Capital Transactions

Summary

This course will examine specialized situations involving capital gains and losses. A brief overview of definitions, holding periods and cost basis will be followed by an in-depth exploration of issues facing investors. Topics include the tax consequences of buying and selling investment companies, equity options, futures and making short sales. The complex tax treatment of Small Business Stock, Incentive Stock Options and the sale of depreciable property will be reduced to simple methodology while various tax minimization strategies will be presented.

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.

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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. 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 been in fact been derived by separating the taxpayer from his property, the definition of realization has, however, been litigated frequently.

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]

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[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).

[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.

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. 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%

<u>Special Rate</u> (Temporary)

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

An easy formula[6] to determine how many capital gains will be taxed at 0% is:

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

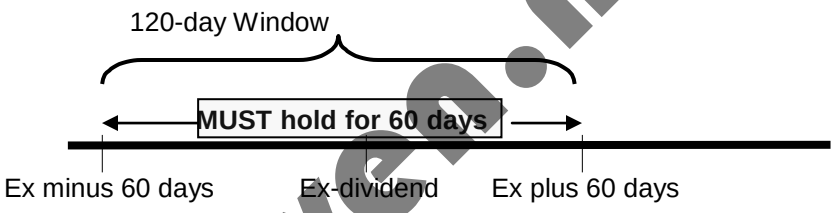
Top end of 15% marginal bracket – Taxable inc. less adjusted net capital gain

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 the on-half of his support.

C. Special Rates

1. Qualified Dividends[7]

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 is about to expire and will not be applicable (unless renewed) after December 31, 2012.

2. Collectibles

Collectibles include artwork, rugs, antiques, metals, gems, stamps, coins, and any other tangible personal property specified by the IRS. Although gain on sale of these items is taxed at a maximum of 25%, some newly minted gold and silver coins issued by the US government are eligible for 20% treatment.

[7] IRC § 1(h)(11).

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.

<u>New Forms for 2011 and Beyond…</u>

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**. 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".[8]

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.[9] 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**.

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

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

[9] IRS Notice 2012-34.

Reconciliation Act of 2005 allowed sellers of such works to treat the assets as capital when sold.[10]

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[11] 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.[12] 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

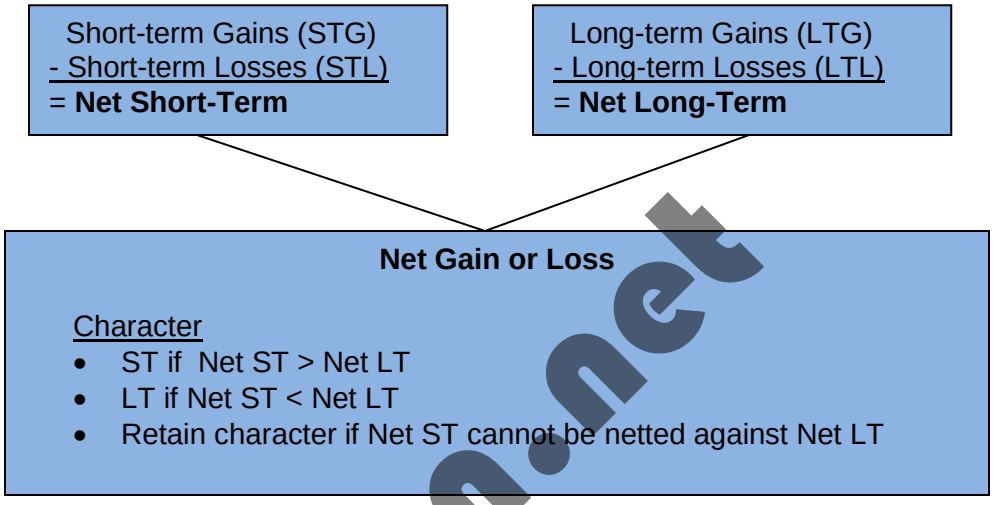
[10] The election became effective in 2007 and was scheduled to expire in 2010, but has now been made permanent with the enactment of the Tax Relief and Health Care Act of 2006.

[11] "[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."

[12] 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[13]

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)

[13] 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*[14] 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?

[14] 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.[15]

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 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

[15] *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).

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.[16] **NOTE:** Lacking substantiation by the taxpayer, the IRS will always assume a zero cost basis.

Routine Safe Harbor Maintenance Rule

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 of renovation or rehabilitation. A proposed IRS regulation[17] 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.

Uniform Capitalization Rules

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 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

[16] 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.

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

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.

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 it 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.[18]

> 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

[18] 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.

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[19]

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 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[20] 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.

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

[19] IRC § 165(g).

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

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[21] 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.

[21] IRC § 852.

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

3. Basis of Shares [See **Appendix B**.]

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.[22]

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

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

- The investor redeems his shares within 90 days of the purchase date AND
- The investor acquires new shares in this or a sister fund as a result of the reinvestment right granted to him

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[23]

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 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.

<u>Holding Period</u>

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

[23] IRC § 1233.

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[24]

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[25], 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:

- 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.

[24] IRC § 1259.

[25] 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 $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.

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. Wash Sale Rule[26]

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

[26] IRC §1091.

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 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 beware.

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!

VII. Derivative Securities

A. Regulated Stock Options

Stock options created by the Options Clearing Corporation (OCC) enable the investor to enter into a contract giving him the choice to either buy (a *call* option) or sell (a *put* option) a security at a specified price (*strike price)* within a specified period of time.

Much like an extended car warranty, the investor pays a price (*premium*) for this contract which allows him to choose a course of action at a later time. In the case of the car warranty, the holder of the contract may choose to have his car fixed (or not) during the warranty period. Conversely, the other party—in this case, the car dealer—is known as the *writer* of the contract and has undertaken an obligation to fix the car if the holder exercises his right.

In the case of stock options, the holder of a call hopes that the market will increase. If it does, he can exercise his option to buy the 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 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.

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 his position, hoping to profit from the difference between the premium received on sale and the premium paid when he bought the contract.

Regulated stock options have a maximum duration of 9 months and all expire on the third Saturday of the expiration month. Thus, all transactions relating to the disposition of options are categorized as short-term since none can exceed the one-year holding period required for favorable long-term tax treatment.[27]

[27] Long-term Equity Anticipation Securities (LEAPS), introduced in recent years, expire within two to five years and therefore can generate long-term capital gains.

Action Taken	Holder	Writer
Close Out • Premium IN > Premium OUT • Premium IN < Premium OUT	 STCG STCL	 STCG STCL
Expiration (Premium = 0)	STCL (= Premium paid)	STCG (= Premium rec'd)
Exercise • Call option	No gain or loss until disposition of *stock* Basis = Cost + Premium paid	STCG or STCL = Strike – Basis Basis = Cost of Stock – Premium rec'd
• Put Option	STCG or STCL = Strike – Basis Basis = Cost of Stock + Premium paid	No gain or loss until disposition of *stock* Basis = Cost of Stock – Premium rec'd

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. Where those transactions occur after the end of the taxpayer's taxable year, income recognition may be 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."[28]

B. §1256 Contracts

Futures, non-equity options and foreign currency contracts are known as §1256 contracts.[29] 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. However, there are some significant differences:

- 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.[30]
- 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!

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 FMV on the last day of the tax year. 60% of the computed gain is then

[28] *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 September 23, 2009].

[29] As per the Restoring American Financial Stability Act of 2010, the following instruments are not considered to be § 1256 contracts: Most swaps, such as interest rate and currency swaps.

[30] 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 will continue to trade electronically.

treated as long-term while the remaining 40% is treated as short-term on **Form 6781**.

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 thus not considered a §1256 contract.

C. 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 (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[31] as well currency *futures* traded on a regulated commodities exchange. Resulting gains and losses are treated as Ordinary, whereby income is taxed at the taxpayer's marginal tax brackets but losses are not limited by the $3,000 capital loss rule.[32]

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

Under certain conditions,[33] 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. Regardless of the taxpayer's actual holding period, 60% of the resulting gains are treated as LTCGs; the remaining 40% are taxed as

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

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

[33] 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).

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

D. Employee Stock Option Plans (ESOPs)

Although these options also give the holder (in this case, the company employee) the right to purchase shares of the company's stock, they are not regulated and not standardized contracts. Therefore, they are treated differently than those mentioned above.

Often the issuing corporation gives its employees the right to buy shares of the employing company in an attempt to motivate the employee or provide for compensation that does not directly affect the bottom line of the employer in the current year.

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. The 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.

1. Types of ESOPs

<u>Statutory</u>

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.

<u>Non-statutory</u>

These options do not meet the criteria of the IRC.

2. Tax Treatment

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[34]. 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.

Example: On February 15, 1999 XYZ granted an ISO option to buy 100 shares at $10/share. Employee exercised the option on October 1, 2001 when the FMV of the stock was $15/share. Employee then sold the stock immediately for $16/share.

The long-term holding period requirements were not met and so $500 (= $1,500 - $1,000) was included on Form W-2, Box 1 in 2001. 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.

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.

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

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.

[34] IRC § 422.

Example:[35] *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).

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.[36] *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!*

NOTE: Beginning in 2007 (through 2012), the Minimum Tax Credit becomes partly refundable, which will allow taxpayers with tax credits due to AMT tax paid more than 3 years ago, to obtain some relief.

<u>ESPPs</u>

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 <u>and</u> two years past the grant date, any gain will be considered long-term[37]. Losses occurring when the stock disposition price is less than option price are reported as LTCL and no compensation will be recognized.

Example: On February 15, 1999 XYZ granted an ESPP option to buy 100 shares at $10/share when the FMV was $12/share. Employee exercised the option on October 1, 2001 when the FMV of the stock was $15/share. The employee then sold the stock immediately for $16/share.

[35] *Marcus*, 129 TC 4.

[36] 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.

[37] IRC §423.

The long-term holding period requirements were met and so $200 (= $1,200 - $1,000) is reported as ordinary income and $400 (= $1,600 - $1,200) as LTCG.

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.

If the holding period had not been met, the employee would report ordinary income of $500 (= $ 1,500 - $1,000) and a LTCL of $800 (= $700 – $1,500).

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.

VIII. Restricted Stock[38]

Often given to an employee at no cost, company stock is nevertheless subject to forfeiture if the employee fails to meet requirements imposed upon him, such as a term of years. When this restricted stock[39] 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), unless the employee makes an election under §83(b) to recognize the income at the date of receipt.

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 is the excess of the stock's value when

[38] 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.

[39] 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).

the restriction lapses over the amount, if any, paid for the stock by the employee. Income tax is withheld and employment taxes are withheld and paid on this income.

Alternatively, an employee may elect to recognize income in the year he receives the restricted stock as per §83(b). The amount included in income is the excess of the stock's value upon receipt over the amount, if any, the employee paid for the stock. Income tax is withheld and employment taxes are withheld and paid on this income.

Tax Consequences of the §83(b) Election

- 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.

TIP: 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. Applying an economic interest test classification hinges on whether the owner of the land is paid regardless of whether the extracted mineral is sold—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:** 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, the land will also be sold or rented.

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

	Sale	Lease
Mineral Rights	ST or LTCG in the year sales proceeds are received Basis of the mineral right is usually zero	Royalty income reportable on Schedule E Landowner may be entitled to a percentage depletion deduction
Surface Land	If a right-of-way or easement granting perpetual access without possibility of reversion, the sale is reported on Schedule D	Rental income must be separately identified on Schedule E

X. Favored Tax Treatments under the IRC

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.[40] 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. 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%--the effective rate on the entire gain thereby becomes

[40] 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 qualified stock must be held five years.

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

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 - $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.

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 and the remaining $2,000 will be reported as LTCG.

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. Thus, $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

XI. Capital Gains Issues for 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[41]. If the following tests are satisfied, a taxpayer may exclude up to $250,000 of his realized gain[42] ($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):

<u>Ownership and Use</u>

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.[43]

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.[44]
- 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

[41] 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.

[42] IRC § 121.

[43] Letter Rul. 200029046.

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

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.[45]

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:

- 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[46]
- 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.

<u>Reduced Exclusion Rules</u>

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

[45] IRC § 1031.

[46] IRC § 121(d)(9)(C)

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.

<u>Business or Rental Use of the Residence</u>

- 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.
- 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.[47]
- 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 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.[48]

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

[47] 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.

[48] 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.

issued a safe harbor ruling for property that is used as the taxpayer's personal dwelling.[49] 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:

<u>Non-recourse Debt</u>

Where the borrower is not personally liable to repay the debt even if the value of the property is less than the outstanding debt, he will *realize the full amount of the canceled debt*.

<u>Recourse Debt</u>

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.

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**.

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

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; or where the debt is qualified farm or qualified real property business indebtedness (other than C corporations).[50]

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.[51] 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: [52]

- 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[53] 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**.

[50] IRC § 108.

[51] IRC § 108(e)(2).

[52] IRC § 108(c)(3).

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

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

3. Personal Residence Debt

For tax years 2007 – 2012, 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[54], 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.

Example # 2: Loan Restructure

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

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).

XII. 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[55] 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.

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[55] "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 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 that 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.

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.[56]

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

[56] 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.

- 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

XIII. 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). 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.[57]

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.[58] 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.

[57] IRC §56(b)(3).

[58] IRC §172.

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[59]).

Although Merlo lost, a provision of the Tax Relief and Health Care Act of 2006[60] now grants relief to similarly situated taxpayers by offering a refundable AMT credit [61] for 2007 and beyond.

XIV. Tax Strategies

A. Mark-to-Market Election[62]

Normally an investor is bound by the rules regarding Wash Sales[63] and Capital Loss Limitations[64] 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![65]

[59] *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.

[60] Enacted December 20, 2006.

[61] IRC §53(e)(1).

[62] IRC §475.

[63] I.R.C §1091.

[64] IRC §1211.

[65] 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.

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 2-½ 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.

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 Strategies

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 2011) 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 during 2008 – 2012.

APPENDIX A

Summary of Cost Basis and Holding Periods

Type of Distribution	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

APPENDIX B
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**.

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.