

6 Investment Income

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■ New for 2024 ■

- **Capital gain tax rates.** The income brackets for the long-term capital gain and qualified dividends tax rates have increased. See *Capital Gain Tax Rates*, page 6-10.

Common Elections

- Election to amortize bond premium, page 6-7.
- Election to treat the sale of self-created musical works as a sale of a capital asset, page 6-10.
- Election to exclude QSB stock gain, page 6-11.
- Election of a trader in securities to use mark-to-market accounting method, page 6-14.
- Election to defer income for capital gain invested in qualified opportunity fund, page 6-14.
- Election to report the entire gain in the year of sale for an installment sale, page 6-19.
- Election to defer income on stock options, page 6-20.
- Election to suspend the 5-year test period of a principal residence for taxpayers on official extended duty, page 6-23.

2024 Tax Rates: Capital Gain & Dividend Income (page 6-8)

If income is...	Maximum tax rate %	If asset is held...
Gain from the sale of collectibles	28%	More than 1 year
Taxable portion of gain on qualified small business stock (section 1202 exclusion)	28%	More than 5 years
Unrecaptured section 1250 gain	25%	More than 1 year
Long-term capital gain	See below	More than 1 year
Qualified dividend income	See below	More than 60 days
Taxable Income		
Single.....	\$0 – \$47,025	0%
MFJ/QSS.....	\$0 – \$94,050	
MFS.....	\$0 – \$47,025	
HOH.....	\$0 – \$63,000	
Estates and trusts.....	\$0 – \$ 3,150	
Taxable Income		
Single.....	\$47,026 – \$518,900	15%
MFJ/QSS.....	\$94,051 – \$583,750	
MFS.....	\$47,026 – \$291,850	
HOH.....	\$63,001 – \$551,350	
Estates and trusts.....	\$ 3,151 – \$ 15,450	
Taxable Income		
Single.....	\$518,901 and over	20%
MFJ/QSS.....	\$583,751 and over	
MFS.....	\$291,851 and over	
HOH.....	\$551,351 and over	
Estates and trusts.....	\$ 15,451 and over	
Short-term capital gain	37%	1 year or less
Ordinary dividend income	37%	60 days or less

Income Tax Treaties—Qualified Dividends

The U.S. has income tax treaties with the following countries, which allows for qualified dividend treatment from foreign corporations in these countries.

Australia	Egypt	Jamaica	Pakistan	Sweden
Austria	Estonia	Japan	Philippines	Switzerland
Bangladesh	Finland	Kazakhstan	Poland	Thailand
Barbados	France	Latvia	Portugal	Trinidad and Tobago
Belgium	Germany	Lithuania	Romania	Tunisia
Bulgaria	Greece	Luxembourg	Slovak Republic	Turkey
Canada	Iceland	Malta	Slovenia	Ukraine
Chile	India	Mexico	South Africa	United Kingdom
China	Indonesia	Morocco	South Korea	Venezuela
Cyprus	Ireland	Netherlands	Spain	
Czech Republic	Israel	New Zealand	Sri Lanka	
Denmark	Italy	Norway		

Net Investment Income Tax (NIIT) (page 6-4)

3.8% additional tax on investment income if MAGI above threshold amount

Filing status	Single, HOH	MFJ, QSS	MFS
Threshold amount	\$200,000	\$250,000	\$125,000

Types of Business Property (page 6-16)

Section 1231 (page 6-17)	Section 1245 (page 6-17)	Section 1250 (page 6-17)
Trade or business property. Not inventory.	Depreciable personal property.	Depreciable real property.

Tax Treatment of Settlement Costs on Purchase or Sale of Real Estate

[See *Sales of Business Property (Form 4797)*, page 6-16, and *Sale of Principal Residence*, page 6-22]

Settlement Costs	Home Buyer	Home Seller	Rental/Investment Property Buyer	Rental/Investment Property Seller
Real estate taxes: city/town taxes, county taxes.	Deductible beginning on the date of purchase.	Deductible up to, but not including, the date of sale.	Deductible beginning on the date of purchase.	Deductible up to, but not including, the date of sale.
Assessments: condominium fees and homeowners' association fees.	Not deductible.	Not deductible.	Deductible beginning on the date of purchase.	Deductible up to, but not including, the date of sale.
Commission.	Increase basis.	Reduce amount realized. ¹	Increase basis.	Reduce amount realized. ¹
Loan origination fee, loan discount (points).	Deductible (including amounts paid by seller).	Reduce amount realized. ¹	Amortize over term of loan.	Reduce amount realized. ¹
Appraisal fee, credit report, lender's inspection fee, mortgage insurance application fee, assumption fee, mortgage broker fee.	Not deductible.	Reduce amount realized. ¹	Amortize over term of loan.	Reduce amount realized. ¹
Interest.	Deductible beginning on the date of purchase.	Deductible up to, but not including, the date of sale.	Deductible beginning on the date of purchase.	Deductible up to, but not including, the date of sale.
Items required to be paid in advance: mortgage insurance premium, hazard insurance premium, flood insurance.	Not deductible.	Not deductible.	Deductible beginning on the date of purchase.	Deductible up to, but not including, the date of sale.
Title expenses: settlement or closing fee, abstract or title search, title examination, title insurance binder, document preparation, notary fees, attorney's fees, title insurance.	Increase basis.	Reduce amount realized. ¹	Increase basis.	Reduce amount realized. ¹
Government recording and transfer charges: recording fees, city/county tax/stamps, state tax/stamps.	Increase basis.	Reduce amount realized. ¹	Increase basis.	Reduce amount realized. ¹
Additional settlement charges: survey, pest, and other inspections, lead-based paint inspections.	Increase basis.	Reduce amount realized. ¹	Increase basis.	Reduce amount realized. ¹

¹ Amount realized is defined by the IRS as the selling price minus selling expenses. The property's adjusted basis is subtracted from the amount realized to compute a gain or loss on the sale.

Note: Amounts placed in escrow for future payments of items such as taxes and insurance are not deductible until expenses are actually paid by lender.

Tax Treatment of Stock Options

(See *Employee Stock Options*, page 6-20)

	Statutory Stock Option (ISO)¹	Statutory Stock Option (ESPP)	Nonstatutory Stock Option
Income subject to... ²	Regular tax	Regular tax	Regular tax
At Grant Date	Not subject to tax.	Not subject to tax.	Not subject to tax unless FMV is readily determined.
At Exercise Date	Not subject to tax. Note: Taxpayer will generally receive Form 3921. Use Form 3921 to determine basis when ISO is sold.	Not subject to tax. Note: Taxpayer will generally receive Form 3922. Use Form 3922 to determine basis when ESPP is sold.	Substantially vested stock: FMV of option minus the exercise price is treated as compensation (code V, box 12, Form W-2). Restricted stock: Defer income recognition until substantially vested. ⁴ Restricted stock units (RSUs): Defer income recognition until substantially vested. ¹
At Date of Sale (Holding period met)³	<ul style="list-style-type: none"> Income subject to capital gain or loss treatment. Basis equals exercise price. 	<ul style="list-style-type: none"> For options granted at a discount (less than FMV), the difference between the option price and the FMV of the stock at the grant date is treated as compensation (on Form W-2). Excess gain is capital gain. Loss is a capital loss. 	<ul style="list-style-type: none"> Holding period requirement not applicable. Income is subject to short-term or long-term capital gain or loss treatment. Basis equals the amount treated as compensation plus exercise price. A same-day exercise/sell transaction typically generates compensation equal to the FMV of the option minus the exercise price and a short-term loss equal to the broker transaction fees.
At Date of Sale (Holding period not met)³	Gain on sale: An amount equal to the FMV of the option minus the exercise price is treated as compensation (on Form W-2); excess gain is capital gain. Loss on sale: The loss is a capital loss.	<ul style="list-style-type: none"> An amount equal to the FMV (at exercise date) of the option minus the exercise price is treated as compensation (on Form W-2). Basis in the stock is increased by the amount included in compensation. Difference between the increased basis and the selling price is a capital gain or loss. 	

¹ AMT adjustment may be required at exercise date and date of sale, unless stock is exercised and sold in same year.

² Certain stock options exercised or restricted stock units (RSUs) settled may be eligible for a deferral of income election.

³ Required holding period for statutory stock options is the later of one year from the exercise date or two years from the grant date.

⁴ If employee made IRC section 83(b) election, restricted stock is treated the same as substantially vested stock. If no election made, the excess of the stock's FMV at the vesting date over the option price when the stock vests is treated as compensation (on Form W-2).

Basis and Holding Period Rules

Property Type	Basis for Determining Gain and Loss	Holding Period (IRC §1223)
Property acquired by purchase	Cost is the amount paid in cash, debt obligations, other property, or services. Cost also includes sales tax, freight, installation and testing, excise taxes, legal and accounting fees (when they must be capitalized), revenue stamps, recording fees, and real estate taxes (if assumed for the seller). (IRC §1012)	Begins on the date the property was purchased.
Property received for services	If property is received for services, the FMV of the property must be included in income. The amount included in income becomes the basis of the property.	Begins on the date the property becomes substantially vested, meaning it is either transferable or no longer subject to a substantial risk of forfeiture.
Property received in taxable exchange	The FMV at the time of the exchange. A taxable exchange occurs when the taxpayer receives cash or property not similar or related in use to the property exchanged.	Begins on the date the new property was acquired.
Property received in a nontaxable exchange	Usually the same as the basis of the property that was given up, plus any boot paid. Special rules apply for related persons (IRC §1031). See <i>Like-Kind Exchanges (Form 8824)</i> , page 6-19.	Begins on the date the original (given up) property was acquired.
Property transferred from a spouse	For property transferred to a taxpayer by a spouse (or former spouse if the transfer is incident to divorce), the basis of the property received is the same as the spouse's adjusted basis. (IRC §1041) See <i>Divorce</i> , page 12-11.	Begins on the date the spouse acquired the property.
Property received as a gift and sold at a gain	The donor's adjusted basis at the time of the gift, adjusted for any gift tax paid (IRC §1015). See <i>Basis of Gifts</i> , page 21-34.	Begins on the date the donor acquired the property.
Property received as a gift and sold at a loss	Losses cannot be transferred by gift. If the donor's adjusted basis was more than FMV at the time of the gift, the donee's basis is the lesser of: 1) The donor's adjusted basis at the time of the gift, adjusted for any gift tax paid, or 2) The FMV of the property at the time of the gift. (IRC §1015) If using the FMV as the basis results in a gain, there is no gain or loss on the sale.	If (1) donor's adjusted basis is used, the holding period begins on the date the donor acquired the property. If (2) FMV is used, the holding period begins on the date of the gift.
Property received as an inheritance	The FMV of the property on the date of the decedent's death or the alternate valuation date, if used (IRC §1014). See <i>Basis of Inherited Property</i> , page 21-33,	Begins on the date of the decedent's death. Inherited property is considered long term.
Property converted to business or rental use and sold at a gain	Adjusted basis (cost, plus or minus adjustments to basis) at the time the property is sold (IRC §1016). See <i>Property converted from personal use</i> , page 9-3.	Begins on the date the property was purchased.
Property converted to business or rental use and sold at a loss	Basis for recognition of loss is the lesser of: • Adjusted basis at the time of the conversion, plus or minus adjustments to basis after the conversion, or • The FMV at the time of the conversion, plus or minus adjustments to basis after the conversion.	Begins on the date the property was purchased.
Real property repossessed by seller	Basis is the sum of the following amounts: • Adjusted basis in the installment obligation, • Repossession cost, and • Taxable gain on the repossession. See <i>Foreclosure or Repossession</i> , page 6-27.	Includes the period the property was held before the original sale and the period held after the repossession.

For a personal residence, see *Adjusted Basis of a Residence*, page 6-22, for adjustments that must be made to the basis of property before computing gain or loss.

Where to Report Common Types of Investment Income

Type of Income	Individuals Report On...	TTB Tab Page
Tax-exempt interest	Line 2a, Form 1040	page 6-6
Taxable interest	Line 2b, Form 1040	page 6-5
Savings bond interest excluded because of higher education expenses	<ul style="list-style-type: none"> Schedule B (Form 1040) Form 8815 	page 6-6
Qualified dividends	Line 3a, Form 1040	page 6-8
Ordinary dividends	Line 3b, Form 1040	page 6-7
Capital gain distributions	Line 7, Form 1040 or, if required, Line 13, Schedule D (Form 1040)	page 6-8
Section 1250, 1202, or collectibles gain (Boxes 2b, 2c, or 2d, Form 1099-DIV)	<ul style="list-style-type: none"> Form 8949 Schedule D (Form 1040) 	§1250 & §1202 – page 6-11 Collectibles – page 6-10
Nondividend distributions (Box 3, Form 1099-DIV)	Generally not reported ¹	page 6-8
Undistributed capital gains (Boxes 1a – 1d, Form 2439)	Schedule D (Form 1040)	page 6-15
Gain or loss from exchanges of like-kind investment property	<ul style="list-style-type: none"> Line 7, Form 1040 Schedule D (Form 1040) and worksheets Form 8824 	page 6-19

¹ Report amounts in excess of basis in mutual fund shares on Form 8949. Use Part I for shares held one year or less and Part II for shares held more than one year.

Investment Considerations

Cross References

- Form 8938, *Statement of Specified Foreign Financial Assets*
- Form 8960, *Net Investment Income Tax – Individuals, Estates, and Trusts*
- IRS Pub. 550, *Investment Income and Expenses*
- FinCEN Form 114, *Report of Foreign Bank and Financial Accounts (FBAR)*

Related Topics

- Nominee interest and dividends, Tab 3
- Foreign Tax Credit, page 11-11
- Backup withholding, page 23-5

Net Investment Income Tax

Individuals owe an additional 3.8% Medicare tax if they have net investment income and their modified AGI is over the threshold amount of \$250,000 for MFJ and QSS, \$125,000 for MFS, and \$200,000 for Single and HOH. The net investment income tax applies to the lesser of net investment income or the excess of modified AGI over the threshold amount. (IRC §1411)

Net Investment Income*	Excluded From Net Investment Income
<ul style="list-style-type: none">• Interest.• Dividends.• Capital gains from sale of stock, bonds, mutual funds, investment real estate.• Capital gain distributions from mutual funds.• Rental and royalty income.• Nonqualified annuities.• Business income from passive activities.	<ul style="list-style-type: none">• Wages.• Unemployment compensation.• Operating income from a nonpassive business.• Social Security benefits.• Alimony.• Tax-exempt interest.• Self-employment income.• Alaska Permanent Fund Dividends.• Distributions from qualified plans.• Distributions from IRAs.• Gain excluded on sale of personal residence.

* To arrive at net investment income, gross investment income is reduced by any allocable investment deductions (e.g., investment interest expense, investment advisory and brokerage fees, rental and royalty income expenses, tax preparation fees, fiduciary expenses, and state and local income taxes).

Example: Bob, single, has \$180,000 of wages and received \$90,000 from a passive partnership interest. Bob's MAGI is \$270,000, which exceeds the threshold of \$200,000 for single taxpayers. The net investment income tax is based on the lesser of \$70,000 (the amount that Bob's MAGI exceeds the threshold) or \$90,000 (Bob's net investment income). Bob's net investment income tax is \$2,660 ($\$70,000 \times 3.8\%$).

Form 8960, Net Investment Income Tax—Individuals, Estates, and Trusts. Use Form 8960 to calculate the net investment income tax. Individuals report the additional tax on line 12, Schedule 2 (Form 1040), *Additional Taxes*.

Backup Withholding

Investment income is generally not subject to regular withholding. However, it may be subject to backup withholding if the payee fails to furnish the payer a correct taxpayer identification number (TIN). It may also be required if interest or dividends were underreported on the taxpayer's return or the taxpayer failed to certify that they are not subject to backup withholding on this underreported income. See *Backup withholding*, page 23-5.

Nominee Income

If a taxpayer receives Form 1099-INT, 1099-DIV, or 1099-OID showing amounts belonging to another person(s), the taxpayer

is considered a nominee recipient. See *Nominee interest and dividends*, Tab 3.

Foreign Accounts and Trusts

Individuals and domestic entities must report any interests in foreign financial accounts (e.g., bank accounts, brokerage accounts, mutual funds) if certain thresholds are met.

Form 8938, Statement of Specified Foreign Financial Assets. Specified individuals (U.S. citizens, resident aliens, and certain nonresident aliens) living in the United States and holding interests in foreign financial assets with an aggregate value more than \$50,000 (\$100,000 MFJ) on the last day of the year, or more than \$75,000 (\$150,000 MFJ) at any time during the year, must file Form 8938 with their tax return.

Specified individuals living outside the United States must file Form 8938 with their tax return if the total value of their foreign financial assets was more than \$200,000 (\$400,000 MFJ) on the last day of the year, or more than \$300,000 (\$600,000 MFJ) at any time during the year.

Domestic corporations, partnerships, and trusts must file Form 8938 with its tax return if the total value of assets was more than \$50,000 on the last day of the tax year, or more than \$75,000 at any time during the tax year.

Foreign financial asset. An interest in a foreign financial asset includes those assets in which income, gains, losses, deductions, credits, gross proceeds, or distributions from holding or disposing of the account or asset is required to be reported, included, or otherwise reflected on the taxpayer's income tax return.

Due date. Form 8938 is attached to the taxpayer's annual return and due on the date of that return, including applicable extensions.

Exception. Taxpayers who are not required to file an income tax return, do not have to file Form 8938.

Penalties. A penalty up to \$10,000 applies for a failure to disclose and an additional \$10,000 for each 30 days of non-filing after IRS notice of a failure to disclose, for a potential maximum penalty of \$50,000.

FinCEN Form 114, Report of Foreign Bank and Financial Accounts (FBAR). A U.S. person is required to file Form 114 if the person had a financial interest in or signature authority over at least one financial account located outside the U.S., and the aggregate value of all foreign financial accounts exceeded \$10,000 at any time during the calendar year. A U.S. person includes U.S. citizens, U.S. residents, and business entities, trusts and estates, created or organized in the U.S.

FinCEN Form 114 must be filed online separately from the tax return. File at <https://bsaefiling.fincen.treas.gov>, or through tax software.

Due date. The due date for filing FinCEN Form 114 is April 15 of the year following the calendar year being reported. There is an automatic six-month extension to October 15 each year.

Penalties. A penalty up to \$16,117 (2024) applies for each non-willful FBAR reporting violation, and up to the greater of \$161,166 (2024), or 50% of account balances for willful violations.

Note: Additional information comparing Form 8938 and FBAR requirements can be found at <https://www.irs.gov/businesses/comparison-of-form-8938-and-fbar-requirements>.

Form 3520, Annual Return to Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts. U.S. persons, including executors of estates of U.S. decedents, must file Form 3520 to report certain transactions with foreign trusts, ownership of foreign trusts under the rules of IRC section 671 through IRC section 679, and receipt of certain large gifts or bequests from certain foreign persons.

Interest and Dividends (Schedule B)

Cross References

- Form 1099-INT, *Interest Income*
- Form 1099-DIV, *Dividends and Distributions*
- Form 1099-OID, *Original Issue Discount*
- IRS Pub. 525, *Taxable and Nontaxable Income*
- IRS Pub. 550, *Investment Income and Expenses*
- IRS Pub. 1212, *Guide to Original Issue Discount (OID) Instruments*

Related Topics

- Form 1040 U.S. Individual Income Tax Return 2024 Line-by-Line Instructions, page 3-2
- Distributions to Shareholders, page 18-15,

Schedule B (Form 1040), Interest and Ordinary Dividends

Complete Schedule B (Form 1040) if the taxpayer:

- Has over \$1,500 of taxable interest or ordinary dividends.
- Receives interest from a seller-financed mortgage and the buyer used the property as a personal residence.
- Has accrued interest from a bond. See *Accrued interest on bonds*, page 6-6.
- Is reporting original issue discount (OID) in an amount less than the amount shown on Form 1099-OID.
- Is reducing interest income on a bond by the amount of amortizable bond premium. See *Bond Premium Amortization*, page 6-7.
- Is claiming the exclusion of interest from Series EE or I U.S. Savings Bonds issued after 1989.
- Receives interest or ordinary dividends as a nominee. See *Nominee interest and dividends*, Tab 3.
- Has a financial interest in, or signature authority over, a financial account in a foreign country or receives a distribution from, or was a grantor of, or transferor to, a foreign trust.

Taxable Interest

Taxable interest includes interest received from bank accounts, loans made by a taxpayer to another person, and other sources. Interest income is reported to the taxpayer on Form 1099-INT and Form 1099-OID. Distributive shares of interest from partnerships, estates, and S corporations are reported on Schedule K-1 (Form 1065, Form 1041, and Form 1120-S).

Form 1099-INT, Interest Income. A taxpayer receives Form 1099-INT upon any of the following occurrences.

- Interest income of at least \$10,
- Foreign tax withheld or paid on interest, or
- Federal income tax withheld under backup withholding rules.

See *Foreign Tax Credit*, page 11-11, for claiming a deduction or credit for foreign tax paid.

Payer's RTN (optional)		OMB No. 1545-0112	Interest Income
1 Interest income Report on line 2b, Form 1040. See <i>Taxable Interest</i> , above.		Form 1099-INT (Rev. January 2024) For calendar year _____	
2 Early withdrawal penalty Report on line 18, Schedule 1 (Form 1040). See <i>Penalty on Early Withdrawal of Savings</i> , Tab 3.		For Recipient	Copy B
3 Interest on U.S. Savings Bonds and Treas. obligations Report on line 2b, Form 1040. See <i>U.S. Treasury bills, notes, and bonds</i> , page 6-6.			
4 Federal income tax withheld Report on line 25b, Form 1040.	5 Investment expenses See <i>Miscellaneous Itemized Deductions</i> , page 4-26.		

continued in next column

Form 1099-INT continued				
6 Foreign tax paid See <i>Foreign Tax Credit</i> , page 11-11.	7 Foreign country or U.S. possession	This is important tax information and is being furnished to the IRS. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.		
8 Tax-exempt interest Report on line 2a, Form 1040. See <i>Tax-Exempt Interest</i> , page 6-6.	9 Specified private activity bond interest Shows tax-exempt interest subject to AMT. Report on Form 6251. See <i>Alternative Minimum Tax</i> , page 14-2.			
10 Market discount Accrued market discount may be included in income as interest income, if elected. See <i>Market Discount Bonds</i> , page 6-7.	11 Bond premium See <i>Bond Premium Amortization</i> , page 6-7.			
12 Bond premium on Treasury obligations See <i>Bond Premium Amortization</i> , page 6-7.	13 Bond premium on tax-exempt bond See <i>Bond Premium Amortization</i> , page 6-7.	15 State	16 State identification no.	17 State tax withheld

Reporting taxable interest. Report taxable interest income on line 2b, Form 1040 and on Part I, Schedule B (Form 1040), if required. See *Schedule B (Form 1040), Interest and Ordinary Dividends*, previous column.

Seller-financed mortgage interest. Interest received from a seller-financed mortgage should be listed on Schedule B (Form 1040). Report the buyer's name, address, and SSN.

Dividends that are actually interest. Certain distributions commonly called dividends are actually interest. Report as interest so-called "dividends" on deposits or on share accounts in:

- Cooperative banks,
- Credit unions,
- Domestic building and loan associations,
- Domestic savings and loan associations,
- Federal savings and loan associations, and
- Mutual savings banks.

The "dividends" will be shown as interest income on Form 1099-INT.

Money market funds. Money market funds are offered by non-bank financial institutions such as mutual funds and stock brokerage houses, and pay dividends. Generally, amounts received from money market funds should be reported as dividends, not as interest. See *Taxable Dividends*, page 6-7.

Certificates of deposit (CDs). If the taxpayer buys a certificate of deposit (CD) or opens a deferred interest account, interest may be paid at fixed intervals of one year or less during the term of the account. Include this interest in income when actually received or entitled to receive without paying a substantial penalty. The same is true for accounts that mature in one year or less and pay interest in a single payment at maturity. If interest is deferred for more than one year, see *Original Issue Discount (OID)*, page 6-6.

Gift for opening account. If a taxpayer receives noncash gifts or services for making deposits or for opening an account in a savings institution, the value may be reported as interest income on Form 1099-INT and the taxpayer may have to report it on his or her tax return. For deposits of less than \$5,000, gifts or services valued at more than \$10 must be reported as interest. For deposits of \$5,000 or more, gifts or services valued at more than \$20 must be reported as interest. The value is determined by the cost to the financial institution.

Example: Jordy opens a savings account at his local bank and deposits \$800. The account earns \$20 interest. Jordy also receives a \$15 calculator. If no other interest is credited to his account during the year, the Form 1099-INT he receives will show \$35 interest for the year. Jordy must report \$35 interest income on his tax return.

Interest on tax refunds. Any interest payment received on a tax refund is taxable income. The IRS will report interest on tax refunds on Form 1099-INT to anyone who receives interest totaling at least \$10.

Interest on insurance dividends. Interest on insurance dividends left on deposit with an insurance company that can be withdrawn annually is taxable in the year it is credited to the taxpayer's account. However, if the taxpayer can withdraw it only on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.

Prepaid insurance premiums. Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for the taxpayer to withdraw.

U.S. Treasury bills, notes, and bonds. Treasury bills, notes, and bonds are direct debts (obligations) of the U.S. government. Interest income from Treasury bills, notes, and bonds is subject to federal income tax, but is exempt from all state and local income taxes. Interest is reported to the taxpayer in box 3, Form 1099-INT.

Reporting U.S. Treasury Bill, Note, and Bond Interest

Type	Maturity	Interest Income	Reported
Bill	One year or less.	Difference between discounted price and face value.	At maturity.
Note	More than one year, up to 10 years.	Interest paid every six months.	In year paid.
Bond	Longer than 10 years.	Interest paid every six months.	In year paid.

Below-market loans. Taxpayers who make a below-market loan must report as interest income any forgone interest from that loan. See *Imputed Interest on Below-Market Loans*, Tab 3.

U.S. Savings Bonds

Interest on Series EE and Series I bonds is payable when the taxpayer redeems the bonds. The difference between the purchase price and the redemption value is taxable interest.

Series EE bonds. Series EE bonds have a maturity period of 30 years. Paper Series EE bonds were issued at a discount. The face value is payable at maturity. Electronic Series EE bonds are issued at their face value. The face value plus accrued interest is payable at maturity.

Series I bonds. Series I bonds are inflation-indexed bonds issued at their face value amount with a maturity period of 30 years. The face value plus all accrued interest is payable at maturity.

Reporting options for cash method taxpayers. Cash method taxpayers can report the interest on Series EE, Series E, and Series I bonds in either of the following ways.

Method 1. Postpone reporting the interest until the earlier of the year in which the bonds are cashed or disposed of or the year in which they mature.

Method 2. Choose to report the increase in redemption value as interest each year.

Taxpayers must use the same method for all Series EE, Series E, and Series I bonds owned.

Change from method 1. A taxpayer can change from method 1 to method 2 by reporting all interest accrued to date and not previously reported for all of his or her bonds.

Change from method 2. A taxpayer must request permission from the IRS to change from method 2 to method 1. Permission is granted automatically if the required statements are attached to the return or Form 3115, *Application for Change in Accounting Method*, is filed.

Who Pays the Tax on U.S. Savings Bond Interest

IF the taxpayer...	THEN the interest must be reported by...
Buys a bond in his or her name and the name of another person as co-owners, using only taxpayer funds,	The taxpayer.
Buys a bond in the name of another person, who is the sole owner of the bond,	The person for whom the taxpayer bought the bond.
And another person buy a bond as co-owners, each contributing part of the purchase price,	Both the taxpayer and the other co-owner, in proportion to the amount each paid for the bond.
And spouse, who live in a community property state, buy a bond that is community property,	The taxpayer and spouse. If separate tax returns are filed, both taxpayer and spouse each report one-half of the interest.

Excluding interest on Series EE and Series I bonds. Taxpayers may be able to exclude part or all of the interest income from Series EE and Series I savings bonds that were cashed during the year. Bond proceeds must be used to pay qualified higher education expenses for the taxpayer, the taxpayer's spouse, or the taxpayer's dependent. For details, see *U.S. Savings Bond Interest Exclusion*, page 12-7.

Accrued interest on bonds. If Form 1099-INT reflects accrued interest paid on a bond purchased between interest payment dates, report the full amount shown as interest on Schedule B (Form 1040). Then, subtract the amount of accrued interest from the subtotal of all interest income received.

Bonds sold and purchased between interest dates:

Seller. Part of the sales price represents interest accrued to the date of sale. Report that part of the sales price as interest income.

Buyer. Part of the purchase price represents interest accrued before the purchase date. When the taxpayer receives the interest, treat it as a return of capital by reducing the basis in the bond.

Tax-Exempt Interest

Interest on a municipal bond used to finance government operations is generally not subject to federal tax if the bond is issued by a state, the District of Columbia, a U.S. possession, or any of their political subdivisions (such as port authorities, toll road commissions, utility services authorities, community redevelopment agencies, or qualified volunteer fire departments). Most states tax interest on municipal bonds issued by other states but exempt interest on municipal bonds issued by their own state. (IRC §103)

Expenses incurred to produce tax-exempt income and interest expense on money borrowed to buy tax-exempts are not deductible.

Reporting tax-exempt interest. Report tax-exempt interest income on line 2a, Form 1040.

Original Issue Discount (OID)

OID is a form of interest. It is generally included in income as it accrues over the term of the debt instrument, whether payments are received from the issuer or not.

A debt instrument generally has OID when it is issued for a price that is less than its stated redemption price at maturity. OID is the difference between the stated redemption price at maturity and the issue price.

All debt instruments that pay no interest before maturity are presumed to be issued at a discount. Zero coupon bonds are one example of these instruments.

Form 1099-OID, Original Issue Discount. The issuer of the debt instrument, or broker if applicable, should give the taxpayer

Form 1099-OID, or a similar statement, if the total OID for the calendar year is \$10 or more. Form OID will show the following.

- Box 1 – shows the amount of OID for the part of the year that the bond was held.
- Box 2 – shows the stated interest that must be included in the taxpayer’s income for the year.
- Box 8 – shows OID on a U.S. Treasury obligation for the part of the year the taxpayer owned it and is not included in Box 1.
- Box 10 – shows bond premium amortization.

In most cases, the taxpayer must report the entire amount in boxes 1, 2, and 8 as interest income.

Recomputing OID. OID must be recomputed if the debt instrument:

- Was purchased after its original issue and a premium was paid, or
- Is a stripped bond or stripped coupon (including certain zero coupon instruments).

Include the amount from Form 1099-OID in the subtotal of all interest received on Schedule B (Form 1040) and show the OID adjustment as an addition or subtraction to the subtotal. For details on recomputing OID, see IRS Pub. 1212, *Guide to Original Issue Discount (OID) Instruments*.

Bond Premium Amortization

If a taxpayer pays a premium to buy a bond, the premium is part of the taxpayer’s basis in the bond.

Example: A taxpayer may pay \$1,050 for a bond with a maturity value of \$1,000 if the bond is paying a higher rate of interest than current market conditions. The \$50 premium paid is part of the taxpayer’s basis in the bond.

Election to amortize bond premium. If the bond yields taxable interest, the taxpayer can elect to amortize the premium. Each year, over the life of the bond, a part of the premium is used to reduce the amount of interest included in income. The taxpayer’s basis in the bond is then reduced by the amount of amortization claimed. For bonds acquired after 1987, total interest reported on Form 1099-INT for the bond should be listed on Schedule B (Form 1040). Then subtract the amount of premium amortized as an “ABP Adjustment” from the subtotal of all interest income received. For information on bonds acquired before 1988, or if bond premium amortization is more than interest income, see IRS Pub. 550, *Investment Income and Expenses*.

Bonds yielding tax-exempt interest. If the bond yields tax-exempt interest, the taxpayer must amortize the premium. The amount is used to reduce the amount of tax-exempt interest reported on line 2a, Form 1040, and also reduces the taxpayer’s basis in the bond.

Market Discount Bonds

Market discount arises when the value of a debt obligation decreases after its issue date (generally due to an increase in interest rates). Bonds purchased on the secondary market may have a discount.

Election to accrue market discount. When purchasing a market discount bond, a taxpayer can elect to accrue the market discount over the period the bond is owned and include it in income currently as interest income. Market discount included in income increases the taxpayer’s basis in the bond. For details, see IRS Pub. 550, *Investment Income and Expenses*.

Taxable Dividends

Dividends are distributions of money, stock, or other property made by a corporation, or a mutual fund, to a shareholder. Ordinary dividends that are paid out of the earnings and profits of a

C corporation are taxed as ordinary income unless the dividends are qualified dividends. See *Qualified Dividends*, page 6-8.

Dividends paid by C corporations are reported to shareholders on Form 1099-DIV, *Dividends and Distributions*. Distributive shares of dividends from partnerships, S corporations, and estates are reported on Schedule K-1 (Form 1065, Form 1120-S, and Form 1041 respectively).

Form 1099-DIV, Dividends and Distributions. A taxpayer receives Form 1099-DIV from any of the following transactions.

- Dividend income (including capital gain dividends and exempt-interest dividends) and other distributions on stock of at least \$10.
- Foreign tax withheld on dividends and other distributions on stock.
- Federal income tax withheld under backup withholding rules on dividends.
- Received \$600 or more as part of a liquidation.

For claiming a deduction or credit for foreign tax paid, see *Foreign Tax Credit*, page 11-11.

1a Total ordinary dividends Report on line 3b, Form 1040. See <i>Taxable Dividends</i> , page 6-7.		OMB No. 1545-0110 Form 1099-DIV (Rev. January 2024)	Dividends and Distributions
1b Qualified dividends Report on line 3a, Form 1040. See <i>Qualified Dividends</i> , page 6-8.		For calendar year _____	
2a Total capital gain distr. Report on line 7, Form 1040. See <i>Capital Gain Distributions</i> , page 6-8.		2b Unrecap. Sec. 1250 gain Report on Schedule D (Form 1040). See <i>Unrecaptured Section 1250 Gain</i> , page 6-11.	
2c Section 1202 gain Report on Form 8949. See <i>Gains on Small Business Stock</i> , page 6-10.		2d Collectibles (28%) gain Report on Schedule D (Form 1040). See <i>28% Rate Gain</i> , page 6-10.	
2e Section 897 ordinary dividends Shows portion of amount in box 1a that is IRC section 897 gain attributable to disposition of U.S. real property interests (USRPI).*		2f Section 897 capital gain Shows portion of amount in box 2a that is IRC section 897 gain attributable to disposition of USRPI.*	
3 Nondividend distributions Reduce basis. See <i>Nondividend Distributions</i> , page 6-8.		4 Federal income tax withheld Report on line 25b, Form 1040.	
5 Section 199A dividends See <i>Qualified Business Income Deduction (QBIID)—IRC §199A</i> , page 8-15.		6 Investment expenses See <i>Miscellaneous Itemized Deductions</i> , page 4-26.	
7 Foreign tax paid See <i>Foreign Tax Credit</i> , page 11-11.		8 Foreign country or U.S. possessions	
9 Cash liquidation distributions See <i>Corporate Liquidations</i> , page 18-22.		10 Noncash liquidation distributions See <i>Corporate Liquidations</i> , page 18-22.	
12 Exempt-interest dividends Report on line 2a, Form 1040. See <i>Exempt-interest dividends</i> , page 6-8.		13 Specified private activity bond interest dividends Report on line 2g, Form 6251. See <i>Alternative minimum tax (AMT)</i> , page 6-8.	
14 State	15 State identification no.	16 State tax withheld	

* Boxes 2e and 2f apply only to foreign persons and entities whose income maintains its character when passed through or distributed to its direct or indirect foreign owners or beneficiaries. It is generally treated as effectively connected to a trade or business within the United States.

Dividends received in January. Dividends declared by a mutual fund or real estate investment trust (REIT) in October, November, or December, but actually paid in January of the following year, are considered to be received on December 31. The taxpayer reports the dividend in the year it was declared.

Reporting ordinary dividends. Report total ordinary dividend income on line 3b, Form 1040, and on Part II, Schedule B (Form 1040), if required. See *Schedule B (Form 1040), Interest and Ordinary Dividends*, page 6-5.

Reinvested dividends. Reinvested dividends are dividends the shareholder opts to use to buy more shares of stock rather than receive in cash. The dividends are reported as income, and the shares of stock owned and cost basis increase.

Qualified Dividends

Qualified dividends are ordinary dividends that are qualified for the same 0%, 15%, or 20% maximum tax rate that applies to net capital gains. They are reported in box 1b, Form 1099-DIV, and also included in box 1a, Form 1099-DIV. See *2024 Tax Rates: Capital Gain & Dividend Income*, page 6-1.

Note: Qualified dividends, in general, are those paid by U.S. corporations, corporations in a U.S. possession, foreign corporations that have tax treaties with the U.S., and by foreign corporations that trade on exchanges in the U.S. There is also a holding period requirement for the shareholder or mutual fund.

Reporting qualified dividends. Enter total qualified dividends on line 3a, Form 1040. For a calculation example, see *Capital Gain Tax Rates*, page 6-10.

Capital Gain Distributions

Capital gain distributions are paid by a mutual fund or real estate investment trust (REIT) from net realized long-term capital gains. Capital gain distributions are reported to taxpayers in box 2a, Form 1099-DIV, *Dividends and Distributions*. Taxpayers report capital gain distributions on line 13, Schedule D (Form 1040), *Capital Gains and Losses*.

Exception: Taxpayers report capital gain distributions directly on line 7, Form 1040, if both of the following apply.

- The taxpayer has no capital losses and the only capital gains are capital gain distributions from box 2a, Form(s) 1099-DIV, and
- None of the Form(s) 1099-DIV have an amount in box 2b (unrecaptured section 1250 gain), box 2c (section 1202 gain), box 2d [collectibles (28%) gain], or box 2f (section 897 capital gain).

Nondividend Distributions

Some distributions are a return of cost or other basis. They will not be taxed until cost or other basis is completely recovered. Reduce cost or other basis by these distributions. If the taxpayer gets back all cost or other basis, report the excess distributions as capital gains on Form 8949, *Sales and Other Dispositions of Capital Assets*.

Cash and Noncash Liquidation Distributions

Proceeds from cash and noncash liquidation distributions in excess of the taxpayer's original stock basis are taxable and reported as a capital gain. A taxpayer may have a capital loss if the total liquidating distributions are less than the taxpayer's stock basis. See *Corporate Liquidations*, page 18-22.

Other Dividend Distributions

Exempt-interest dividends. Exempt-interest dividends received from a mutual fund or other regulated investment company are not included in taxable income, but must be reported as tax-exempt interest on line 2a, Form 1040. Basis is not reduced for distributions that are exempt-interest dividends.

Alternative minimum tax (AMT). Exempt-interest dividends paid from specified private activity bonds subject to AMT are reported in box 13, Form 1099-DIV.

Stock dividends. Stock dividends are distributions made by a corporation of its own stock. Generally, stock dividends are not taxable. If the stock dividend is nontaxable, the total basis in the stock remains the same, allocated to the existing shares and new shares.

Taxable stock dividends. Distributions of stock dividends and stock rights are taxable if any shareholder has the choice to receive cash or other property instead of stock. The distribution may also be taxable if the distributed shares are a different class of

shares, for example if a shareholder of common stock receives a distribution of preferred stock, or if the distribution results in an increased percentage of ownership of the corporation. The basis for shares received as a taxable stock dividend is the FMV of the stock on the date of distribution. For more information, see IRS Pub. 550, *Investment Income and Expenses*.

Dividends paid on insurance. Dividends paid on insurance policies are a partial return of the premiums paid. Do not report them as dividends. Include them in income only if they exceed the total of all net premiums paid for the contract.

Alaska Permanent Fund dividends. Do not report these amounts as dividends. Instead, report these amounts as Other Income on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*.

Capital Gains and Losses (Schedule D)

Cross References

- Form 1099-B, *Proceeds From Broker and Barter Exchange Transactions*
- Form 8949, *Sales and Other Dispositions of Capital Assets*
- IRS Pub. 544, *Sales and Other Dispositions of Assets*
- IRS Pub. 550, *Investment Income and Expenses*
- IRC §1221, *Capital asset defined*

Related Topics

- Form 1040 U.S. Individual Income Tax Return 2024 Line-by-Line Instructions, page 3-2
- Stock, page 18-7

Schedule D (Form 1040), Capital Gains and Losses

Use Schedule D (Form 1040), to report the following:

- The overall gain or loss computed from transactions reported on Form 8949, *Sales and Other Dispositions of Capital Assets*.
- Certain transactions not required to be reported on Form 8949.
- Capital gain distributions not reported directly on line 7, Form 1040.
- Gains and losses from the following forms.
 - Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains*.
 - Form 4684, *Casualties and Thefts*.
 - Form 4797, *Sales of Business Property*.
 - Form 6252, *Installment Sale Income*.
 - Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles*.
 - Form 8824, *Like-Kind Exchanges*.
 - Schedules K-1 from partnerships, S corporations, estates, and trusts.
- Loss carryovers from previous years.

Form 8949, Sales and Other Dispositions of Capital Assets.

Taxpayers who sell stock or any other capital asset must usually file Form 8949. The form lists each transaction by type and totals are carried to Schedule D (Form 1040). Use Form 8949 to report the following transactions.

- Transactions reported on Form 1099-B, see page 6-9.
- The sale or exchange of a capital asset not reported on another form or schedule.
- Gains from involuntary conversions (other than from casualty or theft) of capital assets not used in a trade or business.
- Nonbusiness bad debts.
- Worthlessness of a security.
- The election to defer capital gain invested in a Qualified Opportunity Fund (QOF). See *Qualified Opportunity Fund Deferral Election*, page 6-14.
- The disposition of interests in QOFs.

A separate Part I (short-term transactions) and separate Part II (long-term transactions) of Form 8949 must be filed for each of the following categories.

- Form 1099-B showing basis reported to IRS (box A or D).
- Form 1099-B showing basis was not reported to IRS (box B or E).
- Transaction not reported on Form 1099-B (box C or F).

Columns (f) and (g). Enter any necessary adjustments to gain or loss in column (g), Form 8949. Enter the appropriate explanation code in column (f).

Capital assets. Most property a taxpayer owns and uses for personal or investment purposes is a capital asset. For example, a house, furniture, car, stocks, and bonds are capital assets.

Personal-use property. Gain from a sale or exchange of personal-use property is a capital gain. Loss from the sale or exchange of personal-use property is not deductible.

Investment property. Investment property is property held for the production of income or anticipated appreciation in value. A gain or loss from the sale or exchange of investment property (such as stocks and bonds) is a capital gain or loss.

Worthless stock. Stocks that become wholly worthless during the tax year are treated as though they were sold on the last day of the year. Worthless stock includes abandoned stock, permanently surrendered for no consideration. Different rules apply to stock in a corporation affiliated with the taxpayer. [(IRC §165(g)]

Nonbusiness bad debt. A nonbusiness bad debt is not deductible until it is totally worthless. The taxpayer must be able to show that reasonable steps have been taken to collect the debt. Court action to establish worthlessness is not required if the taxpayer can show that a judgment from the court would be uncollectible.

How to deduct nonbusiness bad debt. Report nonbusiness bad debts as a short-term capital loss on Form 8949, *Sales and Other Dispositions of Capital Assets*.

Enter the debtor's name and "bad debt statement attached" in column (a), the amount of the bad debt in column (e), and zero in column (d). Use a separate line for each bad debt.

The attached statement should include:

- A description of the debt, including amount and due date.
- Name of the debtor.
- Details of any business or family relationship to the taxpayer.
- Efforts made to collect the debt.
- Why the taxpayer decided the debt was worthless (e.g. the debtor declared bankruptcy).

Court Case: Taxpayers agreed to lend their son \$97,000 to purchase a small business, funded by a home mortgage of \$55,000 and withdrawal from a savings account of \$42,000. The son signed an unsecured promissory note for \$55,000 to the parents. Within five years, the business closed, and the son filed bankruptcy. The taxpayers claimed a nonbusiness bad debt of \$55,000. The IRS disallowed the deduction on grounds there was no valid debtor/creditor relationship.

The Tax Court noted that transactions between family members are subject to careful scrutiny and that the execution of a note does not necessarily establish the existence of a bona fide debt. Nevertheless, the court held that a genuine debtor/creditor relationship existed in this case and allowed the \$55,000 deduction. The court's conclusion was supported by the testimony of the taxpayers that, although they never expected repayment of the \$42,000, they fully expected repayment of the \$55,000. (*A/t, T.C. Summary 2006-96*).

Noncapital assets. The following kinds of property are not capital assets.

- Stock in trade or other property included in inventory or held mainly for sale to customers.

- Accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered, or from the sale of stock in trade or other property held mainly for sale to customers.
- Depreciable property used in a trade or business, even if it is fully depreciated.
- Real estate used in a trade or business.
- Patents, inventions, models or designs (whether or not patented), secret formulas or processes, copyrights, literary, musical, or artistic compositions, letters or memoranda, or similar property created by the taxpayer's personal efforts, prepared or produced for the taxpayer, or received from a person who created the property. See *Capital Gains Election for Self-Created Musical Works*, page 6-10.
- U.S. government publications the taxpayer received from the government, other than by purchase at the normal sales price.
- Certain commodities derivative financial instruments held by a dealer.
- Certain hedging transactions entered into in the normal course of a trade or business.
- Supplies regularly used in a trade or business.
- Property deducted under the de minimis safe harbor for tangible property.

Form 1099-B, Proceeds From Broker and Barter Exchange Transactions

A taxpayer receives Form 1099-B from the following transactions.

- Sale of stocks, bonds, commodities, regulated future contracts, foreign currency contracts, forward contracts, debt instruments, etc., for cash,
- Receipt of cash, stock, or other property from a corporation that had its stock acquired in an acquisition of control or had a substantial change in capital structure, or
- Exchange of property or services through a barter exchange.
- Disposition of an interest in a qualified opportunity fund.

Covered security. Generally, a covered security is a security acquired after 2010, with certain exceptions explained in the Instructions for Form 8949, *Sales and Other Dispositions of Capital Assets*. Cost or other basis must be reported on Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*, for a covered security.

Basis adjustments. If no basis is shown on Form 1099-B or the basis was not reported to the IRS, enter the correct basis of the property in column (e) of Form 8949. If the basis shown on Form 1099-B is not correct, use columns (f) and (g) to make the necessary adjustment. An adjustment may be necessary if a taxpayer is excluding or postponing a capital gain or in the event of a disallowed loss. For information on the use of other codes for basis adjustments, see *Instructions for Form 8949*. For exceptions of how to report these adjustments, see *Exception 2*, below, *Exclusion of gain election (IRC §1202)*, page 6-11, and *Wash Sales*, page 6-12.

Reporting transactions on Form 8949. Generally a taxpayer must report each transaction on separate row of Form 8949.

Exception 1. A taxpayer may be able to combine the transactions and report them on line 1a (for short-term transactions) or on line 8a (for long-term transactions) of Schedule D (Form 1040). The exception applies to transactions for which:

- Form 1099-B shows basis was reported to the IRS and does not show any adjustments in box 1f or 1g,
- The ordinary box in box 2 of Form 1099-B is not checked,
- No adjustments to basis or type of gain or loss are needed, and
- The taxpayer is not electing to defer income (or terminating deferral) from an investment in a qualified opportunity fund (QOF).

Exception 2. Instead of reporting each transaction on a separate row of Form 8949, the transactions may be reported on an attached statement containing all the information of Form 8949 and in a similar format. Use as many attached statements as needed. Enter

the combined totals from each attached statement on a separate line of Form 8949. Enter the name of the broker followed by the words “see attached statement” in column (a) of Form 8949. Leave columns (b) and (c) blank. Enter M in column (f) along with other codes that apply. Enter the totals that apply in columns (d), (e), (g), and (h).

This exception is not available for the election to defer eligible gain by investing in a Qualified Opportunity Fund. See *Qualified Opportunity Fund Deferral Election*, page 6-14.

Basis

The basis of investment property is generally the purchase price plus the costs of purchase, such as commissions and recording fees. For property acquired other than by purchase, basis may be determined by fair market value or the previous owner’s adjusted basis.

Basis substantiation. Taxpayers may not estimate to substantiate basis of stock sold. If a taxpayer cannot prove basis with adequate records, the basis is zero. (*Hoang*, 11th Cir., May 2, 2014)

Inherited basis. The fair market value used to determine the basis of assets acquired from a decedent is required to be consistent with the value used for estate tax purposes. The executor of an estate required to file an estate tax return must provide beneficiaries the value of each interest received. See *Basis of Inherited Property*, page 21-33.

Holding Periods

Capital gains and losses must be separated according to how long the taxpayer held or owned the property. To determine how long property has been held or owned, begin counting on the day after the date the property was acquired and include the date of disposition. See *Basis and Holding Period Rules* chart, page 6-3.

Holding Period Rules

Type of gain or loss	Holding period or treatment
Short-term	One year or less.
Nonbusiness bad debt	Treat as short-term capital loss. See <i>Nonbusiness bad debt</i> , page 6-9.
Long-term	More than one year.
Inherited property	Treat as long-term regardless of time held.

Capital Gain Tax Rates

Tax rates that apply to net capital gain are generally lower than tax rates that apply to other income and are referred to as maximum capital gain tax rates. Net capital gain is the amount by which net long-term capital gain for the year is more than net short-term capital loss. The maximum capital gain tax rate is based on the taxpayer’s taxable income and the type of income. If tax is computed using the maximum capital gain tax rate and the regular tax computation results in a lower tax, the regular tax computation applies.

Long-Term Capital Gain and Qualified Dividends Tax Rates

	0%	15%	20%
<i>For taxpayers with taxable income of:</i>			
Single	\$0 – \$47,025	\$47,026 – \$518,900	\$518,901 and over
MFJ/QSS	\$0 – \$94,050	\$94,051 – \$583,750	\$583,751 and over
MFS	\$0 – \$47,025	\$47,026 – \$291,850	\$291,851 and over
HOH	\$0 – \$63,000	\$63,001 – \$551,350	\$551,351 and over
Estates/Trusts	\$0 – \$3,150	\$3,151 – \$15,450	\$15,451 and over

Note: Net short-term capital gain is taxed at ordinary income tax rates.

Example: Fred is single and for 2024 has taxable income of \$495,000. Included in taxable income are qualified dividends and net capital gain of \$30,000. The maximum capital gain tax rate for Fred is 15% since his income is greater than \$47,025 and less than \$518,901. Fred’s tax for 2024 is calculated as follows.

Taxable income	\$ 495,000
Qualified dividends and net capital gain	\$ 30,000
Maximum capital gain tax rate	15%
Capital gain tax	\$ 4,500
Taxable income minus qualified dividends and net capital gain (\$495,000 – \$30,000)	\$465,000
Regular tax on \$465,000	133,125
Total tax using maximum capital gain tax rate	\$137,625
Regular tax on \$495,000	\$143,625

Fred’s tax on all taxable income is the smaller of the regular tax on \$495,000 or the total tax using the maximum capital gain tax rate. Fred’s total tax for 2024 is \$137,625.

Other maximum tax rate. 28% maximum capital gain tax rate specifically applies to all gains from the sales of collectibles and small business stock. See *28% Rate Gain*, below.

All unrecaptured section 1250 gain is taxed at a 25% maximum capital gain tax rate. See *Unrecaptured Section 1250 Gain*, page 6-11.

Capital Gains Election for Self-Created Musical Works

A taxpayer can elect to treat the sale or exchange of a musical composition or copyright in musical works created by the taxpayer’s personal efforts as a sale of a capital asset, subject to capital gains treatment. This is true even if the musical composition or copyright in musical works is otherwise considered inventory held mainly for sale to customers. The election is made when the taxpayer treats the sale as a sale of a capital asset on Form 8949.

28% Rate Gain

The 28% tax rate applies to gain from the sale or exchange of collectibles and the eligible gain from the sale of qualified small business stock minus the section 1202 exclusion.

Collectibles gain or loss. A collectibles gain or loss is any long-term gain or deductible long-term loss from the sale or exchange of a collectible that is a capital asset. Collectibles include works of art, rugs, antiques, metals (such as gold, silver, and platinum bullion), gems, stamps, coins, or alcoholic beverages and certain other tangible property. Collectibles gain includes gain (but not loss) from the sale of an interest in a partnership, S corporation, or trust held for more than one year and attributable to unrealized appreciation of collectibles.

Note: The IRS has issued Notice 2023-27 announcing its intent to treat certain NFTs as collectibles. See *Non-fungible tokens (NFTs)*, page 6-15.

Gains on Small Business Stock

A taxpayer who sells qualified small business stock may be able to roll over the gain tax free or exclude part of the gain from income.

Qualified small business (QSB) stock. QSB stock is stock originally issued by a QSB after August 10, 1993, that meets all seven tests listed in IRS Pub. 550, *Investment Income and Expenses*. The tests include:

- The stock must be C corporation stock.
- The corporation must have total gross assets of \$50 million or less at all times after August 9, 1993, up to and including the point immediately after the stock was issued.
- The stock was acquired at its original issue in exchange for money or other property (not including stock) or as pay for services. Certain individuals may meet the test if they acquired the stock through gift or inheritance.
- The corporation must have met the active business test and have been a C corporation during substantially all the time the taxpayer held the stock.

Rollover of gain (IRC §1045). Taxpayers can elect to roll over a capital gain from the sale of QSB stock held longer than six months into other QSB stock. If this election is made, the gain from the sale is generally recognized only to the extent the amount realized is more than the cost of the replacement QSB stock bought within 60 days of the date of sale. The basis of the replacement QSB stock must be reduced by the gain not recognized.

Exclusion of gain election (IRC §1202). A taxpayer can elect to exclude from gross income gain from the sale or exchange of QSB stock held more than five years. The gain from stock of any one issuer that is eligible for the exclusion is limited to the greater of the following amounts.

- 10 times the taxpayer's basis in all qualified stock of the issuer sold or exchanged during the year.
- \$10 million (\$5 million for MFS) minus the gain from the stock of the same issuer used to compute the exclusion in earlier years.

The exclusion varies based on date of stock purchase.

Exclusion of Gain Percentages

Stock Acquired After...	And Before...	Percent of Gain Excluded	
		Qualified Small Business Stock	Qualified Empowerment Zone Business Stock
8/10/1993	2/18/2009	50%	60%*
2/17/2009	9/28/2010	75%	75%
9/27/2010	No deadline	100%	100%

* Gain attributable to periods after December 31, 2018, is not eligible for the 60% exclusion.

Note: C corporation shareholders cannot elect to roll over or exclude gain from the sale or exchange of QSB stock.

Reporting exclusion of gain (IRC §1202). Report the sale or exchange on Form 8949, as the taxpayer would if the exclusion were not being taken. Enter code Q in column (f). Enter the amount of the exclusion as a negative number in column (g).

Losses on Small Business Stock (IRC §1244)

If statutory requirements are met, a loss on the sale of designated stock of a small business corporation is eligible for ordinary loss treatment up to \$50,000 (\$100,000 MFJ) per taxable year.

On a joint return, the limit is \$100,000 even if only one spouse has this type of loss. For example, if a taxpayer has a loss of \$110,000, and the spouse has no loss, the taxpayer can deduct \$100,000 as ordinary loss. The remaining \$10,000 is a capital loss.

Net operating loss (NOL). Any amount of loss that is treated as an ordinary loss under section 1244 shall be treated as attributable to the trade or business of the taxpayer. A taxpayer may deduct the maximum ordinary loss permitted under section 1244 even though all or a portion of the taxpayer's NOL carryover for the taxable year was, when incurred, a loss on section 1244 stock. See *Net Operating Loss (NOL)*, page 8-20.

Depending on the taxpayer's situation, the excess business loss limitation may apply. See *Excess Business Loss Limitation*, Tab 5.

Example: Sam, a single taxpayer, computes an NOL of \$15,000 for 2023. Included in Sam's NOL is a deduction for loss on section 1244 small business stock. Sam carried the entire \$15,000 loss forward. In 2024, Sam has gross income of \$75,000 and again sustains a loss on section 1244 stock. The amount of Sam's 2024 loss on section 1244 stock is \$50,000. Sam may deduct the full \$50,000 as ordinary loss under section 1244 and up to \$15,000 as a net operating loss carryover in 2024, subject to any applicable taxable income limitation. See *NOL Carryback and Carryforward*, page 8-20.

Section 1244 stock qualifications. A section 1244 loss is reported on Form 4797, *Sales of Business Property*, and must meet the following qualifications.

- When the stock was issued, the corporation was a "small business corporation," meaning capital contributions did not exceed \$1 million at the time.
- The stock was issued by the corporation for money or other property (other than stock and securities).
- During the period of its five most recent taxable years ending before the date the loss was sustained, the corporation derived more than 50% of its aggregate gross receipts from sources other than royalties, rents, dividends, interests, annuities, and sales or exchanges of stock or securities.

Additional basis. Section 1244 losses apply only for capital contributions made in exchange for stock. If additional capital contributions are made, the increase in basis is treated as allocable to stock that is not section 1244 stock.

Unrecaptured Section 1250 Gain

Unrecaptured section 1250 gain is taxed at a 25% maximum capital gain rate and is the part of any long-term capital gain on section 1250 property (real property) that is due to depreciation. Unrecaptured section 1250 gain cannot be more than the net section 1231 gain or include any gain otherwise treated as ordinary income. See *Depreciation Recapture—Sale of Business or Investment Property*, page 6-17.

Easements

The amount received for granting an easement reduces the basis of the property. If only a specific part of the entire tract of property is affected by the easement, only the basis of that part is reduced by the amount received. If it is impossible or impractical to separate the basis, the basis of the whole property is reduced.

Amount received more than basis. If the amount received is more than the basis of the part of the property affected by the easement, reduce the basis in that part to zero and treat the excess as a recognized gain. The gain is treated as a capital gain or an ordinary gain, depending upon whether the property is used for personal, investment, or business purposes. The transaction is reported as a sale of property.

Capital Loss Limitation/Carryover

Capital loss limitation. If capital losses are more than capital gains, the difference must be deducted even if there is no ordinary income to offset it. The annual limit on the amount of capital loss that can be deducted is \$3,000 (\$1,500 MFS).

Net capital losses. If a taxpayer has both short-term and long-term losses, the short-term losses are used first against his or her allowable capital loss deduction. If, after using the short-term losses, the taxpayer has not reached the limit on the capital loss deduction, use the long-term losses until the limit is reached.

Capital loss carryover. A capital loss is carried over if either of the following situations applies.

- The net loss on line 16, Schedule D (Form 1040), is more than \$3,000 (\$1,500 MFS), or
- The amount shown on line 15, Form 1040, is less than zero.

When a taxpayer carries over a loss, the loss remains long term or short term. A long-term loss carried over to the next tax year will reduce that year's long-term capital gains before it reduces that year's short-term capital gains.

Computing carryover loss. The amount of capital loss carryover is the amount of the taxpayer's total net loss that is more than the lesser of:

- The allowable capital loss deduction for the year, or
- Taxable income increased by the allowed capital loss deduction for the year.

Example: Carl sold property in 2024 that resulted in a capital loss of \$9,000. Carl had no other capital transactions. On his 2024 return, Carl deducts \$3,000, the annual limit. The unused part of the loss, \$6,000 (\$9,000 – \$3,000), is carried over to 2025.

Below filing requirements. If a taxpayer is not required to file a tax return, but has a capital loss carryover, the taxpayer's taxable income for the year must still be calculated in order to determine the amount of the capital loss carryover to the next year.

Joint and separate returns. If spouses file separate returns in one year, and in a subsequent year file a joint return, separate capital loss carryovers can be combined on the joint return. However, if spouses file a joint return in one year, and in a subsequent year file separate returns, any capital loss carryover from the joint return can be deducted only on the return of the spouse who actually had the loss.

Death of taxpayer. Capital losses cannot be carried over after a taxpayer's death. They are deductible only on the final income tax return filed on the decedent's behalf. The annual \$3,000 (\$1,500 MFS) limit still applies in this situation. Even if the loss is greater than the limit, the decedent's estate cannot deduct the difference or carry it over to following years.

Wash Sales

If a taxpayer sells stock at a loss, then repurchases the same stock within 30 days, the loss is not deductible unless it was incurred in the ordinary course of the taxpayer's business as a dealer in stock or securities. (IRC §1091)

A wash sale occurs when a taxpayer sells or trades stock or securities at a loss and within 30 days before or after the sale:

- Buys substantially identical stock or securities,
- Acquires substantially identical stock or securities in a fully taxable trade,
- Acquires a contract or option to buy substantially identical stock or securities, or
- Acquires substantially identical stock or securities in an individual retirement account (IRA) or Roth IRA. (Rev. Rul. 2008-5)

Substantially identical. All facts and circumstances must be taken into account to determine whether stocks or securities are substantially identical. Ordinarily, stocks or securities of one corporation are not considered substantially identical to stocks or securities of another corporation. However, they may be substantially identical in some cases, such as stocks or securities of predecessor and successor corporations involved in a reorganization. For more information, see IRS Pub. 550, *Investment Income and Expenses*.

Basis of acquired stock or securities. The basis of the newly acquired stock or securities is increased by the amount that has been disallowed due to the wash sale rules. This adjustment postpones the loss deduction until the new stock or securities are sold or traded. The holding period for the newly acquired stock or securities is extended to include the holding period for the stock or securities sold.

Example: On September 4, 2024, Marcie paid \$5,000 for 100 shares of IMT stock. On December 27, 2024, she sold the stock for \$4,000. On January 3, 2025, Marcie paid \$4,100 for 100 shares of IMT stock identical to the stock she had recently sold.

Since wash sale rules apply, Marcie is not allowed to deduct the \$1,000 capital loss on the sale in 2024. Her new basis in the stock is \$5,100 (\$4,100 cost + \$1,000 disallowed loss).

Different number of shares bought than sold. If the number of shares of substantially identical stock purchased is more or less than the number of shares sold, determine the particular shares to which the wash sale rules apply. Match the shares that were purchased within 30 days of the sale up to an equal number of shares sold. Match the shares that were purchased in the order they were purchased.

Example: Gail bought 100 shares of Minimart stock on September 27, 2023. On February 2, 2024, she sold those shares at a \$1,000 loss. On each of the 4 days from February 6, 2024, to February 9, 2024, she bought an additional 50 shares of Minimart stock. Gail cannot deduct the \$1,000 loss. She must add half the disallowed loss (\$500) to the basis of the 50 shares bought on February 6. Add the other half (\$500) to the basis of the shares bought on February 7.

Reporting a wash sale transaction. Report a wash sale transaction in Part I or Part II of Form 8949, *Sales and Other Dispositions of Capital Assets*, with the appropriate box checked. Complete all columns. Enter "W" in column (f). Enter as a positive number in column (g) the amount of loss not allowed.

Money market fund wash sale rule. The redemption of shares in any money market fund will not be treated as a redemption that is part of a wash sale and any loss will be realized. (Rev. Proc. 2023-35)

Demutualization of Life Insurance Companies

Demutualization is when a life insurance company changes from a mutual company to a stock company. A policyholder can elect to receive newly issued stock in the new stock company or cash. Generally, a demutualization is a tax-free reorganization if only stock is received. (IRC §368)

Stock received. If stock is received, the taxpayer is treated as having exchanged his or her voting and liquidation rights for stock of the demutualized company and no gain or loss is recognized. The holding period for the new stock includes the period the taxpayer held an equity interest in the mutual company as a policyholder or an annuitant.

Cash received. If cash is received, the taxpayer must recognize a capital gain. If the policy was owned for more than one year, the gain is long-term capital gain.

Basis. It is the current IRS position that basis in stock received in a demutualization is zero. Several courts have ruled differently on the basis issue. See *Fischer*, U.S. Court of Federal Claims, August 6, 2008 and *Dorrance*, 9th Cir., December 9, 2015.

Short Sales

A short sale is a strategy used by an investor who wants to take advantage of a falling stock price, but does not own the stock, or owns it but does not want to sell. This type of sale is made in two steps.

- 1) **The taxpayer sells short.** The taxpayer borrows the property from a brokerage firm and delivers it to a buyer. Margin rules and other fees and charges may apply.
- 2) **The taxpayer closes the sale.** At a later date, the taxpayer either buys substantially identical property and delivers it to the lender or makes delivery of property held at the time of

sale. Delivery of property borrowed from another lender does not satisfy this requirement.

Gain or loss is not realized until the short sale is closed by delivery of the property. The gain or loss is long-term or short-term, depending on the length of time the property was held. Report any short sale in the year it closes on Form 8949.

Example: Even though Bob did not own any stock of Ace Corp., he contracted to sell 100 shares of it, which he borrows from his broker. After 13 months, when the price of the stock has risen, Bob buys 100 shares of Ace Corp. stock and immediately delivers them to his broker to close out the short sale. Bob's loss is a short-term loss because his holding period for the delivered property is less than one day.

Calls and Puts

Calls and puts are options to buy or sell securities. Calls and puts are issued by writers (grantors) to holders for cash premiums. They are ended by exercise, closing transaction, or lapse.

Call option. A call option is the right to buy from the writer of the option, at any time before a specified future date, a stated number of shares of stock at a specified price. The holder (buyer) is anticipating an increase in the value of the stock and will exercise the option if the value increases. If the value of the stock decreases, the holder will allow the option to lapse without exercising the option.

Put option. A put option is the right to sell to the writer, at any time before a specified future date, a stated number of shares at a specified price. The holder (seller) in this case is generally protecting currently owned stock against a decrease in value. If the value of the stock does not decrease, the holder will allow the option to lapse without exercising the option.

Reporting calls and puts. Report on Form 8949 gain or loss from the closing or expiration of a call or put option. A call or put option remaining open at the end of the year is not reported until the year it is closed or expired. Gross proceeds and adjusted basis of call and put options are reported on Form 1099-B.

Tax Rules for Calls and Puts

When a call...	The holder (buyer) must...	The writer (seller) must...
Is exercised	Add the cost of the call to the basis in the stock purchased.	Increase the amount realized on the sale of the stock by the amount received for the call.
Expires	Report the cost of the call as a capital loss on the date it expires.	Report the amount received for the call as a short-term capital gain.
Is sold by the holder	Report the difference between the cost of the call and amount received for it as a capital gain or loss.	This does not affect the writer (seller).
When a put...	The holder (seller) must...	The writer (buyer) must...
Is exercised	Reduce the amount realized from the sale of the underlying stock by the cost of the put.	Reduce the basis in the stock purchased by the amount received for the put.
Expires	Report the cost of the put as a capital loss on the date it expires.	Report the amount received for the put as a short-term capital gain.
Is sold by the holder	Report the difference between the cost of the put and the amount received for it as a capital gain or loss.	This does not affect the writer (buyer).

Example: Bigcorp stock has a current FMV of \$40. An investor buys a call on Bigcorp stock with a strike price of \$50 and an option expiration date of 90 days. The investor pays a premium of \$5 for the call option. Assume that at the end of the 90-day period, the stock price has risen to \$60. The investor would exercise the option (buy the stock for \$50) and could either hold the stock or sell it and recognize a gain of \$5 (\$60 – \$50 strike price – \$5 premium fee). On the other hand, if the stock price does not rise to \$50 by the end of the 90-day period, the option would expire as worthless and the investor would recognize a \$5 loss on the premium fee.

Straddles

A straddle is a set of offsetting positions on actively traded property, including stock options and contracts to buy stock. For example, a straddle may consist of purchased put and call options to buy and sell on the same number of shares with the same exercise price and period.

Loss deferral rules. Generally, a taxpayer can deduct a loss on a straddle upon disposition of one or more positions only to the extent the loss is more than any unrecognized gain on offsetting positions. Unused losses are treated as sustained in the next tax year.

Exceptions: The loss deferral rules do not apply to:

- Positions established after October 21, 2004 comprising an identified straddle,
- Certain straddles consisting of qualified covered call options and the stock to be purchased under the options,
- Hedging transactions, and
- Straddles consisting entirely of section 1256 contracts.

Section 1256 contracts. If a taxpayer holds a section 1256 contract at the end of the tax year, he or she must generally treat it as sold at its fair market value on the last business day of the tax year and any gain or loss that results must be recognized.

Form 6781, *Gains and Losses From Section 1256 Contracts and Straddles*, is used to compute gains and losses on straddles, which are then reported on Schedule D (Form 1040), *Capital Gains and Losses*.

Classifying Investors and Traders

The rules that apply to taxpayers who trade in securities or commodities depend on whether the taxpayer is classified as an investor, a trader, or a dealer.

Investor. A taxpayer who trades in securities is considered an investor if the taxpayer's activity does not meet the definition of a trader. Investors typically trade in securities to profit from investment earnings and capital appreciation.

Trader. A trader in securities is engaged in the business of buying and selling securities for the trader's own account. To be engaged in business as a trader in securities:

- A trader must seek to profit from daily market movements in the prices of securities and not from dividends, interest, or capital appreciation,
- Trading activity must be substantial, and
- A trader must carry on the activity with continuity and regularity.

Court Case: The court found that the taxpayers did not meet the requirements to be traders in securities rather than investors. The taxpayers did not demonstrate they tried to profit from the swings in the daily market movements. A significant amount of their holdings were held more than 31 days, and they rarely bought and sold on the same day. The court also determined the taxpayers' trading was not substantial and expressed doubt that trading on 63 days in 2001 and 110 days in 2002 is conducting an activity with the frequency, continuity, and regularity indicative of a business. (*Holsinger*, T.C. Memo. 2008-191)

Dealer. A dealer in securities is in the business of purchasing securities for resale to customers. Dealers typically make a profit from the business transaction and not from appreciation of the security.

Traders and dealers may hold securities for investment. The rules for investors apply to securities held for investment purposes by traders or dealers. The securities held for investment purposes must be clearly identified as such before the close of the day on which the security was purchased. Interest and other expenses must be allocated between business activities and investment activities.

Mark-to-market election. A trader in securities may elect the mark-to-market accounting method. Under the mark-to-market method, securities held as a trader are treated as being sold and reacquired for FMV on the last day of the tax year. Gains and losses are treated as ordinary gains or losses and reported on Part II, Form 4797, instead of as capital gains or losses on Form 8949. The mark-to-market election does not apply to securities held by a trader for investment. [IRC §475(f)]

The election must be made by the original due date of the tax year prior to the year for which the election is to be effective. For example, the mark-to-market election for tax year 2024 must have been made by April 15, 2024. Approval from the IRS is not required, but once the election is made, it applies for all later tax years and cannot be revoked without IRS consent.

Change in accounting method. If the taxpayer's method of accounting is inconsistent with the mark-to-market election, the method of accounting must be changed under Revenue Procedure 2024-23 which requires filing Form 3115, *Application for Change in Accounting Method*.

Dealers. Dealers in securities are required to use the mark-to-market accounting method.

Reporting Rules—Investors, Traders, and Dealers

	Investor	Trader	Dealer	Mark-to-Market Trader
Gain or loss from sale of securities reported on...	Form 8949	Form 8949	Part II Form 4797	Part II Form 4797
Gain or loss from sales to customers reported on...	n/a	n/a	Schedule C	n/a
Expenses reported on... ¹	Schedule A ²	Schedule C	Schedule C	Schedule C
Margin interest reported on...	Schedule A	Schedule C	Schedule C	Schedule C
Wash sale rules apply?	Yes	Yes	No	No
Capital loss limitation applies?	Yes	Yes	No	No
Taxpayer eligible for office-in-home expenses?	No	Yes	Yes	Yes
Earnings subject to SE taxes?	No	No	Yes	No

¹ Commissions and other costs of acquiring or disposing of securities are not deductible but must be used to compute gain or loss upon disposition of the securities.

² Miscellaneous itemized deductions subject to the 2% AGI limitation, including investment expenses, are not allowed for tax years 2018 through 2025.

Qualified Opportunity Fund Deferral Election

All taxpayers may elect to temporarily defer tax on short-term and long-term capital gains that are invested in a qualified opportunity fund (QOF). The tax on the gain can be deferred or partially excluded if certain holding periods are met. When the deferred gain is recognized, its character remains the same (short-term or long-term) as when it was deferred. (IRC §1400Z-2)

Deferral. If deferral is elected, the gain invested in a QOF is deferred until the date the QOF investment is sold or December 31, 2026, whichever is earlier. Taxpayers electing deferral must file Form 8949. To qualify, capital gains must be invested in a QOF within 180 days.

Exclusion. If the taxpayer previously elected to defer gain invested in a QOF, and held the investment in the QOF for at least:

- Five years, basis in the QOF is increased by 10% of the amount of deferred gain.
- Seven years, basis in the QOF is increased by 15% of the amount of deferred gain.
- 10 years, basis in the QOF is the FMV on the date of sale.

Form 8997, Initial and Annual Statement of Qualified Opportunity Fund (QOF) Investments. An investor in a QOF uses Form 8997 to inform the IRS of the QOF investments and deferred gains held at the beginning and end of the current tax year, any capital gains deferred by investing in a QOF, and QOF investments disposed of during the year. An eligible taxpayer holding a QOF investment at any point during the tax year must file Form 8997 with his or her timely filed tax return (including extensions).

Qualified opportunity zones. A list of designated qualified opportunity zones can be found in Notice 2018-48 and Notice 2019-42.

Digital Asset Sale or Exchange

A digital asset is any digital representation of value which is recorded on a cryptographically secured distributed ledger or similar technology. The term includes virtual currencies, stablecoins, and non-fungible tokens (NFTs). If a particular asset has the characteristics of a digital asset, it will be treated as a digital asset for federal income tax purposes.

Digital asset question. All taxpayers must answer a digital asset question on Form 1040. The question asks whether the taxpayer:

- Received (as a reward, award, or payment for property or services), or
- Sold, exchanged, or otherwise disposed of a digital asset (or financial interest in a digital asset).

Note: If the taxpayer's only transactions involving digital assets currency during the year were purchases of digital assets with real currency, he or she is not required to answer yes to the Form 1040 question.

Taxation. For federal tax purposes, virtual currency is treated as property (Notice 2014-21 as modified by Notice 2023-34). A virtual currency transaction includes:

- Receipt of digital assets as payment for property or services; as a reward or award; from mining, staking, or similar activities; or as the result of a hard fork,
- Sale of a digital asset,
- Transfer of digital assets for free (without consideration) as a bona fide gift,
- Disposal of digital assets in exchange for property or services, or in exchange for another digital asset, or
- Any other disposal of a financial interest in a digital asset.

Virtual currency. Virtual currency is a digital asset that functions as a medium of exchange, a unit of account, and/or a store of value. In some environments, it operates like "real" currency, but it does not have legal tender status in the United States.

The IRS uses the term virtual currency to describe the various types of convertible virtual currency that are used as a medium of exchange, such as digital currency and cryptocurrency.

Hardforks and air drops. When new cryptocurrency is split off from existing cryptocurrency the tax impact varies depending on timing. A hard fork (creation of new cryptocurrency) may be followed by an airdrop (distribution to ledger account), which results in taxable income. A taxpayer has constructive receipt from an airdrop at the time it is recorded on the distributed ledger or earlier if able to exercise control. A taxpayer does not have gross income as a result of a hard fork if he or she does not receive units of a new cryptocurrency. (Rev. Rul. 2019-24)

A taxpayer will have ordinary income equal to the FMV of the new cryptocurrency upon constructive receipt. The taxpayer's basis for the new cryptocurrency is the amount included in income. Ordinary income from virtual currency is reported on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*.

Example: Brenda holds 50 units of Crypto R. On August 1, 2024, the distributed ledger for Crypto R experiences a hard fork, resulting in the creation of Crypto S. On that same date, 25 units of Crypto S are airdropped to Brenda's distributed ledger address. She has the ability to dispose of Crypto S immediately following the airdrop. Brenda now holds 50 units of Crypto R and 25 units of Crypto S. On August 1, 2024, the airdrop of Brenda's 25 units of Crypto S is recorded in the distributed ledger with a value of \$50. Brenda must report ordinary income of \$50 for tax year 2024 because she immediately has the ability to dispose of Crypto S. Brenda's tax basis in Crypto S is \$50, the amount of income recognized in the transaction.

Exchange of digital assets for goods or services. If a taxpayer receives any digital assets as compensation for services, or disposed of any digital assets that were held for sale to customers in a trade or business, the taxpayer must report the income as he or she would report other income of the same type. The FMV of digital assets paid as wages is subject to federal income tax withholding, FICA tax, and FUTA tax, and must be reported on Form W-2. For information on digital assets received as payment for goods or services, see *Digital assets income*, Tab 5.

Sale, exchange, disposition of digital assets. A taxpayer generally recognizes capital gain or loss on the sale, exchange, or disposition of digital assets that are held as a capital investment (investment property). Transactions using digital assets must be reported in U.S. dollars as of the date of the transaction to determine gain or loss. The holding period begins the day after the digital assets are received and must be held longer than one year to be considered a long-term capital gain or loss. Capital gain or loss from digital asset transactions is calculated and reported on Form 8949, *Sales and Other Dispositions of Capital Assets*, and then summarized on Schedule D (Form 1040), *Capital Gains and Losses*. If a taxpayer transfers property that is not a capital asset in exchange for a digital asset, he or she will recognize an ordinary gain or loss.

Author's Comment: Many cryptocurrencies are available through online exchanges. It is easy for casual investors to trade these investments. These exchanges are not required to issue tax forms for tax year 2024. Therefore, taxpayers should ensure that the trading platform maintains purchase and sale records for them or they should maintain their own transaction histories. Online cryptocurrency tracking services are available that can help taxpayers track the needed information and facilitate tax reporting.

Determining fair market value (FMV). Generally, the value of virtual currency is listed on a cryptocurrency exchange. However, if a taxpayer receives cryptocurrency in a peer-to-peer transaction or some other transaction not facilitated by a cryptocurrency exchange, the FMV of the cryptocurrency is determined as of the date and time the transaction is recorded on the distributed ledger. The IRS will also accept as evidence of FMV the value as determined by a cryptocurrency or blockchain explorer that analyzes worldwide indices of a cryptocurrency and calculates the value of the cryptocurrency at an exact date and time. If a taxpayer receives cryptocurrency that is not traded on any cryptocurrency exchange and does not have a published value, then the FMV of the cryptocurrency received is equal to the FMV of the property or services exchanged for the cryptocurrency when the transaction occurs.

Non-fungible tokens (NFTs). NFTs are unique digital assets that exist on a blockchain and cannot be replicated. They can represent

digital assets or real-world assets such as artwork, sports cards, or real estate. Each token is unique and irreplaceable. NFTs are usually purchased with cryptocurrency.

The IRS has issued Notice 2023-27 announcing its intent to treat certain NFTs as collectibles.

Mutual Funds

Cross References

- IRS Pub. 550, *Investment Income and Expenses*
- Reg. §1.1012-1

Related Topics

- Investment Interest Paid, Tab 4
- IRA Investment, page 13-7

Mutual Funds

A mutual fund is a regulated investment company generally created by pooling funds of investors to allow them to take advantage of a diversity of investments and professional management.

Mutual fund basis. Shares in a mutual fund are generally acquired at various times, in various quantities, and at various prices. When shares of a mutual fund are sold, it is necessary to determine which shares were sold and the basis of those shares. Taxpayers can use either a cost basis or an average basis to compute gain or loss.

Cost basis. Cost basis can be used only if the taxpayer did not previously use an average basis for a sale of other shares in the same mutual fund. To compute cost basis use either the specific share identification method or the first-in first-out (FIFO) method.

Average basis. Average basis can be used only if the taxpayer acquired the shares at various times and prices, and the shares are held in an account handled by a custodian or agent who acquires or redeems those shares. To compute average basis, the total cost of all shares is divided by the total number of shares that existed just prior to the sale of shares. The average basis of shares remaining will be the same unless additional shares have been acquired.

Electing average basis method. For covered securities, the election to use the average basis method is made by sending written notice to the custodian or agent who keeps the account. For noncovered securities, the taxpayer elects the average basis method on his or her income tax return for the first year the election applies.

Transfer of mutual fund shares. Any exchange of shares in one fund for shares in another fund is treated as a sale. This is true even if shares in one fund are exchanged for shares in another fund within the same family of funds.

Author's Comment: This is a source of confusion for taxpayers. The investment community may use the terms "transfer" or "exchange," but for tax purposes the transaction is a sale and a purchase.

Undistributed capital gains. Undistributed capital gains are reported to mutual fund shareholders when the mutual fund retains some of its long-term capital gains and pays taxes on the undistributed amounts. The amounts are reported to the taxpayer on Form 2439, *Notice to Shareholder of Undistributed Long-Term Capital Gains*. Taxpayers must report the undistributed capital gains on line 11, Schedule D (Form 1040), *Capital Gains and Losses*, and may claim a credit for the amount of tax paid on line 13a, Schedule 3 (Form 1040) *Additional Credits and Payments*.

Addition to basis. Increase the shareholder's basis in mutual fund shares by the difference between the amount of undistributed capital gain included in income and the amount of tax considered paid by the shareholder on that income.

Nondividend distributions. A nondividend distribution is a distribution that is not out of earnings and profits. It is a return of the shareholder's investment or capital in the mutual fund.

Reduction in basis. Decrease the shareholder's basis in mutual fund shares by any nondividend distributions received. If a shareholder's basis is reduced to zero, any further nondividend distributions must be reported as capital gain on Schedule D (Form 1040).

Commissions and load charges. The fees and charges paid to acquire or redeem shares of a mutual fund are not deductible.

- Acquisition fees and charges are added to basis.
- Fees paid to redeem shares usually reduce the redemption price (sales price).

Sales of Business Property (Form 4797)

Cross References

- Form 4797, *Sales of Business Property*
- IRS Pub. 544, *Sales and Other Dispositions of Assets*
- IRC §1231, *Property used in the trade or business and involuntary conversions*
- IRC §1245, *Gain from dispositions of certain depreciable property*
- IRC §1250, *Gain from dispositions of certain depreciable realty*

Related Topics

- Section 179 Recapture, page 9-9
- Sale of a Business, page 28-2

Disposing of Business Property

Use Form 4797, *Sales of Business Property*, to report sales of business property and other depreciable and amortizable property.

Types of Business Property		
Section 1231	Section 1245	Section 1250
Trade or business property. Not inventory.	Depreciable personal property. ¹	Depreciable real property. ²
Page 6-17	Page 6-17	Page 6-17

¹ Section 1245 property also includes certain depreciable real property.

² Section 1250 property is real property that is not and never has been section 1245 property. It is generally buildings and structural components.

Ordinary or capital gain or loss for business property. When a taxpayer disposes of business property, the taxable gain or loss is usually a section 1231 gain or loss. Its treatment as ordinary or capital is determined under the rules for section 1231 transactions. See *Section 1231—Special Treatment for Gains and Losses on Sale of Business Assets*, page 6-17.

When a taxpayer disposes of depreciable property (section 1245 or section 1250 property) at a gain, all or part of the gain may be recognized as ordinary income under the depreciation recapture rules. Any remaining gain is a section 1231 gain. See *Depreciation Recapture—Sale of Business or Investment Property*, page 6-17.

Example: Brooke has owned residential rental property since 2012. She originally purchased the property for \$120,000, of which \$20,000 was the cost for the land. Brooke claimed \$43,481 in depreciation over the years on the building. In 2023, Brooke spent \$5,000 for apartment furnishings and claimed \$1,800 in depreciation on the furnishings. In 2024, Brooke sold the rental property for \$212,000. The breakdown of purchase price indicated \$180,000 for the building, \$30,000 for the land, and \$2,000 for the furnishings. Brooke reports the sale on Part I and Part III of Form 4797. She has a total long-term capital gain of \$132,281 (\$8,800 + \$123,481), which is carried from Form 4797 to line 11, Schedule D (Form 1040).

Form 4797, Part I	Gross Sales Price	Depreciation Allowed	Cost or Other Basis	Gain or (Loss)
Furnishings	\$ 2,000	\$1,800	\$ 5,000	(\$ 1,200)
Land	30,000		20,000	10,000
Total gain				\$ 8,800

Form 4797, Part III	
Gross sales price	\$180,000
Cost or other basis	\$100,000
Depreciation allowed	43,481
Adjusted basis	56,519
Total gain	\$123,481

Reporting Sales of Business Property (Form 4797)

Type of property	Held 1 year or less	Held more than 1 year
1 Depreciable tangible trade or business property: Sold or exchanged at a gain	Part II	Part III (1245)
Sold or exchanged at a loss	Part II	Part I
2 Depreciable real trade or business property: Sold or exchanged at a gain	Part II	Part III (1250)
Sold or exchanged at a loss	Part II	Part I
3 Farmland held less than 10 years upon which soil or water expenses were deducted: Sold at a gain	Part II	Part III (1252)
Sold at a loss	Part II	Part I
4 Real or tangible trade or business property which was deducted under the de minimis safe harbor	Part II	Part II
5 All other farmland used in a trade or business.	Part II	Part I
6 Disposition of cost-sharing payment property described in IRC section 126	Part II	Part III (1255)
7 Cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes: Sold at a gain	Held less than 24 months Part II	Held 24 months or more Part III (1245)
Sold at a loss	Part II	Part I
Raised cattle and horses sold at a gain	Part II	Part I
8 Livestock other than cattle and horses used in a trade or business for draft, breeding, dairy, or sporting purposes: Sold at a gain	Held less than 12 months Part II	Held 12 months or more Part III (1245)
Sold at a loss	Part II	Part I
Raised livestock sold at a gain	Part II	Part I

See *Basis and Holding Period Rules* chart, page 6-3.

Form 4797, Part IV. Recapture of depreciation and amortization under Section 179 and section 280F(b)(2) when business use drops to 50% or less is reported on Form 4797, Part IV. The recapture amount is reported as Other Income on the same form or schedule where the deduction was originally taken.

Partial disposition. A taxpayer may claim a loss upon the disposition of a structural component (or portion thereof) of a building or any other asset without identifying the component as an asset before the disposition event. This partial disposition rule is generally elective, but is required in the following transactions.

- Sale of a portion of a MACRS asset.
- Involuntary conversion of a portion of a MACRS asset, other than from casualty or theft.
- Like-kind exchange of a portion of a MACRS asset (line 5 or 16, Form 4797).

The partial disposition election is made by reporting the gain, loss, or other deduction on the taxpayer's timely filed return (including extensions) for the tax year in which the asset is disposed of by the taxpayer. Include the words "Partial Disposition Election" in the description of the partially disposed asset.

Section 1231—Special Treatment for Gains and Losses on Sale of Business Assets

Section 1231 provides the best of both worlds on the sale of business assets and residential rental property.

Gains. Treated as capital gains and subject to favorable tax rates.

Losses. Treated as ordinary losses (not limited to the annual capital loss limit of \$3,000 per year).

If the total of all gains from sales of business property exceed the total of all losses, all transactions are considered to generate capital gain or loss. If the total of all gains does not exceed the total of all losses, all transactions are considered to generate ordinary income and loss.

Nonrecaptured net section 1231 losses. If cumulative net section 1231 losses have exceeded section 1231 gains for the prior five years, the difference is treated as ordinary income.

Example: Andrew owns a graphic arts company and has the following net section 1231 gains and losses:

Tax Year	Net §1231 Losses	Net §1231 Gains	Tax Year	Net §1231 Losses	Net §1231 Gains
2021	\$8,000	\$0	2023	\$0	\$5,250
2022	\$0	\$0	2024	\$0	\$4,600

In 2023, Andrew reports the entire gain of \$5,250 as ordinary income. In 2024, Andrew reports the \$4,600 gain as \$2,750 of ordinary income and \$1,850 capital gain (\$8,000 – \$5,250 = \$2,750 nonrecaptured net section 1231 loss).

Involuntary conversions. Section 1231 treatment also applies to involuntary conversions of business property. See *Involuntary Conversions*, page 6-25.

Sale of property converted from personal to business or investment use. See *Basis and Holding Period Rules* chart, page 6-3, and *Property converted from personal use*, page 9-3.

Depreciation Recapture—Sale of Business or Investment Property

Depreciation recapture. The term depreciation recapture refers to the amount of gain that is treated as ordinary income upon the sale or other disposition of property.

Gain on Sale of Business Property

Section 1245 Property (Personal property*)	Section 1250 Property (Real property**)
Ordinary Income All depreciation is recaptured as ordinary income, limited to gain on sale.	Ordinary Income <i>MACRS.</i> Accelerated depreciation in excess of straight-line is recaptured as ordinary income. <i>ACRS.</i> All depreciation is recaptured as ordinary income for property depreciated under accelerated methods. Certain exceptions apply. For disposition of property placed in service before 1987, see IRS Pub. 544, <i>Sales and Other Dispositions of Assets</i> .
Capital Gain Any gain remaining after subtracting depreciation recapture is subject to regular capital gain maximum rate of 20%.	Capital Gain <ul style="list-style-type: none"> 25% maximum tax rate. Gain attributable to straight-line depreciation is capital gain subject to a special 25% maximum rate. Referred to as “unrecaptured section 1250 gain.” 20% maximum tax rate. Gain remaining after subtracting the 25% rate gain is capital gain subject to the regular capital gain maximum rate of 20%.

* Section 1245 property also includes certain other assets used as an integral part of manufacturing, production, or extraction; or of furnishing transportation, communications, electricity, gas, water, or sewage disposal services. Also includes single purpose agricultural (livestock) or horticultural structures.

** Section 1250 property includes all real property that is subject to an allowance for depreciation and that is not and never has been section 1245 property.

Example—Section 1245 property: Greg purchased personal property several years ago for use in his business. The cost of the property was \$10,000. Over the years, Greg claimed depreciation of \$4,000. He later sold the property for \$11,000.

Selling price	\$11,000
Less adjusted basis (\$10,000 – \$4,000 accumulated depreciation)	6,000
Gain on sale	\$ 5,000

Allocating \$5,000 Gain—Section 1245 Property

\$4,000 Ordinary Income	\$1,000 Capital Gain (20% maximum)
All depreciation on section 1245 property is recaptured up to amount of gain.	Gain remaining after subtracting recaptured amount.

Example—Section 1250 property: In 2013, Joan paid \$190,000 for non-residential real property to use in her business. She used MACRS depreciation for cost recovery (39-year). In 2024, Joan sold the property for \$240,000. Accumulated depreciation at the time of sale was \$56,000. The overall gain on the sale is \$106,000.

Selling price	\$240,000
Less adjusted basis (\$190,000 – \$56,000 accumulated depreciation)	134,000
Gain on sale	\$106,000

Allocating \$106,000 Gain—Section 1250 Property

\$56,000 Capital gain at 25% maximum rate (unrecaptured section 1250 gain)	\$50,000 Regular capital gain (20% maximum rate)
Gain attributable to straight-line depreciation.	Gain remaining after subtracting gain attributable to straight-line depreciation.

Depreciation defined. Items taken into account in addition to regular depreciation (MACRS, ACRS, and pre-1981 depreciation) include:

- Special depreciation.
- Amortization of Section 197 intangibles.
- Section 179 deduction.
- Amortization deductions for acquiring a lease, leasehold improvements, pollution control facilities, and reforestation expenses.

Depreciation allowed or allowable. When determining the amount of depreciation for purposes of calculating depreciation recapture or unrecaptured section 1250 gain, depreciation is defined as the amount allowed or allowable [IRC §1016(a)(2)]. The courts have long held this rule to mean that even if a taxpayer does not claim depreciation, the basis in the property must still be reduced by the depreciation allowable under IRC section 167. (*Hollen*, T.C. Memo. 2000-99, footnote #7)

However, if the amount allowed was less than the amount allowable, the depreciation taken into account for basis reduction purposes is the amount allowed. [Reg. §1.1245-2(a)(7)]

Correcting depreciation. If it is discovered that an incorrect amount of depreciation was previously taken, or if no depreciation was taken at all, a taxpayer can make a correction in the year it is discovered. See *Correcting Depreciation Errors*, page 9-15.

Installment Sales (Form 6252)

Cross References

- Schedule D (Form 1040), *Capital Gains and Losses*
- Form 6252, *Installment Sale Income*
- IRS Pub. 537, *Installment Sales*
- IRC §453, *Installment method*

Related Topics

- Depreciation, Tab 9
- Sale of Business Examples, page 28-4

Installment Sales

An installment sale is a sale of property where the taxpayer receives at least one payment after the tax year of the sale. If a sale qualifies as an installment sale, the gain must be reported under the installment method unless the taxpayer elects out of using it. Each payment on an installment sale usually consists of:

- Interest income,
- A return of adjusted basis in the property, and
- Gain on the sale (installment sale income).

The installment sale method is not available for:

- A sale that results in a loss.
- The sale of inventory.
- The sale of personal property by a dealer.
- The sale of real property held for sale to customers in the ordinary course of a trade or business. However, the installment sale method is available for the sale of property used or produced in farming.
- The sale of publicly traded property (such as stocks or securities).
- The sale of depreciable property between related parties. For an exception, see *Sale of depreciable property*, next column.

Interest Income From an Installment Sale

The portion of each payment characterized as interest income is reported by the seller as ordinary income on Schedule B (Form 1040), *Interest and Ordinary Dividends*. If an installment sale contract does not provide for adequate stated interest, part of the stated principal amount of the contract may be recharacterized as interest. However, the unstated interest rules do not apply to a debt given in consideration for a sale of personal-use property.

Calculating Installment Sale Income (Gain on Sale)

Form 6252, *Installment Sale Income*, is used to calculate installment sale income.

Selling price. The selling price includes:

- Any money the seller is to receive,
- The FMV of any property the seller is to receive,
- Any existing mortgage or other debt the buyer pays, assumes, or takes (a note, mortgage, or any other liability, such as a lien, accrued interest, or taxes the seller owes on the property), and
- Any of the seller's expenses paid by the buyer.

Note: Selling price does not include interest, whether stated or unstated.

Adjusted basis for installment sale purposes. The adjusted basis used for installment sale purposes includes:

- Adjusted basis,
- Selling expenses paid by the seller, and
- Depreciation recapture income reported in year of sale.

Gross profit. Gross profit is the total gain reported on the installment method. It is computed as:

- Selling price, minus
- Adjusted basis for installment sale purposes.

If the property sold was the taxpayer's main home, gross profit is reduced by any gain that can be excluded. See *Sale of Principal Residence*, page 6-22.

Note: If the sale results in a loss, the installment method cannot be used.

Contract price. The contract price includes the total of all principal payments to be made to the seller over the term of the installment sale. Contract price is calculated as:

- Selling price, minus
- Existing mortgages or other debt the buyer assumes, plus
- The portion of existing mortgages or other debt the buyer assumes in excess of the adjusted basis for installment sale purposes.

If the existing mortgage or other debt assumed by the buyer is greater than the seller's adjusted basis for installment sale purposes, the seller recovers all basis in the property and is also relieved of debt. The portion of the assumed mortgage that is greater than basis is treated as a payment in the year of sale.

Gross profit percentage. A percentage of each payment is reported as installment sale income. The percentage is calculated as:

- Gross profit, divided by
- Contract price.

Selling price reduced. If the selling price is reduced at a later date, the gross profit on the sale will also change. The gross profit percentage must be recalculated for the remaining payments. Any remaining gain is spread over future installments.

Installment sale income. Calculated as:

- Payments received during the year (less interest), times
- Gross profit percentage.

This amount is reported as taxable income each year.

Reporting installment sale income. Form 6252, *Installment Sale Income*, is used to report an installment sale in the year of the sale and to report payments received in later years.

The gain calculated on Form 6252 is transferred to either Schedule D (Form 1040), *Capital Gains and Losses*, for the sale of capital assets or to Form 4797, *Sales of Business Property*, for the sale of property used in a trade or business.

Depreciation recapture. Gain treated as ordinary income under section 1245 or 1250 cannot be reported under the installment method. Depreciation recapture is reported in the year of sale whether or not any installment payments have been received. See *Gain on Sale of Business Property* chart, page 6-17.

Example: In 2017, Bill paid \$90,000 for an airplane that he held to produce rental income. In December 2024, Bill sold the airplane on the installment method for \$120,000, with the first installment scheduled for January 2025. At the time of sale, the cost of the property had been completely recovered through accelerated depreciation deductions. Bill's federal marginal tax rate is 32%. Because the property was personal property, the entire amount of prior depreciation is recaptured as ordinary income in the year of sale. Bill must pay \$28,800 in tax for 2024 ($\$90,000 \times 32\%$) even though he did not receive any payments in 2024.

Unrecaptured section 1250 gain. The amount of capital gain on each installment payment is treated as unrecaptured section 1250 gain until the total unrecaptured section 1250 gain has been used in full. See *Unrecaptured Section 1250 Gain*, page 6-11.

Installment Sale to a Related Party

Sale of depreciable property. The installment method cannot be used to report the sale of depreciable property to a related party. (IRC §1239)

Exception: The installment method is allowed if the seller can show that tax avoidance is not a principal purpose of the sale.

Sale and later disposition. If a taxpayer sells property under the installment method to a related party who then sells the same property within two years of the first sale and before making all payments on the first sale, the taxpayer must treat part or all of the amount realized by the related party on the second sale as if the amount was received by the taxpayer at the time of the second sale. For this purpose, a related party includes a taxpayer's spouse, child, grandchild, parent, brother, sister, or a related corporation, S corporation, partnership, estate, or trust. [IRC §453(f)(1)]

Electing Out of an Installment Sale

A taxpayer may elect not to use the installment method by reporting the entire gain in the year of the sale, even though not all of the sale proceeds have been received. The gain is reported on Form 8949, *Sales and Other Dispositions of Capital Assets*, which flows to Schedule D (Form 1040), or Form 4797, whichever applies.

The election must generally be made by the due date, including extensions, for filing a tax return for the year of the sale. However, if a return was timely filed without making the election, an election can still be made on an amended return filed within six months of the due date of the original return (excluding extensions). Write "filed pursuant to section 301.9100-2" at the top of the amended return. Once made, the election can be revoked only with IRS approval.

Like-Kind Exchanges (Form 8824)

Cross References

- Form 8824, *Like-Kind Exchanges*
- IRS Pub. 544, *Sales and Other Dispositions of Assets*
- IRC §1031, *Exchange of real property held for productive use or investment*

Related Topics

- Depreciation for Like-Kind Exchanges and Involuntary Conversions, page 9-18

Like-Kind Exchanges

Under the like-kind exchange rules, if business or investment real property is exchanged solely for other business or investment real property of a like kind, no gain or loss is recognized. To be a like-kind exchange, the property traded and the property received must be qualifying property and like-kind property. The like-kind exchange rules are limited to real property that is not held primarily for sale and do not apply for personal property.

Like-Kind Property

Qualifying property. Both the real property traded and the real property received must be held for productive use in the taxpayer's trade or business or for investment purposes.

Excluded property. The rules for like-kind exchanges do not apply to exchanges of the following property.

- Real property used for personal purposes such as a home.
- Vacation homes held for appreciation but used for recreation are not considered investment properties for like-kind exchanges. (*Moore, T.C. Memo. 2007-134*)
- Real property held primarily for sale (such as inventory).
- Any personal or intangible property.

Note: Excluded property may be eligible for a nontaxable exchange under other rules.

Like-kind property. Properties are of like kind if they are of the same nature or character, even if they differ in grade or quality.

Real property is generally of like kind to other real property regardless of whether the properties are improved or unimproved. However, real property in the United States and real property outside the United States are not like-kind properties.

Deferred Exchanges

A deferred like-kind exchange occurs when replacement property is received after the transfer of property given up. The transaction must be an exchange of property for property rather than a transfer of property for money used to buy replacement property. Deferred exchanges must meet the identification and receipt requirements. If replacement property was received before the transfer of property given up, see *Reverse Exchanges*, page 6-20.

Identification. The property to be received must be identified within 45 days after the property given up in the exchange is transferred. If more than one property is transferred as part of the same transaction, and the properties are transferred on different dates, the identification period and the receipt period begin on the date of the earliest transfer.

Receipt. The property must be received by the earlier of:

- 180 days after the transfer of the property given up in the exchange, or
- The due date, including extensions, for the tax return for the tax year in which the transfer of the property given up occurs.

Boot. Any money or unlike property received in a like-kind exchange is considered boot. If the taxpayer realizes a gain on the exchange, gain must be recognized to the extent of the money and the FMV of the unlike property received. A loss is not deductible in an exchange in which the taxpayer receives boot.

Taxable gain is the lesser of:

- Realized gain, or
- Cash and FMV of unlike property received reduced by exchange expenses (closing costs).

Example: Willy's adjusted basis in real estate property held for investment purposes is \$18,000. He exchanges the property for another real estate property with a FMV of \$20,000. He receives an additional \$1,000 in cash and pays \$500 in expenses on the transaction. Willy's total gain realized is \$2,500 (\$20,000 – \$18,000 + \$1,000 – \$500). However, only \$500 (\$1,000 cash received – \$500 exchange expenses) must be recognized on his income tax return.

Liabilities assumed. If one party in a like-kind exchange assumes liabilities of the other party, the party that is relieved of liability is treated as receiving cash in the amount of the liability. If both parties assume liabilities, the liabilities are netted and the taxpayer who is relieved of greater liabilities than those assumed is treated as receiving cash.

Unlike property given up. If unlike property is given up in a like-kind exchange, the party who gives up the unlike property must recognize gain or loss on the unlike property. The gain or loss is equal to the difference between the FMV of the unlike property and the adjusted basis of the unlike property.

Basis of property received. The basis of property acquired in a like-kind exchange is:

- The basis of the property transferred, plus
- Any additional costs incurred, plus
- Any gain recognized on the exchange, minus
- Any money received, minus
- Any loss recognized on the exchange.

Allocate this basis first to the unlike property, other than money, up to its FMV on the date of the exchange. The rest is the basis of the like-kind property.

Mandatory rules. The like-kind exchange rules are mandatory. A taxpayer who sells property and buys similar property in two mutually dependent transactions may have to treat the sale and purchase as a single nontaxable exchange unless the transactions are structured to avoid the like-kind exchange rules.

Intent. Investment must be the taxpayer's primary motivation for holding exchanged property in order to qualify for a like-kind exchange of investment property.

Court Case: After failing to rent property purchased in a like-kind exchange, the taxpayer moved his family into the single-family home. The court allowed the property to qualify for like-kind exchange treatment because the intent of the taxpayer at the time of the exchange was to use the property as rental property. (*Reesink, T.C. Memo. 2012-118*)

Reverse Exchanges

A reverse like-kind exchange occurs when replacement property is received before the transfer of the property given up. The replacement property is parked with a qualified intermediary for no more than 180 days and the taxpayer must identify the property given up within 45 days. A safe harbor is available under a qualified exchange accommodation arrangement. (Rev. Proc. 2000-37, as modified by Rev. Proc. 2004-51)

Related Parties

If a taxpayer engages in a like-kind exchange with a related party, and within two years either party disposes of the property received, the previously-deferred gain is recognized at the time of disposition. An exception applies for transactions that do not have a purpose of tax avoidance. A related party includes a taxpayer's spouse, child, grandchild, parent, grandparent, brother, sister, or a related corporation, S corporation, partnership, trust, estate, or tax-exempt organization. [IRC §1031(f)]

Qualified Intermediaries

A qualified intermediary is a person who enters into a written exchange agreement with the taxpayer to acquire and transfer the property the taxpayer gives up and to acquire the replacement property and transfer it to the taxpayer. This agreement must expressly limit the taxpayer's rights to receive, pledge, borrow, or otherwise obtain the benefits of money or other property held by the qualified intermediary. Related parties and agents of the taxpayer are not eligible to be qualified intermediaries. [Reg. §1.1031(k)-1(g)(4)]

Employee Stock Options

Cross References

- IRS Pub. 15-B, *Employer's Tax Guide to Fringe Benefits*
- IRS Pub. 525, *Taxable and Nontaxable Income*
- IRC §83, IRC §421, IRC §422, and IRC §423

Related Topics

- Nonqualified Plans, page 13-19

Employee Stock Options

A stock option allows (but does not obligate) an employee to buy a specified number of shares of stock from a company for a specified price during a specified period of time. There are two categories of stock options.

- Nonstatutory (nonqualified) stock options.
- Statutory (qualified) stock options. Statutory stock options include incentive stock options (ISOs) and employee stock purchase plan options (ESPPs).

The employer determines the type of option offered to an employee. See the *Tax Treatment of Stock Options* chart, page 6-2.

Election to defer income on stock options. Qualified employees who are awarded private company stock options in connection with services may elect to defer the recognition of income for up to five years for stock options exercised or restricted stock units (RSUs) settled after December 31, 2017. The election applies for federal income tax purposes only and has no effect on Social Security, Medicare, and federal unemployment taxes. The employee has 30 days from the date that vested qualified stock is transferred to make the election and must be notified by the employer of the election availability. The deferral amount may be included in federal taxable income before the 5-year deferral date if:

- The stock becomes transferable back to the employer,
- The stock becomes publicly tradable,
- The taxpayer becomes an excluded employee, or
- The taxpayer revokes the election.

The employer must withhold federal income tax at 37% in the tax year the deferral amount is included in the employee's income. The election applies to an incentive stock option (ISO) or an option under an employee stock purchase plan (ESPP), but will disqualify the option from those applicable rules.

Form W-2 reporting. In the election year, the deferral amount is reported in box 12, Form W-2 using code HH. In the year the deferral amount is included in income, the deferral amount is reported in box 12, Form W-2 using code GG.

Form 8949, Sales and Other Dispositions of Capital Assets. The basis information reported on Form 1099-B, *Proceeds from Broker and Barter Exchange Transactions*, may or may not reflect any amount the taxpayer included in income upon grant or exercise. Therefore, the basis will likely need to be adjusted on Form 8949. Enter necessary adjustments to gain or loss in column (g), Form 8949. Enter the appropriate explanation code in column (f), Form 8949.

Statutory Stock Options

Statutory stock options have more restrictions than nonstatutory stock options. However, if requirements are met, income from the sale of stock bought by exercising the option is eligible for capital gain or loss treatment.

- The individual receiving the grant must be an employee of the company granting the option, or a related company, from the time an option is granted until three months before the option is exercised (for an ISO, one year before if the individual is disabled).
- The option must be nontransferable except at the death of the employee.

If the taxpayer does not meet the employment requirements, or receives a transferable option, the option is a nonstatutory stock option.

Grant and exercise of option. A taxpayer that receives a statutory stock option does not include any amount in income when the option is granted or when the option is exercised.

Alternative minimum tax (AMT). For AMT, when rights in the stock are transferable or no longer subject to a substantial risk of forfeiture, the taxpayer must include as an AMT adjustment, the amount by which the FMV of the stock exceeds the option price. No adjustment is required if the stock is disposed of in the same year the option is exercised.

Holding period requirement. The holding period requirement is satisfied if the taxpayer does not sell the stock until the end of the later of the 1-year period after the stock was transferred to the taxpayer or the 2-year period after the option was granted. The holding period begins on the day after the option is exercised.

Incentive Stock Option (ISO)

How stock acquired by exercising an ISO is treated upon sale depends on if the taxpayer satisfied the holding period requirement.

Holding period requirement satisfied. Gain or loss from the sale is capital gain or loss if the holding period is satisfied. Basis is the amount paid for the stock.

Holding period requirement not satisfied. If the holding period requirement is not satisfied, a gain from the sale is ordinary income up to the amount by which the stock's FMV when the taxpayer exercised the option exceeded the option price. Any excess gain is capital gain. If the taxpayer has a loss from the sale, it is

a capital loss and he or she does not have any ordinary income. The ordinary income portion is required to be reported as compensation on the employee's Form W-2. However, this amount is not subject to federal income tax withholding, or withholding for Social Security, Medicare, and federal unemployment taxes. Basis is the amount paid when the option was exercised plus the amount reported as compensation on Form W-2.

\$100,000 per year limitation. To the extent that the aggregate FMV of exercisable stock for any individual exceeds \$100,000 during the calendar year, the options are not treated as ISOs. The excess is treated as nonstatutory stock options. [IRC §422(d)]

Employee Stock Purchase Plan (ESPPs)

Options granted under an ESPP may be granted at a discount. If, at the time the option was granted, the option price was less than 100% of the FMV of the share, and the holding period requirement is met, a portion of any gain on the sale of the shares is treated as ordinary income. Include in income as compensation, but not subject to federal income tax, Social Security, or Medicare withholdings, or federal unemployment taxes, the lesser of:

- The excess of FMV of the share at the time the option was granted over the option price, or
- The excess of FMV of the share at the time of disposition or death over the amount paid for the share under the option.

Any excess gain is capital gain. If the sale results in a loss, it is a capital loss.

Failure to meet ESPP holding period requirement. If a stock acquired by exercising an ESPP is sold within one year of the exercise date or within two years of the grant date, the required holding period is not met. The amount treated as ordinary income is the amount by which the stock's FMV on the exercise date exceeded the exercise price. This ordinary income is not limited to gain from the sale of the stock. Rather, the basis in the stock is increased by the amount of ordinary income. The difference between the increased basis and the selling price of the stock is a capital gain or loss.

Same day stock sale. See *Example: Same day exercise and sale reporting*, next column.

Nonstatutory Stock Options

Nonstatutory stock options have fewer restrictions than statutory stock options. They may be granted to anyone including employees, consultants, and directors. The option price may be less than the FMV of the stock at the time an option is granted and there are no limitations on the number of shares that are allowed to be granted. Income is recognized as ordinary income rather than being eligible for capital gain treatment. The amount of income to include, and the time to include it, depend on whether the FMV of the option can be readily determined.

The FMV of the option is readily determined if the option is actively traded on an established market or if all the following conditions are met.

- The recipient can transfer the option,
- The recipient can exercise the option immediately in full,
- The option is not subject to any condition or restriction that has a significant effect on the FMV of the option, and
- The FMV of the option privilege can be readily determined.

Option with readily determinable value. If a nonstatutory stock option has a readily determinable FMV when it is granted, the option is taxable as compensation at the grant date.

Option without readily determinable value. If the FMV of the option is not readily determinable at the time it is granted, no income is reported until the exercise date.

Author's Comment: The conditions to readily determine the FMV of an option are seldom met. It is not common for employer stock options to be actively traded on an established market even though the underlying stock may be actively traded on an established market.

See the *Tax Treatment of Stock Options* chart, page 6-2.

Employer reporting. The amount included as taxable compensation is the FMV of the stock on the exercise date minus the amount paid (exercise price). Compensation is reported to an employee in boxes 1, 3 (up to the Social Security wage base), and 5, Form W-2, and in box 12 with a code V. Income and employment taxes are withheld on this income. The employee's basis in the stock is the amount paid plus the amount included in compensation.

Note: Compensation in the form of nonstatutory options granted to persons who are not employees is reported on Form 1099-NEC, *Nonemployee Compensation*. If a nonemployee spouse exercises nonstatutory stock options received incident to a divorce, the income is reported in box 3, Form 1099-MISC, *Miscellaneous Income*.

Example: Same day exercise and sale reporting. In addition to Steve's \$75,000 salary from Gaga Co. he also received 100 nonstatutory stock options that did not have a readily determinable FMV. Steve exercises the options on January 16, 2024, for \$10 per share and immediately sells the shares for the fair market value of \$40 per share through a brokerage account. The broker charges a \$10 fee to execute the sale. The exercise of the options and sale of stock are reported as follows.

Gaga Co. includes \$3,000 as additional compensation on Steve's 2024 Form W-2 [100 options × (\$40 FMV – \$10 exercise price)].

Form W-2 Wage and Tax Statement 2024	
1 Wages, tips, other compensation 78,000.00	2 Federal income tax withheld 8,000.00
3 Social security wages 78,000.00	4 Social security tax withheld 4,836.00
5 Medicare wages and tips 78,000.00	6 Medicare tax withheld 1,131.00
7 Social security tips	8 Allocated tips
9	10 Dependent care benefits
11 Nonqualified plans	12a See Instructions for box 12 Code V 3,000.00

The brokerage company issues Steve Form 1099-B reporting the sale of Gaga Co. stock.

Applicable check box on Form 8949 A	OMB No. 1545-0715 2024 Form 1099-B	Proceeds From Broker and Barter Exchange Transactions
1a Description of property (Example 100 sh. XYZ Co.) 100 sh. Gaga Co.		
1b Date acquired 1-16-24	1c Date sold or disposed 1-16-24	
1d Proceeds \$ 3,990.00	1e Cost or other basis \$ 1,000.00	
1f Accrued market discount	1g Wash sale loss disallowed \$	

continued on next page

Steve will report a short-term capital loss of \$10 on his 2024 Form 8949, *Sales and Other Dispositions of Capital Assets*.

Form 8949, Sales and Other Dispositions of Capital Assets				
(d) Proceeds (sales price) (see instructions)	(e) Cost or other basis. See the Note below and see <i>Column (e)</i> in the separate instructions	Adjustment, if any, to gain or loss. If you enter an amount in column (g), enter a code in column (f). See the separate instructions.		(h) Gain or (loss). Subtract column (e) from column (d) and combine the result with column (g)
		(f) Code(s) from instructions	(g) Amount of adjustment	
3,990	1,000	B	(3,000)	(10)

Sale of Principal Residence

Cross References

- IRS Pub. 523, *Selling Your Home*
- IRS Pub. 527, *Residential Rental Property*
- IRS Pub. 530, *Tax Information for Homeowners*
- IRS Pub. 544, *Sales and Other Dispositions of Assets*
- IRC §121, *Exclusion of gain from sale of principal residence*

Related Topics

- Real Estate Taxes, Tab 4
- Home Mortgage Interest, Tab 4
- Business Use of Home, Tab 5

Determining Residence Basis

Basis of a residence depends on how the residence was acquired.

Purchase. If a home is purchased or built, the basis is the cost of the home. The basis is increased by allowable settlement costs paid at closing and reduced by any seller-paid points.

Settlement costs. Settlement costs that increase the buyer's basis when a home is purchased include:

- Abstract fees (abstract of title fees),
- Charges for installing utility services,
- Legal fees (including fees for the title search and preparing the sales contract and deed),
- Recording fees,
- Survey fees,
- Transfer or stamp taxes,
- Owner's title insurance, and
- Any amounts the seller owes that the buyer agrees to pay, such as:
 - Real estate taxes owed if the seller does not reimburse the buyer,
 - Back interest,
 - Recording or mortgage fees,
 - Charges for improvements or repairs, and
 - Sales commissions.

Seller-paid points. Points paid by the seller reduce the buyer's basis by amount of the points as shown below.

IF buyer bought home...	THEN reduce buyer's basis by the seller-paid points...
After 1990 but before April 4, 1994.	Only if deducted as home mortgage interest in year paid.
After April 3, 1994.	Even if points were not deducted.

Home received as a gift. As a general rule, the basis of a home received as a gift is the donor's adjusted basis at the time of the gift. See *Basis of Gifts*, page 21-34.

Exceptions to Using Donor's Adjusted Basis for a Gifted Home

IF at the time of the gift...	AND...	THEN...
The donor's adjusted basis was more than the home's FMV,	Usage of the donor's adjusted basis results in a loss,	The basis is the FMV of the home at the time of the gift (if using the FMV results in a gain, no gain is recognized).
The donor's adjusted basis was less than the home's FMV,	The donor paid gift tax on the gift of the home,	The basis is the donor's adjusted basis at the time of the gift plus the of federal gift tax paid due to the increase in value of the home. (Reg. §1.1015-5)

Home received as inheritance. The basis in a home received as an inheritance is the home's FMV on the date of the decedent's death or the alternate valuation date, if used. See *Basis of Inherited Property*, page 21-33.

Gain on inherited home. A long-term capital gain is reported for an inherited home sold at a gain.

Loss on inherited home. A long-term capital loss may be claimed for an inherited home that is not used for personal use and sold at a loss, subject to loss limitations. See *Capital Loss Limitation/Carryover*, page 6-11.

Reporting sale of inherited home. Taxpayers report a long-term capital gain or loss from the sale of an inherited home on Form 8949, *Sales and Other Dispositions of Capital Assets*, and enter "INHERITED" in the column for date the property was acquired.

Author's Comment: The basis for an inherited home is usually stepped up to FMV at the date of death so any gain or loss recognized upon sale of the home shortly after inheriting the property may be minimal.

Surviving spouse in a noncommunity property state. The basis in the home for a surviving spouse who owned the home jointly with the decedent is the total of:

- The basis for the decedent's half interest (one-half of the FMV on the date of death or alternate valuation date), plus
- The basis for the surviving spouse's half interest (one-half of the adjusted basis determined previously).

Example #1: Fern owned a home jointly with her spouse in a noncommunity property state. The home had an adjusted basis of \$50,000 and a FMV of \$200,000 on the date of her spouse's death. Fern's new basis in the home is \$125,000 (\$100,000 for one-half the FMV plus \$25,000 for one-half of the adjusted basis).

Surviving spouse in a community property state. In community property states (Arizona, California, Idaho, Louisiana, Nevada, New Mexico, Texas, Washington, and Wisconsin), each spouse is usually considered to own half the community property. When either spouse dies, the total value of the community property (even the part belonging to the surviving spouse) generally becomes the basis of the entire property. For this rule to apply, at least half the value of the community property interest must be includible in the decedent's gross estate, whether or not the estate must file a return.

Example #2: Assume Fern and her spouse acquired their home while living in a community property state. The FMV of the home was \$200,000 on the date of her spouse's death and one-half the value was includible in his estate. Fern's new basis in the home is \$200,000 (the FMV of the entire community property).

Adjusted Basis of a Residence

Adjusted basis is cost or other basis increased or decreased by the following amounts.

Increases to basis. These include any of the following.

- Additions and other improvements that have a useful life of more than one year.
- Special assessments for local improvements.
- Amounts spent after a casualty to restore damaged property.

Decreases to basis. These include any of the following.

- Discharge of qualified principal residence indebtedness that was excluded from income.
- Some or all of the cancellation of debt income that was excluded due to bankruptcy or insolvency.
- Gain postponed from the sale of a previous home before May 7, 1997, if the replacement home was converted to rental property.
- Deductible casualty losses.
- Insurance payments received or expected to be received for casualty losses.
- Payments received for granting an easement or right-of-way.
- Depreciation allowed or allowable for business or rental use.
- Residential energy credits allowed before 1986 or after 2005 if the cost of the energy items were added to the basis of the home.
- Adoption tax benefits (credit or exclusion) received for the cost of improvements that were added to the basis of the home. See *Adoption Expenses*, page 11-3.
- First-Time Homebuyer Credit that has not been previously recaptured.
- Exclusion from income of subsidies for energy conservation measures.
- District of Columbia First-Time Homebuyer Credit allowed on the purchase of a principal residence in the District of Columbia.
- General sales taxes claimed as an itemized deduction on Schedule A (Form 1040) that were imposed on the purchase of personal property, such as a houseboat or mobile home, used as a principal residence.

Exclusion of Gain

Principal residence defined. A principal residence is the taxpayer's main home, which is the home where he or she ordinarily lives most of the time. A taxpayer can only have one main home at any one time.

Did You Know? A taxpayer's principal residence may be in a different location from his or her tax home. See *Travel and Lodging*, page 8-10, for information on tax home.

Exclusion. Taxpayers can exclude up to \$250,000 (\$500,000 if married filing a joint return) gain on the sale of a principal residence if the following eligibility tests are satisfied.

Ownership test. The taxpayer must have owned the home for at least two years out of the last five years ending on the date of sale. For a married couple filing jointly, only one spouse has to meet the ownership requirement.

Use test. The taxpayer must have used the home as his or her principal residence for at least two years out of the last five years ending on the date of sale. The two years can fall anywhere within the 5-year period and do not need to be consecutive. Unlike the ownership test, for a married couple filing jointly, both spouses must meet the use test to get the full \$500,000 exclusion.

Did You Know? Short, temporary absences for vacations or other seasonal absences are counted as periods of use (even if the property is rented out during the absence).

Previous gain exclusion. The exclusion can only be taken once in a 2-year period. This requirement is satisfied if the taxpayer did not sell another home during the 2-year period before the date of sale or sold a home but did not exclude the gain.

Ineligible taxpayers. Taxpayers who are subject to expatriate tax and those who acquired the property through a like-kind exchange during the previous five years do not qualify for the exclusion.

Married taxpayers. If either spouse does not meet all the requirements, the couple can exclude the total of the exclusions that each spouse would qualify for if not married and the amounts were computed separately. For this purpose, each spouse is treated as owning the property during the period that either spouse owned the property.

Exception: Taxpayers who do not meet the ownership and use conditions may qualify for a reduced exclusion. See *Partial Exclusion of Gain*, page 6-24.

Example: During 2024, married taxpayers Joel and Winnie each sell a residence that each had separately owned and used as a principal residence before their marriage. Each spouse meets the ownership and use tests for his or her respective residence. Neither spouse meets the use requirement for the other spouse's residence. Joel and Winnie file a joint return for 2024. The gain realized from the sale of Joel's residence is \$200,000. The gain realized from the sale of Winnie's residence is \$300,000.

Because the ownership and use requirements are met for each residence by each respective spouse, Joel and Winnie are each eligible to exclude up to \$250,000 of gain from the sale of their individual residences. However, Winnie may not use Joel's unused exclusion to exclude gain in excess of her limitation amount. Joel and Winnie must recognize \$50,000 of the gain realized on the sale of Winnie's residence.

Joint owners not married. If the taxpayer and a joint owner (other than a spouse) sell a jointly owned home, each must compute his or her own gain or loss according to ownership interest in the home. Each applies the eligibility rules on an individual basis.

Surviving spouse. A surviving spouse who does not remarry before the sale of a home is considered to have owned and used the home as a principal residence during any period of time the deceased spouse owned and used it as a principal residence.

The \$500,000 exclusion applies to unmarried individuals whose spouse is deceased on the date of sale provided that the sale occurs no later than two years after the date of death of the deceased spouse, and the couple would have qualified for the \$500,000 exclusion if the sale had occurred immediately before the date of death.

For information on calculating basis for a surviving spouse, see *Surviving spouse in a noncommunity property state*, page 6-22, and *Surviving spouse in a community property state*, page 6-22.

Home transferred from spouse. Individuals who acquire a home in a transfer from a spouse (or former spouse if the transfer was incident to divorce) are considered to have owned the home during any period of time the spouse (or former spouse) owned it.

Divorced individuals. An individual is considered to have used a home as a principal residence during any period when:

- The individual owned the home, and
- The individual's spouse or former spouse is allowed to live in it under a divorce or separation instrument and uses the home as a principal residence.

Inherited home. A taxpayer who inherits a home is generally not eligible for gain exclusion unless he or she meets the ownership and use tests for the inherited home. An inherited home is considered to be held long term, even if sold within a year of death. For information on the basis of an inherited home, see *Home received as inheritance*, page 6-22.

Official duty election. Members of the uniformed services or Foreign Service, employees of the intelligence community, or employees or volunteers of the Peace Corps can elect to suspend the 5-year test period for ownership and use during any period the individual serves on qualified official extended duty.

This provision is intended to allow eligible taxpayers, who would not otherwise meet the use test due to extended duty, to qualify for the exclusion of gain. Applicable rules and definitions:

- The period of suspension cannot last more than 10 years.
- The election is limited to one property at a time.
- The election can be revoked at any time.
- Qualified official extended duty is the call or order to active duty for a period of more than 90 days or for an indefinite period. The duty station must be at least 50 miles from the member's principal residence, or the member must live in government quarters under government orders.

Individuals who are physically or mentally disabled. An individual who becomes physically or mentally incapable of self-care, and who owned and used a home as a principal residence for at least one year during the 5-year period prior to a sale, is considered to have used the home as a principal residence during any period of time that the individual:

- Continued to own the home, and
- Lived in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in such condition.

Previous home destroyed or condemned. To meet the ownership and use tests, the time owned and lived in a previous home that was destroyed or condemned is added to the time owned and lived in the replacement home if any part of the basis of the home sold depended on the basis of the destroyed or condemned home.

Installment sales of principal residence. If a taxpayer sells his or her principal residence under the installment sale method, and the taxpayer qualifies for the exclusion of gain, then the gross profit is reduced by any gain excluded. If the entire gain is excluded, the only taxable portion of an installment payment received is the amount that represents interest income. See *Installment Sales (Form 6252)*, page 6-17.

Excluded gain on repossessed principal residence is taxable. Any gain excluded under IRC section 121 must be included in the reacquisition gain, unless the taxpayer resells the property within one year after the date of the reacquisition. [*DeBough*, 142 T.C. No. 17 (2014)]

Sale of vacant land adjacent to residence.

The sale of vacant land is not treated as a sale of a taxpayer's principal residence unless:

- The vacant land is adjacent to land containing the taxpayer's principal residence,
- The taxpayer owned and used the vacant land as part of taxpayer's principal residence,
- The sale of the taxpayer's principal residence satisfies the requirements for exclusion and occurs within two years before or two years after the date of the sale of the vacant land, and
- The ownership and use requirements for excluding gain from the sale of the vacant land have been satisfied.

If these requirements are met, the sale of the principal residence and the sale of the vacant land are treated as one sale. Only one maximum limitation amount of \$250,000 (\$500,000 for eligible MFJ) applies to the combined sales.

Partial Exclusion of Gain

Taxpayers who do not meet the 2-year ownership and use tests, or who have already excluded gain from the sale of another home during the 2-year period prior to the sale of a current home, can claim a partial exclusion on the sale of a home if the primary reason for the sale is due to a change in workplace location, a health issue, or an unforeseeable event involving a qualified individual.

Qualified individual. For purposes of the partial exclusion, a qualified taxpayer is the taxpayer, the taxpayer's spouse, a co-owner of the home, or a person whose principal residence is the same as the taxpayer's.

Work-related move. A taxpayer meets the requirements for a partial exclusion if any of the following events occurred during his or her time of ownership and residence in the home. A qualified individual:

- Took or was transferred to a new job in a work location at least 50 miles farther from the home than the old work location, or
- Had no previous work location and began a new job at least 50 miles from home.

Health-related move. A taxpayer meets the requirements for a partial exclusion if any of the following health-related events occurred during his or her time of ownership and residence in the home.

- A qualified individual moved to obtain, provide, or facilitate the diagnosis, cure, mitigation, or treatment of a disease, illness, or injury for himself or herself or a family member,
- A qualified individual moved to obtain or provide medical or personal care for a family member suffering from a disease, illness, or injury, or
- A doctor recommended a change in residence because a qualified individual was experiencing a health problem.

Unforeseeable event. A taxpayer meets the requirements for a partial exclusion if any of the following events occurred during his or her time of ownership and residence in the home.

- The home was destroyed or condemned,
- The home suffered a casualty loss because of a natural or man-made disaster or act of terrorism, regardless of whether the loss is deductible,
- A qualified individual died, became divorced, had multiple births resulting from the same pregnancy, became eligible for unemployment compensation, or became unable to pay basic living expenses for the household due to a change in employment status.

Other facts and circumstances. A taxpayer who does not meet the standard requirements listed above may still qualify for a partial exclusion if he or she can demonstrate the primary reason for the sale is work related, health related, or unforeseeable based on the facts and circumstances.

Nonqualified Use (Non-Use)

Gain from the sale or exchange of a principal residence is not excludable from income if it is allocable to periods of nonqualified use. Generally, nonqualified use means any period after 2008 where neither the taxpayer nor spouse (or former spouse) used the property as a principal residence with certain exceptions.

Exceptions: A period of nonqualified use does not include:

- 1) Any portion of the 5-year period ending on the date of sale or exchange that is after the last date that such property is used as the principal residence of the taxpayer or the taxpayer's spouse,
- 2) Any period (not to exceed an aggregate period of 10 years) during which the taxpayer or the taxpayer's spouse is serving on qualified official extended duty, or
- 3) Any other period of temporary absence (not to exceed an aggregate period of two years) due to change of employment, health conditions, or such other unforeseen circumstances as may be specified by the IRS through regulations.

Calculation. To compute the portion of the gain that is allocated to the period of nonqualified use, multiply the gain by the following fraction.

$$\frac{\text{Total Nonqualified Use During the Period of Ownership After 2008}}{\text{Total Period of Ownership}}$$

In addition, any depreciation allowed or allowable on the property after May 6, 1997 is subject to recapture.

Author's Comment: This nonqualified use provision generally affects taxpayers with a vacation or rental home that is later used as a principal residence. This provision was enacted, for ownership periods after 2008, to prevent a taxpayer from converting a rental property with a large capital gain into a principal residence, living in it for two years, and then potentially excluding the entire gain.

Example #1: Ken bought a house as a rental property for \$300,000 on January 1, 2019. On January 1, 2022, Ken moves into the house and begins using it as his principal residence. On January 5, 2024, Ken sells the house for \$500,000. Ken owned the house for five years and he met the two-year ownership and use test. However, a three-year period of his ownership is treated as nonqualified use (the period from January 1, 2019, through January 1, 2022, when the house was used as a rental property and not his principal residence). Of Ken's \$200,000 (\$500,000 – \$300,000) gain on the sale of the house, \$120,000 [$\$200,000 \times (3 \text{ years}/5 \text{ years})$] is not eligible for the exclusion. Ken may only exclude \$80,000 of the \$200,000 gain.

Example #2: Assume the same facts as Example #1, except that Ken bought the house as a principal residence and lived in it for three years. On January 1, 2022, Ken converted the house to a rental property. In 2024, when Ken sells the house, he has owned it for five years and met the two-year ownership and use test. However, as a result of Exception (1), page 6-24, the three-year period after Ken moved out of the house and stopped using it as a principal residence is not treated as a period of nonqualified use. Ken may exclude the entire \$200,000 gain.

Business Use or Rental of Home—Application of Exclusion Rules

Taxpayers can exclude gain from the sale of a principal residence that has also been used for business or rental purposes if the exclusion of gain ownership and use rules are met.

Post-May 6, 1997 depreciation. The part of any gain equal to depreciation allowed or allowable after May 6, 1997 cannot be excluded.

Property used partly for business or rental purposes. The treatment of gain depends on whether the portion of the home used for business or rental purposes is part of the home (such as a room in the home used as a home office) or separate from the home (such as a home office in a separate structure).

Business use or rental property is part of home. If the portion of the home used for business or rental purposes is within the taxpayer's principal residence, the sale of the home is treated as a single sale. A taxpayer who qualifies for the exclusion of gain on the portion of the home used as a principal residence can exclude gain on the entire property. It is not necessary to allocate the basis of the property and the amount realized between the business part of the property and the part used as a home. The sale is not reported on Form 4797, *Sales of Business Property*, even if depreciation was claimed on the portion of the home used for business or rental purposes. However, the taxpayer cannot exclude the part of any gain equal to depreciation allowed or allowable after May 6, 1997. The part of the gain allocable to nonqualified use cannot be excluded.

Author's Comment: Business use of a home, such as an office in home where the home is also used as the taxpayer's principal residence, is not considered nonqualified use. Thus, with the exception of post May 6, 1997 depreciation, gain attributable to the office in home portion of the home is excludable under IRC section 121.

Business use or rental property is separate from the home. If the portion of the home used for business or rental purposes is separate from the taxpayer's principal residence, the sale of the home is treated as a sale of two properties. Basis and the amount realized from the sale must be allocated between the properties. These rules apply to properties such as:

- A working farm on which the taxpayer's home was located,
- A duplex in which the taxpayer lived in one unit and rented the other, or
- A store building with an upstairs apartment in which the taxpayer lived.

Exclusion of Gain for Separate Business/Rental Portion

<i>Use test met for business part?</i>	<i>Can the taxpayer's gain be excluded?</i>	<i>Report on Form 4797.</i>
No.	No.	Yes.
Yes, with business use in year of sale.	Yes, if taxpayer has met the ownership and use tests for that portion of the property.	Yes. Allocate gain and treat as sale of two properties.
Yes, but no business use in year of sale.	Yes, if taxpayer owned and used that portion of the property as a principal residence for at least two years during the 5-year period prior to the sale.	No. Gain allocation not required and treat as a single sale.

Reporting Sale of Principal Residence

The sale of a principal residence is only reported if:

- The taxpayer has a gain on the sale and does not qualify to exclude the entire gain,
- The taxpayer elects not to exclude a gain, or
- The taxpayer received Form 1099-S, *Proceeds From Real Estate Transactions*.

Form 8949, Sales and Other Dispositions of Capital Assets. If the taxpayer has taxable gain on the sale of a principal residence that cannot be excluded, the entire gain is reported on Form 8949. Report any allowable exclusion as a negative number in column (g) and enter code H in column (f).

Form 4797, Sales of Business Property. If the home was used partly as a home and partly for business or rental during the year of sale, the sale of the business or rental part may be reported on Form 4797. See *Business Use or Rental of Home—Application of Exclusion Rules*, previous column.

Involuntary Conversions

Cross References

- IRS Pub. 544, *Sales and Other Dispositions of Assets*
- IRS Pub. 547, *Casualties, Disasters, and Thefts*
- IRC §1033, *Involuntary conversions*

Related Topics

- Casualty and Theft Losses, Tab 4
- Postponing Gain on Weather-Related Sales of Livestock, Tab 5

Involuntary Conversion Defined

An involuntary conversion occurs when:

- Property is destroyed, stolen, condemned, or disposed of under threat of condemnation, and
- The taxpayer receives other property or money in payment, such as insurance proceeds or a condemnation award.

Tax treatment. An involuntary conversion is treated as a sale or exchange. Gain or loss on the involuntary conversion is the difference between the net payment received and the adjusted basis of the converted property. Net payment is the condemnation award or insurance payment minus expenses of obtaining the award or payment.

Gain from conversion. Part or all of the gain may be postponed if the taxpayer receives or purchases replacement property within the replacement period. See *Postponement of Gain Election*, page 6-26.

Taxpayer receives similar property. The gain is not reported if the taxpayer receives only property that is similar or related in

service or use to the converted property. Basis for the new property is the same as basis for the converted property.

Taxpayer receives money or unlike property. Gain is reported unless the taxpayer buys replacement property within the replacement period and chooses to postpone reporting the gain. To postpone reporting all of the gain, the replacement property must cost at least as much as the amount realized.

Loss from conversion. A loss is deductible only if the converted property is used in a trade or business or for the production of income. However, casualty or theft losses on personal-use property may be deductible. See *Casualty and Theft Losses*, Tab 4.

Livestock. The destruction of livestock by disease or weather-related conditions, or the sale or exchange of livestock because of disease or weather-related conditions, is treated as an involuntary conversion [IRC §1033(d)]. Also see *Postponing Gain on Weather-Related Sales of Livestock*, Tab 5.

Tax relief in disaster situations. If a taxpayer is affected by a federally declared disaster, the IRS may grant disaster relief by extending the periods to perform certain tax-related acts. Information on recent tax relief is available at www.irs.gov/newsroom/tax-relief-in-disaster-situations.

Involuntary Conversion Replacement Periods	
Type of Property	Replacement Period
All property except as noted below.	2 years
Main home in federal disaster area.	4 years
Other real property held for use in a trade or business or for investment.	3 years
Weather-related sales of livestock in an area eligible for federal assistance.	4 years*

* The IRS may further extend the four-year replacement period if the weather-related conditions that caused the area to be eligible for federal assistance continue beyond three years. See *Involuntary conversion rules for livestock*, Tab 5.

Condemnations

A condemnation is the legal taking of private property by a government body, or other condemning authority, for public use without the owner's consent. The owner receives a condemnation award in exchange for the property taken. A condemnation is like a forced sale.

Threat of condemnation. A threat of condemnation exists if:

- A government representative or public official informs the taxpayer that it has decided to acquire the taxpayer's property for public use, or
- The taxpayer learns through the news media of a decision to acquire the property for public use, and the report is confirmed by a government representative or a public official.

The taxpayer has the option to sell the property under threat of condemnation or wait until the property is condemned. The sale of property under threat of condemnation qualifies as an involuntary conversion.

Condemnation of principal residence. The taxpayer can generally exclude up to \$250,000 of the gain (up to \$500,000 if Married, Filing Jointly). If the gain is more than the taxpayer can exclude, the remaining gain can be postponed if the taxpayer receives or purchases replacement property. See *Sale of Principal Residence*, page 6-22, and *Gain from conversion*, page 6-25.

Postponement of Gain Election

Taxpayers may elect to postpone reporting gain on condemned property by buying replacement property within the replacement period. The election is made by attaching detailed statements to the tax returns in the year the gain is realized and in the year in

which the replacement property is acquired. An amended return must be filed in the following situations.

- Replacement property is not acquired within the replacement period. Report the gain and pay any additional tax due.
- Replacement property costs less than the amount realized for the condemned property. Report any gain that cannot be postponed and pay any additional tax due.
- The taxpayer changes his or her mind about reporting or postponing gain. File an amended return at any time before the end of the replacement period.

Replacement property. The replacement property must be acquired by purchase for the specific purpose of replacing condemned property.

- Property acquired by gift or inheritance does not qualify.
- Property acquired from a related person does not qualify, unless the related person acquired the property from an unrelated person within the replacement period.
- The replacement property must be similar or related in service or use to the property it replaces.
- Real property that is not similar or related in service or use to the condemned property may qualify if it is like-kind property. See *Like-Kind Property*, page 6-19.
- Replacement property includes acquisition of 80% controlling interest in a corporation that owns replacement property. Like-kind real property does not qualify in this case. [IRC §1033(g)]
- Replacement property includes the cost of restoring property to its former usefulness.

Replacement period. The replacement period for a condemnation begins on the earlier of the following dates.

- The date of disposition of the condemned property.
- The date on which threat of condemnation began.

The replacement period generally ends two years after the end of the first tax year in which any part of gain on the condemnation is realized. See *Involuntary Conversion Replacement Periods* chart, previous column.

Extension of replacement period. An extension may be requested before the end of the replacement period by writing to the IRS director in the district where the return will be filed. Extensions are usually limited to one year or less and are only granted if the taxpayer can show reasonable cause for not making the replacement before the end of the regular period.

Basis of replacement property. The basis of the replacement property is the adjusted basis of the converted property, less the net amount received, plus the amount paid for the replacement property.

Example: Justin received \$100,000 from the City of Minneapolis when land he held for investment was condemned. His adjusted basis was \$50,000. He paid related attorney fees of \$5,000. Justin purchased replacement land for \$120,000 within one year of the condemnation. The entire gain (\$45,000) is postponed. The basis of the new land is:

Basis of converted property.....	\$ 50,000
Amount received from the city.....	(100,000)
Attorney fees.....	5,000
Cost of new property.....	120,000
Basis of new property.....	\$ 75,000

Recapture of First-Time Homebuyer Credit. First-time homebuyers who purchased a home in 2008 continue to repay the credit in installments each year after the home is involuntarily converted. See *First-Time Homebuyer Credit*, page 11-10.

Foreclosures, Repossessions, and Cancellation of Debt

Cross References

- Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*
- IRS Pub. 523, *Selling Your Home*
- IRS Pub. 544, *Sales and Other Dispositions of Assets*
- IRS Pub. 4681, *Canceled Debts, Foreclosures, Repossessions, and Abandonments*
- IRC §108, *Income from discharge of indebtedness*
- IRC §1038, *Certain reacquisitions of real property*

Related Topics

- Farm Debt Cancellation, Tab 5
- Abandonment, page 9-16

Definitions

Term	Definition	Page
<i>Bankruptcy</i>	The process of settling the estate of a debtor in the U.S. Bankruptcy court.	6-29
<i>Cancellation of Debt</i>	Settlement of a debt for less than the amount owed. A debt may be cancelled by a lender voluntarily or through bankruptcy or other legal proceedings.	6-27
<i>Deed in Lieu of Foreclosure</i>	A borrower deeds property to the lender voluntarily to avoid foreclosure.	6-29
<i>Foreclosure</i>	The process that allows a lender to take title to, or force the sale of, property in satisfaction of a mortgage.	6-27
<i>Insolvency</i>	Having debts that exceed the value of assets.	6-29
<i>Nonrecourse Debt</i>	Debt that the borrower is not personally liable to repay. The creditor's only recourse is to repossess the property that secures the loan.	6-28
<i>Recourse Debt</i>	Debt that the borrower is personally liable to repay. The lender can repossess the property, but the borrower remains liable for any deficiency if the property does not fully repay the loan.	6-28
<i>Repossession</i>	The recovery of goods sold on credit or in installments when the buyer fails to pay for them.	6-27
<i>Short Sale</i>	Sale of property for less than the outstanding mortgage and closing costs.	6-29

Cancellation of Debt

Cancellation of debt may result in ordinary income, income from the sale of assets, or both. For exceptions and exclusions see *Nontaxable Cancellation of Debt Income*, page 6-29.

Cancelled Debt Situation	Tax Treatment
Debt owed by a taxpayer is cancelled or forgiven. Example: Credit card debt.	Amount cancelled or forgiven is generally taxable as ordinary income from cancellation of debt. ¹
Property that is security for a debt is taken by the lender in full or partial satisfaction of that debt. Example: Vehicle repossession. ²	The transaction is treated as a sale of the property, which may result in a gain or a loss. ¹
Property that is security for a debt is taken by the lender, and lender cancels recourse debt in excess of FMV of property taken. Example: Main home foreclosure or abandonment. ^{2,3}	Excess of cancelled debt over FMV of the property is ordinary income from cancellation of debt, in addition to any gain or loss from the sale. ¹
Cancelled debt is intended as a gift.	Amount cancelled is not income. ⁴

continued in next column

continued

- ¹ Cancelled debt may be excluded from income if certain conditions are met. See *Nontaxable Cancellation of Debt Income*, page 6-29.
- ² Loss from foreclosure or abandonment of personal-use property is not deductible.
- ³ See *Qualified Principal Residence Debt*, page 6-30.
- ⁴ Gift tax may apply. See *Gifts Subject to Gift Tax*, page 21-25.

Cancellation of business debt. Individual taxpayers report cancelled business debt as follows:

Cancelled Debt Related to:	Report On:
• Nonfarm sole proprietorship.....	Schedule C (Form 1040)
• Nonfarm rental of real property.....	Schedule E (Form 1040)
• Farming activity and taxpayer is the farmer.....	Schedule F (Form 1040)
• Farm rental activity and taxpayer reports income based on tenant's crop or livestock production using Form 4835, <i>Farm Rental Income and Expenses</i>	Form 4835

Cancelled business debt is not reported as income if the amount was not deducted but would have been deductible, had the debt been paid.

Cancellation of nonbusiness debt. Individual taxpayers report cancelled nonbusiness debt as Other Income on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*.

Discounts and loan modifications. If a lender discounts or reduces the principal balance of a loan to reward an early payoff, or agrees to a loan modification that includes a reduction in the principal balance, the amount of discount or principal reduction is cancelled debt.

- If the debt is nonrecourse and the taxpayer did not retain the collateral, there is no cancellation of debt income.
- If the taxpayer is personally liable for the loan (recourse debt), then the cancelled debt is income unless an exception or exclusion applies. See *Nontaxable Cancellation of Debt Income*, page 6-29.

Main home loan modification (workout agreement). If a lender agrees to a mortgage loan modification or workout that includes a reduction in the principal balance of the loan, all or part of the cancelled debt may qualify for exclusion. See *Qualified Principal Residence Debt*, page 6-30.

Foreclosure or Repossession

A foreclosure or repossession is treated as a sale from which the taxpayer may realize gain or loss. If the outstanding loan balance was more than the FMV of the property, and the lender cancels all or part of the remaining loan balance, the taxpayer may also realize income from cancellation of debt unless certain exceptions or exclusions apply. See *Nontaxable Cancellation of Debt Income*, page 6-29.

Worksheet for Foreclosures and Repossessions

Part 1. Income from cancellation of debt. (**Note:** If nonrecourse debt, there is no income from cancellation of debt. Skip Part 1 and go to Part 2.)

- 1) Enter the amount of debt cancelled by the transfer of property..... 1) _____
- 2) Enter the FMV of the transferred property..... 2) _____
- 3) Ordinary income from cancellation of debt.* Subtract line 2 from line 1. If less than zero, enter zero..... 3) _____

continued on next page

Part 2. Gain or loss from foreclosure or repossession.

- 4) Enter the smaller of line 1 or line 2. If Part 1, page 6-27, was not completed (because the taxpayer was not personally liable for the debt), enter the amount of outstanding debt immediately before the transfer of property. Add any proceeds received from the foreclosure sale..... 4) _____
- 5) Enter the adjusted basis of the transferred property... 5) _____
- 6) Gain or loss from foreclosure or repossession. Subtract line 5 from line 4..... 6) _____

* The income may not be taxable. See *Nontaxable Cancellation of Debt Income*, page 6-29.

Borrower's gain or loss. Gain or loss from a foreclosure is computed and reported in the same way as gain or loss from a sale. The selling price used to compute the gain or loss depends on whether the taxpayer is personally liable for repaying the debt. See *Amount realized*, below.

Gain from foreclosure of a principal residence can be excluded from income if the tests for the exclusion are met. Personal losses from foreclosures and repossessions are not deductible. See *Exclusion of Gain*, page 6-23.

Two transactions. If the loan is a recourse loan, the taxpayer must generally report two transactions on the tax return. (1) Cancellation of debt income, and (2) gain or loss on the sale.

Bankruptcy, insolvency, and other exceptions that apply to cancellation of debt income do not apply to exclude gains from income. If the loan is a nonrecourse loan, a foreclosure or repossession will be treated as a sale (which may result in gain or loss), but there will be no cancellation-of-debt income.

See *Property Secured by Recourse Debt*, next column, and *Property Secured by Nonrecourse Debt*, next column.

Amount realized. Gain or loss is computed the same whether the sale covers the debt in full or not.

Sales price – adjusted basis of property = gain or loss.

If the debt is paid in full, the sales price is stated on the sales agreement.

If the debt is not paid in full, the amount realized depends on whether the debt is recourse or nonrecourse, the amount of the debt, and in a foreclosure, the fair market value of the property.

Type of Transfer	Type of Debt	Amount Realized
Foreclosure	Recourse	Lesser of outstanding debt reduced by any amount for which the taxpayer remains liable, or FMV of property.
	Nonrecourse	Full amount of debt regardless of FMV of property.
Short Sale	Recourse	Actual price paid by purchaser.
	Nonrecourse	Outstanding balance of debt regardless of FMV of property.

Worksheet for Determining Taxability of Home Foreclosure or Short Sale

- 1) Sales price of home (see *Amount realized*, above)... 1) _____
- 2) Purchase price..... 2) _____
- 3) Closing costs at purchase*..... 3) _____
- 4) Improvements..... 4) _____
- 5) Depreciation allowed or allowable 5) _____
- 6) Reductions to basis (Form 982)..... 6) _____
- 7) Basis (lines 2 + 3 + 4 – 5 – 6) 7) _____
- 8) Closing costs at sale*..... 8) _____
- 9) Fix-up costs..... 9) _____

- 10) Selling costs (add lines 8 and 9)..... 10) _____
- 11) Capital gain or loss (lines 1 – 7 – 10) 11) _____

If line 11 is positive, the gain is all taxable even if the seller did not receive any cash, unless the home qualifies for a full or partial exclusion under IRC section 121 for a principal residence. If line 11 is negative, the loss has no tax benefit unless the home was real property used in a business (such as a rental property). See *Sale of Principal Residence*, page 6-22.

* Closing costs include fees and transfer taxes but do not include points, insurance, property taxes, loan payoffs, or interest.

Property Secured by Recourse Debt

Foreclosure or repossession can result in two types of income.

Income from cancellation of debt:

- Amount of debt cancelled by the transfer of property.
- Minus FMV of the property.

Gain or loss from foreclosure or repossession:

- The smaller of FMV or cancelled debt (plus any proceeds received from foreclosure sale).
- Minus the adjusted basis of the property.

See *Worksheet for Foreclosures and Repossessions*, page 6-27.

Fair market value. The lender reports FMV in box 4, Form 1099-A, or box 7, Form 1099-C. See *Forms 1099-A and 1099-C*, page 6-30.

Property Secured by Nonrecourse Debt

Gain or loss from foreclosure or repossession is:

- Full amount of debt cancelled by transfer of property.
- Minus adjusted basis of the property.

FMV of property secured by nonrecourse debt is irrelevant to the calculation of gain or loss.

Example #1: Tom and Bob each purchase a personal residence for \$200,000. After owning the properties for two years, the FMV of each home has dropped to \$110,000. Tom and Bob both owe \$150,000 on their homes, and both are behind on payments. The banks foreclose on both Tom and Bob, and their debts are cancelled. The only difference between the two is that Tom's loan is recourse, and Bob's loan is nonrecourse.

Tom (Recourse)	Bob (Nonrecourse)
<i>Cancellation of debt income:</i>	
Debt owed \$150,000	
FMV (sale proceeds) (110,000)	
Ordinary income from cancellation of debt..... \$ 40,000	
<i>Gain(loss) on sale:</i>	
Sale proceeds (cancelled debt up to FMV)..... \$110,000	<i>Gain(loss) on sale:</i>
Basis (\$200,000 reduced by \$40,000 cancellation of debt exclusion)..... (160,000)	Sale proceeds (full debt cancelled)..... \$150,000
Capital loss on sale (\$ 50,000)	Basis (200,000)
	Capital loss on sale (\$ 50,000)

Even though both Tom and Bob realized a \$50,000 net loss on the foreclosure of their homes, since Tom's loan was recourse, he has \$40,000 cancellation of debt income. Bob realizes a nondeductible loss of \$50,000.

Tom reports \$40,000 income from cancellation of debt on Schedule 1 (Form 1040), *Additional Income and Adjustments to Income*, and realizes a nondeductible capital loss of \$50,000. To exclude the cancellation of debt from income, Tom files Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness (and Section 1082 Basis Adjustment)*.

Example #2: Assume the same facts as Example #1, except that Tom's cancellation of debt does not qualify for the exclusion for principal residence debt. In this case, Tom reports \$40,000 income from cancellation of debt on Schedule 1 (Form 1040), and realizes a nondeductible capital loss of \$90,000.

Situations that result in gain or loss with no cancellation of debt income:

- The FMV of the property may be higher than the debt. The debt is satisfied, not cancelled.
- Lenders do not always cancel recourse debt during foreclosure. They may pursue a deficiency judgment to collect the difference between debt and what they received on sale.

Short Sale and Deed in Lieu of Foreclosure

A short sale of real estate occurs when the net proceeds from the sale do not cover the outstanding mortgage and closing costs. A deed in lieu of foreclosure is given by a borrower to convey property to a lender voluntarily before foreclosure.

Short sale tax consequences. For recourse mortgages, the tax results are comparable to foreclosure. A short sale results in gain or loss from the sale, as well as cancellation of debt income. A deed in lieu of foreclosure is treated as a foreclosure.

Taxpayers in states with anti-deficiency laws that prevent lenders from pursuing the borrower for a deficiency after foreclosure should get legal advice within their state.

Nontaxable Cancellation of Debt Income

Student loan discharges. Student loan discharges for 2021 through 2025 may be excluded from income if the loan was:

- A loan for postsecondary education,
- A private education loan, or
- A loan from certain non-profit organizations.

Author's Comment: The exclusion can apply to any discharge of student loan debt as long as there is no provision for the student to provide services to the lender.

Cancelled debt. Exceptions to the inclusion of cancelled debt income apply before the exclusions. The following types of cancelled debt are not included in income.

- Gifts and bequests.
- Payment of a liability that would have given rise to a deduction. [IRC §108(e)(2)]
- Student loans where certain debts are cancelled in return for public service. This includes any state loan repayment or forgiveness programs that reward health care professionals working in under-served communities. [IRC §108(f)]
- Price reduced after purchase. If the seller reduces debt owed for property purchased, the reduction is generally treated as a purchase price adjustment that reduces basis.

Exclusions. If a cancelled debt is excluded from income under one of these provisions, the associated tax attributes (certain credits, losses, and basis of assets) must be reduced. The exclusion is claimed on Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*. See *Reduction of Tax Attributes (Form 982)*, next column.

- **Bankruptcy.** Debt cancelled in a bankruptcy case under Title 11 of the U.S. Code.
- **Insolvency.** Do not include cancelled debt in income to the extent that the taxpayer was insolvent immediately prior to the cancellation. See *Taxpayer Insolvency*, below.
- **Qualified farm indebtedness to a qualified person.** See *Farm Debt Cancellation*, Tab 5.
- **Qualified real property business indebtedness.** See *Qualified Real Property Business Debt*, next column.
- **Qualified principal residence indebtedness.** See *Qualified Principal Residence Debt*, page 6-30.

Taxpayer Insolvency

A taxpayer is insolvent to the extent that the total of all their liabilities exceeds the FMV of all their assets immediately before the cancellation of debt.

Did You Know? Insolvency must be determined separately for each instance of debt cancellation during a tax year in order to establish whether the exclusion applies to each cancellation.

Insolvency Worksheet

Liabilities

- | | |
|---|----------|
| 1) Credit card debt..... | 1) _____ |
| 2) Mortgages on real property | 2) _____ |
| 3) Vehicle loans..... | 3) _____ |
| 4) Income and real estate taxes due..... | 4) _____ |
| 5) Other loans and past-due bills..... | 5) _____ |
| 6) <i>Total liabilities.</i> Add lines 1 through 5..... | 6) _____ |

Assets

- | | |
|--|-----------|
| 7) Cash and bank account balances..... | 7) _____ |
| 8) FMV of real estate..... | 8) _____ |
| 9) FMV of vehicles..... | 9) _____ |
| 10) FMV of household items..... | 10) _____ |
| 11) Investment and retirement accounts, IRAs, etc. | 11) _____ |
| 12) Cash value of life insurance..... | 12) _____ |
| 13) Other assets..... | 13) _____ |
| 14) <i>Total assets.</i> Add lines 7 through 13..... | 14) _____ |
| 15) <i>Amount of insolvency.</i> Subtract line 14 from 6.
If zero or less, taxpayer is not insolvent..... | 15) _____ |

Abandonment—Foreclosure or Repossession

Abandonment occurs when a taxpayer voluntarily and permanently gives up possession and use of property with the intention of ending ownership without passing it on to anyone else. An abandonment is often associated with foreclosure or repossession.

Loss from abandonment of business or investment property is deductible as an ordinary loss, even if the property is a capital asset. See *Abandonment*, page 9-16.

Reduction of Tax Attributes (Form 982)

If a taxpayer excludes cancelled debt from income, he or she must reduce certain tax attributes (but not below zero) by the amount excluded. Use Form 982, *Reduction of Tax Attributes Due to Discharge of Indebtedness*, to report the exclusion and reduce tax attributes for items such as basis, credits, or net operating loss carryovers.

Reduce basis. If the debt discharged is due to bankruptcy, insolvency, or qualified farm indebtedness, the taxpayer can elect to apply all or part of the amount discharged to first reduce the basis of depreciable property. The balance of debt will then be applied to reduce other tax attributes. Attach a statement describing the property and transactions resulting in the reduction of basis.

Qualified Real Property Business Debt

Qualified real property debt is debt (other than qualified farm debt) that meets all the following conditions.

- 1) The debt was incurred or assumed in connection with real property used in a trade or business,
- 2) The debt was secured by the real property,
- 3) The debt was incurred or assumed either:
 - a) Before January 1, 1993, or
 - b) After December 31, 1992, if incurred or assumed to acquire, construct, or substantially improve the real property, and
- 4) The taxpayer elects to treat the debt as qualified real property business debt.

Qualified real property business debt includes refinancing of the debt described in (3), above, but only to the extent it does not exceed the debt being refinanced.

Property for lease. Real property that a taxpayer develops and holds for lease in its leasing business is eligible for the qualified real property business debt exclusion. This provision does not apply to real property held for sale to customers. (Rev. Rul. 2016-15)

Limit on exclusion. The exclusion from income of cancelled qualified real property business debt is subject to the following limitations.

- The excess, if any, of:
 - The outstanding principal of qualified real property business debt immediately before the cancellation, over
 - The FMV (immediately before cancellation) of the business real property that is security for the debt, reduced by the outstanding principal amount of any other qualified real property business debt secured by this property immediately before the cancellation, or
- The total adjusted basis of depreciable property held by the taxpayer immediately before the cancellation. Basis is determined after any basis reduction due to a cancellation in bankruptcy, insolvency, or of qualified farm debt. Do not take into account depreciable real property acquired in contemplation of the cancellation.

Example: Mike owns real property he uses in his business. His basis in the property is \$120,000, and Mike still owes the lender the \$120,000 principal amount. The FMV of the property is \$80,000. The debt is recourse. The lender cancels the debt on Mike's property. The debt meets the criteria as qualified real property business debt.

Under the rules for recourse loans, Mike has \$40,000 in cancellation of debt income (\$120,000 cancelled debt – \$80,000 FMV). Since the debt meets the criteria as qualified real property business debt, the cancellation of debt income is excluded from Mike's income.

Mike must file Form 982 to reduce tax attributes, in this case, basis. Mike would check the box on line 1d, Form 982, and fill in \$40,000 on line 2. He would also fill in \$40,000 on line 4 reducing the basis in the real property. After the \$40,000 reduction based on the excluded income, Mike's \$120,000 basis is reduced to \$80,000. Mike does not realize a gain or loss on the sale (\$80,000 FMV less \$80,000 adjusted basis).

Qualified Principal Residence Debt

Taxpayers may be able to exclude income from cancellation of qualified principal residence indebtedness which is discharged before January 1, 2026. It also applies if the discharged debt is subject to a written arrangement entered into before January 1, 2026. The exclusion is subject to the following limitations.

- The exclusion is limited to \$750,000 (\$375,000 MFS) of acquisition debt (proceeds used to buy, build, or substantially improve a main home or second home).
- Any amount excluded reduces the taxpayer's basis in the residence.
- The exclusion does not apply to debt discharged on account of services performed for the lender or any other factor not directly related to a decline in the value of the residence or the financial condition of the taxpayer.
- The exclusion for discharge of debt on a qualified principal residence is used before the insolvency exclusion, unless the taxpayer elects to apply the insolvency exclusion instead.
- If a portion of a loan that is discharged is not qualified principal residence indebtedness, the exclusion is limited to the amount discharged that exceeds the amount of the loan that is not qualified principal residence indebtedness.

Qualified principal residence. For purposes of exclusion from income of qualified principal residence indebtedness, a qualified principal residence has the same definition as is used for the exclusion of gain on the sale of a principal residence. [IRC §108(h)] See *Exclusion of Gain*, page 6-23.

Forms 1099-A and 1099-C

Generally, the taxpayer will receive Form 1099-A, *Acquisition or Abandonment of Secured Property*, from the lender if a property is transferred in a foreclosure or abandoned. Form 1099-A reports the information needed to determine the amount of gain or loss and any ordinary income from the foreclosure or abandonment of the property. If the debt is cancelled, the taxpayer may receive Form 1099-C, *Cancellation of Debt*. If the foreclosure or abandonment and cancellation of debt occur in the same year, the lender may file only Form 1099-C.

Comparison of Form 1099-A and Form 1099-C

Form 1099-A, <i>Acquisition or Abandonment of Secured Property</i>	Form 1099-C, <i>Cancellation of Debt</i>
What is the purpose of the form?	
<ul style="list-style-type: none"> • Reports information about property that secures a loan. • Alerts the IRS that the lender may issue Form 1099-C at some point in the future. 	<ul style="list-style-type: none"> • Reports debt that has not been repaid by the borrower. • Notifies the IRS that the borrower has income from debt cancellation.
Who must file the form?	
<ul style="list-style-type: none"> • A taxpayer that lends money in the course of a trade or business, even if the taxpayer is not in the business of lending money. 	<ul style="list-style-type: none"> • A financial institution, credit union, certain federal corporations and agencies, or any organization in the trade or business of lending money.
When is the form issued?	
<ul style="list-style-type: none"> • A lender repossesses or forecloses on property that was security for a loan, or • A lender acquires property that the borrower abandoned. 	<ul style="list-style-type: none"> • A lender cancels or forgives a debt of \$600 or more, or • An identifiable event occurs for which the IRS requires the debt to be treated as cancelled.
What is reported?	
<ul style="list-style-type: none"> • Names, addresses, and identification numbers of lender and borrower, as well as lender's phone number. • Date of lender's acquisition or knowledge of abandonment. • Balance of debt principal outstanding. • Fair market value of the foreclosed, repossessed, or abandoned property. • Whether the borrower was personally liable for the debt. • Description of foreclosed, repossessed, or abandoned property. 	<ul style="list-style-type: none"> • Names, addresses, and identification numbers of creditor and debtor, as well as creditor's phone number. • Date of debt cancellation or identifiable event. • Amount of debt discharged. • Interest, if included in amount discharged. • Description of debt. • Whether the debtor was personally liable for the debt. • Identifiable event code showing reason form was filed. • Fair market value, if foreclosure or abandonment of property has occurred.

Coordination. Taxpayers who have a cancellation of debt and a foreclosure or abandonment of property on the same property in the same year may receive only Form 1099-C to report these transactions.

Court Case: A credit card company accepted \$1,000 from a cardholder in settlement of a \$2,875 disputed balance and sent her Form 1099-C for \$1,875. The IRS said the \$1,875 should be fully taxable cancellation of debt income, but the Tax Court disagreed. The taxpayer was able to prove that she had an ongoing dispute about the balance owed. Because she had paid the credit card company to settle the dispute, there was no cancellation of debt income. (*McCormick*, T.C. Memo. 2009-239)