¶ 88 Average Itemized Deductions

For those taxpayers who itemize their deductions on Schedule A of Form 1040, the following chart should be of special interest. Based on preliminary statistics for 2014 returns, the chart shows the average deductions of taxpayers for tax year 2014 for interest (¶ 1043), taxes (¶ 1021), medical and dental expenses (¶ 1015), and charitable contributions (¶ 1058). While it may be interesting for those who itemize their deductions to compare them with these average figures, the chart should *not* be considered as indicating amounts that would be allowed by the IRS. In any case, taxpayers must be able to substantiate claimed itemized deductions.

Individual Income Tax Returns, Preliminary Data, 2014, Table 1 (Source: *Spring 2016 Statistics of Income (SOI) Bulletin*).

PRELIMINARY AVERAGE ITEMIZED DEDUCTIONS FOR TAX YEAR 2014 BY ADJUSTED GROSS INCOME RANGES

Adjusted Gross Income Ranges	*Medical Expenses*	*Taxes*	*Interest*	*Charitable Contributions*
Under $ 15,000	$8,787	$3,566	$7,129	$1,427
$ 15,000 to $ 30,000	8,477	3,376	6,619	2,339
$ 30,000 to $ 50,000	8,209	4,098	6,511	2,594
$ 50,000 to $ 100,000	9,614	6,679	7,553	3,147
$ 100,000 to $ 200,000	11,122	10,983	9,147	4,130
$ 200,000 to $ 250,000	18,092	17,763	11,642	5,786
$ 250,000 or more	38,992	50,679	16,982	21,596

Chapter 1
INDIVIDUALS

	Par.
Filing of Tax Returns	101
Computation of Tax Liability	123
Personal and Dependency Exemptions	133
Filing Status	152
Tax Treatment of Decedent's Final Return	178

Filing of Tax Returns

101. Who Must File an Individual Tax Return. All U.S. citizens and resident aliens (¶ 2409) are liable for federal income tax on their worldwide income, without regard to whether the income arose from sources within or outside of the United States (Code Sec. 1; Reg. § 1.1-1(b)).[1] For each tax year, a return (¶ 105) must be filed by a U.S. citizen or a resident alien who has at least a specified minimum amount of gross income.

Filing Thresholds. The filing threshold for most individuals is the sum of the applicable exemption amount (¶ 133) and the applicable standard deduction amount (¶ 126) for the tax year (Code Sec. 6012).[2] The additional standard deduction for taxpayers age 65 or older at the end of the tax year is also taken into account for determining the filing threshold amount; the additional standard deduction for taxpayers who are blind at the end of the tax year is *not* considered. A taxpayer's gross income for this purpose is computed without regard to the exclusion of gain from the sale of a personal residence (¶ 1705) and the exclusion of foreign earned income and housing expenses for U.S. citizens and residents living abroad (¶ 2402).

Generally, the gross income levels at which individuals must file income tax returns for 2016 are:

Single individual (including individuals treated as unmarried for tax purposes; see ¶ 173)	$10,350
Single individual, 65 or older	11,900
Married individual, separate return	4,050
Married couple, joint return	20,700
Married couple, joint return, one spouse 65 or older	21,950
Married couple, joint return, both spouses 65 or older	23,200
Head of household	13,350
Head of household, 65 or older	14,900
Qualifying widow(er) (surviving spouse)	16,650
Qualifying widow(er) (surviving spouse), 65 or older	17,900

Generally, the gross income levels at which individuals must file income tax returns for 2017 are:

Single individual (including individuals treated as unmarried for tax purposes; see ¶ 173)	$10,400
Single individual, 65 or older	11,950
Married individual, separate return	4,050
Married couple, joint return	20,800
Married couple, joint return, one spouse 65 or older	22,050
Married couple, joint return, both spouses 65 or older	23,300
Head of household	13,400
Head of household, 65 or older	14,950
Qualifying widow(er) (surviving spouse)	16,750
Qualifying widow(er) (surviving spouse), 65 or older	18,000

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[1] ¶ 3260, ¶ 3265; INDIV: 100; § 1,001

[2] ¶ 35,142; FILEIND: 15,152; § 1,305.05

http://www.pbookshop.com

The income levels for a married couple filing a joint return are not applicable if, at the close of their tax year, the couple does not share the same household or if some other taxpayer is entitled to claim a dependency exemption for either spouse, e.g., a married student who is supported by a parent. In this case, a return for 2016 must be filed if gross income equals $4,050 or more ($4,050 or more for 2017).

Dependents. A child or other individual who can be claimed as a dependent on another person's tax return must file a return if that individual's income exceeds certain threshold amounts for earned or unearned income (Code Sec. 6012(a)(1)(C)).[3] Earned income includes salaries, wages, tips, professional fees, and taxable scholarship and fellowship grants. Unearned income includes investment-type income such as taxable interest, ordinary dividends, capital gain distributions, unemployment compensation, Social Security benefits, pensions, annuities, cancellation of debt income, and distributions of unearned income from a trust. The parent of a child who is subject to the kiddie tax and who has income only from interest or dividends may elect to report the child's income on the parent's return (¶ 103). The child will then *not* have to file a return.

With respect to a dependent child or other individual who is *neither* age 65 or older, or blind, at the end of 2016 and for whom a dependency exemption is allowable to another taxpayer (¶ 137), a return must be filed for the 2016 tax year if the individual has:

- over $1,050 of unearned income ($1,050 for 2017);
- over $6,300 of earned income ($6,350 for 2017); or
- a total of unearned and earned income which exceeds the larger of $1,050 or earned income up to $5,950 ($6,000 for 2017) plus $350.

All married dependents under age 65 with gross income of at least $5 whose spouse files a separate return on Form 1040 and itemizes deductions on Schedule A must file a return.

With respect to a dependent child or other individual who is *either* age 65 or older, or blind, at the end of 2016, and for whom a dependency exemption is allowed to another taxpayer (¶ 137), a return must be filed if the dependent's:

- earned income exceeds the basic standard deduction amount for an unmarried individual plus the additional standard deduction amounts to which he or she is entitled;
- unearned income exceeds the sum of $1,050 plus the additional standard deduction amounts to which he or she is entitled; or
- gross income exceeds the greater of (1) the total of earned income plus $350 (but not to exceed the basic standard deduction amount for an unmarried individual) plus the additional standard deduction amounts to which he or she is entitled; or (2) $1,050 plus the additional standard deduction amounts to which he or she is entitled (¶ 126).

If a guardian or other person is charged with the care of a minor individual or the minor individual's property, or a person under a disability, the return for the individual should be filed by the responsible person, unless already filed by the individual or some other person (¶ 504).

Return Requirement. If the applicable gross income test for the filing threshold is met, then a return must still be filed even though the individual's exemptions and deductions are such that no tax would be due. If the gross income test is *not* met, then a return should be filed whenever a refund of tax or any refundable credit, i.e., the earned income credit, is available. A return is also required if:

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[3] ¶ 35,142; FILEIND: 15,152; § 1,305.05

- net earnings from self-employment in 2016 are at least $400 (¶ 2664);
- Social Security and/or Medicare (commonly referred to as FICA) taxes are due on tip income not reported to an employer (¶ 717) or on wages received from an employer who did not withhold the taxes;
- uncollected Social Security, Medicare, or Railroad Retirement Tax Act (RRTA) taxes are due on tips reported to an employer or on group-term life insurance;
- liability for alternative minimum tax is incurred (¶ 1401);
- additional tax on a qualified retirement plan or individual retirement account (IRA) is due as calculated on Form 5329 (¶ 2169);
- additional tax on a health savings account (HSA) (¶ 2035) or Archer medical savings account (MSA) (¶ 2037) is due as calculated on Form 5329;
- household employment taxes are due (¶ 2652);
- tax is due from the recapture of any of the following: the first-time homebuyer credit (¶ 1324); the investment credit (¶ 1365A); the low-income housing credit (¶ 1365K); the new markets credit (¶ 1365T); the qualified plug-in electric drive motor vehicle credit (¶ 1351); the Indian employment credit (¶ 1365Q); the alternative motor vehicle credit (¶ 1345); the employer-provided child care credit (¶ 1365V); the alternative fuel vehicle refueling property credit (¶ 1355); the education credits (¶ 1303); or on the disposition of a home purchased with a federally subsidized mortgage; or
- wages of $108.28 or more were earned from a church or qualified church-controlled organization that is exempt from employer FICA taxes (¶ 2601).

Any person who is required to file an income tax return must report on that return the amount of tax-exempt interest received or accrued during the tax year (¶ 724) (Code Sec. 6012(d)).

103. Returns of Children or Dependents. A child or dependent is generally taxed in the same manner as any other taxpayer on income, including wages, income from property, and trust income (¶ 554). Special rules, however, apply for calculating a child's tax liability if he or she is required to file a return (¶ 101). First, no personal exemption is allowed to an individual eligible to be claimed as a dependent on another taxpayer's return (¶ 135) (Code Sec. 151(d)(2)).[4] Second, the basic standard deduction for dependents in 2016 is limited to the greater of $1,050 or the sum of $350 plus earned income, but not in excess of $6,300, the standard deduction amount for unmarried individuals ($1,050, $350, and $6,350, respectively, for 2017) (¶ 126) (Code Sec. 63(c)(5); Rev. Proc. 2015-53; Rev. Proc. 2016-55).[5] Finally, if a child's income tax is not paid, an assessment made against the child will be treated as if it were made against the child's parent to the extent that the tax is attributable to amounts received for the child's services (Code Sec. 6201(c)).[6]

Kiddie Tax. Ordinarily, a child's tax liability is computed in the same manner as any other taxpayer after taking into account the limits on the personal exemption and standard deduction, if applicable (¶ 123). Certain children with investment income may be subject to tax on that income at the parent's top marginal rate if this results in a higher tax than would apply at the child's rate (Code Sec. 1(g)).[7] This is commonly referred to as the "kiddie tax," and it applies if:

- the child is required to file a tax return;
- the child does not file a joint return for the tax year;
- the child's investment income is more than $2,100 for 2016 (more than $2,100 for 2017);

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[4] ¶ 8000; FILEIND: 15,152.25; § 1,505
[5] ¶ 6020; FILEIND: 15,152.25; § 1,505
[6] ¶ 37,502; INDIV: 18,156.10; § 3,005.30
[7] ¶ 3260; INDIV: 18,154; § 1,510.05

http://www.pbookshop.com

- either parent of the child is alive at the end of the year; and
- the child is:

— under the age of 18 at the end of the tax year;

— under the age of 19 at the end of the tax year and does not provide more than half of his or her own support with earned income; or

— under the age of 24 at the end of the tax year, a full-time student, and does not provide more than half of his or her own support with earned income.

The kiddie tax applies to the child's net unearned income, which is the portion of the child's adjusted gross income (AGI) for the tax year that is not attributable to earned income. This amount is further reduced by the limitation on the dependent standard deduction amount ($1,050 for 2016; $1,050 for 2017) and by the greater of either $1,050 in 2016 ($1,050 for 2017) or the child's itemized deductions (¶ 1014) relating to the production of the unearned income (Code Sec. 1(g)(4)). Even though, under state law, compensation for a child's personal services may be treated as belonging to the parent, and even though the money is not retained by the child, it is considered gross income of the child for federal income tax purposes (Reg. § 1.73-1).[8]

The marginal tax rate of the parent with the greater amount of taxable income applies in the case of married individuals filing separately. If the child's parents are divorced or legally separated and the custodial parent has not remarried, the return of the custodial parent should be used. If the custodial parent has remarried, the stepparent is treated as the child's parent for purposes of determining the marginal tax rate. Form 8615 is used to figure the kiddie tax.

Parent's Election. The parents of a child may elect to include on their return the unearned income of a child to avoid the kiddie tax (Code Sec. 1(g)(7); Rev. Proc. 2015-53; Rev. Proc. 2016-55). The election can only be made if all of the following requirements are met:

- the child is required to file a tax return and would otherwise be subject to the kiddie tax;
- the child's only income for the tax year is from interest and dividends, including Alaska Permanent Fund dividends;
- the income was more than $1,050 but less than $10,500 for 2016 ($1,050 and $10,500 in 2017, respectively);
- no estimated tax payments were made for the year in the child's name and Social Security number, including any overpayment of tax from the previous tax year; and
- the child is not subject to backup withholding.

The election is made by filing Form 8814. Electing parents are then taxed on their child's income in excess of $2,100 for the 2016 tax year (in excess of $2,100 for 2017). They must also report an additional tax liability of either $105 ($105 for 2017) if the child's taxable income is more than $1,050 (more than $1,050 for 2017) or 10 percent of the child's income if it is less than $1,050 (less than $1,050 for 2017).

105. Forms in Use for 2016. Three principal forms are available for use by the majority of individuals for filing income tax returns. These forms include Form 1040, a shorter return form, Form 1040A, and for certain taxpayers with no dependents, Form 1040EZ. If the applicable filing conditions are met, any of the forms in the 1040 series may serve as a separate return or as a joint return. If a married person's filing status is married filing separately and the taxpayer uses Form 1040 and itemizes deductions, then his or her spouse can file Form 1040 and either itemize deductions or claim a standard deduction of zero. If the individual decides to claim a standard deduction of zero, he or

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[8] ¶ 6150; INDIV: 18,152; § 3,005.30

she may choose to file Form 1040A. These rules do not apply to a spouse who is eligible to file as unmarried or as head of household (¶ 173).

Form 1040EZ. For the 2016 tax year, the simplified income tax return, Form 1040EZ, may be used by a taxpayer who:

- is filing as single or married filing jointly (a taxpayer who was a nonresident alien at any time during the year may file Form 1040EZ *only* if his or her filing status is married filing jointly);
- does not claim any dependents (¶ 137);
- does not claim any adjustments to gross income (¶ 1005);
- does not claim any tax credits other than the earned income tax credit (¶ 1322);
- is under age 65 and not blind, including the spouse if filing a joint return, at the end of 2016;
- has taxable income of less than $100,000 (¶ 123);
- has income from *only* wages, salaries, tips, unemployment compensation, taxable scholarships and/or fellowship grants, Alaska Permanent Fund dividends, and taxable interest income not exceeding $1,500;
- has his or her earned tips included in boxes 5 and 7 of Form W-2;
- does not owe household employment taxes on wages paid to a household employee; and
- is not a debtor in a chapter 11 bankruptcy case filed after October 16, 2005.

If the taxpayer does *not* meet *all* the requirements, then he or she must use either Form 1040 or Form 1040A.

Form 1040A. For the 2016 tax year, Form 1040A may be used by an unmarried individual filing as single, a married couple filing jointly or separately, an individual filing as head of household (¶ 173), or a qualifying widow(er) with a dependent child (a surviving spouse) (¶ 175) if the taxpayer:

- has gross income only from: wages, salaries, tips; interest and ordinary dividends (including Alaska Permanent Fund dividends); capital gains distributions; taxable scholarship and fellowship grants; taxable distributions from IRAs, pensions and annuities; unemployment compensation; and taxable Social Security or railroad retirement benefits;
- has only adjustments to gross income for IRA contributions (¶ 2157), student loan interest paid (¶ 1011), tuition and fees paid (¶ 1011A), or teacher classroom expenses paid (¶ 1011B);
- does not itemize deductions (¶ 1014);
- has taxable income of less than $100,000;
- does not claim any tax credits other than the child tax credit (¶ 1305), the additional child tax credit, the educational credits (¶ 1303), the earned income credit (¶ 1322), the child and dependent care credit (¶ 1301), the elderly and disabled credit (¶ 1302), the retirement savings contributions credit (¶ 1304), or the premium assistance credit (¶ 1331); and
- does not have an alternative minimum tax (AMT) adjustment on stock acquired from the exercise of an incentive stock option (¶ 1435).

Form 1040A may also be used by taxpayers who received dependent care benefits (¶ 2065) or owe tax from the recapture of an education credit (¶ 1303) or the AMT (¶ 1401).

Form 1040. For the 2016 tax year, Form 1040 must be used by a taxpayer if he or she:

- has taxable income of $100,000 or more;
- itemizes deductions (¶ 1014);

http://www.pbookshop.com

- has income that cannot be reported on Form 1040EZ or 1040A, including tax-exempt interest from private activity bonds issued after August 7, 1986 (¶ 729), self-employment (net earnings of at least $400) (¶ 2667), rents and royalties (¶ 762 and ¶ 763), taxable state and local income tax refunds (¶ 799), alimony received (¶ 771), capital gains (¶ 1735), business income (¶ 759), or farm income (¶ 767);
- claims any credit against tax other than those credits which may be claimed on Form 1040A;
- claims any adjustments to income other than the adjustments listed for Form 1040A;
- receives in any month tips of $20 or more that are not reported fully to the employer, has a Form W-2 that shows allocated tips that must be reported in income, owes Social Security or Medicare tax on tips not reported to the employer, or has a Form W-2 that shows any uncollected Social Security, Medicare, or Railroad Retirement Tax Act (RRTA) taxes on tips or on group-term life insurance;
- owes or claims any of the items set out as *Other Taxes* in the discussion following, with the exception of the alternative minimum tax;
- is the grantor of, or transferor to, a foreign trust (¶ 588);
- can exclude foreign earned income received as a U.S. citizen (¶ 2402) or resident alien, certain income received from sources in Puerto Rico due to being a bona fide resident of Puerto Rico, or certain income received from sources in a U.S. possession while a resident of American Samoa (¶ 2414);
- receives or pays accrued interest on securities transferred between interest payment dates (¶ 728);
- earns wages of $108.28 or more from a church or church-controlled organization that is exempt from employer social security taxes;
- receives any nontaxable dividends or capital gain distributions;
- is reporting original issue discount in an amount more or less than that shown on Form 1099-OID;
- receives income as a partner (¶ 415 and ¶ 431), an S corporation shareholder (¶ 309), or a beneficiary of an estate or trust (¶ 554);
- has financial accounts in foreign countries (exceptions apply if the combined value of the accounts was $10,000 or less or if the accounts were with a U.S. military banking facility operated by a U.S. financial institution) (¶ 2570);
- is reporting household employment taxes (¶ 2652);
- receives a health savings account (HSA) funding distribution from his or her individual retirement account (IRA) (¶ 2035);
- is a debtor in a bankruptcy case filed after October 16, 2005; or
- must repay the first-time homebuyer credit (¶ 1324).

Calculating Taxable Income. The basic Form 1040 is a single-sheet, two-page form. To it are added any necessary supporting schedules or forms, depending upon the particular circumstances of the individual taxpayer. Adjustments to gross income on the bottom of page 1 of Form 1040 (commonly referred to as above-the-line deductions) are principally those deductions that may be taken whether or not the standard deduction is employed. They include the deductions for:

- teacher classroom expenses (¶ 1011B);
- employee business expenses of certain fee-basis state or local government officials (¶ 941), performing artists (¶ 941A), and reservist's business expenses (¶ 941E);
- health savings accounts (HSAs) and Archer medical savings accounts (MSAs) (¶ 2035 and ¶ 2037);
- moving expenses (¶ 1073);

- one-half of self-employment tax (¶ 2664);
- contributions to self-employed retirement plans (¶ 2107);
- health insurance premiums paid by self-employed individuals (¶ 908);
- the forfeited interest penalty for premature withdrawals from a time savings account (¶ 1111);
- alimony paid (¶ 771);
- contributions to individual retirement arrangements (IRAs) (¶ 2157);
- student loan interest (¶ 1011);
- qualified tuition and fees (¶ 1011A);
- the domestic production activities deduction (¶ 980A);
- jury duty pay given to an employer (¶ 941 and ¶ 1010);
- amortization of forestation or reforestation expenses (¶ 1287);
- repayment of supplemental unemployment benefits (¶ 1009);
- contributions to Code Sec. 501(c)(18) pension plans (¶ 602);
- contributions by certain chaplains to Code Sec. 403(b) plans (¶ 2191);
- expenses incurred with respect to the rental of personal property (¶ 1006A); and
- attorney's fees and court costs for certain federal claims (¶ 1093).

Once adjusted gross income (AGI) is determined, the appropriate personal exemption amount, and either itemized deductions or the standard deduction amount, are subtracted from AGI to calculate taxable income.

Credits. A number of credits whose excess over tax liability is not refundable in the current year are subtracted from the resulting tax in the following order:

- foreign tax credit (¶ 2475);
- credit for child and dependent care expenses (¶ 1301);
- education credits (¶ 1303);
- retirement savings contributions credit (¶ 1304);
- child tax credit (¶ 1305);
- residential energy credit (¶ 1341);
- credit for the elderly or for the permanently and totally disabled (¶ 1302);
- mortgage interest credit (¶ 1306);
- alternative fuel vehicle refueling property credit (personal use) (¶ 1355);
- general business credit (¶ 1365);
- credit for prior year alternative minimum tax (¶ 1309);
- the new clean renewable energy bond credit (¶ 1374); and
- the qualified plug-in electric drive motor vehicle credit (personal use) (¶ 1351).

Other Taxes. The following taxes are then added:

- alternative minimum tax (¶ 1401);
- self-employment tax (¶ 2664);
- Social Security, Medicare, and/or RRTA tax owing on tip income not reported to the employer, computed on Form 4137, and employee FICA, Medicare, and/or RRTA tax on tips where the employer did not withhold proper amounts, computed on Form 8919 (¶ 2606);
- excess contribution, excess distribution, and premature distribution taxes for IRAs and qualified pension or annuity plans, excess accumulations in qualified pension plans (including IRAs), Archer MSAs and HSAs, or early distribution tax

http://www.pbookshop.com

for a modified endowment contract entered into after June 20, 1988, computed on Form 5329 (¶ 2035, ¶ 2037, ¶ 2151, ¶ 2161, and ¶ 2197);

- household employment taxes (¶ 2652);
- recapture of any of the following: the first-time homebuyer credit (¶ 1324); the investment credit (¶ 1365A); the low-income housing credit (¶ 1365K); the new markets credit (¶ 1365T); the qualified plug-in electric drive motor vehicle credit (¶ 1351); the Indian employment credit (¶ 1365Q); the alternative motor vehicle credit (¶ 1345); the employer-provided child care credit (¶ 1365V); the alternative fuel vehicle refueling property credit (¶ 1355); education credits (¶ 1303); household employment taxes (¶ 2650); or on the disposition of a home purchased with a federally subsidized mortgage;
- the individual responsibility payment ("penalty") for failure to maintain minimal essential health care coverage (¶ 131);
- the "Section 72(m)(5) excess benefits tax" imposed on a five-percent owner of a business who receives a distribution of excess benefits from a qualified pension or annuity plan;
- uncollected Social Security, Medicare, and/or RRTA tax on tips with respect to employees who received wages that were insufficient to cover the Social Security, Medicare, and RRTA tax due on tips reported to their employers;
- uncollected Social Security, Medicare, and/or RRTA tax on group-term life insurance (¶ 2055);
- the additional 0.9-percent Medicare tax on high-income wage earners (¶ 2648);
- the 3.8-percent net investment income tax on high-income individuals (¶ 129);
- any excise tax due on "golden parachute" payments (¶ 907); and
- tax on accumulated distribution of trusts.

Payments. To arrive at final tax due or refund owed, the taxpayer subtracts from the above balance the following:

- federal income tax withheld (¶ 2601);
- 2016 estimated tax payments and amounts applied from 2015 return;
- earned income credit (¶ 1322);
- amounts paid with the application for automatic filing extension (¶ 2509);
- additional child tax credit (¶ 1305);
- refundable portion of the American Opportunity tax credit (AOTC) (¶ 1303);
- excess Social Security tax and/or Tier 1 railroad retirement (RRTA) tax withheld from individuals paid more than a total of $118,500 in wages in 2016 ($127,200 in 2017) by two or more employers (excess Tier 2 RRTA tax withheld from individuals paid more than a total of $88,200 ($94,500 in 2017) by two or more employers is claimed on Form 843, not Form 1040) (¶ 2648);
- health insurance costs credit (¶ 1332);
- credit for excise tax on gasoline and special fuels used in business and credit on certain diesel-powered vehicles (¶ 1329);
- a shareholder's share of capital gains tax paid by a regulated investment company (mutual fund) (¶ 2305); and
- the refundable portion of long-term unused prior year minimum tax credit (expired) (¶ 1327).

Schedules and Supporting Documents. The following schedules and forms are filed with the basic Form 1040 as needed:

- Schedule A for itemizing deductions;

- Schedule B for reporting (a) more than $1,500 of ordinary dividend income and/or other stock distributions, (b) more than $1,500 of taxable interest income or claiming the exclusion of interest from series EE U.S. savings bonds issued after 1989 used for higher educational expenses, and (c) any interests in foreign accounts and trusts;
- Schedule C or Schedule C-EZ for claiming profit or loss from a sole proprietorship;
- Schedule D for reporting a summary of capital gains and losses;
- Schedule E for reporting income or loss from (a) rents and royalties, (b) partnerships and S corporations, (c) estates and trusts, and (d) real estate mortgage investment conduits (REMICs);
- Schedule EIC for providing information regarding the earned income credit;
- Schedule F for computing income and expenses from farming;
- Schedule H for reporting employment taxes for domestic workers paid $2,000 or more during 2016;
- Schedule J for reporting farm income averaging;
- Schedule R for claiming the tax credit for the elderly or the disabled;
- Schedule SE for computing the tax due on income from self-employment;
- Form 2106 or 2106-EZ for computing employee business expenses;
- Form 3903 for calculating moving expenses;
- Form 4562 for reporting depreciation and amortization;
- Form 4684 for reporting personal casualty or theft losses;
- Form 4797 for reporting gains and losses from sales of business assets or from involuntary conversions other than casualty or theft losses (business casualty and theft losses are reported on Form 4684, Section B);
- Form 6251 for computing the alternative minimum tax;
- Form 8283 for claiming a deduction for a noncash charitable contribution where the total claimed value of the contributed property exceeds $500;
- Form 8582 for computing the amount of passive activity loss;
- Form 8606 for reporting nondeductible IRA contributions, for figuring the basis of an IRA, and for calculating nontaxable distributions;
- Form 8615 for computing the tax for certain children who have investment income in excess of $2,100 in 2016;
- Form 8814 for electing to report a child's unearned income on the parents' income tax return;
- Form 8829 for figuring allowable expenses for business use of a home;
- Form 8834 for figuring the personal credit amount for the purchase of a qualified plug-in electric or electric vehicle credit;
- Form 8853 for figuring the allowable deduction for contributions to an Archer Medical Savings Account (Archer MSA);
- Form 8888 for direct deposit of income tax refunds into more than one account including, but not limited to, individual retirement accounts;
- Form 8889 for figuring the allowable deduction for contributions to a Health Savings Account (HSA);
- Form 8919, for reporting uncollected Social Security and Medicare taxes on wages;
- Form 8949 for reporting sales and exchanges of capital assets;
- Form 8959, for reporting additional Medicare tax on high-income wage earners; and

http://www.pbookshop.com

- Form 8960, for reporting the net investment income tax by high-income individuals.

The following forms are for computing and claiming credits:

- Form 1116 to compute the foreign tax credit for individuals, estates or trusts;
- Form 2441 to figure the child and dependent care credit;
- Form 3800 if any of the components of the general business credit are claimed;
- Form 5405 for calculating the amount of the credit recapture for first-time homebuyer claims (¶ 1324);
- Form 5884 to calculate the work opportunity credit;
- Form 8396 to figure the mortgage interest credit and any carryforwards;
- Form 8801 to compute the credit for prior year alternative minimum tax including the refundable portion;
- Form 8812 to claim the additional child tax credit;
- Form 8828 to compute the recapture of a federal mortgage subsidy;
- Form 8834 to determine the amount of qualified electric vehicle passive activity credits from prior years;
- Form 8839 to claim the adoption credit;
- Form 8863 to claim the education credits;
- Form 8880 to claim the credit for qualified retirement savings contributions;
- Form 8882 to claim the credit for employer-provided child care facilities and services;
- Form 8885 to claim the health insurance costs credit;
- Form 8903 to claim the deduction for domestic production activity;
- Form 8910 to claim the alternative motor vehicle credit;
- Form 8911 to claim the alternative fuel vehicle refueling property credit; and
- Form 8912 to claim the credit for holders of tax credit bonds.

IRS Computation of Tax. Any taxpayer who files an individual tax return by the due date, April 18, 2017, can have the IRS compute the tax under certain conditions on Form 1040, Form 1040A, and Form 1040EZ. The IRS may also figure the credit for the elderly or the disabled and the earned income credit. See IRS Pub. 17 for the requirements to have the IRS compute a taxpayer's tax liability or these credits. These returns must have all applicable lines completed, be signed (by both spouses if filing jointly) and dated. If taxpayers want to designate a friend, family member or any other person to be allowed to discuss their 2016 tax return with the IRS, they must check the Yes box in the Third Party Designee area and provide the necessary information. Inclusion of a daytime telephone number of the taxpayer will speed the process should any questions arise. Form W-2 and any other required forms necessary to complete the return should be attached. If the taxpayer overpaid his or her taxes for the year, the IRS will refund that amount. If an amount is due, the taxpayer must pay the amount no later than 30 days from the billing date or due date of the return; failure to do so may result in penalties and interest.

Rounding Off Amounts. Dollar amounts on the return and accompanying schedules and forms may be rounded off to the nearest whole dollar.

107. Due Date for Individual Returns. Individual income tax returns are generally due on or before the 15th day of the 4th month following the close of the tax year (April

15 in the case of a calendar-year taxpayer) (¶ 2505) (Code Sec. 6072; Reg. § 1.6072-1).[9] U.S. citizens and resident aliens living outside the country have an additional two months to file their returns (June 15 in the case of a calendar-year taxpayer). Similarly, a nonresident alien who has wages *not* subject to withholding generally may also file a return as late as the 15th day of the 6th month after the close of the tax year. A nonresident alien who has wages subject to withholding, however, must file a return by the 15th day of the 4th month following the close of the tax year. If any due date falls on a Saturday, Sunday, or legal holiday, the return must be filed on the first following business day (¶ 2549) (Code Sec. 7503; Reg. § 301.7503-1).[10] An individual taxpayer can obtain—without seeking IRS approval—an automatic six-month extension of time to file his or her tax return (¶ 109).

An individual may correct an error in a return, without incurring interest or penalties, by filing an amended return (Form 1040X) and paying any additional tax due on or before the last day prescribed for filing the original return. For further information regarding amended returns, see ¶ 2505.

109. Extension for Filing. An individual may obtain an automatic six month extension for filing Forms 1040, 1040A or 1040EZ by filing Form 4868 before the due date of the return, accompanied by a reasonable estimate of tax due for the year (¶ 2509) (Reg. § 1.6081-4).[11] U.S. citizens or residents who live and have a main place of business or post of duty outside the U.S. and Puerto Rico, or who are in military or naval service on duty outside the U.S. and Puerto Rico, generally file their income tax return by the 15th of the sixth month after the close of the tax year (June 15 in the case of a calendar-year taxpayer). These individuals, upon filing of Form 4868, are given an automatic additional four-month extension for the filing of their return (Reg. § 1.6081-5).[12] An automatic extension of time for filing a return will not extend the time for payment of any tax due, and interest and penalties may apply. Finally, interest will be charged on any unpaid tax from the original due date of the return.

111. Where to File Returns. The IRS strongly encourages all taxpayers to file their returns electronically through the IRS's e-file system. For individuals who prefer to mail their income tax returns, the returns are filed with the Internal Revenue Service Center for the region in which the individual's residence or principal place of business is located (Code Sec. 6091; Reg. § 1.6091-2).[13] Taxpayers must be aware that income tax returns which include a tax payment are mailed to a different address than returns showing a refund or no tax liability. For example, U.S. citizens living abroad, nonresident aliens, and certain other taxpayers must file their income tax returns if no payment of tax is required at the IRS Service Center located in Austin, Texas. If a payment is required, the return should be filed at the IRS Service Center in Charlotte, North Carolina. For a list of addresses of filing locations, see ¶ 5.

116. Identifying Number. Every taxpayer must record his or her taxpayer identification number (TIN) on the income tax return (Code Sec. 6109(a); Reg. § 301.6109-1).[14] This is either the taxpayer's Social Security number (SSN), Individual Taxpayer Identification Number (ITIN) (for use by resident or nonresident aliens who do not qualify for a Social Security number), or Adoption Taxpayer Identification Number (ATIN) (a temporary taxpayer identification number for use by individuals in the process of adopting a child for whom they are unable to obtain a Social Security number until the adoption is final) (¶ 2579). If a taxpayer does not have a TIN, he or she should apply for either a Social Security number using Form SS-5, an ITIN using Form W-7, or an ATIN using Form W-7A. Taxpayers must provide TINs for dependents and qualifying children for the purpose of claiming a dependency exemption (¶ 133), the earned income tax credit (¶ 1322), the child care credit (¶ 1301), the adoption credit (¶ 1307), and the child tax

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[9] ¶ 36,720, ¶ 36,721; FILEIND: 18,052.20; § 1,325.05

[10] ¶ 42,630, ¶ 42,631; FILEBUS: 15,056; § 1,325.05

[11] ¶ 36,793; FILEBUS: 15,104; § 1,325.10

[12] ¶ 36,795; FILEBUS: 15,104.15; § 1,325.10

[13] ¶ 36,800, ¶ 36,808; FILEBUS: 12,150; § 1,325.20

[14] ¶ 36,960, ¶ 36,961; FILEBUS: 12,106; § 1,335

1 INDIVIDUALS

http://www.pbookshop.com

Chapter 11

LOSSES □ PASSIVE ACTIVITY LOSSES

	Par.
Deduction of Losses	1101
Casualty and Theft Losses	1121
Bad Debts	1135
Net Operating Losses (NOLs)	1145
At-Risk Limitations	1155
Passive Activity Limits on Losses and Credits	1165
Rental Activities Subject to Passive Activity Rules	1181
Tax-Exempt Use Property	1191
Hobby Losses	1195

Deduction of Losses

1101. Deductible Losses. A taxpayer may generally deduct losses which have not been compensated for by insurance or otherwise (Code Sec. 165(a); Reg. § 1.165-1).[1] In order to be deductible, a loss generally must be evidenced by a closed and completed transaction and fixed by identifiable events during the tax year, such as a sale, foreclosure, or condemnation. However, any loss arising from theft is treated as sustained during the tax year in which the taxpayer discovers the loss (¶ 1123). In addition, a special election exists for determining the year to deduct a loss attributable to a federally declared disaster (¶ 1133). Only a bona fide loss sustained by the taxpayer may be deducted, and the substance of a transaction, not its form, governs whether there is a deductible loss. Thus, a loss deduction may be disallowed for a transaction that lacks economic substance and is entered into solely for tax benefits.

No portion of a loss may be deducted if there is a reasonable prospect of recovery or reimbursement. Similarly, no deduction is generally allowed for a partial loss resulting from the decline in the value of property, except as reflected in inventory. An exception is provided for the deduction of an addition to a bad debt reserve and a charge-off of that part of a debt which is worthless (¶ 1137). A taxpayer may also claim a deduction for losses sustained from the abandonment of property (¶ 1109).

Losses realized by individuals may be deducted only if they are: (1) losses incurred in a trade or business; (2) losses incurred in a transaction entered into for profit; or (3) casualty and theft losses (Code Sec. 165(c); Reg. § 1.165-1(e)).[2] Individuals, as well as S corporations, partnerships, estates, and trusts, may deduct expenses attributable to activities not engaged in for profit only to the extent of the amount of gross income from the activity under the hobby loss rules (¶ 1195). Thus, an individual's personal losses that are not related to a business or profit-making activity may not be deducted unless they are the result of a casualty (¶ 1121) or theft (¶ 1123). In addition, there are a number of other special provisions that further limit an individual's ability to deduct losses, including the at-risk rules (¶ 1155), the passive activity loss rules (¶ 1165), and the related-party rules (¶ 1717). Losses from gambling or other wagering transactions are also allowed only to the extent of gains from those transactions (¶ 1113).

Amount of Loss. The amount deducted for a loss cannot exceed the taxpayer's adjusted basis in the property (Code Sec. 165(b); Reg. § 1.165-1(c)).[3] Thus, the basis of the property must be adjusted for expenses, receipts, or losses properly chargeable to capital account, and for depreciation, obsolescence, amortization, and depletion to determine the amount of loss allowable as a deduction (¶ 1604). In addition, adjustments must be made for any salvage value, as well as any insurance or other compensation received by the taxpayer.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[1] ¶ 9802, ¶ 9803; BUSEXP: 30,100; § 16,905.05

[2] ¶ 9802, ¶ 9803; BUSEXP: 30,150; § 16,901

[3] ¶ 9802, ¶ 9803; BUSEXP: 30,202; § 16,905.15

The amount or character of a loss may be limited by a number of other rules. For example, capital losses are permitted to be deducted by a taxpayer but only to the extent allowed under the capital loss limitation rules (¶ 1752) (Code Sec. 165(f); Reg. § 1.165-1(c)(3)).[4] A worthless nonbusiness bad debt is only deductible as a short-term capital loss (¶ 1143). Special rules also apply for losses on small business stock (¶ 1911), losses on worthless securities (¶ 1916), losses on wash sales of securities (¶ 1935), and losses on debt obligations required to be in registered form (¶ 1963).

1103. Loss on Sale of Residential Property. A loss realized from a sale or exchange of residential property acquired and held as a personal residence is not deductible by an individual. However, a loss on the sale or exchange of residential property realized at the time it is being rented or otherwise used for income-producing purposes is deductible (Reg. § 1.165-9).[5] If the property is used as the taxpayer's personal residence after having been acquired as income-producing property, then a loss realized on its sale or exchange at the time it is being used as a residence is not deductible. For the basis of residential or converted property, see ¶ 1626.

1105. Demolition Losses. A taxpayer may not deduct losses sustained in the demolition of buildings and their structural components, including certified historic structures. Any amount expended or loss sustained by an owner or lessee on account of the demolition of any structure must be capitalized as part of the basis of the land on which the structure was located (Code Sec. 280B).[6] The IRS has provided a safe harbor for certain structural modifications to a building that are not treated as a demolition and thus not properly chargeable to the capital account with respect to the land on which the building is located (Rev. Proc. 95-27).[7] While demolition costs are nondeductible, a loss deduction may nonetheless be claimed by a taxpayer when depreciable business property is retired from use in a trade or business or from use in production of income (¶ 1109).

1107. Loss on Foreclosure or Tax Sale. The foreclosure of a mortgage by a judicial sale and disposition of the encumbered real estate is a sale of an asset. If the owner of an equity interest receives less than his or her basis in real estate when it is sold upon foreclosure, his or her investment may represent a deductible loss only if the property was used in a trade or business or a transaction entered into for profit.[8] The character of the loss—capital loss or ordinary loss—depends on the nature of the property foreclosed upon and whether or not it was a capital asset (¶ 1741) or section 1231 property (¶ 1747). The loss occurs when the redemption period expires or in the year the property becomes worthless. If there is no equity of redemption, however, the loss is fixed by the foreclosure sale and not by the decree of foreclosure that ordered the sale.[9] These principles also apply to a sale for delinquent taxes.[10]

If real property is disposed of by reason of foreclosure or similar proceedings, the amount of depreciation subject to recapture (¶ 1779) is determined as if the taxpayer ceased to hold the property on the date the proceedings began (Code Sec. 1250(d)(7)).[11]

1109. Abandonment and Obsolescence Losses. A taxpayer is allowed a deduction for a loss sustained in the abandonment of property used in a trade or business or a transaction entered into for profit. Depreciable property is abandoned when the taxpayer withdraws the property from use, or voluntarily and permanently gives up possession with the intention of ending ownership but without passing it on to someone else (Reg. § 1.167(a)-8(a)).[12] The abandonment loss equals the taxpayer's adjusted basis in the abandoned property, less any salvage value, insurance, or other compensation that the

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[4] ¶ 9802, ¶ 9803; BUSEXP: 30,102.05; § 16,901

[5] ¶ 10,102; BUSEXP: 30,158; § 16,930

[6] ¶ 14,900; BUSEXP: 39,150; § 16,915

[7] ¶ 14,901.60; BUSEXP: 39,156; § 16,915

[8] ¶ 9805.155, ¶ 10,103.54; BUSEXP: 30,268; § 18,205.20

[9] ¶ 21,817.45, ¶ 21,817.451; BUSEXP: 30,268; § 18,205.20

[10] ¶ 9808.453; BUSEXP: 30,268; § 18,205.20

[11] ¶ 31,000; DEPR: 18,260.15; § 11,710

[12] ¶ 11,020; BUSEXP: 39,104; § 16,910.05, § 16,910.10

http://www.pbookshop.com

taxpayer receives for the loss. An abandonment of property is not treated as a sale or exchange. Thus, an abandonment loss is an ordinary loss—regardless of whether or not the abandoned asset is a capital asset—and is reported on Form 4797 (IRS Pub. 544).

If nondepreciable property is abandoned following a sudden termination of its usefulness, an obsolescence loss is allowed in an amount equal to its adjusted basis. The obsolescence loss is deductible in the tax year in which it is sustained, even though the overt act of abandonment or the loss of title to the property may not occur in that year (Reg. § 1.165-2).[13]

A taxpayer cannot deduct the costs of acquiring and developing creative property (i.e., screenplays, scripts, story outlines, and similar property for film development or production) as an abandonment loss unless the taxpayer establishes either: (1) an intent to abandon the property and an affirmative act of abandonment, or (2) identifiable events which show a closed and completed transaction establishing the property's worthlessness (Rev. Rul. 2004-58).[14] Mere nonuse of an asset does not constitute abandonment, and the treatment of abandonment losses for financial reporting purposes does not control their federal tax treatment. To minimize accounting disputes, the IRS has provided a safe harbor allowing taxpayers to amortize ratably over a 15-year period any creative property costs that have been properly written off by the taxpayer under the generally accepted accounting principles (GAAP) for financial reporting purposes (¶ 1229).

1111. Interest Forfeited on Premature Withdrawals. Interest that was previously earned on a time savings account or deposit with a savings institution and that is later forfeited because of premature withdrawals is deductible by an individual in computing adjusted gross income in the year when the interest is forfeited (Code Sec. 62(a)(9)).[15]

> **Example:** Tom Smith opened a four-year time savings account in January 2015. He was credited with $400 in interest earned for 2015 and reported this income on his 2015 return. He withdrew the funds in October 2016. This premature withdrawal triggered a penalty provision so that he received only $230 of interest for 2015, plus $195 in interest earned on the account for 2016. Thus, Tom has incurred a loss of $170 that should be claimed on his 2016 return. He should also report the $195 in interest earned for 2016 on his 2016 income tax return.

The necessary information is provided on Form 1099-INT. The deduction must be claimed on Form 1040. No deduction is available on Form 1040A or Form 1040EZ.

1113. Gambling Losses. An individual can deduct gambling losses only to the extent of the amount of gambling winnings included in his or her gross income (Code Sec. 165(d); Reg. § 1.165-10).[16] For most taxpayers, deductible gambling losses are reported as miscellaneous itemized deductions not subject to the two-percent-of-adjusted-gross-income floor (¶ 1079). Professional gamblers, however, can deduct losses as an adjustment to gross income. Spouses who file a joint return can combine their gambling winnings and losses.

Casualty and Theft Losses

1121. Casualty Losses. An individual may deduct a loss from nonbusiness property only if it arises from fire, storm, shipwreck, or other casualty, or from theft (Code Sec. 165(c)(3)).[17] Each loss is subject to a $100 floor (¶ 1129), and net losses for the tax year are deductible only to the extent they exceed 10 percent of the taxpayer's adjusted gross income (AGI) (¶ 1131). However, an individual cannot claim a casualty loss deduction for damage to insured property unless a timely insurance claim is filed (Code Sec. 165(h)(4)(E)).[18] For a discussion of how to determine the amount of the deduction for a casualty loss, see ¶ 1127. Casualty and theft losses are reported on Form 4684. Theft losses are discussed at ¶ 1123.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[13] ¶ 9901; BUSEXP: 39,102; § 16,910.15
[14] ¶ 9902.27; BUSEXP: 30,104.15; § 16,910.05
[15] ¶ 6002; FILEIND: 9,068; § 5,020
[16] ¶ 9802, ¶ 10,104; BUSEXP: 30,256; § 7,110.20, § 16,940.05
[17] ¶ 9802; INDIV: 54,050; § 7,701
[18] ¶ 9802; INDIV: 54,168; § 7,701

A casualty loss is generally deductible only for the tax year in which the loss is sustained (¶ 1101) (Reg. § 1.165-7(a)(1)).[19] If the extent of the damage cannot reasonably be ascertained in the year of occurrence, the deduction can be taken in a later year when the extent of the damage is known. In addition, a special election exists for determining the year to deduct a loss attributable to a federally declared disaster (¶ 1133).

Casualty Defined. A casualty is the damage, destruction, or loss of property resulting from an identifiable event due to some sudden, unexpected, or unusual cause (IRS Pub. 547).[20] Examples of casualties include earthquakes, fires (not willfully set), floods, storms, hurricanes, tornados, volcanic eruptions, government-ordered demolition or relocation, mine cave-ins, shipwrecks, sonic booms, terrorist attacks, or vandalism. A casualty also includes damage that is a result of any ordinary automobile accident whether the taxpayer, or someone else driving his or her car, is at fault in a collision, or whether the other driver is at fault (Reg. § 1.165-7(a)(3)).[21] However, if a car accident was caused by the willful act or willful negligence of the taxpayer, or his or her agent, the casualty loss deduction is not allowed.

The damage or loss of property due to progressive deterioration is not considered a casualty and is not deductible (IRS Pub. 547).[22] Examples include the weakening of property due to normal weather conditions, losses caused by drought to property not used in a trade or business or for the production of income unless the drought can be characterized as sudden or unusual, the deterioration and damage to a water heater, and damage to trees or other plants by normal infestations of fungi, disease, worms, or similar pests. The IRS takes the position that a casualty loss deduction for termite damage is not permitted because the "suddenness" test is not met, but some courts have allowed the deduction.[23]

A casualty loss is deductible only to the extent it is not compensated for by insurance or otherwise (¶ 1101). If there is no limitation on the manner in which money or property received as compensation for damaged property must be used, the amount received is a gift and does not reduce the amount of the taxpayer's casualty loss.[24] If, as the result of insurance or other reimbursement, a taxpayer realizes a gain from a casualty or theft loss, the taxpayer can defer recognition of the gain under the involuntary conversion rules by making an election and purchasing qualifying replacement property within the applicable replacement period (¶ 1715).

A casualty loss incurred with respect to either business or nonbusiness property can result in a net operating loss (NOL) (¶ 1147). The $100 floor and the 10-percent-of-AGI limitation are applied in the nonbusiness situation in determining an NOL.

1123. Theft Losses. A loss from the theft of property that is not compensated for by insurance or otherwise is generally deductible for the tax year in which the taxpayer discovers the loss (Code Sec. 165(e); Reg. § 1.165-8(a)).[25] No deduction may be claimed in the year of discovery, however, if a reimbursement claim exists with respect to which there is a reasonable prospect of recovery (Reg. § 1.165-1(d)(3)).[26] As with casualty losses (¶ 1121), an individual cannot claim a deduction for theft of insured property unless a timely insurance claim is filed (Code Sec. 165(h)(4)(E)).[27] In addition, each theft loss is subject to a $100 floor (¶ 1129), and net losses from combined personal casualty and theft losses for the tax year are deductible only to the extent they exceed 10 percent of the taxpayer's adjusted gross income (AGI) (¶ 1131).

A theft includes the taking of money or property by robbery, larceny, burglary, blackmail, embezzlement, extortion, or kidnapping for ransom. Theft does not include property that was lost or misplaced. It also does not include the decline in value of stock acquired in the open market caused by the disclosure of accounting fraud by officers or

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[19] ¶ 10,004; INDIV: 54,250; § 7,705.30
[20] ¶ 10,005.123—¶ 10,005.92; INDIV: 54,052, INDIV: 54,084; § 7,705.05
[21] ¶ 10,004; INDIV: 54,068; § 7,705.05
[22] ¶ 10,005.123—¶ 10,005.92; INDIV: 54,058; § 7,705.05
[23] ¶ 10,005.671; INDIV: 54,062; § 7,705.05
[24] ¶ 10,005.117; INDIV: 54,168; § 7,705.25
[25] ¶ 9802, ¶ 10,100; INDIV: 54,100; § 7,710.05, § 7,710.15
[26] ¶ 9803; BUSEXP: 30,110; § 7,710.25
[27] ¶ 9802; INDIV: 54,168; § 7,701

http://www.pbookshop.com

directors of the corporation (IRS Pub. 547).[28] The deduction for theft losses is determined in the same way as for other casualty losses (¶ 1127). Casualty and theft losses are reported on Form 4684.

Losses from Ponzi-Type Schemes. Investors who incur losses from criminally fraudulent investment arrangements such as "Ponzi" schemes are entitled to claim a theft loss, rather than a capital loss (Rev. Rul. 2009-9).[29] The loss is deductible as a loss on a transaction entered into for profit, and it is not subject to the $100 floor or the 10-percent-of-AGI limitation for personal theft losses, or the limitations on itemized deductions (¶ 1014). The theft loss is deductible in the year it is discovered, and the amount of the deduction includes the amount invested in the scheme, less any amounts withdrawn, reimbursements, and claims as to which there is a reasonable prospect of recovery. If the theft loss deduction creates or increases a net operating loss (NOL) in the year the loss is deducted, the taxpayer may carry back up to three years and forward up to 20 years the portion of the NOL attributable to the theft loss (¶ 1149).

The IRS has also provided an optional safe harbor under which a qualified investor may deduct as a theft loss up to 95 percent of a qualified investment if the investor does not pursue any potential third-party recovery, or 75 percent of a qualified investment if the investor is pursuing or intends to pursue any potential third-party recovery. The deduction is reduced by the amount of any actual recovery and any recovery from insurance or the Securities Investor Protection Corporation (Rev. Proc. 2011-58).

1125. Loss on Bank Deposits. An individual may elect to treat the loss on a nonbusiness account in an insolvent or bankrupt financial institution as a personal casualty loss in the year in which the loss can reasonably be estimated (Code Sec. 165(l)).[30] If elected, the casualty loss deduction is subject to a $100 floor (¶ 1129) and the 10-percent-of-adjusted-gross-income (AGI) limitation (¶ 1131). The election is made on Form 4684.

Alternatively, an individual can elect to treat the loss as an ordinary loss arising from a transaction entered into for profit in the year the loss can be reasonably estimated, provided that no portion of the deposit is federally insured. The maximum amount that a taxpayer may claim as ordinary loss in any tax year is limited to $20,000 ($10,000 in the case of a married individual filing separately) for each financial institution, reduced by the amount of insurance proceeds that the taxpayer can reasonably expect to receive under state law (Code Sec. 165(l)(5)). The loss is deducted on Schedule A of Form 1040 as a miscellaneous itemized deduction subject to the two-percent-of-AGI limit (¶ 1079). The name of the financial institution and "Insolvent Financial Institution" should be written on the appropriate line of Schedule A. The calculation of the deducted loss should be included with the return (IRS Pub. 529).

Once made, either election applies to all losses on deposits in the financial institution during the tax year and it is revocable only with IRS consent. A taxpayer making either election is prohibited from deducting the loss as a bad debt deduction (Code Sec. 165(l)(6) and (7)). Neither election can be made by an individual who is an owner of one percent or more of the value of the institution's stock, an officer of the institution, or a relative of an owner or officer (Code Sec. 165(l)(2)). If neither election is made, then the loss is treated as a nonbusiness bad debt in the year of final determination of the actual loss and is reported as a short-term capital loss on Form 8949 (¶ 1143 and ¶ 1752).

1127. Amount of Casualty or Theft Loss. The amount of a casualty loss (¶ 1121) which is deductible for business and income-producing property or nonbusiness property is the *lesser* of:

(1) the fair market value (FMV) of the property immediately before the casualty reduced by its FMV immediately after the casualty, or

(2) the adjusted basis of the property immediately before the casualty (Reg. § 1.165-7(b)).[31]

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[28] ¶ 10,101.237, ¶ 10,101.318; INDIV: 54,102; § 7,710.05, § 7,710.10

[29] ¶ 10,101.123; INDIV: 54,106.10; § 7,710.30

[30] ¶ 9802; INDIV: 54,082; § 7,105.55, § 7,705.10

[31] ¶ 10,004; BUSEXP: 30,212, INDIV: 54,152; § 7,705.10, § 7,705.15

If business or income-producing property is totally destroyed and the property's FMV immediately before the casualty is less than its adjusted basis, then the casualty loss is the adjusted basis of the property.

The amount of a theft loss (¶ 1123) which is deductible is the fair market value or the adjusted basis of the property stolen (Reg. § 1.165-8(c)).[32] When money is stolen, the theft loss is the amount stolen. The amount of a theft loss in the case of nonbusiness property other than money is the lesser of the value of the property or its adjusted basis. In the case of stolen business or income-producing property, the theft loss is the adjusted basis of the property stolen.

A personal casualty or theft loss is subject to a $100 floor (¶ 1129) and a 10-percent-of-adjusted-gross-income (AGI) limit (¶ 1131) in determining the allowable deduction. The $100 floor and AGI limit do not apply to a business or income-producing property casualty or theft loss.

A casualty or theft loss is reduced by any insurance or other compensation received by the taxpayer, and in the case of a casualty loss, it is also reduced by any salvage value (¶ 1101). An individual cannot claim a personal casualty or theft loss to the extent the loss is covered by insurance, unless a timely insurance claim is filed with respect to the loss (¶ 1121 and ¶ 1123).

When there is damage to different kinds of business property, losses must be computed separately for each single, identifiable property damaged or destroyed. This rule does not apply to nonbusiness property. For example, if a tree is blown down in the front yard of a taxpayer's residence, the loss is the difference in the FMV of the taxpayer's whole property before and after damage to the tree (Reg. § 1.165-7(b)).[33]

The taxpayer's basis for property damaged or destroyed by casualty or theft is reduced by the amount allowable as a casualty or theft loss deduction, as well as by the amount of any insurance or other recovery for the loss (Rev. Rul. 71-161).[34]

1129. $100 Floor for Personal Casualty or Theft Losses. The deduction for a personal casualty (¶ 1121) or theft loss (¶ 1123) is limited to the amount that the loss from each casualty or theft exceeds $100 (Code Sec. 165(h)(1); Reg. § 1.165-7(b)(4)).[35] The $100 floor applies separately to the loss from each single casualty or theft, regardless of how many pieces of property are involved in the event. Thus, if several items of nonbusiness property are damaged or stolen in the course of a single casualty or theft, the $100 floor is applied only once against the sum of the allowable losses. In the case of married taxpayers filing a joint return, *only one* $100 floor applies to each casualty or theft loss; it does not matter if the property is owned jointly or separately. If married taxpayers file separate returns, each spouse is subject to the $100 limitation for each casualty or theft loss. When property is used for both business and personal purposes, the $100 floor applies only to the net loss attributable to that portion of the property used for personal purposes. After the first $100 is subtracted from each personal casualty and theft loss, all personal casualty and theft losses for the tax year are netted against any personal casualty and theft gains. If personal casualty losses and theft losses exceed personal casualty and theft gains, a loss deduction is allowed to the extent that the excess is greater than 10 percent of adjusted-gross-income (AGI) (¶ 1131).

1131. 10 Percent of AGI Floor for Personal Casualty or Theft Losses. If a taxpayer's personal casualty (¶ 1121) or theft losses (¶ 1123) exceed his or her personal casualty or theft gains for the tax year, the excess generally is deductible only to the extent that it exceeds 10 percent of the taxpayer's adjusted gross income (AGI) for the year (Code Sec. 165(h)(2)).[36] For this purpose, gains and losses from personal casualties and thefts calculated on Form 4684 are netted without regard to holding periods for the initial determination of whether there was a gain or loss. The $100 floor (¶ 1129) is applied to each personal casualty or theft before this netting occurs. If the recognized

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[32] ¶ 10,100; BUSEXP: 30,212, INDIV: 54,152; § 7,705.10, § 7,710.20

[33] ¶ 10,004; BUSEXP: 30,212, INDIV: 54,152; § 7,705.10, § 7,705.15

[34] ¶ 10,005.16; SALES: 6,360.05; § 16,110.25

[35] ¶ 9802, ¶ 10,004; INDIV: 54,202, INDIV: 54,354; § 7,705.15

[36] ¶ 9802; INDIV: 54,204, INDIV: 54,206; § 7,705.15

http://www.pbookshop.com

gains exceed the recognized losses, the net gain is reported as a capital gain on Schedule D of Form 1040. If the recognized losses exceed the recognized gains after netting, the net loss is deductible as an itemized deduction on Schedule A of Form 1040 but only to the extent it exceeds 10 percent of the taxpayer's AGI.

Example 1: A taxpayer who has AGI of $50,000 (without regard to casualty gains or losses), a $25,000 casualty gain, and a $15,000 casualty loss (after the $100 floor) will report a $10,000 capital gain on Schedule D.

Example 2: A taxpayer who has AGI of $40,000, a $25,000 casualty loss (after the $100 floor), and a $15,000 casualty gain is allowed a $6,000 itemized deduction. The $10,000 loss resulting from netting the casualty gains against the casualty losses is deductible only to the extent that it exceeds 10 percent of AGI ($10,000 - $4,000 = $6,000).

Limitation for Estates and Trusts. The 10-percent-of-AGI limitation on personal casualty and theft losses applies to estates and trusts. AGI is computed in the same manner as it is for individuals, except that estates and trusts are allowed to deduct their administration expenses in arriving at AGI (Code Sec. 165(h)(4)(C)).[37] No deduction for a personal casualty or theft loss may be taken if, at the time of filing a decedent's return, the loss has been claimed for estate tax purposes (¶ 531).

1133. Disaster Area Loss. A taxpayer that sustains a loss occurring in a disaster area and attributable to a federally declared disaster can either (1) deduct the loss on the tax return for the year in which the loss occurred, or (2) elect to deduct the loss on the return for the preceding tax year (Code Sec. 165(i); Temporary Reg. § 1.165-11T).[38] The disaster area loss deduction is calculated using the same rules as those for any other personal casualty losses (¶ 1127). If, however, the taxpayer elects to claim a disaster area loss on the return for the year immediately preceding the loss year, the 10-percent-of-adjusted-gross-income (AGI) limit (¶ 1131) is determined with respect to the preceding year's AGI. In addition, the IRS is authorized to issue guidance allowing the use of an appraisal used to secure a federal loan or loan guarantee as a result of federally declared disaster to establish the disaster loss amount.

The election to deduct a disaster area loss in the tax year prior to the loss year is made by filing a return, an amended return, or a refund claim that clearly shows that the election is being made. The election applies to the entire loss sustained by the taxpayer in the disaster area during the disaster period. Effective for elections on or after October 13, 2016, the election generally must be made by the date that is six months after the due date of the tax return for the year of the loss without regard to extensions. For example, the election to deduct a 2016 disaster area loss in 2015 must be made on or before October 18, 2017, for a calendar-year individual. A taxpayer may revoke the election within 90 days after the required due date. Prior to October 13, 2016, the required due date was the original due date of the return, without regard to extensions. The IRS has provided procedures for taxpayers who wished to make the election pursuant to the new due date who failed to make a timely election under the old due date (Rev. Proc. 2016-53).[39]

Although a taxpayer may not deduct a loss incurred on the sale of his or her personal residence, the loss is treated as a disaster area loss if the personal residence is rendered unsafe by a disaster in an area determined by the President of the United States to warrant federal government assistance. In addition, the individual must have been ordered by the state or local government within 120 days after the area is declared a disaster area to demolish or relocate the residence (Code Sec. 165(k)).[40] The amount of the deduction is reduced by any partial payments received from the state in the form of disaster aid.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[37] ¶ 9802; ESTTRST: 12,060.10; § 32,401

[38] ¶ 9802, ¶ 10,200M; INDIV: 54,302; § 7,715.10

[39] ¶ 10,201.13; INDIV: 54,304; § 7,715.10

[40] ¶ 9802, INDIV: 54,306; § 7,715.20

Bad Debts

1135. Business Bad Debts. Business bad debts can generally be deducted from gross income as an ordinary loss when and to the extent that they become totally worthless (Code Sec. 166).[41] If a business bad debt is only partially worthless and is recoverable in part, then the worthless portion is deductible to the extent it is charged off during the tax year (¶ 1137). A business debt is a debt: (1) created or acquired in connection with the trade or business of the taxpayer who is claiming the deduction, or (2) the worthlessness of which has been incurred in the taxpayer's trade or business (Reg. § 1.166-5(b)).[42] If the taxpayer's primary motive for incurring the debt is not business related, then it is a nonbusiness debt and deductible only as a short-term capital loss when the debt becomes totally worthless (¶ 1143).

Only a bona fide debt qualifies for purposes of deducting a bad debt (Reg. § 1.166-1(c)).[43] A debt is considered bona fide if it arises from a true debtor-creditor relationship based on a valid and enforceable obligation to pay a fixed or determinable amount of money. For example, a business bad debt deduction is not available to shareholders who have advanced money to a corporation as a contribution to capital.[44] In addition, the bad debt deduction rules do not apply to a debt that is evidenced by a security (Code Sec. 166(e)).[45] If a security held by a taxpayer other than a bank becomes worthless during the tax year, it is treated as sold or exchanged at a loss on the last day of the tax year (¶ 1916). A bank may treat a loss from a worthless security as a bad debt loss (¶ 2383).

Whether a debt is wholly or partially worthless is a question of fact, requiring consideration of all pertinent evidence, including the debtor's financial condition and the value of any security for the debt (Reg. § 1.166-2).[46] A debt becomes worthless when there is no longer any chance the amount owed will be paid. This can be evidenced (1) by the fact that legal action to enforce payment would result in an uncollectible judgment, or (2) upon a settlement in bankruptcy, although worthlessness may sometimes be determined after bankruptcy and before settlement. It is not necessary for the taxpayer to go to court to demonstrate worthlessness; the taxpayer only has to show that reasonable steps were taken to collect the debt, but he or she was unable to do so (IRS Pub. 535).

Guarantors. A taxpayer is eligible for a business bad debt deduction if in the course of a trade or business, the taxpayer pays an obligation as a guarantor, endorser, or indemnitor (Reg. § 1.166-9).[47] A noncorporate taxpayer is eligible for a nonbusiness bad debt deduction if the taxpayer pays an obligation as a guarantor, endorser, or indemnitor as part of a transaction entered into for profit. In the case of a business bad debt, no deduction is available if the agreement to act as guarantor, endorser, or indemnitor was not made in the course of the taxpayer's trade or business or a transaction for profit, if there is no legal obligation on the taxpayer to make the guaranty payment, or if the agreement was entered into after the debt became worthless.

Employee Loans. An employee's rendering of services for pay is a trade or business for purposes of the bad debt provisions. Therefore, a loan to an employer to protect a job can give rise to a business bad debt deduction if the employer defaults. If a loan by a shareholder-employee is intended to protect the shareholder's job rather than to protect the shareholder's investment in the company, then the failure to repay the loan results in a business bad debt deduction. The larger the shareholder's investment, the smaller his or her salary, and the larger his or her other sources of income, the more likely that a dominant nonbusiness motive exists for making the loan.[48]

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[41] ¶ 10,602; BUSEXP: 48,152; § 17,120.05

[42] ¶ 10,691; BUSEXP: 48,156; § 17,120.05

[43] ¶ 10,603; BUSEXP: 48,050; § 17,105

[44] ¶ 10,650.7301; BUSEXP: 48,108; § 17,120.10

[45] ¶ 10,602; BUSEXP: 48,154; § 16,555

[46] ¶ 10,604; BUSEXP: 48,250; § 17,110.05

[47] ¶ 10,753; BUSEXP: 48,400, BUSEXP: 48,402; § 17,125

[48] ¶ 10,700.241; BUSEXP: 48,160.35, BUSEXP: 48,160.40; § 17,120.10

1137. Accounting for Bad Debt Deduction. Bad debts are generally deductible in the tax year in which they become worthless (Code Sec. 166(a); Reg. § 1.166-3).[49] For a nonbusiness debt (¶ 1143), the deduction is available when the debt becomes wholly worthless. A deduction is allowed for a business debt (¶ 1135) that becomes wholly or partially worthless, but only to the extent the debt is charged off of the taxpayer's books during the tax year. The bad debt deduction is not available for nonbusiness debts that are only partially worthless. A worthless debt arising from unpaid wages, rent, interest, or a similar item is not deductible unless the income that these items represent has been reported for income tax purposes by the taxpayer (Reg. § § 1.166-1(e) and 1.166-6(a)(2)).[50]

Generally, a taxpayer must use the specific charge-off method to claim a deduction for a business bad debt. If a business debt becomes totally worthless during the year, the taxpayer can deduct the entire amount in that year. If a business debt becomes partially worthless during the year, the taxpayer can deduct that amount of the debt charged off his or her books for the year (Reg. § 1.166-3). An exception to the charge-off rule exists for debt which has been significantly modified. Some accrual taxpayers may use the nonaccrual experience method of accounting for bad debts with respect to income to be received from the performance of services (¶ 1538). Small banks and thrift institutions can use the experience method of accounting to deduct bad debts (¶ 2383).

1139. Secured Bad Debt. When secured or mortgaged property is sold either to the secured party or to a third party for less than the amount of the debt, the creditor is entitled to a bad debt deduction (¶ 1135 and ¶ 1143) in an amount equal to the difference between the sale price and the amount of the debt, to the extent that the creditor can show that such difference is wholly or partially uncollectible (Reg. § 1.166-6).[51] No bad debt deduction is allowed if a mortgage is foreclosed and the creditor buys the mortgaged property at a price equal to the unpaid debt. However, gain or loss is realized on the transaction. It is measured by the difference between the amount of the obligations of the debtor that are applied to the purchase or bid price of the property and the fair market value of the property, to the extent that the obligations are capital or represent items the income from which has been returned by the creditor. See ¶ 1838 and ¶ 1841 for a discussion on repossession of property sold on the installment plan.

1141. Debts Owed by Political Parties. No deduction is generally allowable for a worthless debt owed by a political party. However, banks and accrual-basis taxpayers (¶ 1515) who are in the business of providing goods and services (e.g., polling, media, or organizational services) to political campaigns and candidates may deduct such bad debts (Code Sec. 271).[52]

1143. Nonbusiness Bad Debts. If a nonbusiness bad debt held by a taxpayer other than a corporation becomes *totally* worthless during the tax year, then the loss may be deducted as a short-term capital loss regardless of how long the taxpayer held the debt (Code Sec. 166(d); Reg. § 1.166-5).[53] Unlike business bad debts (¶ 1135), however, no deduction is permitted unless and until the debt becomes totally worthless. A nonbusiness bad debt is any debt *other than* one created or acquired in connection with the taxpayer's trade or business, or one that, when worthless, creates a loss that is incurred in the taxpayer's trade or business. For limitations on deduction of a capital loss, see ¶ 1752. For worthlessness of a debt evidenced by a bond or other security of a corporation or a government, see ¶ 1916.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

49 ¶ 10,602, ¶ 10,605; BUSEXP: 48,250; § 17,101, § 17,112
50 ¶ 10,603, ¶ 10,701; BUSEXP: 48,062, BUSEXP: 48,204; § 17,115
51 ¶ 10,701; BUSEXP: 48,274, SALES: 6,064.10; § 17,110.10, § 17,115
52 ¶ 14,306; BUSEXP: 48,068
53 ¶ 10,602, ¶ 10,691; BUSEXP: 48,152, BUSEXP: 48,250; § 17,120.05

Net Operating Losses (NOLs)

1145. Net Operating Loss (NOL). A net operating loss (NOL) from a trade or business may be claimed as a deduction in the current tax year equal to the aggregate amount of NOLs carried back or carried forward from other tax years (¶ 1149) (Code Sec. 172(a); Reg. § 1.172-1).[54] The NOL deduction may not exceed the amount of taxable income for the year of the deduction. An NOL arises in any tax year when the taxpayer's deductible expenses for the year exceed its gross income, subject to certain adjustments (¶ 1147). The NOL deduction is available to most taxpayers, including corporations, individuals, estates and trusts, and participants in common trust funds. An NOL deduction may not be claimed by a partnership or S corporation, but partners and S corporation shareholders use their distributive shares of partnership or S corporation income to calculate their own NOLs (¶ 319 and ¶ 417). An NOL deduction also may not be claimed by regulated investment companies (¶ 2301) and life insurance companies (¶ 2370) (Code Secs. 805(b)(4) and 852(b)(2)(B)).[55]

Noncorporate Taxpayers. Individuals, estates, and trusts may use Form 1045 to claim a quick refund resulting from the *carryback* of an NOL (Code Sec. 6411; Reg. § 1.6411-1).[56] Form 1045 must be filed on or after the date for filing a tax return for the NOL year, but no later than one year after the end of the NOL year (¶ 2773). Form 1045 also contains schedules that can be used to determine the amount of NOL available for carryback or carryover, and the NOL deduction for each carryback year and the amount to be carried over.

As an alternative to Form 1045, an individual may file an amended return on Form 1040X for each carryback year to claim a refund from the *carryback* of an NOL. Form 1040X must generally be filed within three years after the due date of the return for the NOL year. Estates and trusts file an amended Form 1041 for each carryback year and check the "amended return" box. If an amended return is filed, the taxpayer must still attach the NOL computations using the Form 1045 computation schedules.

No special form is used to *carry over* an NOL deduction. If the taxpayer elects to waive the NOL deduction carryback (¶ 1149), however, a statement making the election must be attached to the return or amended return for the tax year. Individuals list an NOL carryover deduction as a negative figure on the "Other Income" line of Form 1040 or 1040NR. Estates and trusts include an NOL carryover deduction on Form 1041 with other deductions not subject to the two-percent-of-adjusted-gross-income limit.

Corporations. Corporations may file for a quick refund resulting from the *carryback* of an NOL using Form 1139. The form can be filed on or after the date on which the return for the NOL year is filed, but no later than one year after the end of the NOL year. Alternatively, a corporation may file an amended return on Form 1120X in place of Form 1139 for each carryback year. Form 1120X must be filed within three years of the due date including extensions for filing the return for the NOL year. Corporations must file Form 1120X rather than Form 1139, however, to carryback a prior year foreign tax credit, minimum tax credit, or general business credit released due to an NOL.

A corporation that expects an NOL in the current tax year may file Form 1138 to extend the time for payment of the tax for the immediately preceding tax year (Code Sec. 6164; Reg. § 1.6164-1).[57] The extension applies only to payments of tax that are required to be paid after Form 1138 is filed. The extension expires at the end of the month in which the return for the tax year of the expected NOL is required to be filed including extensions. However, if the corporation files Form 1139 before the extension period ends, the time for payments is further extended until the date that the IRS mails notice that it has allowed or disallowed the application (Reg. § 1.6164-5).[58]

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

54 ¶ 12,002, ¶ 12,003; BUSEXP: 45,000, BUSEXP: 45,050; § 17,001
55 ¶ 25,770, ¶ 26,420; BUSEXP: 45,052
56 ¶ 38,720, ¶ 38,722; BUSEXP: 45,256.05; § 17,025
57 ¶ 37,240, ¶ 37,241; BUSEXP: 45,260; § 39,315.10
58 ¶ 37,247; BUSEXP: 45,260.10; § 39,315.25

http://www.pbookshop.com

1147. Net Operating Loss (NOL) Defined. A net operating loss (NOL) for the tax year is the excess of allowable deductions over gross income, with certain modifications (Code Sec. 172(c); Reg. § 1.172-1).[59] For calculating the NOL, income and deductions from separate businesses are aggregated, and items that are excludable from gross income are generally excluded. The NOL for any tax year is determined under the law applicable to that tax year, without regard to the law applicable to the tax year to which the NOL is carried. A taxpayer with a short tax year cannot annualize an NOL.

Noncorporate Taxpayers. The following adjustments are made in computing the NOL of a noncorporate taxpayer (Code Sec. 172(d); Reg. § 1.172-3):[60]

(1) No deduction for NOL carryovers or carrybacks from other years is allowed.

(2) No deduction is allowed for personal or dependency exemptions.

(3) Nonbusiness capital losses are deductible only to the extent of nonbusiness capital gains determined without regard to the exclusion for gain from qualified small business stock (¶ 1905).

(4) Business capital losses are deductible only to the extent of the sum of (a) business capital gains determined without regard to the exclusion for gain from qualified small business stock, and (b) any nonbusiness capital gains that remain after deducting nonbusiness capital losses and excess nonbusiness deductions (item (5) below).

(5) Nonbusiness deductions are allowed only to the extent of nonbusiness income including net nonbusiness capital gains. Nonbusiness deductions generally include deductions not related to the taxpayer's trade or business, or employment—e.g., alimony, deductions for contributions to a retirement plan, health savings account (HSA) deductions, the standard deduction, and personal itemized deductions. Nonbusiness income generally includes income from passive investments, such as interest, dividends, annuities, as well at the taxpayer's share of nonbusiness income from a partnership or S corporation. The taxpayer's wages and salary are considered income that *is* attributable to the taxpayer's trade or business.

(6) The domestic production activities deduction (¶ 980A) is not allowed.

Corporations. The following adjustments are made in computing the NOL of a corporation (Code Sec. 172(d); Reg. § 1.172-2):[61]

(1) No deduction for NOL carryovers or carrybacks from other years is allowed.

(2) A corporation is entitled to deductions for dividends received from a domestic corporation, received on certain preferred stock of public utilities, received from certain foreign corporations, and paid on certain preferred stock of public utilities, without regard to the limitations, based on taxable income, imposed on such deductions in computing taxable income (¶ 223 and ¶ 231).

(3) The domestic production activities deduction is not allowed.

1149. Carryback and Carryforward of Net Operating Losses (NOLs). If a taxpayer has a net operating loss (NOL) for the current tax year (¶ 1147), then the loss may be carried back to prior tax years or carried forward to future years as a deduction against taxable income (¶ 1145). NOLs can generally be carried back to the two years preceding the loss year and then forward up to 20 years following the loss year (Code Sec. 172(b)(1)).[62] Special carryover periods, however, are available for NOLs attributable to casualties, disasters, farming losses, and certain other activities (¶ 1151). No deduction is allowed in the year the loss is incurred. In determining the amount of an NOL carryback or carryover, the law in effect during the year to which the NOL is carried back or carried over is applied (Code Sec. 172(e)).

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[59] ¶ 12,002, ¶ 12,003; BUSEXP: 45,100; § 17,005.05
[60] ¶ 12,002, ¶ 12,005; BUSEXP: 45,106; § 17,005.10
[61] ¶ 12,002, ¶ 12,004; BUSEXP: 45,104; § 17,005.15
[62] ¶ 12,002; BUSEXP: 45,150; § 17,010.05

The NOL is first carried back to the second tax year preceding the loss year, then to the next earliest carryback year, and then forward to tax years after the loss year. If an NOL carryover is not fully absorbed in a carryback or carryover year, then the following adjustments must be made to taxable income in the carryback or carryover year (but not less than zero) to determine the portion of the NOL still available to be carried to the next year in the carryback or carryover period (Code Sec. 172(b)(2); Reg. § 1.172-5).[63]

(1) The NOL deduction for the intervening year is computed by taking into account only carryback and carryovers from tax years *preceding* the loss year.

(2) For taxpayers other than corporations, capital losses are deductible only to the extent of capital gains.

(3) Personal and dependency exemptions are not allowed.

(4) The domestic production activities deduction (¶ 980A) is not allowed.

In a year in which an NOL is carried back, any income, deductions, or credits that are based on or limited to a percentage of adjusted gross income (AGI) must be recomputed based on AGI after applying the NOL deduction for the carryback year. The charitable contribution deduction, however, is *not* recomputed. Taxable income is recomputed taking into account the NOL and the preceding adjustments. Income tax, alternative minimum tax, and any credits that are based on or limited to the amount of tax are then recomputed.

Election to Forgo Carryback. A taxpayer may elect to waive the entire carryback period (Code Sec. 172(b)(3)).[64] If the election is made, the loss may be carried forward only. The election must be made by the return due date including extensions for the tax year of the NOL. The election may also be made on an amended return filed within six months of the due date of an original timely return excluding extensions. Refer to the instructions for Form 1045 or Form 1139 for specific statement requirements. Once made, the election is irrevocable.

Married Taxpayers. Married individuals who file a joint return for each year considered in figuring NOL carrybacks and carryforwrds calculate their NOL as though all the income and deductions on the return were those of one taxpayer (Reg. § 1.172-7).[65] If married individuals file separate returns for each year considered in figuring NOL carrybacks and carryovers, then each spouse is entitled to their own NOLs without regard to the income or deductions of the other spouse. Special rules apply for figuring the NOL carrybacks and carryforwards of married people whose filing status changes for any tax year considered in figuring an NOL carryback or carryforward.

1151. Special NOL Carryforward and Carryback Periods. A net operating loss (NOL) generally must be carried back to the two years preceding the loss year and then carried forward to the 20 years following the loss year (¶ 1149). Special carryover periods are available, however, for certain types of NOLs.

Casualties and Disasters. A three-year carryback period is available for: (1) an NOL of an individual arising from a fire, storm, shipwreck, other casualty, or theft, and (2) an NOL of a small business or taxpayer engaged in farming if the loss is attributable to a federally declared disaster (Code Sec. 172(b)(1)(E)).[66] A small business is one with an average annual gross receipts of $5 million or less. An eligible loss does not include a farming loss described below.

Farming Loss. A farming loss may be carried back for five years (Code Sec. 172(b)(1)(F) and (h)).[67] A farming loss is the *smaller* of (1) the amount that would be the NOL for the tax year if only income and deductions attributable to farming businesses (¶ 999) were taken into account, or (2) the NOL for the tax year. A taxpayer may

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[63] ¶ 12,002, ¶ 12,007; BUSEXP: 45,200; § 17,015.15
[64] ¶ 12,002; BUSEXP: 45,152; § 17,010.15
[65] ¶ 12,009; BUSEXP: 45,208.05; § 17,020
[66] ¶ 12,002; BUSEXP: 45,154.35; § 17,010.20
[67] ¶ 12,002; BUSEXP: 45,154.40; § 36,210

http://www.pbookshop.com

11 LOSSES

elect to waive the five-year carryback for a farming loss. In this case, the two-year carryback period generally applies. For ordering purposes, the farming loss is treated as a separate NOL to be taken into account *after* the remaining portion of the NOL for the tax year.

Short Tax Years. If the IRS approves a request for a change in accounting period when the short period required to effect the change is a tax year in which the taxpayer has an NOL, the taxpayer can carry back the short-period NOL only if it is either (1) $50,000 or less, or (2) less than the full 12-month period NOL beginning with the first day of the short period as determined when the 12-month period has expired.[68]

Specified Liability Losses. A 10-year carryback period applies to specified liability losses (Code Sec. 172(b)(1)(C) and (f); Notice 2005-20).[69] A specified liability loss is the portion of an NOL that (1) is attributable to product liability or (2) arises out of satisfaction of a liability under federal or state law requiring land reclamation, nuclear power plant decommissioning, drilling platform dismantling, environmental remediation, or a payment under any workers' compensation act. For ordering purposes, the specified liability loss is treated as a separate NOL to be taken into account *after* the remaining portion of the NOL for the tax year.

Real Estate Investment Trusts (REITs). An NOL from a REIT year—a tax year in which an entity operated as a REIT (¶ 2326)—cannot be carried back to any preceding tax year. An NOL from a non-REIT year cannot be carried back to a REIT year. A REIT NOL can be carried forward 20 years (Code Sec. 172(b)(1)(B); Reg. § 1.172-10).[70]

Corporate Equity Reduction Transactions (CERTs). A C corporation may not carry back a portion of its NOL if $1 million or more of interest expense is incurred in a "major stock acquisition" of another corporation or in an "excess distribution" by the corporation (Code Sec. 172(b)(1)(D) and (g)).[71] The amount subject to the limitation is the lesser of: (1) the corporation's deductible interest expense allocable to the CERT, or (2) the amount by which the corporation's interest expense for the current tax year exceeds the average interest expense for the three tax years preceding the tax year in which the CERT occurs.

1153. NOL Carryovers Between Predecessors and Successors. A net operating loss (NOL) may generally be carried back or carried forward only by the taxpayer who sustained the loss (¶ 1145). A beneficiary of an estate or trust, however, is entitled to any carryover amount remaining unused after the last tax year of the estate or trust. Similarly, a bankruptcy estate succeeds to an individual debtor's NOLs (¶ 535). A successor corporation also is allowed to carry over the NOL and certain other items of its predecessor under specified conditions (¶ 2277).

At-Risk Limitations

1155. At-Risk Limitations on Losses. A taxpayer's deductible loss with respect to an activity is generally limited to the amount that the taxpayer has at risk with respect to the activity (Code Sec. 465).[72] The at-risk rules are designed to prevent certain taxpayers (¶ 1157) from offsetting trade, business, or professional income with losses from investments in activities (¶ 1159) that are largely financed by nonrecourse loans for which they are not personally liable. Even if it has been determined that the loss is deductible under the at-risk rules, the loss may still be limited by the passive activity loss rules (¶ 1165).

Under the at-risk rules, loss deductions are limited to the amount the taxpayer has at risk in the activity. This is the money and the adjusted basis of other property the taxpayer contributes to the activity. It also includes any amounts borrowed for use in the activity if the taxpayer has personal liability for repayment of the loan (recourse) or has pledged assets not used in the activity as security for the loan (Code Sec. 465(b)).[73]

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[68] ¶ 12,014.30; NOL: 12,202; § 38,130.20
[69] ¶ 12,002; BUSEXP: 45,154.25; § 17,010.25
[70] ¶ 12,002, ¶ 12,012; BUSEXP: 45,154.15
[71] ¶ 12,002; NOL: 15,202
[72] ¶ 21,850; BUSEXP: 42,000; § 17,301
[73] ¶ 21,850; BUSEXP: 42,150; § 17,305.05

Amounts are not at risk if they are borrowed from (1) a person who has an interest in the activity other than as a creditor, or (2) a person related to someone other than the taxpayer who has an interest in the activity. Exceptions are available for corporations that borrow from shareholders and qualified nonrecourse financing secured by real property used in an activity. Personal liability of the taxpayer for borrowed amounts generally hinges on whether the taxpayer is the ultimate obligor of the liability with no recourse against any other party.[74] The taxpayer is not considered at risk with respect to amounts protected against loss through nonrecourse financing, guarantees, stop-loss agreements, or similar arrangements.

Any loss not allowed because of the at-risk limitation is carried over to the following tax year, to be deducted subject to the same limitation (Code Sec. 465(a)(2)). The amount allowed as a loss for any year reduces the amount at risk for later years. Conversely, if a taxpayer's amount at risk at the end of any tax year is less than zero, the loss equal to the difference is recaptured (Code Sec. 465(e)).[75] Unused amounts generally are allowed when the activity is transferred or otherwise disposed (¶ 1161).

Form 6198 is used to compute the deductible loss under the at-risk rules. An activity subject to the passive loss rules must file Form 8582. If the activity is subject to both limitations, Form 6198 is completed first, and any allowable loss must be carried over to Form 8582.

For investment tax credit at-risk rules, see ¶ 1365A.

1157. Taxpayers Affected by At-Risk Rules. The at-risk rules (¶ 1155) apply to individuals, estates, and trusts (Code Sec. 465(a)(1)).[76] They also apply to partners and S corporation shareholders at the partner or shareholder level, not at the entity level. Closely held corporations are generally subject to the at-risk rules if they meet the personal holding company stock ownership requirements (¶ 277). However, certain closely held corporations are not subject to the at-risk limits for any qualifying active business carried on; instead, each qualifying business of a corporation is treated as a separate activity (Code Sec. 465(c)(7)). In addition, if a closely held corporation is actively engaged in equipment leasing, the equipment leasing is treated as a separate activity not covered by the at-risk rules (Code Sec. 465(c)(4)).

1159. Activities Covered by At-Risk Rules. The at-risk limit on losses (¶ 1155) generally applies to all activities of a taxpayer engaged in as a trade or business or for the production of income (Code Sec. 465(c)).[77] It also specifically applies to any taxpayer engaged in: the activity of holding, producing, or distributing motion picture films or video tapes; farming; leasing of section 1245 property; or exploring for or exploiting oil and gas resources or geothermal deposits. The at-risk rules do not apply to: (1) the leasing of equipment by closely held corporations (¶ 1157); (2) a qualifying active business carried on by certain closely held corporations; or (3) the holding of real property other than mineral property acquired before 1987 as an interest in a pass-through entity engaged in holding real property placed in service before 1987.

In the case of the specifically identified activities listed previously, each film or tape, each piece of section 1245 property, each farm, and each oil, gas, or geothermal property is treated as a separate activity. However, for a partnership or an S corporation, all leased section 1245 properties that are placed in service in the same tax year are treated as a single activity (Code Sec. 465(c)(2)(B)).[78] Trade or business activities subject to the at-risk rules are aggregated and treated as a single activity if the taxpayer actively participates in the management of the trade or business or, where the trade or business is carried on by a partnership or S corporation, if 65 percent or more of the losses for the tax year are allocable to persons who actively participate in the management of the trade or business.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[74] ¶ 21,893.35; BUSEXP: 42,156.05; § 17,305.05
[75] ¶ 21,850; BUSEXP: 42,206.10; § 17,315
[76] ¶ 21,850; BUSEXP: 42,050; § 17,301
[77] ¶ 21,850; BUSEXP: 42,100; § 17,310
[78] ¶ 21,850; BUSEXP: 42,106; § 17,310

http://www.pbookshop.com

1792. Partnership Distribution of Depreciable Property. For purposes of the depreciation recapture rules (¶ 1779), the basis of section 1245 or section 1250 property distributed by a partnership to a partner is determined by reference to the partnership's adjusted basis in the property (Code Secs. 1245(b)(5) and 1250(d)(5); Reg. §§1.1245-4(f) and 1.1250-3(f)).[175]

For recomputing the basis of the property in the hands of the partner, the amount of the depreciation or amortization adjustments for section 1245 property, or the additional depreciation for distributed section 1250 property, attributable to pre-distribution periods is equal to: (1) the amount of gain that would have been treated as ordinary income under the recapture rules had the partnership sold the property at fair market value immediately before the distribution; minus (2) any gain treated as ordinary income under the partnership rules for distributions of receivables or inventory items (¶ 436).

1793. Corporate Distribution of Depreciable Property. A corporation that distributes a dividend consisting of section 1245 or section 1250 property might be required to recognize ordinary income under the depreciation recapture rules (¶ 1779), even though it would not normally recognize gain under the corporate distribution rules (¶ 736) (Reg. §§1.1245-1(a), 1.1245-6(b), and 1.1250-1(c)).[176]

A corporation's transfer of section 1245 property or section 1250 property to a shareholder for less than fair market value is not treated as a sale, exchange, or involuntary conversion for depreciation recapture purposes (Reg. §§1.1245-1(c) and 1.1250-1(a)). Accordingly, the corporation's gain for recapture purposes is the amount by which the property's adjusted basis is exceeded by the lower of the property's fair market value on the disposition date or the property's recomputed basis.

If a corporation transfers section 1245 property or section 1250 property to a shareholder in a sale or exchange for less than fair market value, the disposition is not treated as a sale, exchange, or involuntary conversion for depreciation recapture purposes (Reg. §§1.1245-1(c) and 1.1250-1(a)). Accordingly, the corporation's gain for recapture purposes is the amount by which the property's adjusted basis is exceeded by the lower of the property's fair market value on the disposition date or the property's recomputed basis.

If the transferee's basis in the property is determined solely by the corporate distribution rules (¶ 735), no depreciation adjustments are reflected in the adjusted basis of section 1245 property, and no additional depreciation is reflected in the adjusted basis of section 1250 property, on the date that the transferee acquires the property (Reg. §§1.1245-2(c) and 1.1250-2(e)).[177]

Farmers' Recapture

1797. Recapture on Land Sale. If farm land held for less than 10 years is disposed of, the lesser of the gain realized or a percentage of the total deductions for soil and water conservation (¶ 982) and land clearing expenses must be recaptured as ordinary income on Form 4797 (Code Sec. 1252).[178] The recapture percentage is 100 percent if the land is held for five years or less, and declines 20 percent for each additional year (to 80 percent in the sixth year, 60 percent in the seventh year, 40 percent in the eighth year, and 20 percent in the ninth year). There is no recapture after the ninth year. This recapture rule does not apply to transfers by gift, transfers at death, and transfers in certain tax-free transactions (Reg. §1.1252-2).[179]

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[175] ¶ 30,902, ¶ 30,906, ¶ 31,000, ¶ 31,003; DEPR: 18,106.05; §30,535.20, §30,555

[176] ¶ 30,903, ¶ 30,908, ¶ 31,001; DEPR: 18,054

[177] ¶ 30,904, ¶ 31,002; DEPR: 18,204.05, DEPR: 18,262

[178] ¶ 31,020; FARM: 9,168; §36,030.10

[179] ¶ 31,022; FARM: 9,168.20; §36,030.10

Chapter 18

INSTALLMENT SALES DEFERRED PAYMENTS

Par.

INSTALLMENT SALES
Installment Method . . . 1801
Computation of Income . . . 1813
Related-Party Sales . . . 1833
Repossessions of Property . . . 1838
Dispositions of Installment Obligations . . . 1846
Corporate Liquidations . . . 1856
DEFERRED PAYMENTS
Imputed Interest . . . 1859
Treatment of Interest . . . 1883

Installment Method

1801. Use of Installment Method. The installment method is a special way of reporting gains (not losses) from sales of property when at least one payment is received in a tax year after the year of sale (deferred payments). Under the installment method, gain from the sale is prorated and recognized over the years in which payments are received (Code Sec. 453).[1] As a result, each payment received usually consists of interest, return of basis, and gain on the sale.

The installment method must be used for installment sales unless the taxpayer elects not to use the installment method (¶ 1803) or it is otherwise prohibited. This rule applies to both cash and accrual basis taxpayers (¶ 1515). The installment method generally is not available for most sales by dealers (¶ 1808), sales of property of a type that would be included in inventory (¶ 1553), sales of personal property under a revolving credit plan (¶ 1805), sales of publicly traded property (¶ 1805), or sales of depreciable property between related taxpayers (¶ 1835). Thus, payments for such sales are treated as if they are received in the year of disposition, even if the taxpayer expects to receive some payments in future years.

Gain Calculation. The amount of gain from an installment sale that is taxable in a given year is calculated by multiplying the payments received in that year by the gross profit ratio for the sale (Code Sec. 453(c)).[2] The gross profit ratio is equal to the anticipated gross profit divided by the total contract price (¶ 1813). However, gain from installment sales of depreciable property subject to recapture under Code Sec. 1245 or Code Sec. 1250 is determined under a special rule (¶ 1823).

> **Example:** On December 1, 2016, Bob Smith sells vacant land that he has held for investment purposes for a number of years. His basis in the land is $12,000. The total contract price is $15,000. Bob receives a $5,000 down payment, with the $10,000 balance due in monthly installments of $500 each, plus interest at the applicable federal rate, beginning on January 1, 2017. His anticipated gross profit from the sale is $3,000. His gross profit percentage is 20% ($3,000 gross profit ÷ $15,000 contract price). Under the installment method, Bob must report $1,000 ($5,000 × 20%) as long-term capital gain in 2016, $1,200 ($6,000 × 20%) in 2017, and $800 ($4,000 × 20%) in 2018. The interest is reported as ordinary income.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[1] ¶ 21,402; SALES: 36,050; §18,301

[2] ¶ 21,402; SALES: 36,100; §18,320

http://www.pbookshop.com

Although use of the installment method determines when gain from an installment sale is reported, it does not affect the characterization of the gain as capital gain or ordinary income. The proper characterization depends on the nature of the asset sold (¶ 1735 and ¶ 1741).

Reporting Requirements for Gain. Gain from an installment sale is reported on Form 6252, which must be filed with the tax return in the year of sale and in each year payments are received. The gain calculated on Form 6252 is carried over and entered on Schedule D of the taxpayer's return or Form 4797, or both, as appropriate.

1803. Election Not to Use Installment Method. If a taxpayer elects not to use the installment method (¶ 1801), the entire gain is reported in the year of the sale, even though not all of the sale proceeds are received in that year (Code Sec. 453(d); Temp. Reg. § 15A.453-1(d)).[3] The election is made by individuals, corporations, partnerships, estates, and trusts by simply reporting the gain on Form 8949 or Form 4797, whichever applies. The election must be made by the due date, including extensions, of the tax return for the year in which the installment sale occurs. If a taxpayer files a timely return without an election out, the taxpayer can elect out by filing an amended return within six months of the due date, excluding extensions (Reg. § 301.9100-2). The IRS will otherwise permit late elections only in rare circumstances where the taxpayer can show good cause for not making the election by the due date. An election out can be revoked only with IRS approval, but revocation is not allowed if one of its purposes is to avoid federal income tax, or if the tax year in which any payment was received has closed.

1805. Publicly Traded Property and Revolving Credit Plans. The installment method (¶ 1801) may *not* be used for: (1) sales of personal property under a revolving credit plan; (2) sales of stock or securities that are traded on an established securities market; or (3) to the extent provided by regulations, sales of other kinds of property that are regularly traded on an established market. All payments to be received from such sales are treated as received in the year of disposition (Code Sec. 453(k)).[4]

1808. Dealer Dispositions by Installment Sale. Dealers in real or personal property may not use the installment method to report the gain from dealer dispositions (Code Sec. 453(b)(2)(A) and (l)(1)).[5] A dealer disposition includes:

- any disposition of personal property by a person who regularly sells or otherwise disposes of such property on an installment plan; and
- any disposition of real property that is held by the taxpayer for sale to customers in the ordinary course of the taxpayer's trade or business.

Certain types of installment transactions by a dealer, however, are not considered dealer dispositions and the installment method of reporting may be used (Code Sec. 453(l)(2)).[6] These include:

- the disposition of any property used or produced in the trade or business of farming;
- the disposition in the ordinary course of the taxpayer's trade or business of:
  - — any residential lot, provided that the dealer or any related person is not obligated to make any improvements to the lot; or
  - — a timeshare right to use or own residential real property for not more than six weeks per year, or a right to use specified campgrounds for recreational purposes.

A timeshare right to use or own property held by an individual's spouse, children, grandchildren, or parents is treated as held by the individual.

Payment of Interest. To use the installment method for the sale of residential lots and timeshares, the taxpayer must pay interest on the amount of tax attributable to the

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[3] ¶ 21,402, ¶ 21,404; SALES: 36,056; § 18,315
[4] ¶ 21,402; SALES: 36,052.05; § 18,310.20, § 18,310.25
[5] ¶ 21,402; SALES: 36,250; § 18,310.10
[6] ¶ 21,402; SALES: 36,054; § 18,310.10

installment payments received during the year. The interest is calculated for the period beginning on the date of sale and ending on the date the payment is received (Code Sec. 453(l)(3)).[7] The amount of interest is based upon the applicable federal rate in effect at the time of sale, compounded semiannually (¶ 1875).

Computation of Income

1813. Amount of Income for Installment Sales. For most nondealer dispositions of property (¶ 1808), the amount of income reported from an installment sale in any tax year (including the year of sale) is equal to the payments received during the year multiplied by the gross profit ratio for the sale (Code Sec. 453(c); Temp. Reg. § 15A.453-1(b)(2)).[8] Payments include all amounts actually or constructively received in the tax year under the installment obligation (¶ 1819). Different computations are required for installment sales of property that are not subject to the depreciation recapture provisions of Code Sec. 1245 or Code Sec. 1250 (¶ 1823)

The gross profit ratio is the gross profit on the installment sale divided by the total contract price. The gross profit is the selling price of the property minus its adjusted basis. The selling price of the property is not reduced by any existing mortgage or encumbrance, or by any selling expenses, but is reduced by any imputed interest (¶ 1859).

The total contract price (denominator of gross profit ratio) is the selling price minus that portion of qualifying indebtedness (¶ 1815) which the buyer assumes or takes the property subject to that does not exceed the seller's basis in the property (adjusted to reflect commissions and other selling expenses). In the case of an installment sale that is a partially nontaxable like-kind exchange (¶ 1723), the gross profit is reduced by that portion of the gain that is not recognized, and the total contract price is reduced by the value of the like-kind property received (Code Sec. 453(f)(6)).[9]

For certain nondealer sales of property over $150,000, a special interest charge may apply (¶ 1825).

1815. Qualifying Indebtedness for Installment Sales. For the purpose of determining the total contract price of an installment sale of property (¶ 1813), qualifying indebtedness includes:

(1) any mortgage or other indebtedness encumbering the property; and

(2) any indebtedness not secured by the property but incurred or assumed by the purchaser incident to the acquisition, holding or operation of the property in the ordinary course of business or investment (Temp. Reg. § 15A.453-1(b)(2)(iv)).[10]

Qualifying indebtedness does not include an obligation of the seller incurred incident to the *disposition* of the property, or an obligation functionally unrelated to the acquisition, holding or operation of the property. Any obligation incurred or assumed in contemplation of disposition of the property is not qualifying indebtedness if recovery of the seller's basis is accelerated.

Wrap-Around Mortgage. When property encumbered by an outstanding mortgage is sold in exchange for an installment obligation equal to the mortgage, the installment obligation is said to "wrap around" the mortgage. The seller generally uses the payments received from the installment obligation to pay the "wrapped" mortgage. In this situation, the IRS will follow the Tax Court's position and will not treat the buyer as having taken the property subject to, or as having assumed, the seller's mortgage (*Professional Equities, Inc.*, 89 TC 165, Dec. 44,064 (1987) (Acq.)).[11] As a result, the seller does not have to reduce the total contract price by the amount of the wrapped mortgage.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[7] ¶ 21,402; SALES: 36,054.10; § 18,310.10
[8] ¶ 21,402, ¶ 21,404; SALES: 36,100; § 18,320.05
[9] ¶ 21,402; SALES: 36,114.05; § 18,350
[10] ¶ 21,404; SALES: 36,106; § 18,320.05
[11] ¶ 21,412.80; SALES: 36,106; § 18,325

http://www.pbookshop.com

1819. Installment Payments. When determining the amount of reportable income under the installment method (¶ 1813), a payment includes all amounts actually or constructively received in the tax year under an installment obligation, as well as:

(1) evidence of indebtedness of a person other than the buyer;

(2) evidence of indebtedness of the buyer that is payable on demand or readily tradable, including a bond issued with coupons or in registered form;

(3) a bank certificate or treasury note;

(4) qualifying indebtedness (¶ 1815) assumed or taken subject to by the buyer, to the extent it exceeds the seller's basis for the sold property as adjusted for selling expenses;

(5) seller's indebtedness to the buyer that is canceled; and

(6) indebtedness on the sold property (for which the seller is not personally liable) when the buyer is the obligee of the indebtedness (Code Sec. 453(f)(3), (f)(4), and (f)(5); Temp. Reg. § 15A.453-1(b)(3)).[12]

Debt instruments in registered form that the seller can establish are not readily tradable are not considered payments. In addition, like-kind property received in a partially tax-free exchange (¶ 1723) that is part of an installment sale transaction is not treated as a payment for purposes of determining the amount of income to be reported under the installment method (Code Sec. 453(f)(6)).[13]

1821. Contingent Payment Sales. A contingent payment sale must be reported on the installment method (¶ 1801) unless the seller elects not to use the installment method (Temp. Reg. § 15A.453-1(c)).[14] A contingent payment sale is a sale or other disposition of property in which the total selling price is not determinable by the close of the tax year in which the sale or disposition occurs. It does not include transactions with respect to which the installment obligation represents, under applicable principles of tax law: (1) a retained interest in the property which is the subject of the transaction; (2) an interest in a joint venture or partnership; (3) an equity interest in a corporation; or (4) similar transactions, regardless of the existence of a stated maximum selling price or a fixed payment term.

In a contingent payment sale, the basis of the property sold (including selling expenses, but not those of real estate dealers) is allocated to payments received in each tax year and recovered as follows:

- for sales with a stated maximum selling price, basis is recovered according to a profit ratio based on the stated maximum selling price;
- for sales with a fixed payment period, basis is recovered ratably over the fixed period; and
- for sales with neither a maximum selling price nor a fixed payment period, basis is recovered ratably over a 15-year period.

Alternate methods of basis recovery may be required when the normal method would substantially and inappropriately accelerate or defer the recovery of basis.

1823. Installment Sale of Property Subject to Depreciation Recapture. For installment sales of real or personal property to which the depreciation recapture provisions of Code Sec. 1245 or Code Sec. 1250 apply (¶ 1779), any recapture income must be reported in the year of disposition, whether or not an installment payment is received in that year (Code Sec. 453(i)).[15] The amount of ordinary income reported in the year of sale is added to the property's basis, and this adjusted basis is used in determining the remaining profit on the disposition. The remaining profit amount is used to compute the gross profit percentage to be applied to each installment payment.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[12] ¶ 21,402, ¶ 21,404; SALES: 36,102; § 18,325

[13] ¶ 21,402; SALES: 36,114.05; § 18,350

[14] ¶ 21,404; SALES: 36,112; § 18,330.05

[15] ¶ 21,402; SALES: 36,108; § 18,355.05

Example: On December 1, 2016, Bob sells a rental building for a total contract price of $100,000, plus interest at the applicable federal rate. He receives a note due in yearly installments of $20,000, plus interest, beginning January 1, 2017. Bob's adjusted basis in the building is $20,000. Assume that $10,000 of the total $80,000 gain is attributable to depreciation that must be recaptured as ordinary income under Code Sec. 1250 (¶ 1779). The $10,000 must be included in Bob's ordinary income for 2016 (the year of sale). The $10,000 is added to his $20,000 adjusted basis for purposes of determining the gross profit on the remaining gain. Therefore, gross profit is, $70,000 ($100,000 − $30,000). Of each $20,000 payment received in the following years, $14,000 is includible in income ($20,000 × ($70,000 ÷ $100,000)).

If a portion of the capital gain from an installment sale of depreciable real property consists of unrecaptured section 1250 gain, and another portion consists of other capital gains (¶ 1736), the taxpayer is required to take the unrecaptured section 1250 gain into account before the other capital gains are received (Reg. § 1.453-12).[16]

1825. Special Interest Rule for Nondealers of Property. A special interest charge may apply to an installment obligation that arises from a nondealer disposition of real or personal property (¶ 1813) under the installment method if the sales price is over $150,000 (Code Sec. 453A).[17] The interest charge does not apply to nondealer dispositions of property used in the business of farming or personal use property. For this purpose, personal use property is property that is not substantially used in connection with the taxpayer's trade or business or in an investment activity. The interest charge also does not apply to dispositions of timeshares and residential lots (but the interest payment rule described in ¶ 1808 does apply).

Generally, the interest charge is imposed on the tax deferred under the installment method with respect to outstanding installment obligations. However, the interest charge will not apply unless the face amount of all obligations held by the taxpayer that arose during and remain outstanding at the close of the tax year exceeds $5 million.

If any indebtedness is secured by a nondealer installment obligation that arises from the disposition of any real or personal property having a sales price over $150,000, the net proceeds of the secured indebtedness will be treated as a payment received on the installment obligation on the later of the date that the indebtedness is secured or the date that the net proceeds are received.

The interest is not reported on Form 6252, but rather is entered as an additional tax on the taxpayer's return. For individuals, it is included on the line for "Other taxes" on Form 1040. For estates and trusts, it is included on the line for "Total tax" on Schedule G of Form 1041. For corporations, it is entered on Schedule J of Form 1120.

Related-Party Sales

1833. Installment Sale to Related Persons. When a person makes an installment sale of property (¶ 1801) to a related person who sells the property before the installment payments are made in full, the amount realized by the related person from the second sale is treated as being received by the initial seller at the time of the second sale (Code Sec. 453(e)).[18] However, the resale rule does not generally apply if the second sale takes place more than two years after the first sale. A related person for this purpose includes the seller's spouse, child, grandchild and other lineal descendants, parent, grandparent and other ancestors, brother, sister, controlled corporation, partnership, certain trusts, estate, or executor (Code Sec. 453(f)(1)).

In applying the resale rule, the amount treated as received by the initial seller is limited to:

(1) the *lesser* of—

(a) the total amount realized from the second disposition before the close of the tax year of disposition; or

(b) the total contract price for the first disposition;

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[16] ¶ 21,425; SALES: 36,100; § 18,355.05

[17] ¶ 21,450; SALES: 36,150

[18] ¶ 21,402; SALES: 36,200; § 18,360

http://www.pbookshop.com

(2) *minus* the sum of—

(a) the total amount received from the first disposition before the close of the year of the second disposition; and

(b) the total amount treated as received for prior years under the resale rule.

There are a number of exceptions to the resale rule. Any sale or exchange of stock to the issuing corporation is not treated as a first disposition. An involuntary conversion (¶ 1713), and any transfer thereafter, is not treated as a second disposition if the first disposition occurred before the threat or imminence of the conversion. Any transfer after the earlier of the death of the person making the first disposition or the death of the person acquiring the property in the first disposition, and any transfer thereafter, is not treated as a second disposition. Further, the resale rule does not apply if it is established to the IRS's satisfaction that neither disposition had federal income tax avoidance as one of its principal purposes.

1835. Installment Sale of Depreciable Property Between Related Persons. The installment method (¶ 1801) generally cannot be used for installment sales of depreciable property between related persons. As a result, all payments are deemed received in the year of sale. However, the installment method may be used if the IRS is satisfied that tax avoidance was not one of the principal purposes of the sale (Code Sec. 453(g)).[19] For this purpose, the term "related person" is defined in Code Sec. 1239(b) (¶ 1744) and includes corporations and partnerships that are more than 50-percent owned, either directly or indirectly, by the same person.

Repossessions of Property

1838. Repossession of Personal Property. When personal property that was sold in an installment sale (¶ 1801) is repossessed, the repossession is treated as a disposition of the installment obligation (¶ 1846) (IRS Pub. 537).[20] Gain or loss is measured by subtracting the seller's basis in the obligation from the fair market value of the property on the date of repossession (and the value of any other property received from the buyer). If the seller did not use the installment method to report the gain on the original sale, the seller's basis in the obligation is equal to the face value of the obligation minus all principal payments that the seller received on the obligation. If the seller used the installment method to report the gain on the original sale, the seller's basis in the obligation is determined by multiplying the unpaid balance of the obligation by the seller's gross profit percentage, and then subtracting that amount from the unpaid balance. The character of the gain or loss, if any, on the repossession is the same as on the original sale.

If the installment obligation is not completely satisfied by repossession of the property, and the seller is unable to collect the balance of the debt, the seller may be able to claim a bad debt deduction for the portion of the obligation that is not satisfied through repossession (¶ 1135 and ¶ 1143).

1841. Repossession of Real Property. When real property is sold on the installment method (¶ 1801) and the seller accepts an installment debt secured by the property, the seller will recognize only a limited amount of gain and no loss upon repossession of the property (Code Sec. 1038; Reg. § 1.1038-1).[21] Gain on the repossession is limited to the lesser of:

(1) the amount by which the amount of money and the fair market value of other property (other than obligations of the purchaser) received, prior to the reacquisition, with respect to the sale of such property, exceeds the amount of the gain on the sale of such property returned as income for periods prior to the reacquisition; or

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[19] ¶ 21,402; SALES: 36,204; § 18,310.30

[20] ¶ 21,406.048; SALES: 36,452; § 18,365.10

[21] ¶ 29,740, ¶ 29,741; SALES: 36,454; § 18,365.15

(2) the amount by which the price at which the real property was sold exceeded its adjusted basis, reduced by the sum of (a) the amount of the gain on the sale of such property returned as income for periods prior to the reacquisition of such property, and (b) the amount of money and the fair market value of other property (other than obligations of the purchaser received with respect to the sale of such property) paid or transferred by the seller in connection with the reacquisition of such property.

The same rules apply when an estate or beneficiary repossesses real property that had been sold by a decedent on the installment method (Code Sec. 1038(g)).[22]

Repossession of Principal Residence. Special rules apply if a seller repossesses a principal residence that was sold under the installment method and gain realized from the sale was excluded from gross income (¶ 1705). If the seller resells the residence within one year of repossession, the original sale and the resale are treated as one transaction and realized gain is determined on the combined sale and resale (Code Sec. 1038(e); Reg. § 1.1038-2).[23] If the resale does not take place within one year, the general rules for repossessions of real property apply.

1843. Basis After Repossession of Real Property. The seller's basis in repossessed real property (¶ 1841) is generally the adjusted basis of the debt secured by the property (determined at the time of the repossession), increased by any gain recognized at the time of the repossession and by the seller's repossession costs (Code Sec. 1038(c)).[24] If the debt to the seller is not discharged as a result of the repossession, the basis of the debt is zero. If, before repossession, the seller has treated the secured debt as having become worthless or partially worthless, then, upon repossession, the seller is considered to have received an amount equal to the amount that was treated as worthless. However, the seller's adjusted basis in the debt is increased by the same amount (Code Sec. 1038(d)).

Dispositions of Installment Obligations

1846. Dispositions or Transfers of Installment Obligations. Gain or loss is generally recognized when an installment obligation is sold, disposed of, or satisfied other than at face value (Code Sec. 453B).[25] The character of any resulting gain or loss on the disposition of an installment obligation is determined by the character of the original asset that was sold (¶ 1741). The amount of gain or loss is the difference between the basis of the obligation and either:

(1) the amount realized, if the obligation is satisfied other than at face value or is sold or exchanged; or

(2) the fair market value of the obligation, if the obligation is distributed or disposed of other than by sale or exchange.

For this purpose, the basis of the obligation to the transferor is the excess of the face value of the obligation over the income that would have been returnable had the obligation been satisfied in full. To determine the basis, the unpaid balance of the installment obligation is multiplied by the gross profit percentage, and the result is subtracted from the unpaid balance. The result is the basis in the installment obligation (IRS Pub. 537).

The cancellation or lapse of an installment obligation is treated as a disposition other than a sale or exchange. This includes a self-canceling installment note that is extinguished at the death of the holder (*R.E. Frane Est.*, CA-8, 93-2 USTC ¶ 50,386).[26] Therefore, gain or loss is computed based on the fair market value of the obligation.

Transfers Between Spouses. The transfer of an installment obligation between spouses or incident to divorce (other than a transfer in trust) will not trigger recognition

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[22] ¶ 29,740; ESTTRST: 9,166; § 18,365.15

[23] ¶ 29,740, ¶ 29,742; REAL: 6,156.35; § 18,365.20

[24] ¶ 29,740; REAL: 6,156.25; § 18,365.15

[25] ¶ 21,470; SALES: 36,350; § 18,370

[26] ¶ 21,471.15; SALES: 36,352.15

of gain (Code Sec. 453B(g)).[27] Thus, the same tax treatment applies to the transferee spouse that would have applied to the transferor spouse.

Transfers at Death. The transfer of an installment obligation at the death of the obligee (other than to the buyer) is not a taxable disposition requiring the recognition of any gain or loss (Code Sec. 453B(c)).[28] Instead, the gain portion of any installment obligation acquired from a decedent is considered income in respect of a decedent (¶ 182). The taxpayer who receives such installment payments (estate, beneficiary, etc.) must report as income the same portion of the payments that would have been taxable income to the decedent. The amount considered to be an item of gross income in respect of the decedent is the excess of the face value of the obligation over its basis in the hands of the decedent.

While the transfer of an installment obligation upon a seller's death is generally not a taxable disposition, the seller's estate is deemed to have made a taxable disposition if the obligation is transferred by bequest, devise, or inheritance to the obligor or if the estate allows the obligation to become unenforceable. If the decedent and obligor-recipient of the obligation were related persons (¶ 1833), the fair market value of the obligation may not be determined at less than its face amount (Code Sec. 691(a)(5)).[29]

Corporate Liquidations

1856. Installment Obligations Received from Liquidating Corporations. Liquidating corporations, other than certain liquidating S corporations (¶ 1858), that distribute installment obligations to shareholders in exchange for their stock must currently recognize gain or loss from the distribution (¶ 1846). However, a shareholder that receives a qualifying installment obligation may treat the exchange as though it were an ordinary sale of stock for an installment obligation. Thus, the shareholder may be able to use the installment method to report the gain from the exchange (Code Sec. 453(h)(1)(A); Reg. § 1.453-11(a)(1)).[30]

If the liquidating corporation is traded on an established securities market, installment sale treatment is generally not available (¶ 1805). However, a shareholder *may* use the installment method if the stock of the liquidating corporation is not traded on an established market, even if the obligation arose from the sale by the liquidating corporation of securities that are traded on an established market (so that the liquidating corporation could not have used the installment method). For this rule to apply, the liquidating corporation must not have been formed or used to avoid the prohibition against using the installment method for publicly traded stock (Reg. § 1.453-11(c)(5)).

Gain on the transfer of a qualifying installment obligation to a shareholder during a liquidation is not immediately taxed to the shareholder. Instead, the payments received under the installment obligation are treated as payments for the stock, and any gain is included in the shareholder's income as payments are received. This rule applies when:

(1) stockholders exchange their stock in the corporation in a Code Sec. 331 liquidation (¶ 2253);

(2) the corporation, during the 12-month period beginning with the adoption of the plan of liquidation, had sold some or all of its assets in exchange for an installment note;

(3) the corporation, within that 12-month period, distributes the installment notes acquired in connection with those sales to the shareholders in exchange for their stock; and

(4) the liquidation is completed within that 12-month period.

This rule does not apply to obligations arising from a sale of inventory, stock in trade, or assets held for sale to customers in the ordinary course of business, unless those assets are sold in a bulk sale (Code Sec. 453(h)(1)(B)).

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[27] ¶ 21,470; SALES: 36,354.40; § 18,230

[28] ¶ 21,470; SALES: 36,354.35; § 18,370

[29] ¶ 24,900; SALES: 36,352.15; § 18,370

[30] ¶ 21,402, ¶ 21,419; SALES: 36,354.20; § 26,710

Subsidiary Liquidations. In a complete liquidation of a subsidiary, in which gain or loss on distributions of property is generally not recognized by the parent or the subsidiary (¶ 2261), the distribution of installment obligations will not cause recognition of gain or loss (Code Sec. 453B(d)).[31]

1858. Installment Obligation Received in S Corporation Liquidations. If an installment obligation is distributed by an S corporation in a complete liquidation (¶ 2253), and the receipt of the obligation is not treated as payment for stock in a complete 12-month liquidation (¶ 1856), then the corporation generally does not recognize gain or loss on the distribution. This is true even for accrual-basis S corporations (Code Sec. 453B(h)).[32]

Imputed Interest

1859. Inadequate or Unpaid Interest on Deferred Payments. When a sale or exchange of property involves the issuance of a debt instrument with deferred payments, such as with an installment sale (¶ 1801), the instrument generally should provide for the payment of adequate interest. If the instrument does not provide for the payment of adequate stated interest, interest income must be imputed to the seller or holder of the debt under the original issue discount (OID) rules of Code Sec. 1274 (¶ 1954) or the unstated interest rules of Code Sec. 483 (¶ 1868). The unstated interest rules will apply only if the transaction does not come within the scope of the OID rules (Code Sec. 483(d)(1)).[33]

If neither the unstated interest rules nor OID rules apply, interest may be imputed under other Code sections (Reg. § 1.483-1(a) and (c)(3); Reg. § 1.1274-1(b)).[34] For example, interest is imputed to certain obligations given in exchange for services or for the use of property under Code Secs. 404 and 467 (¶ 906 and ¶ 1541). Further, the interest imputation rules of Code Sec. 7872 apply to certain below-market demand loans (¶ 795).

In addition, the unstated interest rules and OID rules do not apply to transfers of property between spouses or incident to divorce (¶ 778), to cash method debt instruments (¶ 1954), or to a purchaser who gives debt when buying personal use property.

The following steps should be taken with respect to deferred contracts:

(1) determine whether the transaction is covered by either the unstated interest rules or the OID rules (¶ 1868 and ¶ 1954);

(2) test for unstated interest or OID;

(3) compute the total unstated interest or OID under the contract; and

(4) apportion the unstated interest or OID over the payments.

1868. Scope of Code Sec. 483. The unstated interest rules of Code Sec. 483 impute interest income (¶ 1872) on any payments on the sale or exchange of property that are due more than six months after the sale or exchange if any payments are due more than one year after the sale or exchange (Code Sec. 483).[35] The rules under Code Sec. 483 do not apply in the following situations:

(1) debt instruments for which an issue price is determined under Code Sec. 1273(b)(1), (2) or (3), or Code Sec. 1274;

(2) sales for $3,000 or less;

(3) with respect to the buyer, any purchase of personal property or educational services (under Code Sec. 163(b)) on an installment basis if the interest charge cannot be ascertained and is treated as six percent; and

(4) sales or exchanges of patents (¶ 1767) to the extent of any payments that are contingent on the productivity, use or disposition of the property transferred.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[31] ¶ 21,470; SALES: 36,354.20; § 18,370

[32] ¶ 21,470; SCORP: 352.45; § 28,905.10

[33] ¶ 22,290; ACCTNG: 36,304.05; § 18,355.10

[34] ¶ 22,291, ¶ 31,301; ACCTNG: 36,154.05

[35] ¶ 22,290; ACCTNG: 36,300; § 19,505.05

http://www.pbookshop.com

1872. Testing for and Imputing Unstated Interest. The imputed interest rules of Code Sec. 483 apply (¶ 1868) when there is "unstated interest," which is the excess of the total payments (excluding any interest payments) due more than six months after the date of sale over the total of their present values (including the present values of any interest payments). Generally, present value is determined by using a discount rate equal to the applicable federal rate (AFR) determined under Code Sec. 1274(d) (¶ 1875) (Code Sec. 483(b); Reg. §§1.483-2 and 1.483-3).[36] However, the discount rate will not exceed six percent, compounded semiannually, in the case of transfers of land between family members. This rule only applies if the aggregate sales price of all land sales between the family members does not exceed $500,000, and if no party to the sale is a nonresident alien (Code Sec. 483(e); Reg. §1.483-3(b)).[37] In addition, a discount rate not in excess of nine percent (if less than the AFR), compounded semiannually, applies to most debt instruments given in consideration for the sale or exchange of property if the stated principal amount does not exceed a certain amount adjusted for inflation (¶ 1954).

1875. Adequate Stated Interest. A debt instrument with deferred payments is considered to have adequate stated interest for purposes of the unstated interest rules of Code Sec. 483 (¶ 1868) if the stated principal amount is less than or equal to its imputed principal amount (Code Secs. 483(b) and 1274(b) and (c); Reg. §§1.483-2(b) and 1.1274-2(c)).[38] The imputed principal amount is determined by totaling the present values of all principal and interest payments due on the instrument discounted at the applicable federal rate (AFR) (¶ 83). Payments within six months after the sale are taken into account.

The AFR is the lowest rate in effect for any month in the three-calendar-month period ending with the first calendar month in which there is a binding written contract. It is determined by reference to the term of the debt instrument, including renewal and extension options, as shown in the following table (Code Sec. 1274(d); Reg. §§1.483-3(a) and 1.1274-4(a)).[39]

Term of Debt Instrument:	*Applicable Federal Rate:*
Not over 3 years	Federal short-term rate
Over 3 years but not over 9 years .	Federal mid-term rate
Over 9 years	Federal long-term rate

For sale and leaseback transactions, the discount rate is 110 percent of the AFR, compounded semiannually (Code Sec. 1274(e); Reg. §1.1274-4(a)(2)).[40] For transactions in which a debt instrument is given in consideration for the sale or exchange of property (other than new Code Sec. 38 property) and the stated principal amount of the instrument does not exceed an inflation-adjusted amount ($5,664,800 for 2016), a nine-percent rate may be substituted for the AFR (Code Sec. 1274A; Rev. Rul. 2015-24).[41] The discount rate will not exceed six percent, compounded semiannually, in the case of certain transfers of land between family members (¶ 1872).

1881. Assumptions of Debt. If any person in connection with the sale or exchange of property assumes any debt instrument or acquires any property subject to any debt instrument, the assumption or acquisition is not generally taken into account in determining whether the unstated interest rules apply. However, when the instrument's terms and conditions are modified in a manner that would constitute an exchange, the unstated interest rules may be applied (Reg. §1.483-1(d)).[42]

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[36] ¶ 22,290, ¶ 22,292, ¶ 22,294; ACCTNG: 36,310; §19,510.10
[37] ¶ 22,290, ¶ 22,294; ACCTNG: 36,308.25; §19,510.15
[38] ¶ 22,290, ¶ 22,292, ¶ 31,300, ¶ 31,302; ACCTNG: 36,310; §19,510.05
[39] ¶ 22,294, ¶ 31,300, ¶ 31,304; ACCTNG: 36,162; §19,410.10
[40] ¶ 31,300, ¶ 31,304; ACCTNG: 36,308.20
[41] ¶ 31,320, ¶ 31,322.30; ACCTNG: 36,308; §19,315.10
[42] ¶ 22,291; ACCTNG: 36,264; §19,505.10

Treatment of Interest

1883. Treatment of Imputed Interest. The amount of unstated interest determined under Code Sec. 483 is classified as interest for tax purposes (Reg. §1.483-1(a)(2)).[43] As a result, it may be deductible by the buyer. Unstated interest is not deductible, however, by the issuer of a debt instrument given in consideration for the sale or exchange of personal use property (Reg. §1.483-1(c)(3)).[44] Instead, the unstated interest must be accrued by the holder. Personal use property means any property substantially all the use of which by the taxpayer is not in connection with the taxpayer's trade or business or activities engaged in for profit (Code Sec. 1275(b)(3)).[45]

Reporting Requirements. The reporting of unstated interest depends upon whether the seller is on the cash or accrual basis. Cash basis sellers include unstated interest as interest income in the year payments are received. Sellers on the accrual basis include unstated interest in income in the year payments are due (Reg. §1.446-2(a)).[46]

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[43] ¶ 22,291; ACCTNG: 36,302; §19,515
[44] ¶ 22,291; ACCTNG: 36,306.30; §19,505.10
[45] ¶ 31,340; ACCTNG: 36,224.10; §19,315.10
[46] ¶ 20,610; ACCTNG: 36,200; §19,310.05

http://www.pbookshop.com

Chapter 19

SECURITIES TRANSACTIONS

	Par.
Taxation of Securities Transactions	1901
Gains and Losses on Small Business Stock	1905
Worthless Securities	1916
Options	1919
Wash Sales	1935
Short Sales	1944
Commodities and Related Instruments	1947
Corporate Bonds and Other Debt Instruments	1950
Accounting Issues	1973

Taxation of Securities Transactions

1901. Securities Transactions. Securities such as stocks and bonds held for investment are generally capital assets. Gain or loss from the sale of securities is calculated as it is for other capital assets (¶ 1701). There are, however, a number of special rules that apply to the sale or exchange of certain securities, including securities held by dealers (¶ 1903), worthless securities (¶ 1916), options to buy securities (¶ 1919), wash sales (¶ 1935), short sales (¶ 1944), tax straddles (¶ 1948), and a corporation dealing in its own stocks or bonds (¶ 1729). In addition, gain on the sale of qualified small business stock may be excluded from gross income (¶ 1905) or rolled over to other small business stock (¶ 1907). A taxpayer may also roll over gain from the sale of publicly traded securities to an interest in a specialized small business investment company (¶ 1909). Losses from the sale of stock in certain small businesses may be treated as ordinary losses (¶ 1911 and ¶ 1913).

1903. Dealer in Securities. Securities held by dealers for sale to their customers in the ordinary course of a trade or business are not capital assets (¶ 1741). Thus, gain or loss realized from the sale or disposition is treated as ordinary gain or loss unless the securities are held primarily for personal investment (Code Sec. 1236; Reg. § 1.1236-1).[1] Securities that are held by a dealer for personal investment must be clearly identified in the dealer's records before the close of the day on which they are acquired and must never be held primarily for sale to the dealer's customers. See ¶ 1760 for a discussion of the distinction between a dealer, trader, and investor.

Mark-to-Market Requirements. Dealers in securities must use the mark-to-market method of accounting to report gains and losses from the disposition of securities (Code Sec. 475(a)).[2] Under the mark-to-market rules, any security that is inventory in the hands of a dealer must be included in inventory at its fair market value. The dealer may use the fair market value reported on its financial statements (Reg. § 1.475(a)-4).[3]

Any security that is not classified as inventory in the dealer's hands and that is held at the close of the tax year is treated as if it were sold at its fair market value on the last business day of the year. The dealer must recognize any gain or loss that would result from the deemed sale and take it into account when calculating gain or loss on the actual sale or exchange of the security.

The mark-to-market rules generally apply to all securities held by a dealer, other than those held as investments or not for sale to customers in the ordinary course of the

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[1] ¶ 30,670, ¶ 30,671; SALES: 45,054; § 18,805.05

[2] ¶ 22,265; SALES: 45,350; § 38,235.05

[3] ¶ 22,265E; SALES: 45,362; § 38,235.05

dealer's trade or business (Code Sec. 475(b)).[4] The rules also do not apply to debt instruments acquired in the ordinary course of a trade or business or securities that are hedges of certain positions (¶ 1949). In order for a security to be exempt from the mark-to-market requirements, it must be clearly identified in the dealer's records before the close of the day on which it is acquired, originated, or entered into.

Commodity dealers and traders in securities or commodities may elect to apply the mark-to-market rules to their noninvestment positions (Code Sec. 475(e) and (f)).[5] The election applies to commodities held by a commodities dealer in the same manner as securities held by a dealer. A trader in securities or commodities that elects mark-to-market treatment must recognize gain or loss on any security or commodity held in connection with the trading business as if the security or commodity were sold at fair market value on the last business day of the tax year.

The mark-to-market election must be made by the due date (not including extensions) of the tax return for the year prior to the year for which the election becomes effective. For example, the election must have been made by April 15, 2016, to be effective for 2016. The election is made by attaching a statement to the taxpayer's timely filed return or request for a filing extension (Rev. Proc. 99-17; Rev. Proc. 2015-13; Rev. Proc. 2016-29).[6] A taxpayer that is not required to file a tax return makes the election by placing a statement in its books and records no later than March 15 of the election year. The election may be made without the consent of the IRS, and in the case of trader of securities or commodities, may be made separately for each trade or business of the taxpayer. Once made, the election continues to apply to every tax year of the taxpayer until it is revoked with the IRS's consent.

http://www.bookshop.com

Gains and Losses on Small Business Stock

1905. Exclusion of Gain from Small Business Stock. A noncorporate taxpayer can exclude from gross income 100 percent of gain from the sale or exchange of most qualified small business stock acquired after September 27, 2010, and held for more than five years (Code Sec. 1202, amended by the Protecting Americans from Tax Hikes (PATH) Act of 2015 (P.L. 114-113)).[7] The exclusion is 75 percent for qualified small business stock acquired after February 17, 2009, and before September 28, 2010, and 50 percent for qualified stock acquired before February 18, 2009. The exclusion is 60 percent for gain attributable to periods before 2019 if the stock is issued by a corporation in an empowerment zone (¶ 999B) and the taxpayer acquires the stock after December 21, 2000. For stock acquired before September 28, 2010, seven percent of the excluded gain is a tax preference item for alternative minimum tax (AMT) purposes (¶ 1425). The sale or exchange of qualified small business stock is reported on Form 8949.

Excludable gain on dispositions of stock from any single issuer for any given tax year is limited to the greater of: (1) $10 million reduced by the aggregate amount of eligible gain on the issuer's stock that the taxpayer excluded in prior years ($5 million for married individuals filing separately); or (2) 10 times the taxpayer's adjusted basis in all of the issuer's qualified stock disposed of during the tax year.

Qualified Small Business Stock. Qualified small business stock is stock issued after August 10, 1993, and acquired by the taxpayer at its original issue (directly or through an underwriter) in exchange for money or property, or as compensation for services provided to the corporation (Code Sec. 1202(c) and (d); Reg. § 1.1202-2).[8] Qualified stock acquired by exercising options or warrants or by converting debt is deemed acquired at original issue. The issuing corporation must be a domestic C corporation (other than a regulated investment company (RIC) (¶ 2301), cooperative, or other similar pass-through corporation).

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[4] ¶ 22,265; SALES: 45,354; § 38,235.15

[5] ¶ 22,265; SALES: 45,360; § 38,235.20

[6] ¶ 22,268.20; SALES: 45,360.15; § 38,235.20

[7] ¶ 30,372; SALES: 15,300; § 16,605.05

[8] ¶ 30,372, ¶ 30,374; SALES: 15,304.05; § 16,605.10

Both before and immediately after the qualified stock's issuance, the corporation's aggregate gross assets must not exceed $50 million. All corporations that are members of the same parent-subsidiary controlled group are treated as one corporation in applying this test. In addition, during substantially all of the taxpayer's holding period, at least 80 percent of the value of the corporation's assets must be used in the active conduct of one or more qualified trades or businesses (Code Sec. 1202(e)). The performance of services in the fields of health, law, engineering, architecture, etc., are not qualified trade or business, nor are the hospitality, farming, insurance, finance or mineral extraction industries. However, a specialized small business investment company (SSBIC), licensed under section 301(d) of the Small Business Investment Act of 1958, meets the active business test (¶ 1909). Small business stock is not qualified if it has been the subject of certain redemptions that are more than *de minimis*.

Qualified stock that is converted to other stock of the corporation (such as preferred stock) remains qualified stock (Code Sec. 1202(f)). A taxpayer who acquires qualified stock by gift or inheritance is treated as having acquired it in the same manner as the transferor and adds the transferor's holding period to his or her own (Code Sec. 1202(h)). Gain on dispositions of qualified stock held by a pass-through entity (partnership, S corporation, RIC, or common trust fund) for more than five years is excludable when it is passed through to partners, shareholders, and participants who held interests in the entity when it acquired the stock and at all times thereafter. However, the exclusion cannot reflect any increase in that person's share of the entity after the entity acquired the stock (Code Sec. 1202(g)).

1907. Rollover of Gain from Small Business Stock. A noncorporate taxpayer may elect to roll over capital gain from the sale of qualified small business stock (¶ 1905) held for more than six months if other qualified small business stock is purchased during the 60-day period beginning on the date of sale (Code Sec. 1045; Reg. § 1.1045-1).[9] The replacement stock must meet the active business requirement for the six-month period following its purchase. Except for purposes of applying the six-month active business test, the holding period of the stock purchased includes the holding period of the stock sold. Gain is recognized only to the extent that the amount realized on the sale exceeds the cost of the replacement stock. The basis of the newly purchased stock is reduced by the amount of gain rolled over. Special rules apply for partnerships that want to roll over gain from a business that is held in the form of qualified small business stock. The sale of the stock is reported on Form 8949.

1909. Rollover of Gain from Publicly Traded Securities. Individuals and C corporations may elect to defer recognition of capital gain realized on the sale of publicly traded securities if the sale proceeds are used within 60 days to purchase common stock or a partnership interest in a specialized small business investment company (SSBIC) (Code Sec. 1044; Reg. § 1.1044(a)-1).[10] Gain must be recognized to the extent that the sale proceeds exceed the cost of the SSBIC common stock or partnership interest. An SSBIC is a corporation or partnership licensed under section 301(d) of the Small Business Investment Act of 1958 to finance small business concerns owned by disadvantaged persons.

The exclusion for an individual (including spouses who file a joint return) is limited to $50,000 in any single tax year and $500,000 over the taxpayer's lifetime ($25,000 and $250,000, respectively, for a married individual filing separately). Gain excluded on a joint return is allocated equally between the spouses in applying the $500,000 lifetime limit. For a C corporation, the annual and cumulative limits are $250,000 and $1 million, respectively. All corporations that are members of the same controlled group are treated as one taxpayer, and any gain excluded by the predecessor of a C corporation is treated as gain excluded by the successor corporation. The deferred gain generally reduces the taxpayer's basis in the acquired stock or partnership interest. However, if the stock is

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[9] ¶ 29,850, ¶ 29,852; SALES: 15,308; § 16,610.05

[10] ¶ 29,845, ¶ 29,845B; SALES: 27,400; § 16,615, § 18,245

qualified small business stock, basis is not reduced when calculating gain eligible for the exclusion for qualified small business stock (¶ 1905).

The election to roll over gain into an SSBIC must be made by the due date (including extensions) for the taxpayer's return for the year in which the publicly traded securities are sold. The election is made by reporting the entire gain from the sale on Form 8949. The taxpayer must also attach a statement showing how the nonrecognized gain was calculated, the SSBIC in which the sale proceeds were invested, the date the SSBIC stock or partnership interest was purchased, and the basis of the SSBIC interest. Once made, the election is revocable only with the IRS's consent.

1911. Losses on Small Business Stock (Section 1244 Stock). An individual's loss on the sale, exchange, or worthlessness of small business stock (section 1244 stock) may be treated as an ordinary loss, even if the stock is a capital asset (Code Sec. 1244).[11] The maximum amount deductible as an ordinary loss in any tax year is $50,000 ($100,000 for married individuals filing a joint return).

The ordinary loss is treated as a loss from the taxpayer's trade or business in computing a net operating loss (NOL) for the tax year (¶ 1145) and is reported on Form 4797. Any loss that exceeds the annual limit is treated as a capital loss and reported on Form 8949. Any gain on the disposition of section 1244 stock is capital gain if the stock was a capital asset in the taxpayer's hands (¶ 1741).

Section 1244 stock is stock of a domestic corporation (including preferred stock) issued after November 6, 1978, that meets the following requirements (additional requirements apply to stock issued after June 30, 1958, and before November 7, 1978):

- the stock must have been issued to the taxpayer, or a partnership in which the taxpayer was a partner, in exchange for money or property other than stock or securities;

- the issuing corporation must be a small business corporation, meaning that at the time the stock was issued the aggregate amount of money and other property (taken into account at its adjusted basis) received by the corporation as contributions to capital and as paid-in surplus (not only for the stock in question but any previously issued stock) did not exceed $1 million (so S corporation stock does not automatically qualify as section 1244 stock); and

- during the corporation's five most recent tax years ending before the date the stock is sold by the taxpayer, more than 50 percent of its gross receipts must have been derived from sources other than royalties, rents, dividends, interest, annuities, and gains from the sales of securities (since the corporation must be largely an operating company, stock in corporations with little or no gross receipts is not eligible for ordinary loss treatment) (Reg. §§ 1.1244(c)-1 and 1.1244(c)-2).[12]

1913. Losses on Small Business Investment Company Stock (SBIC). A loss on the sale, exchange, or worthlessness of stock in a small business investment company (SBIC) (¶ 2392) may be treated as an ordinary loss on Form 4797, even if the stock is a capital asset in the taxpayer's hands (Code Sec. 1242; Reg. § 1.1242-1(b)).[13] The SBIC must be licensed to operate as an SBIC when the loss is sustained. The loss is not subject to the limitations on the allowance of nonbusiness deductions in computing net operating losses (NOLs) (¶ 1145). When a taxpayer has several transactions involving SBIC stock, each transaction is considered separately; they are not netted to determine if the taxpayer has an overall gain or loss. A loss on a short sale of SBIC stock (¶ 1944) with other SBIC stock acquired only for the purpose of closing the short sale is a capital loss under the short sale rules, rather than an ordinary loss (Rev. Rul. 63-65).

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[11] ¶ 30,790; SALES: 18,200; § 16,620.05

[12] ¶ 30,793, ¶ 30,794; SALES: 18,100; § 16,620.15

[13] ¶ 30,753, ¶ 30,754; SALES: 18,304; § 45,410.15

http://www.pbookshop.com

Worthless Securities

1916. Worthless Securities. A security that becomes completely worthless during the tax year is treated as sold or exchanged on the last day of the tax year (Code Sec. 165(g); Reg. § 1.165-5).[14] If the security is a capital asset (¶ 1741), the loss is generally a capital loss subject to the limits on capital losses (¶ 1752). If the security is not a capital asset, the loss is an ordinary loss subject to the limits on ordinary losses (¶ 1101). The amount of the loss is the taxpayer's adjusted basis in the security, less any amount compensated for by insurance.

> **Example:** On December 10, 2015, Judy Green purchased shares of Xetco Corporation for $5,000. On May 1, 2016, she received formal notification that the shares of Xetco were worthless. In claiming a capital loss for the worthless shares on her 2016 tax return, Judy must treat the shares as becoming worthless on December 31, 2016. As a result, her $5,000 capital loss is a long term loss even though she did not own the shares for more than 12 months before they became worthless.

A security becomes totally worthless when it has no value or potential value as the result of an identifiable event. The abandonment of a security establishes its worthlessness to the taxpayer. To abandon a security, the taxpayer must permanently surrender and relinquish all rights in it and receive no consideration for the exchange. Deductions for partial worthlessness are generally not allowed.

A security includes stock, the right to subscribe for or receive stock, and bonds, debentures, notes, certificates, or other evidence of indebtedness issued with interest coupons or in registered form by a corporation or government to pay a fixed or determinable sum of money. A worthless debt that does not meet the definition of a security (e.g., because it was not issued by a corporation or government) is treated as a bad debt (¶ 1135 and ¶ 1143).

Securities held by a securities dealer as inventory are not capital assets, so a dealer's loss from worthlessness is an ordinary loss (¶ 1903). An ordinary loss may also be claimed for losses from worthless securities that are section 1244 stock (¶ 1911), issued by a small business investment company (SBIC) (¶ 1913), held by a small business investment company (¶ 2392), securities in an affiliated corporation, or securities held by a bank or other financial institution (¶ 2383).

Options

1919. Options to Buy or Sell Property. Gain or loss from the sale or exchange of an option to buy or sell property, including a cash settlement option and an option on a section 1256 contract (¶ 1947), is considered gain or loss from the sale or exchange of the underlying property (Code Sec. 1234; Reg. § 1.1234-1).[15] Thus, the gain or loss is capital only if the option covers property that would be a capital asset in the taxpayer's hands (¶ 1741). The length of time the taxpayer held the option determines whether a capital gain or loss is short term or long term unless the sale or exchange is part of a hedging transaction (¶ 1949). If the underlying property is section 1231 property, gain or loss on the sale or exchange of the option may be section 1231 gain or loss (¶ 1747).

If a loss arises from an option holder's failure to exercise an option, the option is deemed to have been sold or exchanged on the date it expired. For the grantor of an option for stock, securities, commodities, or commodity futures (including an option granted as part of a straddle (¶ 1948)), gain or loss from any closing transaction and gain on the lapse of the option is a short-term capital gain or loss. See ¶ 1921 for a discussion of holders and writers of options on securities (i.e., puts and calls).

These characterization rules do not apply to gain or loss realized on the sale or exchange of an option by a dealer who holds options primarily for sale to customers (¶ 1903). They also do not apply to gain realized from the sale or exchange of an

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[14] ¶ 9802, ¶ 10,000; BUSEXP: 30,262; § 16,935

[15] ¶ 30,610, ¶ 30,611; SALES: 45,202; § 19,110, § 19,115

employee stock option (¶ 1925 and ¶ 1927), an option to lease property, an option to buy or sell inventory, an option equivalent to a dividend, an option involving section 306 stock (¶ 739), and an option included as part of a short sale (¶ 1944).

1921. Puts and Calls. Puts are options to sell, and calls are options to buy, stock, securities, or commodities at a set price on or before a specified date. Puts and calls are issued by writers (grantors) to holders for premiums. They end when the holder exercises the option, the option lapses, or the option is effectively terminated at its current fair market value in a closing transaction (Rev. Rul. 78-182; IRS Pub. 550).[16]

Holders of Puts and Calls. The purchase of a put option or call option is not a taxable event. The cost of purchasing the put or call is a nondeductible capital expenditure (Rev. Rul. 71-521).[17] If the holder sells a put or call without exercising it, the difference between its cost and the amount received is either a long-term or short-term capital gain or loss, depending on how long it was held (¶ 1919). If the option expires, its cost is either a long-term or short-term capital loss, depending on the taxpayer's holding period, which ends on the expiration date. If the holder exercises a call, its cost is added to the basis of the security purchased. If the holder exercises a put, the amount realized on the sale of the underlying security is reduced by the cost of the put when computing gain or loss on the sale of the security. That gain or loss is long term or short term depending on the taxpayer's holding period for the underlying security (Rev. Rul. 78-182; IRS Pub. 550).[18] The acquisition of a put is considered a short sale, and the exercise, sale, or lapse of the put is a closing of the short sale (¶ 1944).

Writers of Puts and Calls. If a taxpayer writes or grants a call or put option, the premium received is not included in income at the time of receipt. Instead it is deferred until the option expires, the taxpayer buys or sells the underlying security when the option is exercised, or the taxpayer engages in a closing transaction.

When the option expires, the premium can then be treated as a short-term capital gain. If a call is exercised and the taxpayer sells the underlying security, the premium is added to the amount realized on the sale and any gain or loss is long-term or short-term depending on how long the taxpayer held the security. If a put is exercised and the taxpayer buys the underlying security, then the premium reduces its basis in the security. The taxpayer's holding period on the security begins on the date of the purchase, not on the date the put was written.

The taxpayer can also terminate a put or call through a closing transaction—such as repurchasing the option or substituting the original option by purchasing another option with identical terms. The difference between the premium originally received and the amount paid in the closing transaction is short-term capital gain or loss.

> **Example 1:** Ten call options were issued on April 8 for $4,000. The options expired in December without being exercised. The holder (buyer) of the options recognizes a short-term capital loss of $4,000. The writer of the options recognizes a short-term capital gain of $4,000.

> **Example 2:** Assume the same facts as in Example 1, except that on May 10, the options were sold for $6,000. The holder (buyer) of the options who sold them recognizes a short-term capital gain of $2,000. If the writer of the options bought them back, he or she would recognize a short-term capital loss of $2,000.

> **Example 3:** Assume the facts as in Example 1, except that the options were exercised on May 27. The holder (buyer) adds the $4,000 cost of the options to the basis of the stock bought through the exercise of the options. The writer adds the $4,000 received from writing the options to the amount realized from selling the stock. The gain or loss is short term or long term, depending on the holding period of the stock.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[16] ¶ 30,614.14; SALES: 45,200; § 19,105

[17] ¶ 30,592.70; SALES: 45,202; § 19,120

[18] ¶ 30,614.14; SALES: 45,200; § 19,105

http://www.ifrbookshop.com

1923. Nonstatutory Stock Options. An employee or independent contractor granted a stock option as compensation for services rendered is generally subject to the rules regarding restricted property transfers (¶ 713) when the option is granted or exercised, unless it is an incentive stock option (ISO) (¶ 1925) or an option granted under an employee stock purchase plan (ESPP) (¶ 1929) (Code Sec. 83(e)(1); Reg. § 1.83-7).[19]

If a nonstatutory stock option has a readily ascertainable fair market value (FMV) when it is granted, the restricted property rules apply on the grant date. The taxpayer has ordinary income equal to the stock's fair market value on the grant date, less any amount paid. If a nonstatutory stock option does not have a readily ascertainable FMV when it is granted, the restricted property rules apply when the option is exercised or disposed of by the taxpayer, even if the FMV becomes ascertainable before exercise or disposition. If the option is exercised, the taxpayer has ordinary income equal to the stock's FMV at the exercise date or when substantially vested, less the exercise price.

If a nonstatutory stock option is sold or disposed of in an arm's-length transaction, the taxpayer is considered to have exercised the option and has income equal to the money or property received, less the exercise price. If the sale or disposition is not an arm's-length transaction, the taxpayer is not considered to have exercised the option. The taxpayer must, nonetheless, include in income as compensation the amount of money or property received. In addition, when the transferee exercises the option, the taxpayer (transferor) has additional income equal to the FMV of stock acquired by the transferee, less the exercise price and any amount the taxpayer received from the sale of the option. A sale or disposition to a related person is not an arm's-length transaction. If the holder of an option incurs a loss on failure to exercise the option, then it is deemed to have been sold or exchanged on the date it expired (¶ 1919).

Readily Ascertainable Market Value. A stock option generally has a readily ascertainable FMV if it is actively traded on an established securities market (Reg. § 1.83-7(b)).[20] An option that is not actively traded on an established securities market has a readily ascertainable value if the taxpayer can demonstrate that the option is transferable and immediately exercisable, there is no condition or restriction on the underlying property that would have a significant effect on its FMV, and the FMV of the option privilege is readily ascertainable.

Sale of Stock. Stock acquired through the exercise of a nonstatutory stock option is treated as any other investment property when sold or exchanged (IRS Pub. 525). The taxpayer's basis is the amount paid for the stock, plus any amount included in income upon grant or exercise of the option. The taxpayer's holding period begins when the option was acquired if it had a readily ascertainable value, or the date the option was exercised if it did not.

Employer's Deduction. An employer may deduct the value of a nonqualified stock option as a business expense for the tax year in which the option is included in the employee's gross income (Code Sec. 83(h); Reg. § 1.83-6(a)).[21] When the employer and the employee have different tax years, the employer generally claims the deduction in the tax year in which, or with which, the employee's tax year ends. If the option's market value, however, is not readily ascertainable at the time of grant, and the employee's rights in the stock are substantially vested upon exercise, the employer may take the deduction in accordance with its usual method of accounting.

Reporting Requirements. In most situations, when an employee exercises a nonqualified stock option, the employer must report the excess of the fair market value of the stock received over the amount that the employee paid for that stock (i.e., "the spread") on the employee's Form W-2.

1925. Incentive Stock Options. An incentive stock option (ISO) is an option granted by an employer corporation (or related corporation) that gives an employee the

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[19] ¶ 6380, ¶ 6388; COMPEN: 18,500; § 21,701

[20] ¶ 6388; COMPEN: 18,502, COMPEN: 18,504; § 21,710.05

[21] ¶ 6380, ¶ 6386; COMPEN: 18,508; § 21,720

right to purchase stock of the employer, often at a discount. Unlike with a nonstatutory stock option (¶ 1923), the employee generally does not realize gain or loss when an ISO is granted or exercised if certain requirements are met (Code Sec. 421(a)).[22] Instead, the employee is not subject to income tax until the shares acquired by the exercise of the option are sold. See ¶ 1927 for a discussion of ISO plan requirements.

Gain or loss from the sale of the stock received in an ISO is a capital gain or loss if the taxpayer holds the stock for at least two years after the option is granted and for at least one year after the option is exercised (Code Sec. 422(a); Reg. § 1.422-1(a)).[23] The amount of gain or loss is the difference between the amount the taxpayer paid for the stock (the option price) and the amount received when the taxpayer sold the stock. The taxpayer must remain an employee of the corporation from the time the option is granted until three months before the option is exercised (one year if employment ends because of the taxpayer's permanent and total disability). If the holder of an ISO dies, the deceased's executor, administrator, or representative may exercise the option and receive the same treatment but does not have to do so within three months after the death of the employee (Reg. § 1.421-2(c)).[24]

If the employee sells the stock before the required holding period ends (a disqualifying disposition), gain on the sale is ordinary income to the extent that the fair market value of the stock when the option was exercised exceeds the exercise price (Code Sec. 421(b); Reg. § 1.421-2(b)).[25] Any additional gain is capital gain, and any loss is a capital loss. The gain is recognized for the tax year in which the sale occurs. Gain from a disqualifying disposition is excluded from wages for FICA and FUTA tax purposes and is not subject to income tax withholding (Code Secs. 3121(a)(22) and 3306(b)(19)).

Basis of ISO. An employee's basis in an ISO is the amount that the employee paid for the option. If the employee did not pay for the option and the option lapses, the employee does not have a deductible loss because there is no basis. An employee's basis in stock purchased through an ISO is the amount paid for the stock when the option was exercised, plus any amount paid for the option.

Annual Dollar Limit. The maximum value of stock with respect to which ISOs may first become exercisable in any one year is $100,000. Stock is valued when the option is granted. Options are taken into account in the order in which they are granted, and options issued under ISO plans of any parent, subsidiary, or predecessor corporation are taken into account (Code Sec. 422(d)).[26]

Minimum Tax. The favorable tax treatment of ISOs does not apply for purposes of the alternative minimum tax (AMT). Instead, the *excess* of the (1) fair market value of the stock received upon the exercise of the option, over (2) the amount paid for the stock, plus any amount paid for the ISO, must generally be recognized as an AMT adjustment (¶ 1435). As a result, individuals who have exercised ISOs to purchase stock with a high fair market value that declined before they were able to sell it could be left with large AMT liabilities and no cash to pay them.

1927. Incentive Stock Options Plan Requirements. A stock option granted by an employer to an employee must satisfy several requirements to qualify for favorable tax treatment as an incentive stock option (ISO) (¶ 1925) (Code Sec. 422(b); Reg. § 1.422-2).[27] ISOs must be granted under a plan adopted by the granting corporation that sets out the total number of shares that may be issued under options and the employees who may receive the options. The plan must be approved by the stockholders within 12 months before or after the corporation adopts it.

The options must be granted within 10 years from the date the plan is adopted or approved, whichever is earlier, and the options must be exercisable within 10 years from

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[22] ¶ 19,602; COMPEN: 24,050; § 21,510

[23] ¶ 19,800, ¶ 19,801A; COMPEN: 24,150; § 21,525.05

[24] ¶ 19,609; COMPEN: 24,152; § 21,520.15

[25] ¶ 19,602, ¶ 19,609; COMPEN: 24,056, COMPEN: 24,154; § 21,530.10

[26] ¶ 19,800; COMPEN: 24,116; § 21,515.40

[27] ¶ 19,800, ¶ 19,801C; COMPEN: 24,100; § 21,515.05

http://www.pbookshop.com

the date of the grant. The option price may not be less than the fair market value of the stock at the time the option is granted, and the option may not be transferable other than at the grantee's death. The option may be exercised only by the employee. In addition, the employee, *at the time the option is granted*, may not own stock with more than 10 percent of the total combined voting power of all classes of stock of the employer corporation or its parent or any subsidiary.

1929. Employee Stock Purchase Plans. An employee stock purchase plan (ESPP) may grant employees the option to purchase stock in their employer or the employer's parent or subsidiary. Unlike with a nonstatutory stock option (¶ 1923), the employee generally does not realize gain or loss when an option is granted or exercised under an ESPP, if certain requirements are met (Code Sec. 421(a)).[28] Instead, the employee is not subject to income tax until the shares acquired by the exercise of the option are sold. See ¶ 1931 for a discussion of ESPP plan requirements.

Gain or loss from the sale of the stock received in an ESPP is a capital gain or loss if the taxpayer holds the stock for at a least two years after the option is granted and for at least one year after the option is exercised (Code Sec. 423(a)).[29] The amount of gain or loss is the difference between the amount the taxpayer paid for the stock (the option price) and the amount the taxpayer received when he or she sold the stock. The taxpayer must remain an employee of the corporation from the time the option is granted until three months before the option is exercised (one year if employment ends because of the taxpayer's permanent and total disability). If the employee dies, his or her executor, administrator, or representative may exercise the option and receive the same treatment but does not have to do so within three months after the employee's death (Reg. § 1.421-2(c)).[30]

If the option price is less than 100 percent (but not less than 85 percent) of the fair market value of the stock, then the favorable tax treatment does not apply when the taxpayer disposes of the stock (Code Sec. 423(c)).[31] Instead, the employee recognizes ordinary income equal to the *lesser* of:

- the excess of the fair market value of the shares when sold or on the employee' death, over the option price, or
- the excess of the fair market value of the shares when the option was granted, over the option price.

The balance of any gain is capital gain. Any loss from the sale is a capital loss.

If the employee sells the stock before the required holding period ends (a disqualifying disposition), gain on the sale is ordinary income equal to the fair market value of the stock when the option was exercised, less the exercise price (Code Sec. 421(b); Reg. § 1.421-2(b)).[32] Any additional gain is capital gain, and any loss is a capital loss. The gain is recognized for the tax year in which the sale occurs. Gain from a disqualifying disposition is excluded from wages for FICA and FUTA tax purposes and is not subject to income tax withholding (Code Secs. 3121(a)(22) and 3306(b)(19)).

An ESPP is different from an employee stock ownership plan (ESOP) (¶ 2103). While both plans involve employee ownership of company stock, an ESOP is a retirement plan that holds employer stock for the benefit of participating employees.

1931. Employee Stock Purchase Plan Requirements. An employee stock purchase plan (ESPP) must satisfy several requirements in order for options acquired under the plan to qualify for favorable tax treatment (¶ 1929) (Code Sec. 423(b)).[33] ESPPs are written, shareholder-approved plans under which employees are granted options to purchase shares of their employer's stock or the stock of a parent or subsidiary corporation.

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[28] ¶ 19,602; COMPEN: 21,050; § 21,601
[29] ¶ 19,900; COMPEN: 21,054; § 21,625.10
[30] ¶ 19,609; COMPEN: 21,054.15; § 21,625.10
[31] ¶ 19,900; COMPEN: 21,054.10; § 21,625.10
[32] ¶ 19,602, ¶ 19,609; COMPEN: 21,054; § 21,625.10
[33] ¶ 19,900; COMPEN: 21,052; § 21,610.05

An ESPP cannot grant options to any employee who has more than five percent of the voting power or value of the employer's stock, or that of any parent or subsidiary of the employer. The plan must include all full-time employees except those with less than two years of employment, highly compensated employees (¶ 2114), part-time employees, and seasonal workers. The plan must be nondiscriminatory, though it may limit the amount of stock any employee can buy, and the amount of stock that each employee may become entitled to buy may be tied to compensation.

The option price must be at least equal to the *lesser* of: (1) 85 percent of the fair market value of the stock at the time the option is granted, or (2) 85 percent of the fair market value of the stock at the time the option is exercised. The option must be exercised within 27 months after it is granted (or within five years if the option price test considers the fair market value of the stock at the time the option is exercised). No employee can acquire the right to buy more than $25,000 of stock per year (valued at the time the option is granted).

Wash Sales

1935. Wash Sales of Stock or Securities. Under the wash sale rule, a loss on a sale or other disposition of stock or securities is not deductible unless it is incurred in the ordinary course of a securities dealer's trade or business (¶ 1903) (Code Sec. 1091; Reg. § 1.1091-1).[34] A wash sale occurs if the taxpayer sells or disposes of stock or securities, and within 30 days before or after the disposition date (the 61-day period), the taxpayer acquires substantially identical stock or securities (¶ 1937). Stock and securities acquisitions include contacts and options to acquire them, and acquisition by the taxpayer's traditional IRA or Roth IRA (Rev. Rul. 2008-5).

Only a portion of the total loss is disallowed if a taxpayer acquires less stock or securities during the 61-day period than the taxpayer sold. The nondeductible loss is allocated to the stock or securities disposed of in the order of their time of acquisition. When the amount of stock and securities acquired during the 61-day period is more than the amount sold, the shares acquired that resulted in the nondeductibility of the loss are determined by the order of their acquisition.

A loss realized on the closing of a short sale of stock or securities (¶ 1944) is disallowed under the wash sale rule if within 30 days before or after the closing, the taxpayer sells substantially identical stock or securities or enters into another short sale of substantially identical stock or securities. The wash sale rule also applies to a loss realized on the sale, exchange, or termination of a securities futures contract to sell stock or securities. However, it does not apply to losses from sales or trades of commodity futures contracts and foreign currencies.

The disallowance of a loss under the wash sale rule does not apply to stock or securities acquired in a nontaxable exchange (¶ 1719). This includes stock or securities acquired by gift, bequest, or devise, or through a nonrecognition transaction such as a like-kind exchange, exchange of property for stock, exchange of stock for stock, and spousal transfer incident to divorce. The wash sale rule also does not apply to any loss attributable to a section 1256 contract (¶ 1947) (Code Sec. 1256(f)(5)).[35]

A loss that is disallowed because of the wash sale rule is added to the cost basis of the new stock or securities unless they are acquired through an IRA. The adjustment postpones the loss deduction until the disposition of the new stock or securities (Code Sec. 1091(d); Reg. § 1.1091-2).[36] The taxpayer's holding period of the new stock or securities includes the holding period of the stock or securities sold (Code Sec. 1223(3)).[37]

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[34] ¶ 30,180, ¶ 30,181; SALES: 45,150; § 18,905
[35] ¶ 31,100; SALES: 45,150; § 18,910
[36] ¶ 30,180, ¶ 30,182; SALES: 45,164; § 18,920
[37] ¶ 30,460; SALES: 45,164; § 18,925

http://www.pbookshop.com

Example: Betty buys 100 shares of Rapid Corporation stock for $1,000 on January 1, 2016. She sells these shares on January 2, 2017, for $750. Within 30 days from the sale, she buys another 100 shares of Rapid Corporation for $800. Because Betty purchased substantially identical stock, she cannot deduct the $250 loss that she realized on the sale. However, she adds the disallowed loss of $250 to the cost of her new shares. As a result, her basis in the new shares is $1,050 ($800 cost, plus the $250 loss she could not claim under the wash sale rule). If she sells the new shares on March 31, 2017, any gain is long-term capital gain.

The wash sale rule applies without regard to gain or loss realized on the sale of separate lots of the same stock or security. Thus, a disallowed loss on one lot does not reduce gain realized on a separate lot (Rev. Rul. 70-231).[38] The wash sale rule also does not specifically apply when stock is sold at a loss and a related party, such as the seller's spouse, reacquires the stock within the prohibited 61-day period; however, the loss may be disallowed under the related party rules of Code Sec. 267 (¶ 1717) on the ground that there is an indirect sale to the spouse (*J. P. McWilliams*, SCt, 47-1 USTC ¶ 9289).[39]

1937. Substantially Identical Stock or Securities. In determining whether stock or securities are substantially identical under the wash sale rule (¶ 1935), all facts and circumstances must be considered. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. They may, however, be substantially identical in some cases such as in a reorganization—the stocks and securities of the predecessor and successor corporations may be substantially identical (IRS Pub. 550).

A corporation's bonds or preferred stock are not ordinarily substantially identical to its common stock. When the bonds or preferred stock are convertible into common stock, however, the relative values, price changes, and other circumstances may make them substantially identical to common stock (Rev. Rul. 77-201).[40]

1942. Share Lending Agreements. No gain or loss is recognized on an exchange of securities that is part of a qualifying securities lending arrangement in which the taxpayer transfers the securities and later receives identical securities in return (Code Sec. 1058).[41] In effect, the taxpayer is merely lending securities to the other party to the transaction. This provision is intended to mitigate delays that a broker may face in obtaining securities by allowing the broker to borrow securities without creating tax consequences for the lender. However, the provision applies to any taxpayer that lends securities, not just those that lend to brokers. The securities lending agreement must require the borrower to return securities to the taxpayer that are identical to those that were lent. The taxpayer's basis in the securities received is the same as the taxpayer's basis in the securities that were loaned to the borrower.

Short Sales

1944. Short Sales. A short sale is a transaction in which a taxpayer sells shares of stock or property that he or she does not own or wish to transfer at the time of the sale. The taxpayer sells short by: (1) borrowing property (usually from a broker) and delivering it to the buyer; and (2) closing or covering the transaction at a later date by purchasing substantially identical property and delivering it to the lender, or making delivery out of property the taxpayer held at the time of the sale (Code Sec. 1233(a); Reg. § 1.1233-1(a)).[42]

The seller generally does not recognize gain or loss on a short sale transaction until the property is delivered to the lender and the short sale is closed. However, if the property that has been sold short becomes substantially worthless, the seller must recognize gain as if the short sale were closed when the property became substantially

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[38] ¶ 30,183.11; SALES: 45,160; § 18,930
[39] ¶ 30,183.109; SALES: 45,166.10
[40] ¶ 30,183.14; SALES: 45,154; § 18,915
[41] ¶ 30,000; SALES: 3,302.35; § 18,855
[42] ¶ 30,590, ¶ 30,591; SALES: 45,100; § 19,001

http://www.bookshop.com

worthless (Code Sec. 1233(h)).[43] In addition, a short sale of an appreciated financial position may cause the taxpayer to be treated as making a constructive sale at the time that the taxpayer entered into the transaction (¶ 1945). A taxpayer can avoid the prohibition on recognizing losses from a short sale if the position is part of a mixed straddle (¶ 1948).

Gain or loss on a closed short sale is the difference between the amount realized on the sale of the borrowed property and the taxpayer's adjusted basis in the property used to close the transaction. The character of that gain or loss generally depends on the character of the property used to close the sale in the hands of the taxpayer. Thus, a taxpayer has capital gain or loss if the property used to close the short sale is a capital asset (¶ 1741). Hedging transactions, however, generally result in ordinary income or loss (¶ 1949). If a short seller has a gain on the transaction when the replacement property is purchased, the gain is recognized at that time. A loss is not recognized until the replacement property is delivered to the lender (Rev. Rul. 2002-44).[44]

Holding Period. The short-term or long-term nature of a short seller's capital gain or loss generally depends on how long the seller held the property that is delivered to the lender to close out the sale.

Example: On January 2, Mary Edwards agrees to sell 100 shares of Niftexo Corp. for $10 a share to Susan Croft. Mary does not own any Niftexo shares, so she borrows the 100 shares from her broker and delivers them to Susan. On May 1, Mary buys 100 shares of Niftexo at a price of $15 a share, and immediately delivers them to her broker to replace the shares she had borrowed. Her recognized loss of $500 is short term because her holding period of the Niftexo shares she delivered to her lender (the broker) is determined by the amount of time she held the shares (i.e., less than one day).

Gain from the short sale of a capital asset is short-term capital gain if the taxpayer owned substantially identical property for one year or less on the date of the short sale, or if the taxpayer acquired substantially identical property after the short sale and by the date the sale is closed (Code Sec. 1233(b); Reg. § 1.1233-1(c)).[45] The holding period of the substantially identical property begins on the closing of the short sale or on the date the property is sold, whichever happens first. Any loss realized on the short sale of a capital asset is a long-term capital loss if the taxpayer owned substantially identical property for more than one year even when the property used to close the short sale is held by the seller for one year or less (Code Sec. 1233(d)).

Special holding period rules apply to brokers' arbitrage transactions (Code Sec. 1233(f); Reg. § 1.1233-1(f)).[46] Losses on short sales of stock or securities are also subject to the wash sales rule (¶ 1935).

1945. Constructive Sale of Appreciated Positions. Appreciated financial positions are treated as constructively sold when the taxpayer enters into certain transactions (Code Sec. 1259(a)).[47] The taxpayer must recognize gain as if the position were sold, assigned, or otherwise terminated at its fair market value *as of the date of the constructive sale* and immediately repurchased. Any gain or loss subsequently realized on the position is adjusted to reflect the gain recognized. A new holding period begins on the date of the constructive sale.

An appreciated financial position is generally any position with respect to any stock, debt instrument, or partnership interest if gain would arise if the position were sold, assigned, or otherwise terminated at its fair market value (Code Sec. 1259(b)). It does not include any position that is subject to mark-to-market requirements (¶ 1903), including section 1256 contracts (¶ 1947). It also does not include any position or hedge of a position with regard to straight debt if:

References are to Standard Federal Tax Reports; Tax Research Consultant; and Practical Tax Explanations.

[43] ¶ 30,590; SALES: 45,120; § 19,005
[44] ¶ 30,463.4383; SALES: 45,102
[45] ¶ 30,590, ¶ 30,591; SALES: 45,104; § 19,010.10
[46] ¶ 30,590, ¶ 30,591; SALES: 45,112
[47] ¶ 31,130; SALES: 45,450