on the company books within 2½ months after the start of the first year. A copy of this statement must be attached to the first-year tax return.

The IRS distinguishes between investors, traders, and dealers in the following manner:

Investor: Typically, an investor buys and sells securities for capital appreciation and is not concerned with short-term fluctuations in the market. A taxpayer will be presumed to be an investor unless he or the facts and circumstances of the situation can satisfactorily demonstrate that he is actively engaged in a trade or business.

Trader: A trader is engaged in the business of buying and selling securities and seeks to profit from daily market movements. He carries on the activity with continuity and regularity and the activity is substantial.

[100] IRC §475.

[101] I.R.C §1091.

[102] IRC §1211.

[103] A full-time securities trader was denied the §475 election which he failed to make on a timely basis based on insufficient advice received from his tax professional (PLR 200209052). Similarly, the taxpayer in *Lehrer v Commissioner*, No. 06-75584 (9th Circ. May 23,2008) was denied his mark-to-market election since he did not make the election as outlined in Rev. Proc. 99-17.

Dealer: This individual has a place of business and buys and sells securities to and from customers with the intent of reaping a profit on mark-ups and mark-downs.

It is often hard to determine the taxpayer's status. **NOTE:** To qualify as a "trader," the trading activity must be regular, continuous, extensive, an intended for short-swing profit. Most taxpayers will not qualify under the stringent case-law criteria and should be treated as "investors." The following factors should be considered when making the determination:

- Holding periods
- Trading frequency and volume
- Time devoted to the activity
- Profitability
- The extent to which this activity supports the taxpayer
- Business-like record keeping
- Minimal dividend or interest income earned

	Form for Gain/Loss	Form for Expenses	Form for Margin Int.	Hobby Loss Rule	Home Office Deduction	SE Tax	Eligible for IRA	Wash Sale	$3K Loss Limitation
Investor	D	A	A	No	No	No	No	Yes	Yes
Dealer [i]	C	C	C	Yes	Yes	Yes	Yes	No	No
Trader	D	C	C	Yes	Yes	No	No	Yes	Yes
Trader w/ MTM	4797, Part II	C	C	Yes	Yes	No	No	No	No

B. Year-end Planning

1. Offsetting Gains

In hopes of minimizing potential tax liabilities, taxpayers often resort to aggressive housecleaning strategies at the end of a calendar year. Having accumulated capital losses throughout the year from sales of securities held in this era of market volatility and economic instability, taxpayers typically seek to engage in transactions which will yield capital gains that can be used to offset realized losses. By selling securities at a gain just prior to year-end, these investors can net the resulting profits against the painfully amassed losses that would otherwise be useless and would have to be carried forward into future years. Thereby the realized gains effectively become tax-free.

Should the investor fail to find a security in his portfolio that can be sold at a gain, he may instead want to consider:

- Selling rental property that has been depreciated
- Selling an appreciated vacation home

- Selling a personal residence which has appreciated in excess of the allowable §121 exclusion of either $250,000 for singles or $500,000 for married-filing-jointly
- Selling his interest in a limited partnership which has a negative basis
- Accelerating installment sale collections

2. Kiddie Tax

To prevent income shifting between family members, the Kiddie Tax subjects a child's unearned income to the higher of his own marginal rate or that of his parents if the child is under age 19 (or age 24 if the child is a full-time student). The unearned income limitation (set at $1,900 for 2012) will be adjusted for inflation in ensuing years. **EXCEPTION:** If the child provides more than one-half of his support from his own earned income, the Kiddie Tax Rule does not apply.

TIP: Higher-bracket taxpayers should consider gifting appreciated capital assets to family members who are in one of the two lowest marginal brackets, so that they may then (when selling the assets) take advantage of the 0% capital gains rate effective after 2008.

3. Expiring Provisions

Affected by ATRA 2012

Unless extended, the following taxpayer-friendly provisions are scheduled to expire on December 31, 2013:[104]

- Exclusion of Gain on Sale of Qualified Small Business Stock (IRC § 1202), and
- Exclusion of COD income resulting from the cancellation of qualified principal residence indebtedness.

4. California Residency

Prior to 2002, a taxpayer who incurred a capital loss while living outside of California (CA) could not carry-over any of his losses into CA after becoming a resident. On the other hand, a former CA resident could carry his excess loss forward and use it to offset any CA-source income even if he was a non-resident in future years.

Example: Jason became a CA resident on January 1, 2001. He had a $13,000 capital loss carryover from the sale of stock on from his 2000 federal tax return, but cannot use this loss carry-over on his 2002 CA return.

After 2001, the taxpayer may carry some capital losses into CA when arriving from out-of-state if the losses were the result of CA-source

[104] Numerous other Code provisions are scheduled to expire as well but only those addressed within the context of this manual are listed here.

income. However, gains and losses from stock sales are always sourced to the state of residence—thus, losses resulting from sales of securities cannot be transferred into CA.

Losses incurred in-state, however, cannot be taken out-of-state by a former resident of CA who has moved away.

Life gets even more complicated for part-year residents:

- Capital loss carry-overs from previous years are pro-rated for resident and non-resident periods.
- Capital loss carry-overs into future years are restated to reflect the taxpayer's residency status at the end of the current tax year

So, while taxpayers can bring some out-of-state capital losses into CA, they cannot take any in-state losses out of CA.

XIV. Capital Punishment

As we come to the conclusion of this grueling topic, it may indeed seem to be just that—capital punishment! Defined as the "penalty of death for the commission of a crime," it may be the preferred alternative to the aforementioned code sections which are often considered cruel and unusual.

(Sorry about that!)

APPENDIX A
Pertinent Code Sections Discussed in this Text

Internal Revenue Code §	Summary of Provision
108	Cancellation of Debt
121	Sale of Personal Residence Exclusion
197	Intangible Assets
267	Related Party Transactions
421	Incentive Stock Option Plans
423	Employee Stock Purchase Plans
475	Mark-to-Market Election for Traders
1031	Like-Kind Exchanges
1035	Exchanges of Insurance Policies
1045	Rollover of Gain on Sale of Small Business Stock
1091	Wash Sales
1202	Gain on Small Business Stock
1211	Capital Loss Limitations
1221	Capital Assets
1222	Other Related Terms
1223	Holding Periods
1231	Property Used in Trade or Business
1233	Short Sales
1234	Options
1234A	Gains and Losses from Certain Terminations
1234B	Futures
1235	Patents
1236	Securities Dealers
1237	Subdivided Real Property
1239	Gain on Sales Between Spouses
1241	Lease Cancellation
1242	Loss on Small Business Investment Company Stock
1243	Loss of Small Business Investment Company
1244	Loss on Small Business Stock
1245	Gain on Sale of Depreciable Property
1246	Gain on Foreign Investment Company Stock
1248	Gain on Sale from Sale of Foreign Corporations
1249	Gain on Sale of Patents to Foreign Corporations
1250	Gain on Sale of Depreciable Real Property
1252	Gain on Sale of Farm Land
1253	Transfers of Franchises, Trademarks and Trade Names
1254	Gain on Sale of Natural Resources
1255	Cost-sharing Payments
1256	Mark-to-Market
1257	Converted Wetlands
1258	Re-characterization of Gains
1259	Appreciated Positions
1260	Constructive Ownership
1411	Surtax on Net Investment Income

APPENDIX B
Code Section Quiz

Which code § applies?

A. IRC § 1045
B. IRC § 1202
C. IRC § 1231
D. IRC § 1244
E. IRC § 1245
F. IRC § 1250
G. None of the Above

1. Taxpayer realized a gain on sale of low-income residential rental property he held for 20 years.

2. Taxpayer realized a gain on sale a qualified small business stock.

3. Taxpayer realized a loss on sale of timber held for more than one year.

4. Taxpayer realized a gain on sale of inventory.

5. Taxpayer realized a gain on sale of qualified small business stock held for 9 months and reinvested the proceeds into another qualified small business stock within 60 days.

6. Taxpayer realized $47,000 loss on sale of small business stock.

7. Taxpayer's gain on sale of small business stock in excess of allowable exclusion is considered an AMT tax preference item.

8. Taxpayer's gain on sale of depreciable personal property is reported on Form 4797, Part III.

9. Taxpayer's loss on sale of small business stock exceeds the $100, 000 limitation on ordinary losses and must be deducted as a capital loss on Schedule D.

10. Depreciation in excess of straight-line upon sale of real property is recaptured as a capital gain on Form 4797, Part III.

11. Gain on sale of small business stock is rolled over to another small business stock within 6 months.

12. Taxpayer recognized gain is the lesser of depreciation claimed or the realized gain.

13. Taxpayer realized a gain on sale of depreciable real property.

14. Taxpayer realized a gain on sale of a small business company organized as an S-Corp.

15. Taxpayer realized a loss on sale of a foreign small business stock.

1.G 2.B 3.C 4.G 5.A 6.D 7.B 8.E 9.D 10.G 11.G 12.E 13.F 14.B 15.G

APPENDIX C

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040).
▶ Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.

OMB No. 1545-0074

2011

Attachment Sequence No. **12**

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

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

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

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

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

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

11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824	11	
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	12	
13 Capital gain distributions. See the instructions	13	
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your **Capital Loss Carryover Worksheet** in the instructions	14	( )
15 **Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (h). Then go to Part III on the back	15	

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

Part III **Summary**

16	Combine lines 7 and 15 and enter the result	16	
	• If line 16 is a **gain**, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below. • If line 16 is a **loss**, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22. • If line 16 is **zero**, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.		
17	Are lines 15 and 16 **both** gains? ☐ **Yes.** Go to line 18. ☐ **No.** Skip lines 18 through 21, and go to line 22.		
18	Enter the amount, if any, from line 7 of the **28% Rate Gain Worksheet** in the instructions ▶	18	
19	Enter the amount, if any, from line 18 of the **Unrecaptured Section 1250 Gain Worksheet** in the instructions ▶	19	
20	Are lines 18 and 19 **both** zero or blank? ☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 41. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). **Do not** complete lines 21 and 22 below. ☐ **No.** Complete Form 1040 through line 43, or Form 1040NR through line 41. Then complete the **Schedule D Tax Worksheet** in the instructions. **Do not** complete lines 21 and 22 below.		
21	If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the **smaller** of: • The loss on line 16 or • ($3,000), or if married filing separately, ($1,500) **Note.** When figuring which amount is smaller, treat both amounts as positive numbers.	21	( )
22	Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b? ☐ **Yes.** Complete Form 1040 through line 43, or Form 1040NR through line 41. Then complete the **Qualified Dividends and Capital Gain Tax Worksheet** in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). ☐ **No.** Complete the rest of Form 1040 or Form 1040NR.		

APPENDIX D

Form **8949**

Department of the Treasury
Internal Revenue Service (99)

Sales and Other Dispositions of Capital Assets

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

OMB No. 1545-0074

2011

Attachment Sequence No. **12A**

Name(s) shown on return

Your social security number

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

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

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

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

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

2	**Totals.** Add the amounts in columns (e) and (f). Also, combine the amounts in column (g). Enter here and include on Schedule D, **line 1** (if **box A** above is checked), **line 2** (if **box B** above is checked), or **line 3** (if **box C** above is checked) . . . . . ▶	2			

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 37768Z Form **8949** (2011)

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

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

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

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

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

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

4 **Totals.** Add the amounts in columns (e) and (f). Also, combine the amounts in column (g). Enter here and include on Schedule D, **line 8** (if **box A** above is checked), **line 9** (if **box B** above is checked), or **line 10** (if **box C** above is checked) . . . . . ▶	4			

APPENDIX E

Form **4797**

Department of the Treasury
Internal Revenue Service (99)

Sales of Business Property

(Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2))

▶ Attach to your tax return. ▶ See separate instructions.

OMB No. 1545-0184

2011

Attachment Sequence No. 27

Name(s) shown on return | Identifying number

1	Enter the gross proceeds from sales or exchanges reported to you for 2011 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)	1	

Part I **Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year** (see instructions)

2 (a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)

3	Gain, if any, from Form 4684, line 39	3	
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37	4	
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824	5	
6	Gain, if any, from line 32, from other than casualty or theft.	6	
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows:	7	
	Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below. **Individuals, partners, S corporation shareholders, and all others.** If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.		
8	Nonrecaptured net section 1231 losses from prior years (see instructions)	8	
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)	9	

Part II **Ordinary Gains and Losses** (see instructions)

10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):

11	Loss, if any, from line 7	11	( )
12	Gain, if any, from line 7 or amount from line 8, if applicable	12	
13	Gain, if any, from line 31	13	
14	Net gain or (loss) from Form 4684, lines 31 and 38a	14	
15	Ordinary gain from installment sales from Form 6252, line 25 or 36	15	
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824.	16	
17	Combine lines 10 through 16	17	
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below:		
a	If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions	18a	
b	Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14	18b	

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 13086I Form **4797** (2011)

Part III **Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255** (see instructions)

19 (a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)
A		
B		
C		
D		

These columns relate to the properties on lines 19A through 19D. ▶		Property A	Property B	Property C	Property D
20 Gross sales price (**Note:** *See line 1 before completing.*)	20				
21 Cost or other basis plus expense of sale	21				
22 Depreciation (or depletion) allowed or allowable	22				
23 Adjusted basis. Subtract line 22 from line 21	23				
24 Total gain. Subtract line 23 from line 20	24				
25 **If section 1245 property:**					
a Depreciation allowed or allowable from line 22	25a				
b Enter the **smaller** of line 24 or 25a	25b				
26 **If section 1250 property:** If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.					
a Additional depreciation after 1975 (see instructions)	26a				
b Applicable percentage multiplied by the **smaller** of line 24 or line 26a (see instructions)	26b				
c Subtract line 26a from line 24. If residential rental property **or** line 24 is not more than line 26a, skip lines 26d and 26e	26c				
d Additional depreciation after 1969 and before 1976	26d				
e Enter the **smaller** of line 26c or 26d	26e				
f Section 291 amount (corporations only)	26f				
g Add lines 26b, 26e, and 26f	26g				
27 **If section 1252 property:** Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).					
a Soil, water, and land clearing expenses	27a				
b Line 27a multiplied by applicable percentage (see instructions)	27b				
c Enter the **smaller** of line 24 or 27b	27c				
28 **If section 1254 property:**					
a Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion (see instructions)	28a				
b Enter the **smaller** of line 24 or 28a	28b				
29 **If section 1255 property:**					
a Applicable percentage of payments excluded from income under section 126 (see instructions)	29a				
b Enter the **smaller** of line 24 or 29a (see instructions)	29b				

Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.

30 Total gains for all properties. Add property columns A through D, line 24	30	
31 Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31	
32 Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32	

Part IV **Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less** (see instructions)

		(a) Section 179	(b) Section 280F(b)(2)
33 Section 179 expense deduction or depreciation allowable in prior years	33		
34 Recomputed depreciation (see instructions)	34		
35 Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35		

APPENDIX F

Declaration Control Number (DCN)

00 – ☐☐☐☐☐☐ – ☐☐☐☐☐ – 3

IRS Use Only—Do not write or staple in this space.

Form **8453**

Department of the Treasury
Internal Revenue Service

U.S. Individual Income Tax Transmittal for an IRS *e-file* Return

For the year January 1–December 31, 2012

▶ **See instructions on back.**

OMB No. 1545-0074

2012

Please print or type.

PRINT CLEARLY

Your first name and initial	Last name	**Your social security number**
If a joint return, spouse's first name and initial	Last name	**Spouse's social security number**
Home address (number and street). If you have a P.O. box, see instructions.	Apt. no.	▲ **Important!** You **must** enter your SSN(s) above. ▲
City, town or post office, state, and ZIP code (If a foreign address also complete spaces below.)		
Foreign country name	Foreign province/county	Foreign postal code

FILE THIS FORM ONLY IF YOU ARE ATTACHING ONE OR MORE OF THE FOLLOWING FORMS OR SUPPORTING DOCUMENTS.

Check the applicable box(es) to identify the attachments.

☐ Appendix A, Statement by Taxpayer Using the Procedures in Rev. Proc. 2009-20 to Determine a Theft Loss Deduction Related to a Fraudulent Investment Arrangement

☐ Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes (or equivalent contemporaneous written acknowledgement)

☐ Form 2848, Power of Attorney and Declaration of Representative (or POA that states the agent is granted authority to sign the return)

☐ Form 3115, Application for Change in Accounting Method

☐ Form 3468 - attach a copy of the first page of NPS Form 10-168a, Historic Preservation Certification Application (Part 2—Description of Rehabilitation), with an indication that it was received by the Department of the Interior or the State Historic Preservation Officer, together with proof that the building is a certified historic structure (or that such status has been requested)

☐ Form 4136 - attach the Certificate for Biodiesel and, if applicable, Statement of Biodiesel Reseller or a certificate from the provider identifying the product as renewable diesel and, if applicable, a statement from the reseller

☐ Form 5713, International Boycott Report

☐ Form 8283, Noncash Charitable Contributions, Section A, (if any statement or qualified appraisal is required) or Section B, Donated Property, and any related attachments (including any qualified appraisal or partnership Form 8283)

☐ Form 8332, Release / Revocation of Release of Claim to Exemption for Child by Custodial Parent (or certain pages from a divorce decree or separation agreement, that went into effect after 1984 and before 2009) (see instructions)

☐ Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities

☐ Form 8864 - attach the Certificate for Biodiesel and, if applicable, Statement of Biodiesel Reseller or a certificate from the provider identifying the product as renewable diesel and, if applicable, a statement from the reseller

☐ Form 8885, Health Coverage Tax Credit, and all required attachments

☐ Form 8949, Sales and Other Dispositions of Capital Assets, (or a statement with the same information), if you elect not to report your transactions electronically on Form 8949

DO NOT SIGN THIS FORM.

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 62766T Form **8453** (2012)

APPENDIX G

Form **8594**
(Rev. February 2006)
Department of the Treasury
Internal Revenue Service

Asset Acquisition Statement
Under Section 1060

▶ Attach to your income tax return. ▶ See separate instructions.

OMB No. 1545-1021

Attachment Sequence No. **61**

Name as shown on return	Identifying number as shown on return

Check the box that identifies you:
☐ Purchaser ☐ Seller

Part I **General Information**

1 Name of other party to the transaction	Other party's identifying number

Address (number, street, and room or suite no.)

City or town, state, and ZIP code

2 Date of sale	3 Total sales price (consideration)

Part II **Original Statement of Assets Transferred**

4 Assets	Aggregate fair market value (actual amount for Class I)	Allocation of sales price
Class I	$	$
Class II	$	$
Class III	$	$
Class IV	$	$
Class V	$	$
Class VI and VII	$	$
Total	$	$

5 Did the purchaser and seller provide for an allocation of the sales price in the sales contract or in another written document signed by both parties? . . . . . ☐ Yes ☐ No

If "Yes," are the aggregate fair market values (FMV) listed for each of asset Classes I, II, III, IV, V, VI, and VII the amounts agreed upon in your sales contract or in a separate written document? . . . . . ☐ Yes ☐ No

6 In the purchase of the group of assets (or stock), did the purchaser also purchase a license or a covenant not to compete, or enter into a lease agreement, employment contract, management contract, or similar arrangement with the seller (or managers, directors, owners, or employees of the seller)? . . . . . ☐ Yes ☐ No

If "Yes," attach a schedule that specifies **(a)** the type of agreement and **(b)** the maximum amount of consideration (not including interest) paid or to be paid under the agreement. See instructions.

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 63768Z Form **8594** (Rev. 2-2006)

Part III **Supplemental Statement**—Complete only if amending an original statement or previously filed supplemental statement because of an increase or decrease in consideration. See instructions.

7 Tax year and tax return form number with which the original Form 8594 and any supplemental statements were filed.

8 Assets	Allocation of sales price as previously reported	Increase or (decrease)	Redetermined allocation of sales price
Class I	$	$	$
Class II	$	$	$
Class III	$	$	$
Class IV	$	$	$
Class V	$	$	$
Class VI and VII	$	$	$
Total	$		$

9 Reason(s) for increase or decrease. Attach additional sheets if more space is needed.

APPENDIX H

Form **6781**

Department of the Treasury
Internal Revenue Service

Gains and Losses From Section 1256 Contracts and Straddles

▶ Attach to your tax return.

OMB No. 1545-0644

2011

Attachment Sequence No. 82

Name(s) shown on tax return | Identifying number

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

Part II Gains and Losses From Straddles. Attach a separate schedule 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 the appropriate line of Schedule D (see instructions)	11a	( )
b	Enter the long-term portion of losses from line 10, column (h), here and include on the appropriate line of Schedule D (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 the appropriate line of Schedule D (see instructions)	13a	
b	Enter the long-term portion of gains from line 12, column (f), here and include on the appropriate line of Schedule D (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** (2011)

APPENDIX I

☐ VOID ☐ CORRECTED (99)

Name, address, and ZIP code of RIC or REIT	OMB No. 1545-0145 2012 Form **2439**	**Notice to Shareholder of Undistributed Long-Term Capital Gains** For calendar year 2012, or other tax year of the regulated investment company (RIC) or the real estate investment trust (REIT) beginning_____, 2012, and ending _____, 20 _____	
Identification number of RIC or REIT	**1a** Total undistributed long-term capital gains		**Copy A** Attach to Form 1120-RIC or Form 1120-REIT
Shareholder's identifying number	**1b** Unrecaptured section 1250 gain		
Shareholder's name, address, and ZIP code	**1c** Section 1202 gain	**1d** Collectibles (28%) gain	
	2 Tax paid by the RIC or REIT on the box 1a gains		**For Instructions and Paperwork Reduction Act Notice, see back of Copies A and D.**

Form **2439** Cat. No. 11858E www.irs.gov/form2439 Department of the Treasury - Internal Revenue Service

Part II: Options

op·tion [op-shuh n][105]
noun
1. the power or right of choosing.
2. something that may be or is chosen; choice.
3. the act of choosing.

I. Introduction

An option is a choice to do something—whether you state your preference, make a selection, come to a decision, or simply elect to "keep your options open"; you are presented with the opportunity to evaluate alternatives. Even "[i]f you choose not to decide, you still have made a choice."[106] In some unfortunate circumstances you may find yourself faced with an "option of last resort" or discover that you are "out of options".

Since "failure is not an option", I will do my best to help you to understand options in the general sense, as well as options specific to the investment world, including calls, puts, rights, warrants, futures, restricted stock, and mineral rights. Once these options have been defined, I'll discuss the tax treatments of each.

II. Definitions

A. Terms

Let's start off with grocery store coupons; the kind that you clip out of the Sunday paper. Maybe it's a corn flakes coupon that offers a 50¢ discount next time you shop for cereal.

What makes this an option? This corn flakes coupon gives you a choice. If you have a choice, you have an **option**. Actually, you have several choices: You have the *choice* to go shopping, use your coupon and save money on cereal. Of course, if you don't need or want cereal, you have the *choice* to leave the coupon at home or even buy a different brand of cereal and ultimately not use your coupon.

Options of this sort always require two players: In this case, we have you (the coupon clipper and cereal shopper) and the issuer (the cereal manufacturing company that printed the coupon and is now offering the discount) – let's call them Kellogg's to keep things simple. As the coupon

[105] option. (n.d.). *The Free On-line Dictionary of Computing*. Dictionary.com [available at http://dictionary.reference.com/browse/option, last accessed January 13, 2012].

[106] "Freewill", Lyrics by RUSH [available at http://www.azlyrics.com/lyrics/rush/freewill.html, last accessed January 13, 2012].

clipper, you are known as the **holder** since you quite obviously are in possession of the coupon and are holding it. Kellogg's is known as the **writer** since it created the coupon and allowed it to be printed in the paper.

Notice that in this scenario, you as the cereal shopper have choices but that Kellogg's as the issuer has none. If you choose to go shopping and buy cereal, Kellogg's *must* honor the coupon and sell the cereal to you at a discount. Kellogg's does not have the option to walk away from the deal. So, options will always involve two parties – one party will always have a choice; the other will always have an obligation.

Coupons – and by extension options – also have another feature: They have an **expiration date**. In the case of the cereal coupon, you have to make your decision to buy cereal before the deadline, usually written in microscopic fine print. If, by chance, you do not make your decision in a timely manner, the coupon becomes null and void and the only choice left to you is to wad up the coupon and toss it in the trash. A bit of a waste since you spent $1.25 on the newspaper and, assuming that you had no interest in news and that your only reason for buying the paper was to clip coupons, you've now lost your investment in its entirety.

B. Types of Options

Following the example of a corn flakes coupon, I can now introduce you to various types of options in the investment world. Keep in mind that in all cases, two parties are involved and that one party will always have the right to choose a course of action which often entails the purchase (or sale) of an **underlying security**. In my original scenario, the underlying security was a box of corn flakes; henceforth underlying securities may be shares of a single stock or an entire index, a bond, a commodity, a foreign currency, or other financial instrument.

For example, a stock option gives one party the right (choice) to buy shares of stock at a designated price, while the contra-party is then required (obligated) to sell those shares. In an attempt to standardize option trading in the investment world, option contracts are established using specified amounts of underlying securities. Here, with a regulated stock option, the set amount is always 100 shares; thus, one party may buy 100 shares of a specific stock by exercising his option prior to the expiration date and the other party must sell 100 shares at the pre-established price.

The option that I have just described is a **call** option; wherein the purchaser of the option (the holder) has the choice to buy 100 shares of, let's say IBM stock, and the seller of the option (the writer) is required to sell 100 shares of IBM in the event that the option is exercised. Note that the holder is in the driver's seat – it is he who has the choices and can dictate the destiny of the IBM stock. He can exercise his option and buy

the stock or he can choose to let the option expire and forego the stock. The writer is simply along for the ride and must wait for the holder to make his decision. In fact, the holder of an option is, by definition, the decision-maker.

However, the parties to a transaction can flip roles. In our first example, the cereal shopper was the holder and had a choice to buy cereal (or not); Kellogg's was required to sell its cereal at the shopper's discretion. What if we wanted to take the choice away from the shopper and instead give it to Kellogg's which could now choose to sell its cereal at a designated price and force the shopper to buy it? Were that the case, we would have just created a **put** option.

In the investment world, puts allow the holder of the option the choice to sell 100 shares of IBM to the writer of the option who must then buy the stock at the designated price. Puts and calls are identical in all respects: Both are options that give the holder a choice and the writer an obligation; both can be used to determine the fate of 100 shares of IBM which may be bought or sold; both expire at a specific time. The only distinction is who is the holder (with the choice) and who is the writer (with the obligation).

Allow me to introduce another example to help clarify: You've just purchased a brand-new BMW and after spending an hour haggling with the car salesman, you're about to close the deal when he asks you if you would like to purchase the extended warranty. Tired and worn-out, you quickly agree.

Once again, we have an option: You, the car buyer now have a choice to have your car repaired at any time before the warranty expires in three years. On the other hand, the car dealer is now obligated to fix your car if ever you should choose to bring it in for repair. In effect, you are the holder of a call option and may *call* upon the writer of the option at your whim.

Now let's switch roles; but be careful which roles we are switching! You are still a car buyer, the one with bundles of cash in your pocket. BMW is still the car dealer with an inventory to sell and a repair shop. Those roles do not change. However, let's switch who gets the choice and who gets the obligation and create a put. While unlikely in the real world, bear with me here: Assume that you create an option which gives the car dealer the right to force you to come in to his shop and have your car repaired – he now has the choice and, however silly it sounds, you now have an obligation. The roles we have switched are those of holder and writer; we have not changed our inherent natures (that of car buyer and car dealer), but we have changed who has a choice and who has an obligation.

C. Let's Talk Money

Options are not free. Even our corn flakes coupon cost $1.25 since it could only be obtained by buying the Sunday paper (which you claimed to have no use for other than the coupon section). Thus, the price that you paid for the paper effectively is the price you paid for the coupon. We refer to that price as the **premium**.

Premiums in the investment world are, for the most part, determined by supply and demand. Since there is only a limited supply of regulated stock options, the cost of these options will increase if many people wish to purchase them and the price will drop if few people want to buy them. Similarly, try selling umbrellas to soaking wet pedestrians on a rainy day versus bikini-clad sunbathers on a sunny day.

But the premium is also dependent on another factor. Say, the stock option gives you the right to buy 100 shares of IBM for $185/share (**strike price**). You check the current market price of the stock and discover that IBM is trading for $180. Of course, there would be no need to use your option to buy the stock since you could buy it for less without the option.

But let's say the option is good for another six months and the price of IBM rises steadily during that time. And at some point the market price of IBM is higher than the strike price, making it very attractive to use the option to buy the stock at a bargain price (there is **intrinsic value**). Now the option has value – it's a coupon that offers you a bargain. You'll want to buy it, as will many other investors.

But time marches on inexorably and eventually runs out. What if, during that time, the market price of the underlying security (IBM) does not change or even begins to drop? The option becomes less and less attractive as you sadly realize that the price of IBM may never exceed the strike price before the expiration date. And remember, that any price increases after the expiration date are irrelevant to you because the option has already become useless (worthless).

Thus, simply due to the passage of time, option premiums will decrease with time and ultimately have no value; much like the corn flakes coupon that had to be tossed if it remained unused by the time the expiration date rolled in. To summarize, the option premium is based on the option's intrinsic and time values – see illustration below:[107]

[107] Causic, Josip, *The Extrinsic and Intrinsic Values of Option Premium*, Online Trading Academy, May 19, 2009 [available at http://lessons.tradingacademy.com/article/the-extrinsic-and-intrinsic-values-of-option-premium/, last accessed October 26, 2012].

TradeStation further explains that "there are six major factors that determine the intrinsic value and time value of an option, which in turn affects the premium of that options contract", including:

- the market price of the underlying stock,
- the strike price of the option contract,
- the remaining time until contract expiration,
- the volatility of the underlying stock,
- the current risk-free interest rate (i.e. Treasury bills), and
- the dividend payout rate of the underlying stock (if any)[108]

While the comparison between the option's strike price and the stock's market price [intrinsic value] as well as the remaining time to expiration [time value] are the primary factors influencing the cost of the option, a stock's volatility and ability to generate an income stream help to make the underlying asset – and by extension, the option – more or less attractive (expensive). The more volatile the underlying stock, the more volatile the option premium and the greater the possibility that the option will ultimately become profitable.

And while potential dividend payouts are attractive for shareholders who own the stock, the market price of that stock will inevitably decline by the

[108] Determining the Intrinsic Value and Time Value of an Option [available at http://help.tradestation.com/08_08/tradestationhelp/options_trading/determining_the_intrinsic_value_and_time_value_of_an_option.htm, last accessed October 26, 2010].

amount of the dividend on the ex-dividend date,[109] yet the strike price of the option remains unchanged. It follows, then, that a decrease in the stock price will cause the premium of a call option to fall and the premium of a put option to rise.

[109] The ex-dividend date is that date on which a stock first trades without a dividend attached. Shareholders who were owners of the stock on the record date will eventually receive a payout when the dividend is ultimately paid. But stockholders who obtained ownership after that critical record date will not be entitled to the forthcoming dividend. Thus, if an investor were to purchase the stock "in time" to be entitled to the dividend, he might be willing to pay $10/share; whereas the investor who would buy the stock later and not enjoy the upcoming dividend would not want to pay for the foregone income – he would only be willing to pay $9/share.

Terms Defined	
Option	a choice to buy or a sell a security
Underlying Security	the financial instrument on which the bet is placed
Holder	the purchaser of the option (said to "long the position") who may choose to buy (or sell) the underlying security
Writer	the seller of the option (said to be "short the position") who is obligated to sell (or buy) the underlying security
Call	the holder of a call has the right to *buy* the underlying security the writer of a call has the obligation to *sell* the underlying security
Put	the holder of a put has the right to *sell* the underlying security the writer of a put has the obligation to *buy* the underlying security
Expiration Date	the date on which the game is up!
Premium	the price of the option (consists of Intrinsic Value + Time Value)
Strike Price	the pre-determined price at which the underlying security may be bought (or sold)
Intrinsic Value	A comparison – made from the holder's perspective – between the strike price of the option and the market price of the underlying asset.

III. Advanced Concepts

A. Breakeven

Intrinsic value should not be confused with profit or gain. Intrinsic value is merely a measure used by the holder of an option to establish whether he would want to exercise his contract. If an option has intrinsic value – in other words the comparison between the strike price of the option and the market price of the stock is favorable – the option holder might consider exercising the contract.

The holder of a call would find the price comparison favorable when the market price was above the strike price since exercise would allow him to buy the stock on the cheap. On the other hand, the holder of a put would prefer to exercise and sell the underlying asset when the strike price exceeded the market price.

	In-the-Money (Intrinsic Value)	Out-of-the-Money
Call	Market > Strike	Strike > Market
Put	Strike > Market	Market > Strike

Once the holder has establish if the option is favorable and should potentially be exercised, he must then determine whether exercise would actually be profitable considering that he had to incur out-of-pocket costs to obtain the option in the first place. Thus, the holder now tallies his outlays: Premium + transaction fees to purchase the option + strike price + transaction fees to buy (or sell) the underlying stock. The sum of these items represents the option trader's **breakeven**; in other words, he has to be able to sell if exercising a call (or buy if exercising a put) the underlying asset for at least an amount equal to the breakeven to make exercise worthwhile.

Let's assume, for example, that a holder of a Microsoft (MSFT) call option with a strike price of 25 chooses to exercise when the stock is trading at $28/share. The option is in-the-money by $3. Let's further assume that this option cost the holder $5; and for simplicity sake, let's ignore all transaction costs.

In this scenario, the holder was out-of-pocket $5 for the premium at the outset of his endeavor and now spends an additional $25 when he exercises his option and buys the stock. His total outlay is $30. He would have to be able to sell MSFT for at least $30/share to breakeven; the stock, however, is currently only trading at $28. Note that while the investor's option has intrinsic value, it is not yet profitable – *intrinsic value is not breakeven!*

Breakeven	The minimum market price at which the underlying asset must trade so that the holder can recoup his outlays when purchasing and exercising his option.

B. Calculating Breakeven

Obviously, it becomes important for the holder of an option to calculate his breakeven point so that he may readily determine if and when he will choose to exercise his option. Similarly, the writer of an option will want to know his breakeven point, although he will not have control over the exercise transaction since only the holder may make that choice.

Of course, the breakeven point for the writer will be identical to the breakeven point for the holder – where one investor makes money on a given transaction, the contra-party to that transaction loses. Options are

considered a zero-sum game in which money leaving the pocket of one party goes into the pocket of the other party.

	Call	Put
Holder	BE = Strike + Premium	BE = Strike - Premium
Writer	BE = Strike + Premium	BE = Strike - Premium

Whether to add or subtract the premium form the strike price is easy to remember with the adage: "You call someone up to put him down." Just remember: Call up; put down.

C. Maximum Gain or Loss

Equally as important as breakeven, option traders must know in advance what their maximum potential loss will be. Much like a conscientious Vegas gambler – if, in fact, there is such a person – an option trader should be aware of his exposure in the event the market turns against him.

The gambler knows that he cannot lose more than he bets. Similarly, an option holder cannot lose more than the cost of the "bet" he has placed (premium). This holds true whether the holder purchases a call or a put.

Knowing that whatever an option holder may lose will go into the pocket of the writer, we can now confidently determine the maximum potential gain (win) that the write will realize: Premium. Again, it does not matter whether the writer has sold a call or a put.

But what might the option holder realize if the market performs as he hoped when he first purchased his option? In the case of a call, the holder has the right to exercise and purchase stock at the strike price. Then, once he owns the stock, he has further choices to hold the stock indefinitely or to sell the stock at the prevailing market price. If the market price rises above his breakeven point and the investor sells the stock he acquired, he will realize a profit. If, instead, the investor holds the stock and watches as the market rises further, he will eventually enjoy a greater profit. Since there is no time restriction as to how long he may hold the stock and since the market could ideally rise higher and higher, the holder of a call has a maximum gain potential that is unlimited.

Conversely, the put holder has the choice to sell his shares of the underlying security at the strike price (money that he will receive from the writer). Since he cannot sell the stock for more than the strike price, the most that he can hope to earn is the strike price. But to obtain the choice to force the contra-party to buy his stock, the holder was first required to purchase the option for the premium. Thus, the most that a put holder could hope to realize is the difference between the strike price and the premium.

And if the put holder can, at most profit from this difference between the strike price and the premium, then the put writer will lose no more than the same amount.

The astute reader will, at this point, notice that option theory is merely a matter of opposites: If the call holder's maximum loss is premium, then the call writer's maximum gain is also premium. By the same token, if the call writer's maximum gain is unlimited [see above], then the call writer's maximum loss must be unlimited as well! For the moment, let's trust the axiom that what goes into the holder's wallet must come out of the writer's and accept that a call writer's maximum loss is, in fact, unlimited. We will encounter the proof later in the text.

	Call Max Loss	Call Max Gain	Put Max Gain	Put Max Loss
Holder	Premium	Unlimited	Strike - Premium	Premium
Writer	Unlimited	Premium	Premium	Strike - Premium

IV. Option Strategies

So far, we have talked only about basic option purchases and sales – our investor either bought or sold a single call or a put. But, as you can imagine, an investor could buy or sell multiple options in combination with each other, or even in combination with the simultaneous purchase or sale of a stock. The combinations are limited only by the creativity (and pocketbook) of the investor.

Some of the more common strategies are described below.

A. Straddles

1. Long Straddle

Defined as the purchase of a call and a put on the same security with the same strike process and same expirations, this strategy is employed by the investor who believes that the market will be volatile. By straddling the market, the investor hopes to benefit from either the up- or down-side of the market.

For example, the investor may purchase both a call and a put on XYZ stock with identical strike prices (say 50) and expirations (say year-end). Due to the current market price of the underlying security, the call is priced at 3 and the put is priced at 2; so our investor spent a total of 5 for both options – thus, his maximum loss will be limited to 5.

But his gain could be unlimited. Presume that the market price of the stock jumps to 80. The investor will, of course, choose to exercise his call while allowing his put to expire. Upon exercise, he would now own shares of XYZ which he could continue to hold as the market continues to climb indefinitely.

2. Short Straddle

This investor, in contrast, expects the market to be stable and seeks to profit only from the combined premiums he collected upon writing the call and put. We've already seen that the buyer of the straddle would only choose to exercise if the market makes a move and would forfeit his premium and allow the options to expire if the market remains stable.

Once again in this zero-sum game, when the buyer loses premiums (his maximum loss), the seller collects those same premiums (his maximum gain). And if the buyer could possibly enjoy and unlimited gain, the seller would necessarily suffer an unlimited loss.

B. Combinations

1. Long Combination

Similar to straddles, long combinations involve the purchase of a call and a put on the same security with the different strike process and/or same expirations. Once again, the investor anticipates market volatility and may lose as much as total premiums paid if the market does not cooperate, or enjoy unlimited gain if the market rises.

2. Short Combination

As before, the combination writer's maximum gain will be the total premiums collected; his maximum loss may be unlimited.

C. Spreads

Spreads involve the simultaneous purchase and sale of the same class of options. A class of options includes all calls on the same underlying security or all puts on the same security.[110]

[110] A series of options, by contrast, includes all calls (or puts) on the same underlying security with the same expiration date. An easy way to remember the difference would be to think of a "class" of high school seniors and a "series" of high school seniors who all graduate in June.

1. Calendar Spread

Also known as Horizontal or Time Spreads, these include the purchase and sale of two calls (or two puts) on the same security but with differing expirations.

2. Price Spread

Known as Vertical or Cost Spreads, these include the purchase and sale of two calls (or two puts) on the same security but with differing strike prices.

3. Diagonal Spread

These spreads include the purchase and sale of two calls (or two puts) on the same security with differing strike prices *and* expirations.

4. Debit or Credit Spread

The afore-mentioned spreads could also be classified as either Debit or Credit Spreads, depending on whether that net premiums allow the investor to pocket money (credit) or spend money (debit). In the case of a debit spread, the investor hopes that the difference in premiums will widen prior to expiration and wants his options to be exercised. Of course, the investor of a credit spread seeks the opposite, wants the premium difference to narrow and hopes the options will expire unexercised.[111]

5. Other Spreads

Option traders are as inventive with strategies as they are naming the positions they create. While a complete discussion is beyond the scope of this course, the reader should know that many more types of strategies exists, including ratio spreads, butterfly spreads, weighted spreads, back spreads, strangles, bull and bear ladders, even iron condors! Inter-commodity spreads formed from two distinct but related commodities, have descriptive names such as crack, spark and crush spreads. In all cases, these complex strategies are intended to benefit from arbitrage, a practice used to take advantage of price differences between two or more markets.

[111] Memory trick: "Dead Ex-wives Can't Nag" helps us to remember that investors want Debit Spreads to widen and Credit Spreads to narrow.

D. Hedges

Much like a garden hedge protects a yard against trespassers; an investment hedge offers a form of insurance against market volatility. Always a combination of a stock position and an option, the following permutations are common:

1. The purchase of a stock along with the purchase of a put on the same underlying security. If the stock price increases, the investor would simply allow his put to expire and would continue to hold the stock for as long as he chooses, ultimately selling his shares at a profit. But if the market goes against the investor, he could choose to exercise his put, allowing him to sell the underlying shares at the strike price. Of course, the investor would have selected a strike price equal to or more than the price he originally paid for the stock; thereby ensuring that he could comfortably unload his holdings without incurring a loss, even if the stock should continue to decline.

2. Similarly, an investor who initially shorted shares of stock could protect himself against market increases by purchasing a call. Exercise of this option would allow him to purchase stock at a favorably selected strike price in the event he receives a margin call from his broker.[112]

3. Some hedges offer both protection and income. For example, an investor may short stock and also sell a put. Once again, he has engaged in a short sale in hopes that the market will decline; however, if the market should rise, his put will allow him to repurchase the stock at a previously set strike price.

   But it is important to note that the investor, this time, is not in the driver's seat. He has sold a put which means that the contra-party to the transaction (the holder) will be the one to choose whether the option is exercised or not. Most likely, the holder will only elect to exercise if the market declines [not what our investor wants!]. Therefore, this hedge offers only a modicum of protection to the investor who probably engaged in the transaction to collect income from the sale of the option. It is the premium, then, that

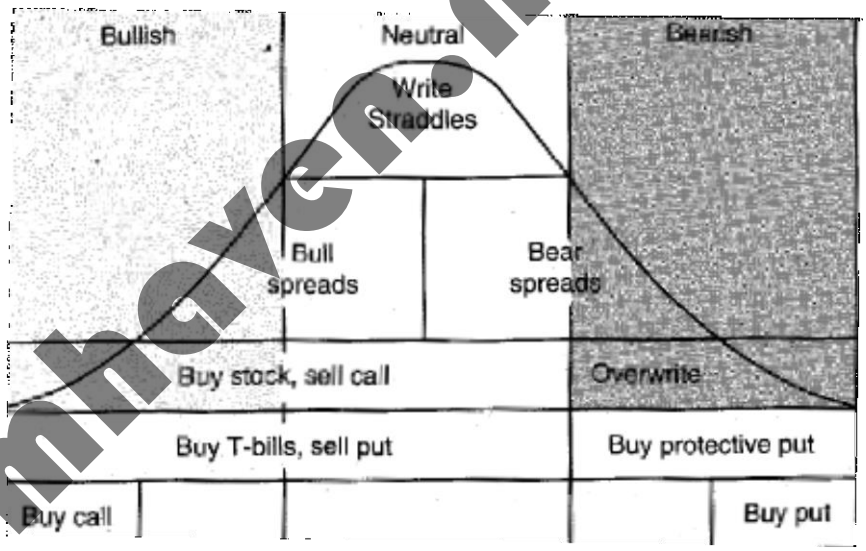
[112] Short selling is a bearish strategy that involves selling borrowed shares. The investor arranges to borrow shares from his broker and immediately sells these shares while the price is high. Anticipating a future decline in the price, the investor then hopes to repurchase these shares at a lower price, reaping a profit before returning the shares to his lender.

But, if the market fails to cooperate and the price of the shares rises (rather than falls), the investor will be forced to repurchase the stock at a higher price and may suffer a significant loss. Since there is no telling how high the price might rise, the investor's loss is potentially unlimited and so it might be wise to hedge his position with the purchase of a call.

mitigates some of the loss the investor may realize if the market goes against him.

4. Lastly, but likely the most common type of hedge includes the combination of the purchase of stock and the sale of a call.[113] Whenever an investor purchases stock, he hopes for a market increase. However, in the event that the market should fall, the investor now has an option that would allow him to sell his stock a comfortable strike price.

   But… once again, the exercise of the call is a choice that falls to the holder (not the writer) and so our investor would only be called upon to sell his stock if it were favorable for the holder; that is, when the market goes up [not what our guy wants!]. So what's in it for the investor? He owns stock that may become profitable if the market goes up but he will be asked to sell his shares at the strike price. If the market goes down, the call will expire unexercised. The investor will have pocketed the option premium and will still own his shares, enabling him to write another call, collect more premium, keep his shares, and so on.



E. Comparison with Stock

To complete the discussion, a brief comparison between options and stock should be made. Presuming that the reader is comfortable with the idea of owning shares of a publicly traded company, the following contrasts can be made:

[113] This strategy is known as covered call writing.

1. Certificate-less Trading

Although most stock today is held in street name,[114] an investor still retains the option to request a stock certificate from the transfer agent verifying his holdings in the company stock. Option traders do not have that choice. Options are wholly without certificate; recordkeeping and investment verification falls to a guarantor [see OCC below].

2. Position Limits

Stock traders may purchase any number of available shares; whereas, options traders are limited to a finite number of contracts. Established by regulatory authorities, these limits are created for the purpose of maintaining fair and stable markets.

However, it should be noted that there are, in fact, no finite numbers of options as an endless quantity could be created, limited only by investor interest. Since the majority of option contracts expire unexercised, there need not be a one-for-one correlation between the numbers of available option contracts and the numbers of corresponding underlying shares.

3. Margin Requirement

Margin, encountered by a stock trader, is only pertinent when the trader seeks to borrow shares or funds from his broker. Most investors in the stock market never deal with margin. Options traders, conversely, must submit a good faith performance deposit – the form of cash, other securities, bank guarantee letters, or escrow receipts – into their trading accounts to ensure that they will be able to cover their short positions when the contra-party (the holder) elects to exercise.

4. Exercise

It should be noted that options not only trade independently from stock (in separate markets and trading forums), but that the underlying stock does not even have to trade on any given day; an option can be exercised even when the stock is not trading or the stock market is closed.

[114] As per the Securities and Exchange Commission (SEC): When you buy securities through a brokerage firm, most firms will automatically put your securities into "street name." This means your brokerage firm will hold your securities in its name or another nominee and not in your name, but your firm will keep records showing you as the real or "beneficial owner." You will not get a certificate, but will receive an account statement from your broker on at least a quarterly and annual basis showing your holdings. [Available at https://www.sec.gov/answers/street.htm, last accessed November 7, 2012.]

5. Time Limit

But the biggest and most defining difference between stocks and options is hope. A stock investor, unencumbered by time limits, may hold his position indefinitely. If during his tenure, the stock should decline in value, the investor may continue to maintain his position and hope for a recovery. Only if the company declares bankruptcy or ceases to trade altogether, does the investor lose the chance to reap a profit.

Option traders, on the other hand, are limited by time. Once the expiration date passes, the option becomes irrevocably worthless. No further hope for potential recovery or profit remains!

V. Regulated Stock Options

These options are standardized contracts created by the Options Clearing Corporation (OCC)[115] which not only establishes the trading ground rules but also approves which financial instruments may be selected by the exchanges to serve as underlying securities, including equities (stocks), indexes, debt securities (bonds) and foreign currencies. While the OCC employs various criteria, the primary factor influencing selection is popularity (evidenced by high trading volume), volatility and market capitalization.[116] Much like gamblers in Vegas are offered odds on horse races and football games because there is sufficient interest, they are not offered the opportunity to bet on extreme ironing or buzkashi.[117] So while there are many thousands of stocks available for trade, only several hundred of these equities serve as underlying securities for options trading.

History

[115] Founded in 1973, the OCC is "dedicated to promoting stability and financial integrity in the marketplaces." The OCC acts as guarantor, ensuring that the obligations of the contracts it clears are fulfilled. [OCC's mission statement, available at http://www.theocc.com/about/, last accessed January 14, 2012].

[116] Mayhew & Mihov, *How Do Exchanges Select Stocks for Option Listing?*, The **Journal of Finance**, Vol. 59, Issue 1, pp. 447 – 471, February 2004.

[117] According to the Extreme Ironing Bureau, [extreme ironing] is "the latest danger sport that combines the thrills of an extreme outdoor activity with the satisfaction of a well-pressed shirt." Originating in England it is now a worldwide phenomenon that has taken place underwater, on mountainsides, and while parachuting. In contrast, the goal of Buzkashi is simple – grab the carcass of a headless goat at full gallop, get it clear of the other players, and pitch it across the goal line. Played all over South Central Asia, it is the national sport of Afghanistan. [*The 25 Most Obscure Sports in The World*, posted by David Pegg, available at http://list25.com/the-25-most-obscure-sports-in-the-world/, last accessed January 14, 2012].

Regulated stock options were first introduced on the Chicago Board Options Exchange (CBOE) in 1973 – at that time, 16 stocks served as underlying securities and only 911 contracts were traded. Today, over 1 billion contracts are traded annually on 2200 companies, 22 stock indices, and 140 exchange-traded funds which serve as underlying securities.[118]

Closing Out a Position

As we have already learned, the holder of a call option hopes that the market will rise. If it does, he can exercise his option to buy the underlying stock at a previously fixed price which is presumably less than what he would have otherwise had to pay on the open market. Thus, this is a bullish strategy. On the other hand, the holder of a put hopes that the market will decline. If it does, he can exercise his option to sell the underlying stock at a previously fixed price which is presumably more than what he could otherwise have gotten on the open market. Thus, this is a bearish strategy.

	Seeks Protection (BUYS insurance)	Seeks Income (SELLS something)
↑ **Bullish**	BUY Call	SELL Call
↓ **Bearish**	BUY Put	SELL Put

The holder, however, need not exercise. He may instead allow his option to expire; thereby forfeiting the premium paid. Or, he may choose to **close out** or sell (eliminate) his position, hoping to profit from the difference between the premium received on sale and the premium paid when he bought the contract.

A. Tax Consequences[119]

Options are considered to be capital assets and, therefore, all transactions involving the purchase, sale or expiration of options are deemed to be capital transactions reportable on Schedule D. Because regulated stock options have a maximum duration of 9 months – all expire on the third Saturday of the expiration month – all transactions relating to the disposition of these options are categorized as short-term since none can exceed the one-year holding period required for favorable long-term tax treatment. NOTE: Long-term Equity Anticipation Securities (LEAPS), introduced in recent years, expire within two to five years; LEAPs, therefore, can generate long-term capital gains.

1. Tax Consequences for the Holder (buyer of the option)

To begin, the holder of an option – whether call or put – was required to pay for the option and has spent the premium plus any

[118] Statistics available at www.cboe.com [last accessed November 7, 2012].

[119] IRC § 1234.

commissions his broker may have charged him. This total, then, represents the holder's cost basis. If no further transactions transpire and the option becomes worthless at expiration, the holder will forfeit his entire investment and suffer a short-term capital loss equal to his cost basis [long-term in the event of a LEAP held for more than one year].

However, you may recall that the holder has several choices which he may employ at any time prior to the option's expiration date. If, for example, the holder elects to use (exercise) his call option to purchase the underlying security, the cost basis of the option is simply added to the cost of the security purchased at the strike price. The taxpayer's holding period for the stock begins on the day after the option is exercised.

Example

On January 13, 2012 when the price of Yahoo stock is $15.48/share, Bob buys a JUL 14 Call on Yahoo for $2.52. Translated into English, Bob has just spent $252 (plus commissions; let's assume $50) on an option contract that allows him to buy 100 shares of Yahoo stock for $14/share any time between now and the expiration date on July 20th, 2012.[120]

This option is currently in-the-money; in other words, if Bob were to exercise the option, he would be able to purchase Yahoo stock for a savings of $1.48/share (= Market Price – Strike Price). If Bob did in fact exercise his option, he would have no immediate taxable event but would instead add the cost of his option ($252 premium + $50 commission) to the cost of the newly purchased stock ($1400 strike price) for a total cost of $1702 (his basis). Should he later sell the stock, he would use this basis to determine his realized gain or loss.

Rather than exercise, the holder may decide to close or rid himself of the position by selling the option – not the underlying stock – to another investor at a price determined by prevailing market conditions. Now the taxpayer must recognize a capital gain or loss equal to the difference between his selling and purchase price of the option (net of commissions).

[120] Standardized nomenclature ensures that all investors know to multiply premiums and strike prices by the standardized contract size of 100 shares and July 20th happens to be the 3rd Saturday of the stated expiration month. This means, that the option was originally created nine months before its expiration and was first traded in October 2011.

Example

On April 10th, 2012, Bob sells his JUL 14 Call on Yahoo for $0.96 when Yahoo stock is trading for $13.50/share to another investor who remains optimistic that Yahoo may yet climb above $14/share in the remaining months before expiration. Bob must now recognize a capital loss of $256, computed as follows:

	Sales Price $96 – Commissions $50	*$46*
–	*Purchase Price $252 + Commissions $50*	*302*
=	*Realized Loss*	*$256*

To summarize, the holder of a call option will be subject to the following tax treatments:

Action Taken	Tax Consequence
Expiration	STCL (= premium + commissions paid)
Exercise	No gain or loss until disposition of *stock* Basis of stock = strike price + option premium paid
Close Out	STCG if net premium received > net premium paid STCL if net premium received < net premium paid

As can be seen from the chart above, option transactions are not taxed until such time as the position is closed, exercised, or allowed to expire. If those transactions occur after the end of the taxpayer's taxable year, income recognition is deferred. Congress is currently weighing alternatives and may introduce legislation that would "tax derivatives across the board on a current basis as opposed to when the contract is liquidated at a later date."[121]

2. Tax Consequences for the Writer (seller of the option)

The premium a holder pays for an option – whether call or put – goes to the writer (less any commissions the writer may owe to his broker to effect the transaction). Although it may seem logical to report the premium as taxable income, the writer does not actually have a taxable consequence since it is, as yet, unknown whether

[121] *House Ways And Means Staff Weigh Tax Changes for Derivatives*, Martin Vaughan, Dow Jones Newswires [available at http://news.alibaba.com/article/detail/americas/100021696-1-house-ways-means-staff-weigh.html, last accessed February 1, 2012].

he will realize a gain or loss. Keep in mind, with the exception of closing out his position (ridding himself of the option by unloading it onto another investor), the writer remains at the mercy of the holder's decision to exercise or allow the option to expire. Until the holder makes that decision, the writer cannot know his tax consequences.

However, the expiration of an option is deemed to be a capital event, resulting in the recognition of a short-term capital gain equal to the premium the writer originally received. Similarly, if the option position is closed out, the writer must recognize a gain or loss based on the difference between the net premium originally received and the net premium later paid to eliminate the position.[122]

Finally, if the holder of a call option elects to exercise and forces the writer to deliver the underlying security, the writer will receive sales proceeds equal to the strike price of the stock he just delivered. The writer must now recognize a short- or long-term gain or loss, depending upon how long he held the underlying security and the cost basis of his shares (adjusted for the option premium he previously received).

Example

On January 13, 2012, Charlie sold the JUL 14 Call on Yahoo to Bob – the contra-party to the transaction – and received $252 (less a $50 broker's commission). Charlie does not yet have a reportable event.

However, if Bob chooses to exercise the call, Charlie will be required to deliver 100 shares of Yahoo stock to Bob and will receive payment from Bob totaling $1400. Assuming that Charlie originally purchased 100 shares of Yahoo on September 30, 2011 for $13.17/share precisely in the event he would be called upon to ***cover*** *his option position, Charlie would realize:*

	Sales Price of Stock	*$1400*
–	*Cost of Stock $1317 + Comm. $50 – Option Inc. $202*	*1165*
=	*Realized Gain*	*$235*

[122] To close or eliminate an option position, the investor must make a transaction that is opposite of the one that originally established his position. Thus, the holder of an option – who originally purchased the option and now wants to rid himself of it – must later sell that option to remove the investment from his portfolio. On the other hand, the writer of an option – who originally sold the position and took in cash – must now buy back the position and spend cash to remove the investment from his portfolio. REMEMBER: Holders *sell* and Writers *buy* to close out their option positions.

Of course, you might wonder why Charlie would go to such lengths to make a profit of only $235. And indeed, it would appear to be pointless unless Charlie had previously managed to purchase the 100 shares of underlying stock for something less than $13.50/share.

In fact, imagine that Charlie owned Yahoo all along – purchased for just about a dollar per share when the stock was first issued in 1996. In the interim, Charlie watched his investment increase to well over $100/share in late 1999, drop precipitously during the next two years and ride a mild roller coaster between $12 and $40/share ever since. Charlie is content to hold the stock since he believes in its long-term growth prospects, but is disappointed that Yahoo has not paid out any dividends in all these years. Charlie's broker suggested that he could generate an income stream by writing covered calls, whereby he earns the premium on call options he sells to Bob and others. If the market price of Yahoo remains below the selected strike price, the calls will remain unexercised; Charlie may keep his premium and his stock and can repeat the process again by writing another covered call. If the market price exceeds the strike price, Bob will almost assuredly exercise the option and Charlie will have to deliver (sell) his stock. But remember, he bought that stock long ago for next to nothing and now realizes a significant gain as well as the premium he collected when he wrote the option.

In some instances, writers may choose to remain **uncovered** – a far riskier endeavor since they will be called upon to deliver stock they do not yet own. Uncovered writers will be required to purchase shares at the prevailing market price should the call be exercised. Since the holder will only choose to exercise when the market price exceeds the strike price – and there's no telling just how high that market price might be at that time(!) – the writer faces unlimited exposure.

To summarize, the writer of a call option will be subject to the following tax treatments:

Action Taken	Tax Consequence
Expiration	STCG (= premium - commissions received)
Exercise	ST or LTCG if Strike Price > Basis of *stock* ST or LTCL if Strike Price < Basis of *stock* Basis of stock = Cost of stock - net premium received
Close Out	STCG if net premium received > net premium paid STCL if net premium received < net premium paid

We have, so far, discussed the tax consequences of call options but not put options. Where calls give the holder the choice to buy and the writer an obligation to sell the underlying security, puts do the opposite in that they give the holder the choice to sell and the writer the obligation to buy the underlying security. While it's easy to offer real-world examples of calls (corn flakes coupons and car warranties), it's difficult to come up with practical comparisons of puts since it almost seems counter-intuitive to force someone to buy something at the whim of the put holder. Nevertheless, it is so!

As a result, I often suggest that students stick with the easier concept – that of a call – and simply accept that puts are the opposite of calls. Once you grasp the concept of calls, just flip that concept upside-down and now you "understand" puts. I offer a complete summary of tax consequences below and ask you to note that the tax consequences for holders at expiration or closing are the same, regardless of whether calls or puts are involved. It is only upon exercise, that the tax consequences differ.

	Expiration	Exercise	Close Out
Call Holder [*may* buy stock]	STCL (= prem. out)	ST or LT after disposition of stock Basis of stock = strike + prem. out	ST or LT (= prem. in – prem. out)
Put Holder [*may* sell stock]	STCL (= prem. out)	ST or LT (= strike – basis) Basis of stock = cost + prem. out	ST or LT (= prem. in – prem. out)
Call Writer [*must* sell stock]	STCG (= prem. in)	ST or LT (= strike – basis) Basis of stock = cost – prem. in	ST or LT (= prem. in – prem. out)
Put Writer [*must* buy stock]	STCG (= prem. in)	ST or LT after disposition of stock Basis of stock = strike – prem. in	ST or LT (= prem. in – prem. out)

B. Holding Periods

As discussed previously, holding periods for option positions, whether expired or closed, are determined by the amount of time the positions remained open. Since regulated stock options most frequently have a maximum duration of only nine months, both holders and writers generally realize short-term gains and losses with holding periods that begin when the positions are opened and end when the options become worthless at expiration or the positions are eliminated in closing transactions.

If, however, the positions are exercised, holding periods are attached to the underlying securities rather than to the options themselves.[123] The applicable rules are designed to "enforce the government's philosophy of allowing long-term treatment of gains only where the [options trader] was at substantial economic risk in the underlying stock during the entire holding period."[124]

To further complicate matters, writers of covered calls – investors who have sold a call option and hold the underlying stock – must establish if their options are in-the-money, at-the-money or out-of-the-money and only then can determine the holding period of the stock. A simple comparison between the strike price of the option and the market price of

[123] IRC § 1223.

[124] Brasher, John, *Tax Rules on Stocks and Stock Options*, Reprinted from CallWriter's MONEY newsletter, June 17, 2003 [available at http://www.callwriter.com/newsletter/stock-option-tax-rules.htm, last accessed January 20, 2012].

the stock is used to determine whether potential exercise of the option would be favorable for the holder. Thus, if the strike price is less than the market price, the holder could exercise his option to call the stock away from the writer and purchase the stock at a bargain, ultimately putting money *in* his pocket. Conversely, if the strike price is greater than the market price, the transaction would be unfavorable for the holder and he would have to shell *out* money from his pocket. And if the strike and market prices were equal, the holder would find neither benefit nor detriment to exercise; the option is said to be at-the-money. [This determination is *always* performed from the perspective of the holder since he is the transaction participant who must determine whether exercise would in fact be favorable or not.]

Stock holding periods are irrelevant for at-the-money and out-of-the-money calls since neither would be exercised. However, options with **intrinsic value** must next be separated into qualified[125] and non-qualified categories to determine if the holding period of the underlying stock is suspended and restarted at the end of the option's life [qualified] or eliminated, reset to zero, and restarted once the option expires or is closed [non-qualified].

C. Wash Sale Rule[126]

This rule was established to prevent investors from making illusionary sales for the purpose of converting paper losses into recognized losses on the tax return. The rule states that an investor, who sells a security at a loss, may not repurchase substantially the same security within 30 days before and 30 days after the date of the sale.

Example

On June 30, 2011 the investor bought 100 shares of XYZ for $4,000. On August 4, 2011 he sells the shares for $3,300 but repurchases another 100 shares of XYZ for $3,900 the next day. Although the investor realized a loss on the sale of $700, he may not deduct it since he repurchased the same security before the expiration of the window. Instead, he must add the non-deductible loss to the cost basis of the new shares ($4,600 = $3,900 + $700).

[125] Qualified in-the-money options are those which are exchange-traded, written on stock already owned by the call writer, have more than 30 days remaining until expiration, and have a strike price only minimally less than the security's market price. If "the option has 31-90 days remaining until expiration, it can't be written more than 1 strike point below yesterday's close. But if the call has more than 90 days remaining, you can go 2 strikes below yesterday's close. However, if the stock is $150 or less, you can't write more than $10 in the money no matter what." [Brasher, John, *Tax Rules on Stocks and Stock Options*].

[126] IRC § 1091.

Clearly, the taxpayer had hoped to deduct the loss on his return which otherwise would have remained unrealized.[127] By repurchasing the same security, he had hoped to retain his position and benefit from future appreciation of the stock. The government cannot prevent an investor from buying and selling, but this rule is designed to discourage sales if done only to recognize losses rather than for viable financial reasons. Taxes should never be the sole or even the primary motivation for making investment decisions.

On the other hand, if the investor had waited until September 5, 2011 to repurchase the stock, his loss would have been deductible. It is assumed that if someone were to sell a security and then willingly wait for at least a month to repurchase it, he would be exposed to market fluctuations just like any other investor. If he were willing to take that kind of risk, the wash sale rule will not prevent his actions.

Some taxpayers try to circumvent the rule by purchasing other securities. For example, the investor may hope to sell XYZ common stock and replace it with XYZ preferred stock. Sadly, this will not "fool" the tax authorities as the rule clearly stipulates *substantially the same* securities. Thus, the following transactions would all fail under the rule: (a) XYZ common stock for XYZ call option; (b) XYZ preferred stock for XYZ convertible bond; (c) XYZ bearer bond for XYZ registered bond.

Typically, if the securities are issued by the same corporation, they will likely be deemed as being substantially the same. Buying a deep in-the-money call on an underlying security sold within the previous 30 days would fall under the category of "substantially the same" since the holder could readily exercise his option at any time to replace his shares of stock, but the writer of this same call would not be subject to the wash sale rule since the sale of this option does not serve to reinstate his stock holding.

VI. §1256 Contracts

Regulated futures, non-equity options and foreign currency contracts are known as §1256 contracts. Frequently, §1256 transactions remain open at year-end; in other words, the contract has not yet expired or been exercised. However, mark-to-market rules require that the investor treat these contracts as if they had been sold at their Fair Market Value (FMV) on the last day of the tax year. 60% of the computed gain is then treated as long-term while the remaining 40% is treated as short-term on **Form 6781**, Gains and Losses from Section 1256 Contracts and

[127] Wash Sale transactions are reported on Schedule D in the normal manner, but a second line entry will be required to remove the disallowed loss by entering it as a positive number as an offset to the loss claimed on the line above.

Straddles.[128]

Example

On June 17, 2006 Taxpayer paid $145,000 for a contract on the S & P 500 Index scheduled to expire in June of 2008. At year-end, the contract was valued at $252,000. Under the mark-to-market regime, the SPX contract was deemed to have been sold and Taxpayer was required to recognize taxable income of $107,000 – of that amount, 40% was reported as a short-term gain ($42,800) and the remainder was reported as a long-term gain ($64,200).

Taxpayer sold the contract for $228,000 on March 12, 2007. While his realized gain totaled $83,000, Taxpayer had previously recognized $107,000. Therefore, his recognized loss now totaled $24,000 – including $9,600 STCL (40% of total) and $14,400 LTCL (60% of total).

NOTE: §1256 contracts are not subject to the rules which govern short sales or wash sales.[129]

A. Futures[130]

A futures contract, also known as a forward contract, is very much like a regulated stock option in that it gives the holder the right to purchase an item at a specified price at a specified time in the future.[131] However, there are some significant differences:

[128] Senator Carl Levin (D-MI), Chairman of the Senate Permanent Subcommittee on Investigations recently introduced Closing the Derivatives Blended Rate Loophole Act that would revise IRC § 1256 to eliminate "a tax loophole that allows traders in complex derivatives to buy and sell these instruments in days or even seconds, yet claim a large portion of the resulting income as a long-term capital gain." Levin Introduces Legislation to End Tax Loophole that Subsidizes Short-term Speculation in Derivatives, January 23, 2012 [available at http://levin.senate.gov/newsroom/press/release/levin-introduces-legislation-to-end-tax-loophole-that-subsidizes-short-term-speculation-in-derivatives, last accessed February 1, 2012].

[129] IRS Publication 550 *Investment Income and Expenses*, Chapter 4, Page 59, Cat. No. 15093R, October 16, 2012.

[130] Futures contracts were first created in Japan during the 1600's by landlords collecting rents from their tenants in the form of bushels of rice. Both landlords and tenants were concerned about price fluctuations throughout the growing season – tenants were concerned with price decreases; landlords with price increases. Futures contracts offered each party a hedge and allowed third parties to speculate, ultimately increasing overall market liquidity.

Pricing – then and now – is based strictly on supply and demand. Today, the American futures markets are regulated by the Grain Futures Act (1922), the Commodities Exchange Act (1936), and the Commodities Futures Trading Commissions Act (1974).

[131] A more down-to-earth example of a futures contract with which we are all familiar would be a real estate sales contract whereby buyer and seller agree on a closing date (in the future), establish a price, identify a quantity (one house), and specify the quality of the commodity to be transferred (e.g. with a new roof).

- Futures, unlike options, involve commodities such as oil, metals, grains, and livestock. Financial futures are now available as well.
- Futures trade using the open outcry system on a commodities exchange.[132]
- But most importantly, futures must be exercised upon expiration and require the physical delivery of the underlying commodity as opposed to options which can expire unexercised. Thus, the holder of a pork belly contract better have a BIG freezer when 40,000 pounds of bacon are delivered to him on the expiration date!

A recently introduced investment, known as a securities futures contract, allows the investor to enter into a contract to buy or sell a single security or a narrow-based index in the future. As this is very similar to an equity option, it is treated in the same manner and is therefore not considered a §1256 contract.

B. Foreign Currency Transactions

The IRS distinguishes between two types of currency transactions—those that are regulated (governed by IRC § 1256) and those that are not regulated (governed by IRC § 988), depending upon the market in which the currencies are traded.

1. Non-Regulated Transactions

These transactions, known as cash forex, include all trades which take place in the interbank market[133] as well currency futures traded on a regulated commodities exchange. Resulting gains and losses are treated as ordinary income and taxed at the taxpayer's marginal tax bracket, although losses are not limited by the $3,000 capital loss rule.[134]

NOTE: Because interbank markets are not regulated, taxpayers' transactions will not be reported to the IRS on **Forms 1099**. Nevertheless, these trades are taxable and should be reported on **Form 1040**, Line 21 by investors and on **Form 4797** by traders.

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[132] In August 2007, the Chicago Mercantile Exchange (CME) announced its decision to close the pork belly trading pit by May 2008 as part of its consolidation with the Chicago Board of Trade (CBOT). Pork bellies continue to trade electronically.

[133] The interbank market is used by banks and financial institutions, excluding retail investors and smaller trading parties, to trade foreign currencies.

[134] Wash Sale and Mark-to-Market Rules also do not apply to §988 transactions.

Under certain conditions,[135] a taxpayer may elect out of §988 treatment, thereby converting his ordinary gains to §1256 capital gains. The election does not apply globally, but rather on a trade-by-trade basis and is best made when the transaction has resulted in a taxable gain (since loss treatment is more favorable under §988).

2. Regulated Transactions

These transactions take place on a regulated exchange (not including currency futures) and are treated as capital rather than ordinary income. Regardless of the taxpayer's actual holding period, 60% of the resulting gains are treated as long-term capital gains ("LTCGs"); the remaining 40% are taxed as short-term capital gains ("STCGs").

These trades will be reported to the IRS on **Forms 1099** and must be reported by the taxpayer on **Form 6781**.

VII. Employee Stock Option Plans (ESOPs)

Often, a corporation gives its employees the right to buy shares of the employing company in an attempt to motivate employees or provide for compensation that does not directly affect the bottom line of the employer in the current year. Although these options give holders (in this case, the company employees) the right to purchase shares of stock, they are not regulated nor standardized contracts and are treated differently than regulated stock options.

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are currently seeking to establish globally accepted standards mandating that companies treat stock options as an expense in the year granted. A rule requiring public companies to expense options was adopted in 2004 – it became effective June 15, 2005 and should help to decrease over-inflated financial statements. However, Congress continues to weigh proposed legislation that would disrupt the FASB's efforts to harmonize global accounting standards by requiring that only the stock options given to a company's top five executives be expensed. No definitive regulatory guidelines have yet been issued.

[135] The election can be made for transactions involving a forward or futures contract, or currency options which are capital assets in the hands of the taxpayer and are not part of a straddle (a position in which the investor holds both a call and put with the same strike price and expiration date).

A. Types of ESOPs

1. Statutory

These options are granted under a plan which meets certain requirements within the Internal Revenue Code (IRC). Again, two variants exist:

- Incentive Stock Options (ISOs) are often granted on a discriminatory basis to key employees and must be exercised with 10 years after the grant date.
- Employee Stock Purchase Plans (ESPPs) must be nondiscriminatory and are usually offered to non-management employees. They must be exercised within 5 years after the grant date if the price of the option is at least 85% of the FMV of the stock at the time of exercise. Otherwise, the option must be exercised within 27 months of the grant date.

2. Non-statutory

These options do not meet the criteria of the IRC.

B. Tax Treatment

1. ISOs (§421)

Recognition of Income
No income is recognized on the grant or exercise dates, only upon ultimate disposition of the stock. However, if the option is not exercised in the same year it was granted, the difference between the FMV of the stock and the Option Price will be considered a tax preference item for AMT purposes. This information will be provided on **Form W-2**, Box 14.

Treatment if Exercised
If the option is exercised and the stock is then held for at least one year past the exercise date and two years past the grant date, the eventual gain or loss will be considered long-term[136]. Otherwise, there will be a Disqualifying Disposition and the resulting gain will be included as compensation on **Form W-2**, Box 1. The basis of the stock is then increased by the amount of compensation recognized.

[136] IRC § 422.

*Example # 1: Holding requirement **not** met*

On February 15, 2009 XYZ granted an ISO option to buy 100 shares at $10/share. Employee exercised the option on October 1, 2011 when the FMV of the stock was $15/share. Employee then sold the stock almost immediately for $16/share.

*The long-term holding period requirements were not met since the **stock** was not held long enough and so $500 (= $1,500 - $1,000) was included on Form W-2, Box 1 in 2011. A Form 1099-B was issued showing sales proceeds of the stock as $1,600. The adjusted basis was $1,500 (= $1,000 + $500 compensation recognized) and so the resulting gain of $100 was reported as a STCG.*

Example # 2: Holding requirement met

If the employee had instead met the long-term holding requirements, no compensation would have been recognized and the entire $600 (= $1,600 - $1,000) would have been LTCG.

Example # 3: Holding requirement met & stock sold at loss

Alternatively, if the stock had been sold at a loss, no compensation would have been recognized and the employee would have reported a LTCL.

The AMT reportable amount is also added to the stock's basis for AMT purposes, which will result in a smaller AMT gain than regular tax gain in the year of eventual sale. In theory, the AMT paid in the year of exercise creates a minimum tax credit that can be used to reduce the regular tax liability when the stock is sold. But the taxpayer suffers significant tax consequences if the stock price *falls* in the interim.

Example[137]

Taxpayer received ISOs to buy his employer's stock and exercised his options from 1998 – 2000, buying stock worth about $4.5 million for only $128,000. Of course, he paid over $1 million of AMT in 2000 alone!

Then, in 2001, the taxpayer sold his stock for $1.7 million, realizing a significant economic gain (= $1.7 million – 128,000). Unfortunately, however, the stock sale generated a tax loss for AMT purposes (= $1.7 million – 4.5 million).

[137] *Marcus*, 129 TC 4.

The taxpayer attempted to subtract the difference between his regular and AMT basis from his AMT calculation in 2001 so that he would have an AMT net operating loss that he could then carry-back to reduce his prior AMT tax liabilities.[138] *But the court held that there was no regulatory authority for this negative adjustment in the year of the stock's sale; instead, only the positive basis adjustment [mentioned above] was allowed. Therefore, instead of an AMT NOL carry-back, the taxpayer was faced with a very large AMT basis that then created a huge AMT loss. And that loss—because stock was considered to be a capital asset—was limited to the $3,000/year limitation on capital losses!*

Beginning in 2007 (through 2012), the Minimum Tax Credit becomes partly refundable, which will allow taxpayers with tax units due to AMT tax paid more than 3 years ago, to obtain some relief. For taxpayers with an AMT liability resulting from transactions that occurred before the Minimum Tax Credit became refundable, a "Bail-out Bill" has come to the rescue. This legislation abates any underpayment of outstanding tax on October 3, 2008 attributable to an AMT adjustment for ISOs in any tax year prior to 2008 (including penalties and interest).[139]

2. ESPPs

Recognition of Income
No income is recognized on the grant or exercise dates, only upon ultimate disposition of the stock. No AMT adjustments are required.

Treatment if Exercised
If the option is exercised and the stock is then held for at least one year past the exercise date *and* two years past the grant date, any gain will be considered long-term.[140] Losses occurring when the stock disposition price is less than option price are reported as LTCL and no compensation will be recognized.

*Example # 1: Holding requirement **not** met*

On February 15, 2009 XYZ granted an ESPP option to buy 100 shares at $10/share when the FMV was $12/share. Employee

[138] The taxpayer based his argument on IRC § 56(d)(1)(B) that says that the AMT NOL calculation starts with regular tax income, adjusted for AMT deductions and preference items.

[139] *Section 83(b) Election Not Always a Good Idea*, Chris Novak, TAXPRO Monthly, August 2009.

[140] IRC § 423.

exercised the option on October 1, 2011 when the FMV of the stock was $15/share. Employee then sold the stock almost immediately for $16/share.

The long-term holding period requirements were not met and so the employee would report ordinary income of $500 (= $1,500 - $1,000) and a STCG of $100 (= $1,600 – $1,500).

Example # 2: Holding requirement met

If the holding periods had been met, the employee would report $200 (= $1,200 - $1,000) as ordinary income and $400 (= $1,600 - $1,200) as LTCG.

Example # 3: Holding requirement met & stock sold at loss

If the stock had instead been sold at $7/share, the employee would report a $300 (= $1,000 - $700) LTCL and no compensation would have been recognized.

3. Non-statutory Stock Options

These options are taxed as compensation on the grant date if the option has a readily determinable FMV and the option is transferable or not subject to forfeiture should the employee fail to comply with specific conditions imposed. The income recognized is the difference between the FMV of the option and the price paid for it, if any. This amount is reported on **Form W-2**, Box 1.

If the FMV cannot be determined on the grant date, recognition of income is postponed until the option is either exercised or transferred.

The basis of the stock acquired equals the amount paid for the option plus any amount the employee is required to include in income.

4. Summary of Tax Treatment

While the facts of situation below merely repeat the examples given in the text above, I am providing a side-by-side comparison so that you may readily identify the tax treatments distinct to each type of employee stock option. Additionally, I have assigned letters to each part of the transaction so that you have a standardized algorithm that can be applied to any taxpayer's situation.

Facts of the Situation:

2/15/09: Option granted to buy 100 shares of XYZ at $10/share (G) when FMV of stock = $12/share (F)
10/1/11: Option exercised when FMV of stock = $15/share (E)

Stock is then sold at either $16/share (Sg) for a gain ...or $7/share for a loss (Sl).

ISO LT hold met	ISO LT hold not met
No compensation Sg – G =$600 LTCG *(Net = $600)*	E – G = $500 Ordinary Sg – E = $100 STCG *(Net = $600)*

ESPP LT hold met; sold at gain	ESPP LT hold not met; sold at gain	ESPP LT hold met; sold at loss	ESPP LT hold not met; sold at loss
F – G = $200 Ordinary Sg – F = $400 LTCG *(Net = $600)*	E – G = $500 Ordinary Sg – F = $100 STCG *(Net = $600)*	No compensation Sl – G = $300 LTCL *(Net = $300)*	E – G = $500 Ordinary Sl - E = $800 STCL *(Net = $300)*

Non-statutory Options
F – G = $500 Ordinary Sg – E = $100 LTCG *(Net = $600)*

C. ISOs and AMT

Although the exercise of an ISO is generally not a taxable event, the bargain element is includible in Alternative Minimum Taxable Income (AMTI). Defined as the difference between the fair market value of the stock on the date of exercise and the actual purchase price of the stock using the option, the bargain element represents the savings enjoyed by the option holder who has the opportunity—due to his option—to purchase the stock for less than the prevailing market price. The taxpayer must include this "savings" as an AMT tax preference item.[141]

[141] IRC § 56(b)(3).

Due to differing treatment under the regular and the AMT tax systems, a taxpayer may well have two different bases for the same shares of stock: His regular tax basis will be the exercise price at which he purchased the stock with the help of the ISO. His AMT basis, on the other hand, will be the exercise price plus the includible AMTI income.

VIII. Restricted Stock[142]

Often given to an employee at no cost, company stock may be subject to restrictions, such as forfeiture if the employee fails to meet requirements imposed upon him, such as a term of years. When this restricted stock[143] is transferred to an employee as payment for services, the employee's income and the employer's deductions are not recognized until vesting occurs (i.e., until the stock is no longer restricted). Alternatively, the employee may elect under §83(b) to recognize the income on the date of the stock's receipt rather than on the date of its vesting.

Without the election, the restricted stock results in compensation income to the employee in the year the forfeiture restriction lapses or the stock becomes transferable. The amount included in income (subject to payroll tax withholdings) is the excess of the stock's value when the restriction lapses over the amount, if any, paid for the stock by the employee.

Instead, an employee may elect to recognize income in the year he receives the restricted stock as per §83(b). The amount included in income (again, subject to payroll tax withholdings) is the excess of the stock's value upon receipt over the amount, if any, the employee paid for the stock.

Tax Consequences of the §83(b) Election[144]

[142] Rule 144 of The Securities Act of 1933. NOTE: The holding period limiting the resale of restricted securities has been shortened from 2 years to only 6 months, effective February 15, 2008.

[143] Stock is considered substantially not vested (restricted) where the recipient risks forfeiture conditioned (directly or indirectly) upon the future (non)performance of substantial employment services AND where the stock is not transferable (i.e. the transferee is subject to the same forfeiture conditions as the employee). IRC § 83(c).

[144] As per Rev Proc 2012-29, the taxpayer (employee) must file a written statement with the IRS Service Center where he expects to file his return within 30 days after receiving the stock from his employer. He must attach a duplicate copy of this statement to his individual income tax return [IRC § 83(b)(2)]. The statement must be signed by the person making the election and must indicate that the election is being made under § 83(b). The statement must include the following: Name, address and taxpayer identification number of the taxpayer; a description of each property with respect to which the election is being made; the date or dates on which the property was transferred and the taxable year for which such election is being made; the nature of the restriction or restrictions to which the property is subject; the fair market value at the time of transfer; and the amount, if any, paid for such property. Sample language which may be used by the taxpayer is provided in the Revenue Procedure [26 CFR 1.83-2].

- The employee must recognize compensation income on the date of transfer, but receives no cash with which to pay the resulting tax. If the stock is subsequently forfeited, the employee can't claim a deduction for the previously recognized income; however, any amount paid for the stock may be deducted as a capital loss.
- Any appreciation in the stock's value after the date of transfer is taxed as capital gain when the stock is ultimately sold. The employee's holding period begins on the date of transfer.
- The employee is treated as the owner of the stock and, therefore, dividends on the stock are treated as such rather than compensation income. Qualified dividends are taxed at a maximum federal rate of 15%.
- There are no tax consequences when the stock vests. Appreciation between the transfer date and vesting date is not recognized until the stock is sold.

The election is best made when the shares given to the employee have nominal value on the date of transfer, or the employee pays full or substantial value for the stock, or significant appreciation between the date of receipt and the time that the stock vests is anticipated. On the other hand, it is best to *not* make the election where the employee would be required to recognize substantial income upon receipt of the stock, or the employee will likely fail to satisfy the conditions creating the substantial risk of forfeiture.

IX. Mineral Rights

The extraction of natural resources by someone other than the owner of these mineral rights may be classified either as a sale or as a lease. Proper classification may be determined by applying an economic interest test and determining if the owner of the land is paid regardless of whether the extracted mineral is sold. If so, he is deemed to have relinquished his rights (and therefore, his economic interest) and so the transaction will be classified as a sale. If, on the other hand, the landowner's payment is sourced to the proceeds from the sale of the mineral, the landowner has retained his interest and the transaction is classified as a lease.

Note that the land surrounding the mineral will inevitably have to be accessed and as such, the transaction will have to be bifurcated. Depending on the circumstances, that surrounding land will also be sold or rented.

Once the transaction has been classified, the chart below can be used to apply the proper tax treatment:

	Sale	Lease
Mineral Rights	ST or LTCG in year proceeds are received Basis of the mineral right is usually zero	Royalties reported on Schedule E Landowner may claim percentage depletion
Surface Land	Sale is reported on Schedule D if right-of-way or easement granting perpetual access without possibility of reversion involved	Rental income must be separately identified on Schedule E

APPENDIX J
Another Way of Looking at Options

Two Sets of Partners

Set # 1 Student buys **CALL** → choice to buy CE units @ $50 before 6/10
School sells **CALL** → must provide CE units @ $50 if Student exercises before 6/10

Set # 2 School buys **PUT** → choice to provide CE units @ $50 before 6/10
Student sells **PUT** → must buy CE units @ $50 each if School exercises before 6/10

Market Sides

Side # 1 Student = Consumer of CE units
Expects (or fears) the price of CE units will rise and is bullish

Side # 2 School = Provider of CE units
Expects (or fears) the price of CE units will fall and is bearish

Pricing

Assume course catalog is published on April 10th and states that the regular price of CE units is $75 – this price remains unchanged in the months to come ➔ the price (or premium) of a CALL will be:

On April 10th $25 coupon savings + $2 time value = $27 total
On May 10th $25 coupon savings + $1 time value = $26 total
On June 10th $25 coupon savings + $0 time value = $25 total

However, if market conditions change in interim and the price of CE units goes to $100 while the CALL guarantees a price of $50 ➔ the CALL premiums will be:

On April 10th $50 coupon savings + $2 time value = $52 total
On May 10th $50 coupon savings + $1 time value = $51 total
On June 10th $50 coupon savings + $0 time value = $50 total

Alternatively, if the price of CE units on the open market declines to $40 ➔ the CALL Premiums would be:

On April 10th $0 coupon savings + $2 time value = $2 total
On May 10th $0 coupon savings + $1 time value = $1 total
On June 10th $0 coupon savings + $0 time value = $0 total

Choices

Student who holds the CALL has the choice to:

- **Exercise** → buy the CE units @ $50 if the price of CE units > Premium Paid + Strike
  ⇨ Premium Paid is added to the cost of CE units
  OR…
- Allow the CALL to **expire** if the price of CE units < Premium Paid + Strike
  ⇨ STCL = Premium Paid
  OR…
- **Sell** the CALL (or close out his position) if he is unable or unwilling to exercise
  ⇨ STCG (or STCL) = Premium Rec'd – Premium Paid

APPENDIX K
Summary of Option Rules

1. Long = Buy = Hold → choice ("may") → $ out / - / DB
   Short = Sell = Write → obligation ("must") → $ in / + / CB

2. Four basic option positions

	B/S OPTION	B/S STOCK
↑	LC = Long Call	(*may* buy stock)
↓	SC = Short Call	(*must* sell stock)
↓	LP = Long Put	(*may* sell stock)
↑	SP = Short Put	(*must* buy stock)

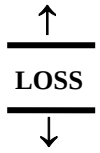
3. "You CALL UP someone to PUT him DOWN"
   [Use phrase when setting up LONG position]

4. Side of the Market: Either both UP or both DOWN
   If bullish or "worried about" markets going up (↑): LC or SP
   If bearish or "worried about" markets going down (↓): SC or LP

5. When long an option, you need volatility to make option profitable
   When short an option, you need stability to make option profitable

6. Spreads: WED/NUC
   Debit spreads must widen & be exercised for profit ["When Debbie widens, she should exercise"]
   Credit spreads must narrow and remain unexercised for profit ["Credit crunch']

7. Straddles:



"Long LOSS between" "Short Straddle Stability"

8. Max Loss when buying (long) an option = Premium
   Max Gain when selling (short) an option = Premium

9. If seeking protection by hedging against…
   - markets going down when you own the stock: SC or LP
   - markets going up when you sell the stock: LC or SP

   Example
   You bought stock (LStock). To protect yourself against a drop in market value, you write a call (SC).
   ➔ LStock + SC = Covered Call (a.k.a. Hedge)

   You could also do the following combinations:
   - LStock + LP
   - SStock + LC
   - SStock + SP

   ➔ A Hedge *always* includes a stock and an option

10. Least aggressive strategy = Covered Call Writing
    Most aggressive strategy = Uncovered Call Writing

11. Intrinsic Value = option is in-the-money [ignore premium!]
    - Call: Market Value > Strike Price
    - Put: Market Value < Strike Price

12. Options can never be bought on margin, but they may be bought in a margin account.

13. OCC = "God"

APPENDIX L
Solving Option Problems

A. Convert all word problems to short-hand:

- "Long" or "Short"? ➔ L or S
- "Call" or "Put" or "Stock"? ➔ C or P or STK
- Strike Price?
- Premium or Stock Price?

The result should look like: LC 40 @ 2 or…SP 60 @ 5 or…LStk @ 73
REMEMBER: Market price in an option problem is always irrelevant!

B. Insert "+" or "-"
"+" for money IN or received
"-" for money OUT or spent

		Strike	Premium
↑	LC	-	-
↓	SC	+	+
↓	LP	+	-
↑	SP	-	+
↑		LStk	-
↓		SStk	+

C. Then decide which method to use:

- Use +/- game® if looking for "Maximum Gain", "Maximum Loss" or "Breakeven" [see D below]
- Use T-Chart (+/- Chart) for *all* other problems [see E below]

D. Five Steps to Happiness® (a.k.a. +/- game®)

Step	Options Only (Basic, Spreads, or Straddles)	Hedges (Stock + Option)
1	Identify position as Basic, Spread or Straddle	Identify option as either Call or Put
2	Assign "+" and "-"	Assign "+" and "-"
3	Add premiums ➔ If sum is positive, then **Max. Gain (MG)** ➔ If sum is negative, then **Max. Loss (ML)**	Add Stock Price and Premium ➔ Sum is **Breakeven**
4	Add Strike Price to Subtotal from Step # 3 • If SPREAD, use Strike from option with highest Premium (="favorite" option) ➔ Sum is **Breakeven** • If STRADDLE, add Strike from each position separately to Step # 3 Subtotal ➔ Sums will be two **Breakevens**	If PUT, skip to Step # 5 If CALL, Step # 3 Subtotal will also be: ➔ If sum is positive, then **Max. Gain** ➔ If sum is negative, then **Max. Loss** Then add Strike Price to Step # 3 Subtotal to obtain other **MG** or **ML** ➔ If sum is positive, then **Max. Gain** ➔ If sum is negative, then **Max. Loss**
5	Add Unused Strike Price to Subtotal from Step # 4 (make sure to add both Premiums and both Strike Price into one grand total) ➔ If sum is positive, then **Max. Gain** ➔ If sum is negative, then **Max. Loss** ➔ If result conflicts with (**MG** or **ML**) from Step # 3, then answer is "unlimited"	If PUT, add Strike Price to Step # 3 Subtotal ➔ If sum is positive, then **Max. Gain** ➔ If sum is negative, then **Max. Loss** Remaining unsolved **MG** or **ML** is "unlimited"

E. T-Chart Problems:

- Buy/Sell (**Trade or Close Out**) OPTION @ **Premium**
- To "close out" a position means to do the opposite of the original transaction and so premium is entered into the opposite column of the T-chart (i.e. if you started by being "in" money, then you close by being "out" money)
- Buy/Sell (**Exercise**) STOCK @ **Strike or Exercise Price**

F. "Offset" problems:

The answer will be one of the 2 Strike Prices given:

- If "above", select higher Strike
- If "below", select lower Strike

APPENDIX M
"Short" Defined

"Short Selling"	"Short a Call (or Put)"
ALWAYS means you're dealing with stock	ALWAYS means you're dealing with an option
Possible transactions include: • Selling stock • Borrowing stock • Repurchasing stock to repay a loan ➔ You are BEARISH	SC: Short Call Write Call Sell Call ➔ You are BEARISH SP: Short Put Write Put Sell Put ➔ You are BULLISH
Short Sale Up-tick Rule applies (Act of 1934)	N/A
MUST be done in a margin account because borrowing is involved	MAY be done *in* a cash or margin account, but CANNOT be done *on* margin "On" means that you would have borrowed money, which you can *never* do when dealing with options
Risky since there is a potential for unlimited loss if the market increases Risk could be mitigated by hedging the position with an option (either LC or SP)	Naked calls have unlimited risk exposure Should the holder of the call choose to exercise when the market increases, the writer will be called upon to deliver stock that he does not own but must now purchase at an inflated stock price