INVESTMENTS AND THE CAPITAL GAIN RULES

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INVESTMENTS AND THE CAPITAL GAIN RULES

I. CAPITAL GAIN PROVISIONS – THE RULES (IRC § 1(H))

The following rates apply to individuals, estates and trusts and generally apply to sales and exchanges after May 5, 2003.

- The maximum tax rate on net capital gains is 15% for sales after May 5, 2003 through 12/31/10. To the extent that individuals are in the 15% bracket, the capital gains tax rate is lowered to 5%.
- The gain element of installment sale payments received after May 5, 2003, is taxed at the 5%/15% rate, even though the sale took place earlier.
- Depreciation on sales of real estate will be recaptured at a 25% rate.
- The same tax rates (e.g., 5%/15/5/25/5) apply to capital gains for alternative minimum tax (AMT) purposes. However, a large capital gain often triggers the alternative minimum tax (as illustrated later).
- For the years 2008 – 2010, the capital gains rate remains at 15% and the 5% rate for low income taxpayers drops to zero. On January 1, 2011, the old pre JGTRRA rates of 10%/20% return

II. HR 4297 – TAX RECONCILIATION ACT OF 2005 EXTENDED 5%/15% RATES THROUGH DECEMBER 31, 2010.

A. The Importance of Holding Period

Long-Term and Short-Term Holding Period. A capital asset is characterized as either a long-term or short-term capital asset, depending on the length of time the asset is owned (holding period) or deemed to have been held under the "tacking" and other rules (§ 1223). The period is computed by excluding the day of acquisition and including the day of disposition (§ 1222).

Short-Term Capital Gain. If property is held for a period of one year or less, the asset is characterized as a short-term capital asset.

The Lower Capital Gains Tax Rate Applies Only to Assets Held Long-Term. For assets sold after May 5, 2003, the 5%/15% rates apply to assets held more than 12 months.

B. A Hidden Rate May Increase the 15% Maximum Rate!

The personal exemption phaseout and the limit on itemized deductions indirectly increases the taxable income

> **Planning Tip:** If a client asks about the tax on a $100,000 capital gain, don't jump to the quick answer of $15,000. The actual individual "effective tax bracket" experienced by net capital gains may be 17% to 20% or higher because

of the 2% personal exemption phaseout and the multiple limits on itemized deductions

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Example

In 2008, John and Noelle have $100,000 in wages, a $25,000 loss from a rental in which they actively participate and $14,000 of itemized deductions. They want to know how much tax $100,000 of long term capital gains will cost them

	Without Capital Gain	**With Capital Gain**
Wages	100,000	$100,000
Capital Gain		**100,000**
Rental Loss	-25,000	
Adjusted Gross Income	75,000	200,000
Itemized deductions	-14,000	13,599
Exemptions	-7,000	-7,000
Taxable Income	$54,000	$179,401
Tax	**$7,298**	**$28,000**

An increase in tax of $20,702 on $100,000 of long term capital gain sounds more like a rate of 20.7%.

C. AMT May Make Tax Higher

Alternative Minimum Tax (AMT) is always a concern for high income taxpayers. The capital gains rates for regular tax also apply to AMT. However, taxpayers with large capital gains should watch out for AMT. Factors contributing to AMT for taxpayers with large capital gains include:

- The lowest rate applied to regular AMTI is 26% (not 10%),
- Phase-out of AMT exemption (due to capital gain), and
- High state income tax (on capital gain).

Example

Married Couple

	Regular Tax	**AMT**
Ordinary Income	$100,000	$100,000
Capital Gain	200,000	200,000
Itemized Deducts	-49,626	-49,626
Disallowed Itemized	1,401	0
Disallowed Taxes	0	24,626
Personal Exempts	-5,834	0
AMT Exemption	0	-13,750
Taxable Income	245,941	261,250
Tax	$ 33,215	$ 43,051
AMT	**$ 9,836**	

D. Only "Adjusted Net Capital Gain" is Eligible for the 15%/5% Rate

Adjusted net capital gain means the net capital gain reduced (but not below zero) by the sum of:

1. Unrecaptured § 1250 gain, and

2. Any gain subject to the 28% rate.

   Gain subject to the 28% rate is the excess of the sum of:
   a. Collectibles gain, and
   b. § 1202 gain, over

   The sum of:
   a. Collectibles losses,
   b. The net short-term capital loss, and
   c. The amount of long term capital loss carried under § 1212(b)(1)(B) to the taxable year.

Plus
QUALIFIED DIVIDEND INCOME

JGTRRA Act. § 302(a) amending§ 1(h) as amended by Act. § 301.

E. Gain Not Eligible for the 15%/5% Rate

1. Collectibles;
2. Real estate depreciation recapture;
3. Gain on qualified small business stock;
4. Net capital gain treated as investment income for purposes of the deduction for investment interest expense, and

5. Dividend Income treated as investment income for purposes of the deduction for investment interest.

F. Collectibles

The 15%/5% rates apply to most capital assets with the exception of collectibles as defined in § 408(m) without regard to the exception for coins in § 408(m)(3). Thus, collectibles such as art, rugs, antiques, any metals, gems, stamps, coins and alcoholic beverages, continue to be taxed at the 28% rate.

G. Real Estate Depreciation Recapture

Not all gains from the sale of depreciable real property will benefit from the same low rate as gains from the sale of other assets. The top rate on real property gain attributable to depreciation, but not already "recaptured," i.e., taxed at ordinary income rates, will be taxed at a top rate of 25% rather than the 15% rate that applies to other capital gain.

Unrecaptured § 1250 gain is the amount of long-term capital gain (not otherwise treated as ordinary income) that would be treated as ordinary income if § 1250 recapture applied to all depreciation. Depreciation claimed in excess of straight line from pre 1986 years is still recaptured as ordinary income and is taxed at the taxpayer's highest marginal rate.

ACRS Property: For nonresidential ACRS real property on which accelerated depreciation was used, all depreciation is recaptured as ordinary income. For residential ACRS real property on which accelerated depreciation was taken, the excess of accelerated over straight line depreciation is recaptured as ordinary income.

MACRS Property: MACRS permits only straight line. depreciation for most real property. Therefore, depreciation on MACRS property will not be taxed as ordinary income but will all be subject to the 25% rate.

Interaction with § 1231: The amount of unrecaptured § 1250 gain may not exceed net § 1231 gain over net § 1231 losses for the tax year. The IRS is authorized to issue regulations to address the allocation of § 1231 gain if any amount of the gain is treated as ordinary income under § 1231(c) applying to the recapture of § 1231 ordinary losses in prior years.

Example

On December 31, 2007, Steve sold a residential rental for $800,000 which he had acquired on January 1, 1993 for $500,000. The property's accumulated depreciation is $175,000. The tax on this sale (ignoring other factors and assuming he is in the top tax bracket) is computed as follows:

		Gain	Tax Rate	Tax
Sales Price		$800,000		
Original Cost	$500,000			
Less Acc. Depr.	-175,000			
Adjusted Basis	325,000	-325,000		
Total Gain		475,000		
Less Gain Due to Depreciation		-175,000	x 25% =	$ 43,750
Remaining § 1231 Capital Gain		$300,000	x 15% -	45,000
Total Tax				$88,750

Example

John sold a residential rental building for $120,000. He paid $74,375 for it and claimed $67,561 regular ACRS deductions. The alternate ACRS deductions (Straight-line depreciation) would have been $66,193. His § 1250 gain is $1,368 and his § 1231 gain is $111,818. The $1,368 § 1250 gain is taxed as ordinary income. $66,193, the amount of depreciation not recaptured under § 1250 and that would be recaptured if all depreciation were recaptured, is taxed at a 25% rate. $45,625 = $111,818 - $66,193 is taxed at the 15% rate. The tax on this sale (ignoring other factors and assuming he is in the top tax bracket) is $23,871, computed as follows:

		Gain	Tax Rate	Tax
Sales Price		$120,000		
Original Cost	$74,375			
Less Depreciation	-67,561			
Adjusted Basis	6,814	-6,814		
Total Gain		113,186		
Less § 1250 Ordinary Income Gain		-1,368	x 35% =	$ 479
Less Gain Due to Rem. Depreciation		-66,193	x 25% =	16,548
Remaining § 1231 Capital Gain		$45,625	x 15% -	6,844
Total Tax				$23,871

III. LOSSES

Losses are first netted within each group - 15%, 25%, 28% and short term. Losses in the long term groups (15% and 28%) are netted against gains in the long term groups (15%, 25%, and 28%) in a manner that reduces the highest taxed gain first. Any net short term losses are then applied to reduce net capital gain first in the 28% group, second in the 25% group and lastly in the 15% group.

Carryovers: Short term capital loss carryovers are netted with short term capital gains. Long term loss carryovers are first netted with capital gains and losses in the 28% group.

IV. INSTALLMENT SALES

A. Installment Sale Rules

The installment sale provision provides the exception to the rule that the entire gain be reported the year a transaction is closed. The installment method permits the paying of the tax on a gain as payments on the sales price are received.

Installment sale treatment is automatic unless the taxpayer elects otherwise for taxpayers selling real property if at least one payment is received after the taxable year in which the sale occurs. Once the installment sale election is made it is binding and only revocable with the consent of the IRS (§ 453(d)(3)).

> **Note:** Therefore an election out of installment sale treatment may not be made on an amended return. To obtain the consent of the IRS the taxpayer must request a letter ruling. IRS Ltr Rul. 9452034 states that they will grant a revocation if the taxpayer always intended to elect out, there was third party error involved and tax avoidance is not the only reason for electing out.
>
> **Planning:** It may be advantageous to elect out in a low income year or in one with offsetting losses.

Certain closely related parties may not use the installment sale method for sales of property (§ 453(g)) All payments to be received are deemed received in the taxable year in which the sale occurs. This rule is intended to deter transactions which are structured to give the related purchaser the benefit of depreciation deductions (measured from a stepped-up basis) before the time the seller has to include in income the corresponding gain on the sale.

B. Calculating the Installment Gain

The gross profit percentage determines how much of each principal payment is currently included in income.

1. The gross profit percentage is the ratio of the total profit to the contract price. The contract price is the amount the seller will actually receive (unreduced by selling expenses.)
2. Payments received include the down payment (unreduced by selling expenses), all other principal payments and any other property received except for the evidence of indebtedness.
3. 3. Mortgages assumed or taken subject to by the buyer are considered payments in the year of sale to the extent the mortgages exceed the basis of the property sold. The excess of mortgage over basis is included in the computation of the contract price.
4. For sales of recovery or depreciable property resulting in depreciation recapture, the amount of gain that is recaptured under § 1245 (including § 179expense) and § 1250,is fully taxable as ordinary income in the year of sale.

For **personal property**, all depreciation taken is recaptured as ordinary income to the extent of gain.

For **real property**, generally the excess of accelerated over straight line depreciation is recaptured. as ordinary income. For ACRS commercial real property, all depreciation is recaptured if an accelerated method was used.

Remember: Remaining depreciation (not excess) is taxed at 25% rather than 15%.

C. Allocating Capital Gain on Installment Sale of Real Property

T.D. 8836, Final Regulations at § 1.453-12, August 23, 1999

Unrecaptured § 1250 Gain "Front Loaded"

The final regulations provide that when the capital gain from an installment sale consists of both unrecaptured § 1250 gain (25%-rate gain) and adjusted net capital gain (15%/5%-rate gain), the unrecaptured § 1250 gain is taken into account before the adjusted net capital gain (§ 1.453-12(a)).

Example 1 (§ 1.453-12(d), Ex. 1)

In 2008, Steve sells his Elm Street rental property for $100,000, to be paid in ten equal installments beginning on December 1, 2008. He purchased the property several years ago for $50,000 and has taken straight line depreciation of $30,000. Steve's gain of $80,000 consists of $30,000 of unrecaptured § 1250 gain and $50,000 of adjusted net capital gain as follows:

Sales Price		$100,000
Basis: Cost	$50,000	
Less Accumulated Depreciation	(30,000)	
Basis	20,000	(20,000)
Gain		$80,000

The profit percentage is 80% ($80,000 profit ÷ $100,000 contract price). Therefore, $8,000 of each payment represents gain. Steve's gain is taxed as follows:

Unrecaptured Year	**Adjusted Net § 1250 Gain**	**Capital Gain**
2008	$8,000	$ -0-
2009	8,000	-0-
2010	8,000	-0-
2011	6,000	2,000
2012-2017	-0-	48,000
Total	$30,000	$50,000

V. EQUITIES ANQ THE REDUCED DIVIDEND RATE (JGTRRA ACT. § 302)

The Jobs and Growth Tax Relief Reconciliation Act of 2003 has reduced the tax rate on dividends received from domestic and foreign corporations after 12/31/02 to a maximum rate of 15%. The term "net capital gain "now means net capital gain increased by qualified dividend income.

Just as for long term capital gains. there is a new 5% rate for taxpayers in the 15% and 10% tax brackets also effective for dividends received after 12/31/02.

These lower rates will terminate 12/31/10. From 2008 -201 0, the rate will remain 15% for taxpayers in marginal rates above 15% and go to zero for taxpayers in the 15% or lower tax bracket.

A. Qualified Dividends

In general the term "qualified dividend income" means dividends received during the taxable year from domestic corporations and qualified foreign corporations. They are further defined as a distribution (§ 316 (a)) paid out of the current or accumulated earnings and profits of a C corporation.

> **Note:** S corporation dividends are not qualified dividends unless the S corporation was a C corporation prior to converting to S status and had accumulated earnings and profits prior to converting to S status.

Most dividends will qualify as "qualified dividend income" but there are some exceptions:

1. Dividends paid from a corporation exempt from tax under Code §§ 50l and 521.
2. Amounts that would be deductible under Code § 591.
3. Dividends paid under Code § 404(k).
4. Dividends paid under Code § 246(c) that fail to meet the revised holding period; or the extent that the taxpayer is under a payment obligation under Code § 246(c).

B. Foreign Corporations

For purposes of the rate cut, foreign dividends qualify if it is an entity incorporated within a U.S. possession or is eligible for the benefits of comprehensive U.S. tax treaty. However, dividends paid by a foreign company that is not "qualified" are eligible for the lower rates if the stock of the corporation is traded on an established U.S. equities market.

> Note: Notice 2003-69 lists treaties qualifying foreign dividends for the qualified dividend rate. Notice 2003-71 lists established US stock exchanges on which foreign corporations may be listed and therefore qualify for the qualified dividend rate.

C. Holding Period Requirements

For common stock dividends to qualify for the special rate the underlying stock must be held at least 61 days during the period beginning 60 days before the ex-dividend date of the stock and ending 60 days after.

The same rule applies for Preferred stock only the holding period is 91 days during the period beginning 90 days before the ex-dividend date and ending 90 days after.

D. Dividends as Investment Income

Qualified dividend income shall not include any amount which the taxpayer takes into account as investment income under § 163(d)(4)(B). Investment income will include dividend income only to the extent the taxpayer elects to treat such income as investment income.

VI. INVESTMENT PLANNING WITH LOWER CAPITAL GAIN AND DIVIDEND RATES

- The Spread between the highest marginal tax bracket of35% and the capital gains rate of 15% is now a full 20%. Gaming for long term gain is now more important.

- Clients holding appreciated capital gain property should consider selling before 2010.

- Capital losses still may only offset capital gains and $3,000 of ordinary income. Offsetting 15% capital gain is not as tax effective as offsetting ordinary income in a higher marginal tax bracket. Plan to use capital losses against ordinary income as much as possible in planning between years.

- Contribution of appreciated property is less attractive.

- Incentive Stock Options may be more attractive.

- Although dividend income is a part of net capital gain, capital losses may not offset dividend income.

- Consider an installment sale to spread the gain to keep the capital gain in the 15% tax bracket and thereby attain a 5% rate.

- Dividend income from Real Estate Investment Trusts (REITS) is not subject to lower tax rates. REITS do not pay corporate tax. But REITS may still be attractive as the dividends are much higher even after tax.

- Day traders should be out of business - if there is desire for short term trading should probably be done in a retirement account which at least allows for a deferral of tax.

- Invest in mutual funds with low cost that do not reduce qualified dividends subject to low rate and funds with low turnover. Excess trading results in short term gain.

- Municipal Bonds are still a viable investment especially in high tax states. In fact municipal bonds probably compliment high paying dividends stocks (which tend to be more volatile than bonds) in the portfolio.

- Fully fund deferred compensation plans. Although income will be ordinary, the offsetting deduction probably creates a wash for income tax purposes and gives the taxpayer tax-deferred growth for investment purposes.

- Although not all clients are eligible for Roth IRAs, for those that are, fixed income investments and REITS (produce ordinary income at highest marginal rates in a taxable account) will produce tax free income in a Roth IRA.

Annuities - Annuities have high costs, produce no tax deduction and at distribution are ordinary income. However annuities may still be a good vehicle for non tax favored investments and for taxpayers who have maximized tax deferred investments.

VII. QUALIFIED SMALL BUSINESS STOCK GAIN (§ 1202)

A noncorporate taxpayer can exclude 50% of any gain from the sale or exchange of qualified small business stock held for more than five years (§ 1202(a)). Such gain is not eligible for the 15%15% capital gain rate but remains subject to the 28%/15% rate. Because § 1202(a) excludes 50% of the gain from gross income, the effective rate on such gain is 14%/7.5%. Gain eligible for the 50% exclusion may not exceed the greater of $10,000,000 or 10 times the taxpayer's basis in the stock.

> AMT: 7% of the excluded gain is the preference amount for AMT purposes i.e., 53.5% (7% of 50% excluded gain plus 50% included gain).

What is small business stock? A qualified small business is a domestic C corporation with aggregate gross assets that do not exceed $50,000,000 as of the date of issuance. The stock must be issued after August 10, 1993 and acquired by the taxpayer as its original issue (directly or through an underwriter) in exchange for money or property, or as compensation for services provided to the corporation. At least 80%, by value, of the corporation's assets must be used in the active conduct of one or more qualified trades or businesses, generally in a manufacturing or retail business, including a Specialized Small Business Investment Company. Personal service activities, such as health, law, engineering, architecture, accounting, etc., are not qualified trades or businesses, nor are the hospitality, farming, insurance, financing or mineral extraction industries.

VIII. ROLLOVER OF GAIN FROM QUALIFIED SMALL BUSINESS STOCK

The 1998 Act eased the five year holding period for QSBS by adding a rollover provision.

An individual may elect to roll over the gain from the sale of qualified small business stock held more than six months if the proceeds from the sale are used to purchase other qualified small business stock within 60 days of the sale. The replacement stock must meet the active business requirement for the six-month period following its purchase. The holding period of the stock

purchased will include the holding period of the stock sold, except for the purpose of determining whether the active business test six-month holding period is met.

Gain is recognized only to the extent that the amount realized on the sale exceeds the cost of the replacement small business stock purchased during the 60-day period, as reduced by the portion of such cost, if any, previously taken into account. To the extent that capital gain is not recognized, that amount will be applied to reduce the basis of the replacement small business stock. The basis adjustment is applied to the replacement stock in the order such stock is acquired.

Example

On September 1,2007, Bob purchases $300,000 in Webmaster stock, a qualified small business. On August 1,2008, Bob sells his Webmaster stock for $500,000. On August 15,2008, he purchases stock in the newly formed (and qualified small business) Hyperlink Corporation for $450,000. Bob will recognize a $50,000 gain on the sale of Web master stock and the rest of the gain, $150,000 ($200,000 . total gain - $50,000 not rolled over) is deferred into the Hyperlink Corporation stock, leaving an adjusted basis of $300,000 ($450,000 - $150,000 gain not taxed). The holding period of the Webmaster stock is tacked onto the holding period of the Hyperlink Corporation stock for all purposes except for determining whether Hyperlink Corporation meets the active business requirement. Thus, for applying the § 1202 50% exclusion rule, Bob's holding period began September 1, 2007.

WEBMASTER STOCK	
8/1/08 SALE PRICE	$500,000
9/1/07 COST (BASIS)	-300,000
GAIN	200,000
HYPERLINK REINVESTMENT	
8/15/08 Cost	450,000
TAXABLE GAIN:	
WEBMASTER SALE PRICE	500,000
HYPERLINK REINVESTMENT	-450,000
TAXABLE GAIN	50,000
DEFERRED GAIN:	
GAIN	200,000
TAXABLE	-50,000
DEFERRED GAIN	150,000
BASIS:	
COST	450,000
DEFERRED GAIN	-150,000
BASIS	$300,000

Gain on the transaction can eventually qualify for the 50% exclusion for small business stock when the replacement stock is sold (for an effective maximum rate of 14%). These rollover rules apply to sales after August 5, 1997.

A. Partnerships and S Corporations Can Rollover Gain From Qualified Stock

Certain pass-thru entities, including partnerships and S corporations, may rollover the gain from the sale of qualified small business stock (if the requirements of § 1045 are satisfied). The benefits of the rollover will flow through to partners or shareholders who are not corporations. However, in order for the rollover provisions to apply at the partner or shareholder level, the partner or shareholder must have held his or her interest in the partnership or S corporation at all times that the entity held the qualified small business stock. These rules are established by reference to § 1202(g) related to the exclusion of 50% of the gain from the sale.

IX. ELECTION TO ROLLOVER GAIN ON QUALIFIED SMALL BUSINESS STOCK

Rev. Proc. 98-48

If the taxpayer makes the election under § 1045 and this revenue procedure, gain from such sale is recognized only to the extent that the amount realized on the sale exceeds:

1. The cost of any Qualified Small Business (QBS) stock that the taxpayer purchases during the 60-day period beginning on the date of sale, reduced by
2. Any portion of the cost of the replacement QSB stock that was previously taken into account under § 1045. However, the election is not available to defer any gain on the sale that is treated as ordinary income.

HOW TO MAKE A § 1045 ELECTION

1. Report the entire gain from the sale of QSB stock on Schedule D, Capital Gains and Losses, of the return in accordance with the instructions for Schedule D;

2. Write "*§ 1045 rollover*" directly below the line on which the gain is reported; and

3. Enter the amount of the gain deferred under § 1045 on the same line as (2) above, as a loss, in accordance with the instructions for Schedule D.

Time for Making Election. A § 1045 election must be made by the due date (including extensions) for filing the income tax return for the taxable year in which the QSB stock is sold.

Scope of the Election. If a person has more than one sale of QSB stock in a taxable year that qualifies for the § 1045 election, the person may make a § 1045 election for anyone or more of those sales.

Revocation. A § 1045 election is revocable only with the prior written consent of the Commissioner by requesting a private letter ruling.

X. DAY TRADERS

A. DEALER, TRADER OR INVESTOR?

Generally, for tax purposes, people who purchase and sell stocks and securities fall into one of three distinct categories; dealers, traders, or investors. The difficulty in making this determination is that individuals may simultaneously be a dealer, a trader, and an investor for different security transactions. Unfortunately, neither the IRS guidelines nor the Code define the term trader, so the courts have created various, and nonexclusive, facts and circumstances tests.

In general, a dealer is primarily interested in the income generated, from selling securities to and buying securities from customers. A trader is primarily interested in the gains derived from speculating with their own securities. An investor is primarily interested in income from long-term appreciation, interest and dividends. So how does the taxpayer with large losses or expenses prove they are "dealing" or "trading" and not "investing"?

B. DO TRADERS OR INVESTORS GET A BETTER TAX DEAL?

1. **Day Traders Have Capital Gains and Losses**. Taxpayers, unless they are dealers, generally recognize capital gain or loss upon the sale or exchange of their stock, rather than ordinary gains or losses (*H.H. Hart v. Comm.*, TC Memo 1997-11; *Estate of Yaeger v. Comm.*, 89-2 USTC ¶ 9633; *Moller v. U.S.*, 83-2 USTC ¶ 9698). Therefore, traders occupy an unusual tax position because they engage in a trade or business which produces capital gains and losses (this anomaly is explained in *Wood v. Comm.*, 16 T.C.213 (1951)).

2. **Day Traders Deduct Expenses on Schedule C!** Because of Sec. 1221, prior courts have determined that trader's stock transactions are reportable on Schedule D, not Schedule C, even though the trader's expenses and other related items (such as interest on a margin account) are reportable on Schedule C (*H.H. Hart v. Comm.*, TC Memo 1997-11; *Estate of Yaeger v. Comm.*, 89-2 USTC '9633; *Moller v. U:S.*,[83-2 USTC ¶9698).

> **Comment:** There is a way to report a trader's stock transaction, including a trader's loss, on Schedule C with the mark-to-market option discussed later.

Tax Reporting	Trader	Investor
Self-Employment Tax Rules	Net earnings are not subject to SE tax (§ 1402(a)(3)(A))	Net earnings are not subject to SE tax (§ 1402(a)(3)(A))
Expenses	Trading expenses deductible on Schedule C as business expense	Investment expenses deductible as miscellaneous itemized deductions (subject to 2% AGI limitation and not allowed on AMT return)
§179 Election	Available if "taxable income" exists	Not available
Stock Trade Reporting	Each separate trade is reported on Schedule D	Each separate trade is reported on Schedule D
Capital Gain	Available for stocks and securities held more than one year	Available for stocks and securities held more than one year
Capital Loss	Net trading loss is subject to annual $3,000 (or $1,500) limit on net capital loss deduction	Net trading loss is subject to annual $3,000 (or $1,500) limit on net capital loss deduction
Home office	Available if home office rules satisfied	Not available
Margin Interest	Deductible on Schedule C as business expense	Margin interest is deductible as investment interest expense, limited to net investment income and calculated on Form 4952 (see § 163(d))

C. THE FOUR CRITERIA FOR INVESTORS TO QUALIFY AS DAY-TRADERS

Unfortunately, the IRS presumes an individual owns stocks and securities as an investor unless their actions establish they are carrying on the business of stock trading. And, as mentioned previously, the § 475(f) election is not available unless the taxpayer can prove they are a trader (Rev. Proc. 99-17, § 6.01). According to the courts, to be treated as a trader, the taxpayer's trading activity must clearly meet all the following four criteria (a very difficult task):

1. Be a trade or business,
2. Conducted regularly, continuously and
3. Extensively,
4. For short-swing gain.

Test # 1: The Trade or Business Requirement

Must be in the "business" of trading: Investing in high-risk securities or securities that don't pay dividends isn't enough to make a trader. The taxpayer must also prove he or she is engaged in a

trade or business and that the expenses incurred are directly related to that trade or business. The management of one's own investments is not considered a trade or business no matter how extensive or substantial the investment activities might be (*Higgins v. Comm.*, 41-1 USTC ¶ 9233).

Is not having clients and customers a problem? Luckily, no. Generally, someone engaged in a trade or business has clients or customers to whom services are rendered or products are sold. Primarily, day-traders trade only for their own account. So how can a day-trader be deemed in a trade or business? Another type of professional gambler supplies the answer. The Supreme Court found in *Groetzinger* that a gambler was engaged in the trade or business of gambling:

> " ... not every income-producing and profit-making endeavor constitutes a trade or business ... We accept the fact that to be engaged in a trade or business, the taxpayer must be involved in the activity with continuity and regularity and that the taxpayer's primary purpose for engaging in the activity must be for income or profit" (*Robert Groetzinger v. Comm.*, 107 S.Ct. 980).

Therefore, tests 2, 3 and 4 are the evidence to prove that the taxpayer is engaged in a trade or business.

Test # 2: The Regular and Continuous Tests

Be involved throughout the year! The Tax Court has held that a taxpayer must engage in the trading activity throughout the year. Sporadic trading does not constitute a trade or business (*Hart v. Comm.*, TC Memo 1997-11; *Comm. v. Groetzinger*, 87-1 USTC ¶9191).

Example

Paoli was an investor considered as <u>not</u> active throughout the year: Despite 326 transactions during the year involving over $10 million, the court concluded that the taxpayer's pattern of buying and selling stock was not sufficiently regular and continuous during the entire year to constitute a trade or business. In holding against Mr. Paoli, the court observed: "His pattern of buying and selling varied significantly from month to month. Most of the transactions made during the 1-month period between January 12 and February 11 (40% of the 326 purchases in the year occurred during this period) involved stocks held for less than a day, which petitioner described as "day trades." During March and may, however, the number of "day trades" declined substantially, and a substantial portion of sales involved stocks held for more than one month. During April, June, July, August, and September, the number of "day trades" was negligible. The only sale made in October involved stock held for more than a year and a half. No sales were made during November or December" (*Paoli vs. Comm.*, 54 TCM 1574 (1988». (See also <u>Rudolph W. & Abbie A. Steffler v. Comm.</u>, TC Memo 1995-271) in which taxpayer was deemed to be an investor despite a claimed 40-60 hours per week on commodity trading activities due to small number of trades, types of commodities and actual days trading (five to 12 days/year)).

Test # 3: The Extensive Test - How is this met?

What doesn't work - the activities of an investor: In trying to determine how extensive the taxpayer is involved in trading, the courts have ruled that spending a great deal of time each week checking market reports, reading investment magazines, et cetera, is not enough. The Tax Court states:

> Establishing continuity of investment activity is not enough. The taxpayer must do more than "merely [keep] records and [collect] interest and dividends from his securities, through managerial attention for his investments." In effect, a "trader" is an active investor in that he does not passively accumulate earnings, nor merely oversee his accounts, but manipulates his holdings in an attempt to produce the best possible yield. That is, the trader's profits are derived through the very acts of trading--direct management of purchasing and selling (*Levin vs. US*, 79-1 USTC ¶ 9176).

The key is the number of transactions: The courts put great weight on the number of trades each year and the 'dollars involved. Unfortunately, no benchmarks have been set.

Example

King was a trader with 11,040 transactions. In *Marlowe King v. Comm.* (89 TC 445 (1987)) the court found that the taxpayer was engaged in a trade or business and noted that King's trading activity included 11,040 futures contracts one year and 6,711 contracts the next year.

Burnett was a trader with 584 transactions. In *O. L. Burnett*, (41-1 USTC ¶ 9347) the court held that the taxpayer who "bought stocks and commodities through a yearly average of 584 transactions involving many thousands of dollars" was engaged in a trade or business.

Test # 4: The Short Swing Gain Test

A trader should seek to catch the swings in the daily market movement, and reap most, if not all, of his or her gains from sales of securities held very short term (*Moller v. U.S.*, supra; *Purvis v. Comm.*, supra, *H.H. Hart v. Comm.*, supra). It appears that, although holding periods of six months or less do not guarantee that this test will be met, holding periods greater than six months will harm the taxpayer's case.

Example

Yaeger was an investor due to length of holding period. In the *Estate of Yaeger*, the Court of Appeals focused mainly on the holding period. Even though *Yaeger* had over 2000 security transactions in two years, purchased over one million shares in over 1,000 transactions, and as the tax court stated, "maintained a margin of debt that would have caused a more fainthearted

investor to quail ($40 million)" the court ruled that he was an investor, not a trader. Why? Because (1) he had less than 100 *sales* transactions in a year [and some of these sales were of stock purchased in prior years], (2) the shortest holding period was three months, (3) most of the sales were securities held over a year to use the long-term capital gain benefits, and (4) he received interest and dividends (*Estate of Yaeger*, T.C. Memo 1988-264).

D. FACTORS TO DETERMINE WHETHER INDIVIDUAL IS A TRADER OR INVESTOR

	Trader	**Investor**
Motivation (the trade or business vs. investor test)	Primary purpose must be income or profit from speculation, not appreciation, dividends or interest.	Generally interested in appreciation, dividends and interest.
Activity (the involved regularly and continuously test)	Almost daily trading during the entire year; few periods without activity.	No particular pattern; months without any transactions; time between trades.
Number of transactions (the extensive test)	The more the better (584 transactions won and 326 transactions lost). Must be active in the direct management of buying and selling.	No particular pattern; months without any transactions; time between trades.
Length of holding period (the short-swing test)	Less than a day to 30 days; seldom more than 1 year.	Can be both short-term and long-term holding periods.

E. MARK-TO-MARKET ELECTION

The Security Dealers Mark-to-market Option Available for Traders: If, and only if, the taxpayer's activities meet the qualifications as a security trader and a timely "§ 475(F) election" is made, then, courtesy of the Taxpayer Relief Act of 1997, all security gains *and losses* are treated as ordinary income or loss. Instead of capital gain or loss treatment, all securities on hand at year-end are *deemed to be sold* at the year-end market value, thus forcing recognition of any unrealized gains and losses. The taxpayer's adjusted bases of all securities are marked (up or down) to their fair market value as the close of the prior year. There are no unrealized gains and losses at the beginning of the new year.

Example

Value Down at Year-End - Danny, a trader with a timely-made § 475(f) election, purchased 1000 shares of Wired. com on December 30, 2007 for $30,000. At the close of business on December 31, 2007, (one day later) they were valued at

$25,000. He sold them on January 2, 2008 for $25,000. He reports the $5,000 loss on his year 2007 tax return. His adjusted basis on January 1,2008 is$25,000, resulting in no gain or loss for 2008 .

Value Up at Year-End - If Danny's value at the close of business on December 31, 2007 was $32,000, he would report a $2,000 gain on his year 2007 tax return, even if it was sold on January 2, 2008 for $25,000. His deemed adjusted ,basis on January 2, 2008 is $32,000, resulting in a $7,000 loss for 2008.

Advantages and Disadvantages: The primary benefit for making the § 475(f) election is that the $3,000 limitation on net capital losses and the wash sale rules[1] no longer apply, allowing the trader to write off trading losses against other income (§ 1211(a), § 475(d)(1),§ 475(f)(l)(D)). This § 475(f) election is still not available for security investors. Prior to the TRA97, mark-to-market had been available only to security dealers and traders were barred from taking ordinary losses on the sale of stocks. Of course, the primary disadvantage of the election is that the net gain, if any, at year end, must be recognized prior to a sale.

How to Make the § 475(f) Election:

Rev. Proc. 99-17 sets forth the "exclusive procedure" for making the § 475(f) mark-to-market election. As the election is a "method of accounting," this also requires existing taxpayers to file Form 3115 for a change in method of accounting. Taxpayers may make both the § 475(f) election and the change to the mark-to-market method of accounting without the consent of the IRS, but the elections, once made, cannot be revoked without the consent of the IRS (Rev. Proc. 99-17, § 2, § 4). The following chart summarizes the filing dates for the § 475(f) election and corresponding Form 3115:

Filing Dates for § 475(f) Election & Form 3115		
Form	**Date Form Needs to be Filed**	**Method Sent to IRS**
Original § 475(f) Election	By April 15 of year election is to be effective	Attach to prior year tax return or extension, whichever filed first
Original Form 3115	By filing date of return (including extensions)	Attach to timely filed return
Copy of Form 3115	By filing date of return (including extensions)	Send to IRS National Office

[1] Relating to losses from wash sales of securities, "a taxpayer cannot deduct any loss claimed to have been sustained from the sale or other disposition of stock or securities if, within a period beginning 30 days before the date of such sale or disposition and ending 30 days after such date ..., he has acquired ...., or has entered into a contract or option so as to acquire, substantially identical stock or securities. *However, this prohibition does not apply (1) in the case of a taxpayer, not a corporation, if the sale or other disposition of stock or securities is made in connection with the taxpayer's trade or business-...*"(Reg. § 1.1091-1(a)).

Warning: A § 475(f) election must generally be made by April 15th of the year for which it is to be effective. For example, a § 475(f) election for the Year 2008 return must have been made by April 15, 2008, and either attached to the 2008 return or attached to a timely filed extension request (Form 4868) for 2008.

Change in Accounting Method Required

Form 3115 Filing Requirement: If the taxpayer, other than anew taxpayer, used another method of accounting (generally cash) in prior years, the trader must request a "change in method of accounting" by filing Form 3115 and complying with Rev. Proc. 2000-8 and Rev. Proc.99-17 to use the § 475 mark-to-market method for securities. The label on Form 3115 should read: "Filed pursuant to Rev. Proc. 99-17." Automatic consent of this accounting method change by the IRS Commissioner is granted, with no user fee required, if the following conditions are satisfied:

1. The taxpayer meets the definition of a security trader (the 4 requirements discussed later),
2. The taxpayer complies with the above mentioned election requirements,
3. The method of accounting is in accordance with its § 475 election,
4. The year of the change is the election year, and
5. The taxpayer complies with the required changes in method accounting (Rev. Proc. 99-17, § 6.01).

§ 481(a) Adjustment: A § 481(a) adjustment is the difference between the fair market value of the securities as of the close of the year prior to the election year and the adjusted bases of those securities as of the close of the year prior to the election year (Rev. Rul. 93-76). Any adjustment required under § 481 as a result of this change in accounting is to be taken into account ratably over four tax years, beginning with the year in which the election is first effective (Rev. Proc. 99-17, § 6.03). If the adjustment is less than $25,000 (positive or negative), the taxpayer may elect to take the whole adjustment on the current return by electing the de minimis rule on Form 3115 (Rev. Proc. 2000-8, § 5.04(3)(a)).

Report Mark-to-market on Form 4797, Line 10

According to Form 4797 instructions, the end-of-year (EOY) valuation requires each set of shares to be reported in a separate transaction on Form 4797, Sale of Business Assets. Individuals making the § 475(f) election must report day trading activity expenses on Schedule C and stock transactions on Form 4797. All mark-to-market transactions are to be reported on line 10 of Form 4797 ,regardless of the holding period (the holding period for commodities on which the mark-to-market election is made is irrelevant as gain or loss from these transactions are always ordinary, not capital gain or loss).

Comment: According to the Form 4797 advance instructions, the net gain (if any) is reported on Form 1040, line 14 (the Form 4797 line). But the net loss (if any) is reported is reported on Form 1040, line 27, and is to be identified as "Form 4797, line 18(b)(1) loss" (this is the self-employment tax line!).

Each stock must be separately reported! For each stock or commodity marked-to-market, a separate transaction should be indicated. Entries for individual transactions should include the

actual purchase date and a sale date of 12/31 of the year in which the FMV is recorded. If the number of transactions exceeds the space provided on the form, a separate statement should be attached listing each individual sale and separately listing each asset marked-to-market.

The draft Form 4797 for tax year 2000 includes updated line instructions for line 1. In the past, the IRS only wanted taxpayers to include the proceeds from Form 1099-S, Proceeds from Real Estate Transactions. Now, in addition to Form 1099-S proceeds, the IRS wants taxpayers to include the proceeds reported on Form 1099-B, Proceeds from Broker and Barter Exchange Transactions, when the mark-to-market election is made.

F. CAN TAXPAYER BE BOTH AN INVESTOR AND A TRADER?

Probably. The courts have acknowledged that a trader (and even a "dealer") may hold simultaneously certain shares for investment and others for trade (*Samuel B. Levin vs. U.S.*, 79-1 USTC ¶ 9176; *Bradford v. U.S.*, 71-2 USTC ¶ 9542). Because this determination is based on facts and circumstances, it is highly recommended that the taxpayer separate the activities, including using a separate set of books and checking accounts to designate which securities are being held for long-term appreciation and which securities are for "day-trading" (see *R.H. Pritchett v. Comm.*, 63 TC 149 for a parallel argument used successfully in the real estate dealer vs. investor controversy).

§ 475(f) election applies only to dealer but not investment securities: If a taxpayer is both a trader and investor, only those securities held by the taxpayer and used in its business are subject to the § 475(f) election (§ 475(f)(1); § 475(f)(2)). Therefore, securities or commodities held for investment and so identified are not subject to the election as long as the trader clearly identifies a security as not held for trading before the close of the day it is acquired, originated or entered into (§ 475(b)(1)(A); § 475(b)(2); § 475(f)(1)(B); Regs. § 1.475(f)-2(d)). Additionally, the trader must demonstrate by clear and convincing evidence that the security has no connection to its trading activities. When substantially similar securities are held for trading and also investing, the trader must hold the investment securities in an account that is separate from the trading account, and which is maintained by a third-party (Prop. Reg. § 1.475(f)-2(a)(3)). If a security or commodity is identified as investment property and then becomes business property, the mark-to-market rules apply to changes in the value of the property that occurs after the time it becomes business property (Prop. Reg. § 1.475(f)-2(a)(2)).

> **Comment:** This is the IRS's attempt to prevent the trader from taking ordinary losses on losers and simultaneously taking capital gains on winners.

XI. TAX TREATMENT OF FINANCIAL INSTRUMENTS

A labyrinth aptly describe the current maze of financial transactions taking place and the convoluted rules governing their tax treatment. The following is a discussion of more commonly encountered transactions.

A. THE RULES

Because financial instruments and combinations of and permutations on them have proliferated, Congress has seen fit to write several anti-abuse rules.

B. CONSTRUCTIVE SALES TREATMENT FOR APPRECIATED FINANCIAL POSITIONS (§ 1259)

What is a constructive sale? A taxpayer is treated as making a constructive sale of an appreciated position when the taxpayer (or, in certain circumstances, a person related to the taxpayer):

1. Enters into a short sale of property already owned,
2. Enters into an offsetting notional principal contract with respect to the same property,
3. Enters into a futures or forward contract to deliver the same property, or
4. Enters into one or more other transactions, or acquires one or more other positions, that have substantially the same effect as any of the transactions described above, to the extent provided in Treasury regulations.

A constructive sale under any part of the definition occurs if the two positions are in property that, although not the same, are substantially identical. In addition, in the case of an appreciated financial position that is a short sale, a notional principal contract or a futures or forward contract, the holder is treated as making a constructive sale when he acquires the same property as the underlying property for the position.

Do related party rules apply? The positions of two related persons are treated as together resulting in a constructive sale if the relationship is one described in § 267 or § 707(b) and the transaction is entered into with a view toward avoiding the purposes of the provision.

When does constructive sale occur? Whether any part of the constructive sale definition is met by one or more appreciated financial positions and offsetting transactions will generally be determined as of the date the last of such positions or transactions is entered into.

Must transactions be aggregated? More than one appreciated financial position or more than one offsetting transaction can be aggregated to determine whether a constructive sale has occurred. For example, it is possible that no constructive sale would result if one appreciated financial position and one offsetting transaction were considered 'in isolation, but that a constructive sale would result if the appreciated financial position were considered in combination with two transactions.

What if only a portion of transaction is considered a constructive sale? Where the standard for a constructive sale is met with respect to only a pro rata portion of a taxpayer's appreciated financial position (e.g., some, but not all, shares of stock), that portion would be treated as constructively sold under the provision. If there is a constructive sale of less than all of any type of property held by the taxpayer, the specific property deemed sold would be determined under the rules governing actual sales, after adjusting for previous constructive sales under TRA 1997. Under the regulations to be issued by the Treasury, either a taxpayer's appreciated financial position or its offsetting transaction might in some circumstances be disaggregated on a non-prorata basis for purposes of the constructive sale determination.

Are there any exceptions to the constructive sale rules? There is a limited exception to constructive sale treatment for transactions that are closed before the end of the 30th day after the close of the taxable year (§ 1259(c)(3)) (see the discussion under short sales below).

Furthermore, a constructive sale does not include a transaction involving an appreciated financial position that is marked-to-market, including positions governed by § 475 (mark-to-market for securities dealers and traders by election) or § 1256 (mark-to-market for futures contracts, options and currency contracts). Nor does a constructive sale include any contract for sale of an appreciated financial position which is not a "marketable security" (as defined in § 453(f)) if the contract settles within one year after the date it is entered into.

C. WASH SALE RULES (§ 1091)

The wash sale rules at § 1091 provide that loss may not be recognized on the sale or other disposition of stock or securities if, within 30 days before or 30 after the sale or other disposition, the taxpayer acquires substantially identical stock or securities (§ 1091(a)). For purposes of the wash sale rules, stock or securities includes contracts or options to acquire to sell stock or securities. The basis of the stock or securities whose acquisition resulted in the nondeductibility of loss, is the basis of the stock or securities so sold, increased or decreased, as the case may be, by the difference, if any, between the price at which the property was acquired and the price at which such substantially identical stock or securities were sold (§ 1091(d)).

> **Caveat:** Case law denies deductions on related party wash sales. For example: if securities are purchased by taxpayer's wholly owned corporation or by a trust over which the taxpayer has complete control losses have been denied.

Revenue Ruling 2008-5

It has been a gray area in recent years as to whether or not a taxpayer would have a wash sale if they sold stock or securities for a loss and then caused their individual retirement account or Roth IRA to purchase substantially identical stock or securities within 30 days before or after the sale.

This Revenue Ruling clears up the question. IRS states that the loss is disallowed under § 1091. In addition the taxpayer's basis in the IRA is not adjusted by the amount of the loss disallowed under § 1091 which is the usual rule. This will cause a permanent disallowance of the loss. The taxpayer will actually be in a worse position than he was before selling the stock.

D. STRADDLE RULES (§ 1092)

The straddle rules at §1092 apply when a taxpayer is holding a position (such as a put or a call) that substantially reduces the risk of loss of holding property. Thus, the purchase of a put (the right to sell stock at a specified price) reduces the risk of holding the underlying stock and is a straddle. § 1092(a)(1)(A) provides that loss may not be recognized on the expiration of a put to the extent of unrecognized gain in the underlying stock.

> **Note:** A modified wash sale rule applies to the disposition of stock or securities that constitute positions of a straddle. First, to the extent the wash sale rules above apply, loss is disallowed. Then, to the extent of any remaining loss on a straddle, the loss deferral provisions of the straddle rules apply.

E. SECTION 1256 CONTRACTS MARKED-TO-MARKET

The marked-to-market rules at § 1256 apply to (1) any regulated futures contract, (2) any foreign currency contract, (3) any nonequity option, and (4) any dealer equity option. These are called "§ 1256 contracts." § 1256(a)(1) provides that each § 1256 contract held by the taxpayer at the close of the taxable year will be treated as sold for its fair market value on the last business day of such taxable year. Thus, unrealized gains and losses are recognized at year-end on § 1256 contracts. 40% of any gain or loss is deemed to be short term and 60% is deemed to be long term (§ 1256(a)(3)). Adjustment is made to the basis of § 1256 contracts held at year-end to reflect the gain or loss recognition of § 1256.

F. SHORT SALES (For Stock or Securities)

Definition: A short sale is a sale of stock, or other property that the taxpayer does not own. However, the taxpayer commits to acquiring and producing this property by the time of delivery; i.e., when the short sale is closed. Put another way:

> "He who sells what isn't his'n
> Must buy it back or go to prison."

Mechanics: In a short sale, the seller sells property (stock or other) that he currently does not own. He then borrows the stock certificates (usually through a broker) or other property for delivery to the buyer. The proceeds from the sale are deposited with the lender until the transaction is completed (by the delivery of identical property back to the lender). In the meantime, the lender receives any dividends that they would have been entitled to had they not loaned the stock. Sometimes the lender will pay the seller a portion of the income earned on the funds from the sale.

Purpose: A pure short sale is a transaction made by a taxpayer that anticipates that a particular stock, commodity or other property will drop in price after it is sold short. The taxpayer may then buy the property back for delivery at a lower price than it was sold for and make a profit on the transaction.

Example

Ann sells 100 shares of Travelalot stock short for $50.00 per share when she expects a downturn in the airline industry. As it turns out, Ann is correct in her thinking and closes the transaction by delivering 100 shares of Travelalot stock back to the lending brokerage that she purchased for $25.00 per share. Ann makes a $2,500 profit.

Revenue Ruling 2002-44 – Tax Consequences of a Short Sale

Prior to clarification by Revenue Ruling 2002-44, gain or loss for tax purposes was determined when the sale was closed (the property is delivered to the lender and payment is made). Rev. Rul 2002-44 now clarifies that the constructive sale rules (discussed above) now "trump" the general

rule of Reg. § 1.233-1(a)(1). Gain is instead recognized when the stock is purchased to close a short sale (not delivered to the lender) at a gain but not losses.

The constructive sale rules apply because a short sale with a gain is an appreciated financial position (there would be a gain if the position is sold). Therefore, when the taxpayer is holding a short position that has increased in value, just acquiring the property to close will trigger the gain under the constructive sale rules.

> **Note:** This is mostly a year end issue. Taxpayers can avoid the problem by making sure that the trade date falls in the year they want to recognize income.

The seller's gain from a short sale is short term, regardless of the actual holding period if the seller, on or before its closing bought substantially identical property (§ 1233(b) and Reg. § 1.1233-(c)(2)).

G. SHORT SALE AGAINST THE BOX

Definition and mechanics: The definition and mechanics of a short sale apply to a short sale against the box. The difference is that the taxpayer its borrowing stock certificates or other property for delivery to a buyer when he or she already holds identical property. The seller does not want to use his property to make this sale. The transaction is complete when the seller either buys identical property to deliver to the lender or uses the property he already owns to close the transaction.

Purpose: In the past, before the advent of the constructive sale rules of § 1259 (enacted in the Taxpayer Relief Act of 1997), taxpayers used short sales against the box as an insurance policy to lock in the gain on stock they already held without actually selling their holdings. This strategy postponed recognition of gain.

Tax Consequences: The constructive sale provisions mentioned above generally eliminate the tax deferral benefits of short sales against the box. The law now limits an investor's ability to accomplish tax deferral by treating this type of short sale transaction *as a constructive sale* for which gain (but not loss) must be recognized.

Did the Constructive Sale Rules "Kill" Short Sales Against the Box? Not entirely, due to a limited exception to constructive sale treatment for transactions that are closed before the end of the 30th day after the close of the taxable year (§ 1259(c)(3)). However, the taxpayer must hold the appreciated financial position to which the transaction relates (i.e., securities, if the transaction is a short sale against the box) throughout the sixty day period beginning on the date the transaction is closed and at no time during the 60 day period may the taxpayer reduce his risk of loss on the stock or substantially similar property. This means that the taxpayer cannot use the stock that he has held long-term to close the transaction, he must buy new stock to cover.

Example

Harold HotShot purchased 100 shares of Surething stock on 1-1-06. On February 2, 2008, he sells 100 shares of Surething short and closed the position on January 9, 2008, with Surething shares purchased on that date. He then continues to hold the original Surething shares until May 5, 2009, when he sells his shares.

There is no constructive sale here because the short-term hedge exception works. The Surething short sale is covered during the first 30 days following the end of the year in January 2008 and the 60 day requirement is also satisfied because Harold retains his open long position in the stock for that time period and does not hedge it again.

Note: If the short position had been covered by the previously owned shares, then the 60 day rule is not satisfied. Therefore, new stock must be purchased to cover the short sale.

H. OPTIONS

An option is a contract that conveys the right to buy or sell a specific item at a specified price within a specified period of time. The underlying property subject to the option can be any type of property such as real estate, stock, debt securities or a futures contract. Options take various forms including warrants, puts and calls and options of § 1256 contracts.

Owners of options do not own the underlying property. Options have their own "intrinsic value". Purchasers of options expect the price of the option to rise and/or fall more rapidly than the underlying stock. Because of this leverage. factor, options can be very risky business.

The following is a discussion of the more common types of options, how they work, why investors use them and the tax consequences that relate to them.

Put Option

Definitions:

Holder or Purchaser: The holder or purchaser pays a premium for the right to sell the writer a set number of shares of stock at a specific price (strike price) for a fixed period of time (or on a future specified date).

Writer or Seller: The writer or seller receives a premium and must buy a set number of shares of stock at the strike price if the purchaser exercises the put within the fixed period of time (or on the future specified date).

Investment Purpose: The purchaser generally owns appreciated stock that he wants to protect from a decrease in price. Therefore in the event that:

1. The stock goes up - the purchaser will let the put option expire.
2. The stock goes down - the purchaser will require the writer to buy.

The writer receives the premium and takes the chance that he will not have to buy the stock.

Tax Consequences:

To Purchaser: If the put option is exercised, the premium paid for the put option is added to the cost basis of the stock the purchaser already owns and is taken into account when the stock is sold. If the put option is allowed to expire unexercised, the purchaser realizes a loss. However, this loss is deferred (not currently recognized) to the extent that the sale of the stock would generate gain. If the option itself is sold or assigned, the purchaser recognizes gain or loss."

To Writer: No income is recognized until the put option is allowed to expire or is exercised. The writer recognizes short term capital gain if the option expires. If the put option is exercised and the writer must buy the stock, the premium that was received reduces the basis in the stock.

Example
Craig has amassed a small fortune in his employer Widget.com's stock. Worried about a slow down in European demand for Widget.com's products, Craig would like to sell about 20,000 shares of his stock now on October l, 2008. However, he is locked out until January of 2009. Therefore, to protect the price, Craig buys a put for $32,000 to sell 20,000 shares at $76/share for 120 days (pushing the sale out to January).

If the price is below $76/share in January, Craig will force the writer to buy his stock and has protected at least 95% of the price. Craig's basis in the stock he sells is increased by the cost of the put of $32,000. If the stock was acquired prior to October 1, 2008 (held long term before the put option was purchased), then the gain on sale due to the exercise of the put option is long term. Otherwise, even if the stock is held long term by the date of actual sale, the gain is short term if the stock was not held long term when the put was acquired (§ 1.1233-1(c)(3)). The writer subtracts $32,000 received for the put from the cost of the stock purchased.

If the price is above $76/share, Craig will allow the option to expire as he can sell the stock on the open market for more. When the option expires, Craig will have a $32,000 capital loss (short term in this case as the option was not held for more than one year). However, such loss is deferred until the actual stock is sold to the extent that the stock would generate a gain if sold. For example, if Craig's basis in the stock is $1/share and the fair market value when the option expires is $811share, potential gain on the sale is greater than the $32,000 cost of the put option and the entire loss is deferred until the stock is sold. The writer recognizes a short term capital gain of $32,000.

> **Caution**: Taxpayers subject to insider trading rules must determine that transactions involving their employer's stock are not in violation of security laws.

Call Option

Definitions:

Holder or Purchaser: The holder or purchaser pays a premium for the right to buy a set number of shares of stock at a strike price for a fixed period of time.

Writer or Seller: The writer or seller receives the premium and must sell a set number of shares of stock at the strike price if the purchaser exercises the call within fixed period of time.

Investment Purpose: A buyer purchases a call option if an increase in value in the stock is anticipated and the buyer is unable or unwilling to purchase the actual stock.

Tax Consequences:

To Purchaser: If the value of the stock falls, the purchaser will allow the option to lapse. If this occurs, the option is deemed sold on the date of expiration resulting in a short term capital loss. If the value of the stock goes up and the call option is exercised, the premium paid is added to the cost basis of the stock. If the purchaser sells the option itself he recognizes gain or loss on the sale.

To Writer: The premium received is a short term capital gain when and if the option is allowed to expire. If the option is exercised and the writer must sell the stock, the premium is added to the proceeds received on the sale of the stock and any gain or loss is treated as short or long term capital gain or loss depending on the writer's holding period of the stock.

Example

Claire is almost certain that Surefire Co. stock's value will increase from its current value of $75/share, but she is broke and unable to purchase the stock. She is able to scrape $250 together to purchase a call which gives her the right to purchase 100 shares for $75/share within the next 3 months. The writer of course expects that the value of the stock will not increase, Claire will not exercise her call option and he will pocket the $250.

If the value increases over $75/share, Claire will exercise the call option and add the $250 cost of the option to the basis of the stock. The writer will add the $250 call option premium to the sale proceeds of the stock.

If the value does not increase over $75/share, Claire Will let the option lapse which results in a short term capital loss. The writer will pocket the $250, keep his or her stock and recognize a $250 short term capital gain when the option lapses.

PUTS AND CALLS AT A GLANCE			
Transaction		**Holder or Purchaser**	**Writer or Seller**
PUT	Definition	Pays premium for right to sell writer a set number of shares of stock at a strike price for a fixed period of time.	Receives premium and must buy a set number of shares of stock at strike price if purchaser exercises the put within fixed period.
	Exercised	Premium paid added to tax basis of stock sold.	Premium received reduces tax basis of stock.
	Expired	Realizes a loss at expiration that is deferred to extent of gain in underlying stock.	Short term capital gain at expiration.
CALL	Definition	Pays premium for right to buy a set number of shares of stock at a strike price for a fixed period of time.	Receives premium and must sell a set number of shares of stock at strike price if purchaser exercises within fixed period.
	Exercised	Premium paid added to tax basis of stock acquired.	Premium received is added to sale proceeds of stock sold.
	Expired	Short term capital loss at expiration.	Short term capital gain at expiration.

Collars

Definition and mechanics: A taxpayer desiring to lock in a range of gain without recognizing gain from the sale of stock should consider a collar. The taxpayer is able to mitigate downside risk at the cost of upside potential at very little or not actual dollar cost with a collar. The collar is a combination of the purchase of a put option and the sale of a call option. The premium paid for the put option is offset by the sales proceeds from the sale of the call option.

Because collars are frequently settled in cash, the taxpayer retains his shares of stock and does not trigger recognition of capital gains.

> **Warning**: A collar may be treated as a constructive sale such that recognition of capital gains is not avoided. See the discussion below regarding collars and the constructive sale rules.

Example

James holds 50,000 shares of his employer, Speedychips.com. His average cost is $5/share and the stock is currently trading at $95. A drastic drop in the market value would ruin James' dream of retiring at the ripe old age of 35. But, he is not ready to take the plunge, sell the stock and pay

the tax. His broker recommends buying a put option to mitigate the downside risk. Despite James' net worth or over $4.5 million, he doesn't have the cash to buy the put (and you can't margin stock to buy options). His broker then recommends selling a call to pay for the put. On July 1,2008 James buys a put at $86 and sells a call at $105, both with a nine month term. In plain words this means if value:

Falls below $86: James will exercise the put and force the writer to buy his stock for $86. Thus he has guaranteed a value of no less than $86.

Climbs above $105: The call James sold will be exercised and he will be forced to sell at $105. Thus, he has limited his upside potential to $105.

Assuming that these options will be settled with cash (rather than actual transfers of stock) and further assuming that the broker both sold the put and bought the call, then the actual value of James' position depending on the stock price when the options are exercised is as follow:

Stock Price at Option Exercise	James Owes Broker	Broker Owes James	Value of James' Position
$110	$(5)	$0	$105
106	(1)	0	105
105	0	0	105
100	0	0	100
95	0	0	95
90	0	0	90
86	0	0	86
84	0	2	86
80	0	6	86

Tax Consequences

Constructive Sale Rules: To determine the tax consequences of a collar, a determination must be made as to whether the constructive sale rules apply. The constructive sale rules at §1259 apply when a taxpayer who holds an appreciated financial position enters into a transaction that produces the same offsetting position. Thus, a collar in which the spread between the downside and upside is relatively small, may be subjected to the constructive sale rules.

The IRS has been instructed by Congress (in TRA '97) to issue regulations to provide guidelines that indicate how large the spread must be to avoid constructive sale treatment. According to Practitioners Publishing Company, Tax Action Memo #760 entitled "Using Options to Reduce Investment Risk", August 8,2000, the IRS has commented that a spread of at least 20% may be a safe harbor.

> **Warning**: Make sure that your client and his or her broker understands the potential tax risk of collars.

When the constructive sale rules apply, the taxpayer will recognize gain as if such position were sold, assigned, or otherwise terminated at its fair market value on the date of such constructive sale (and any gain shall betaken into account for the taxable year which includes such date) (§ 1259(a)(1)). In other words, the taxpayer will be treated as though he or she sold the underlying stock on the date of the constructive sale.

When the options actually expire or are exercised, adjustment will be made in the amount of any gain or loss subsequently realized with respect to such position for any gain taken into account by reason of the constructive sale rules (§ 1259(a)(2)(A)). The holding period of such position is determined as if such position were originally acquired on the date of such constructive sale (§ 1259(a)(2)(B)).

If Constructive Sale Rules Do Not Apply: If the spread on a collar is large enough to avoid the constructive sale rules, then the rules described above for the purchase of puts. and the sale of calls apply to collars.

But Watch Out for the Straddle Rule: The straddle rules at § 1092 apply when a taxpayer is holding a position (such as a put or a call) that substantially reduces the risk of loss of holding property. Thus, the purchase of a put (the right to sell stock at a specified price) reduces the risk of holding the underlying stock and is a straddle. § 1092(a)(l)(A) provides that loss may not be recognized on the expiration of a put to the extent of unrecognized gain in the underlying stock.

XII. OPTIMIZING AFTER - TAX RETURN

A. BASIS FOR DETERMINING GAIN OR LOSS ON SALES

Purchased Stock

The basis of stock acquired by purchase is the purchase price.

First In First Out or the Specific Identification Method?

Qualifying for the long term capital gains treatment described above requires that the equity be held for longer than 12 months. What if the taxpayer holds many shares of the same equity purchased at different times? When the' stock is sold either "first-in, first-out" (FIFO) or the specific identification method must be used to determine the basis of the stock sold. The proper use of these methods can result in substantial tax savings. Generally the taxpayer will want to use the basis of the stock with the highest basis (for lowest profit) which is not always the first stock acquired under the first-in first-out method. Therefore specifically identifying the stock shares sold could be more tax efficient.

Most taxpayers do not keep the certificates of the stock they own personally but rather the stock is held in street name by their broker. The stock sold may still be specifically identified. Adequate identification requires:

- Specifying to the broker or other agent the particular shares to be sold or transferred at the time of the sale or transfer, and
- Receiving confirmation of the specification from the broker in writing within a reasonable time.

***Rendell v Comm'r* T.C. Memo 2006-174**

Merrill Lynch sold 634,000 shares of pledged stock to satisfy a margin call for the taxpayer. Rendell originally purchased 2.5 million shares of the stock for $0.01 per share. Later he purchased 160,000 shares at a much higher price.

When the stock was sold no specific identification was made to Merrill Lynch the broker.

The taxpayer sought to use the specific identification method as a basis for the sold stock. The court determined that FIFO method must be used since specific identification was not made at the time the stock was sold. This is a requirement of § 1.1012-1(c)(3)(i)(a).

The court cited *Hall v. Comm'r* 92 T.C. 1027 and quoted that opinion as follows:

> "One cannot avoid the application of the FIFO method by waiting until the end of a year to allot specific sales to this general inventory of stocks in such a manner as to be most beneficial to him taxwise."

What about Mutual Funds?

The same rules apply for the shares of a mutual fund if the taxpayer is not using an average cost method of figuring gain or loss. on the fund. Average basis may be used if the taxpayer acquired shares at various times and prices and left the shares on deposit in an account handled by a custodian or agent who acquires or redeems those shares. There are two average basis methods:

1. **Single-category method** - Requires a calculation of the average cost of all shares owned at the time of each disposition, regardless of how long owned. This includes shares acquired with reinvested dividends or capital gain distributions. Although only one category is used, it includes both short-term and long-term gains or losses. Holding period is determined by considering the shares disposed of to have been acquired first.

2. **Double-category method** - At each disposition all shares in the account are divided into short-term and long-term (two categories). The basis of each share in a category is the average basis for that category. (Note: The taxpayer may specify to the broker from which category the shares are to be sold or transferred and the broker must confirm in writing the specification). If specific shares are not called out then the taxpayer must first charge the shares sold against the long-term category and then any remaining shares are considered to come from the short-term category.

> **Practice**: Many mutual funds provide average basis information to their shareholders on redemption requiring no calculations by the taxpayer!

If the average cost method is elected, it must continue to be used for all accounts in the same fund. A different method may be used for other funds, even those within the same family of funds.

Gifted Stock

The basis of stock acquired by gift is usually the donor's basis at the date of the transfer. If the FMV is less than the donor's basis, the basis for loss will be the FMV at the date of the gift. If donor's basis is used for figuring gain and a loss results; and FMV at the date of gift is used for figuring a loss and a gain results, there is neither a gain or loss on the sale of the property (§ 1011). (See Example #3).

Examples

#1
Mildred gifts Noelle 100 shares of Cisco that cost her $100 per share. At the date of the gift the FMV of the stock was $110 per share. Noelle sells the stock for $112 per share. Noelle's gain based on Mildred's basis is $12.00 per share.

#2
Assume the same facts except that the FMV of the stock when Mildred gifts it to Noelle is $90 per share and Noelle sells it for $85 per share. Noelle's basis is $90 per share and Noelle sustains a loss of $5,00 per share.

#3
Assuming the same facts again: If the stock sells for $95 per share, Noelle has no gain or loss on the sale of the shares. The tax basis for computing gain is Mildred's cost of $100 per share which would create a loss if used. The tax basis' for computing a loss is the lower of FMV ($90) or cost basis of donor ($100) so in this example basis for loss is $90. Therefore, no gain or loss is recognized.

Inherited Stock

The basis of stock acquired by inheritance is the fair market value at the date of the death of the decedent or alternate valuation date. (§ 1014 (a)).

B. INVESTMENT CHOICES - ANNUITIES, MUTUAL FUNDS (EQUITIES) AND BONDS

Profits on <u>equities</u> are subject to the long term capital gain rates if the stock has been held longer than 12 months. Income from <u>bonds</u> and <u>annuities</u> are taxed at the taxpayer's ordinary income marginal tax rate and dividends from most stocks will be taxed at the long term capital gain rate for a period of seven years (through 2010); On the surface it might then appear that equities are always the best investment. for maximizing after tax savings. The three types of investments, however, must be examined more closely to determine the truth of what is apparently obvious. The discussion that follows ignores risk factors and instead concentrates on maximizing after-tax returns.

A definition of what constitutes an annuity and a mutual fund and the taxation of these investments is first necessary.

ANNUITIES

Definition

An annuity is a series of payments under a contract. The payments must be made regularly for longer than one year. The payments can be either fixed or variable.

Annuities can be purchased in qualified plans or non-qualified plans. The discussion here will be focused on variable commercial annuities in a non-qualified plan.

Under a variable commercial annuity the purchaser makes premium payments to the insurance company (issuer) and the issuer in turn makes a series of payments to the purchaser either for life or a fixed term. The premium payments are invested by the insurer and payments made by the issuer to purchaser are based on the investment return on the account. There is usually no guaranteed return on investment.

Tax Treatment

The earnings in a variable annuity accumulate on a tax deferred basis but when withdrawals are made the earnings are taxed at ordinary income tax rates using the General Rule.

General Rule

Under the general rule, taxpayers determine the tax-free part of each annuity payment based on the ratio of investment in the contract (cost) to the total expected return. Expected return is the total amount the taxpayer and other eligible annuitants can expect to receive under the contract. To figure expected return, life expectancy (actuarial) tables prescribed by the IRS must be used. (See Pub 939).

Exclusion Ratio - The annuitant recognizes as ordinary income the amount of each annuity payment less any portion excludable from income as the result of the application of the exclusion ratio. The exclusion ration is the annuitant's investment in the contract divided by the expected return under the annuity. (§ 72(b)).

Investment in Contract (Cost) - The investment in the contract is the aggregate amount of premiums or other consideration paid for the contract less the aggregate amount received under the contract to the extent excludable from gross income (§ 72(c)(1)(B)).

Expected Return - The expected return is the amount of a single payment multiplied by the anticipated number of payments. If the anticipated number of payments is to be based upon the life expectancy of the annuitant, then the § 72 annuity tables are utilized to make this determination. (§ 72(c)(3)).

> **Note**: A variable annuity contract does not produce a fixed payment. The payments will vary in amount because the return on investment depends up on

how the money was invested and the profits earned. It is possible with a variable annuity contract that the tax free amount calculated for a year is more than the payments.

An alternate calculation is available if this occurs. The tax free portion may be refigured when the next payment is received. The calculation divides the amount of the periodic tax free part that is more than the payment received by the remaining number of payments expected. This amount is then added to the previous tax free amount and the result becomes the new tax free amount for future payments. (See IRS publication 939 for examples and details).

Life Insurance

An element of a variable annuity contract is life insurance. In fact, some would describe a variable annuity as a mutual fund in a life insurance wrapper. The amount paid out to beneficiaries when an annuitant dies as a life insurance benefit is not taxable to the beneficiary.

Other Features of Variable Commercial Annuities

1. No required beginning date for distributions
2. No limit on contributions
3. Tax Free transfers of annuity plans (§ 1035 allows for tax free exchanges of other variable annuity contracts)

MUTUAL FUNDS

Many investors get surprises at the end of the tax year when mutual funds (regulated investment companies) are required by law to distribute realized gains and losses from transactions within the fund during the year. Some of these earnings may be short-term gains taxed at the taxpayer's marginal ordinary rate, not long-term capital gain. The type of mutual fund that is chosen for investment however, can minimize these unpleasant tax surprises at year end. A mutual fund that does not turnover a lot of stocks during the year will make fewer taxable distributions.

Tips for purchasing a low distribution mutual fund:

1. Check out the fund - What is its track record for paying out dividends and capital gains in recent years? (Utilize "Morningstar Reports" at your local library or online). The lower the taxable distribution the better the after-tax return.

2. What is the turnover rate of the fund? The more the manager buys and sells in the account the more taxable distributions there will be (especially short-term gains).

Note: Consider mutual funds that are considered "index funds" and have low turnover ratios because the fund tracks the Dow and there is little buying and selling.

3. Find out how much capital appreciation the fund already has before buying in. This index will give the investor a rough idea of potential tax liability in the fund.

Mutual Fund or an Annuity? What is the Best After Tax Return?

COMPARISON TAX FACTORS	VARIABLE ANNUITY	MUTUAL FUND
Tax Rate	Ordinary Income Rates	15% Capital Gain Rates if shares held long term
Taxation of Annual Earnings	Tax Deferred	Taxable
Taxation of Dispositions	Tax Deferred 1035 Exchange	Taxable
Early Withdrawal Penalty	Yes, on earnings before Age 59 ½	No

Discussion

Although the highest marginal tax rate is now 35%, most annuity income received in retirement years is probably taxed at a lower rate, although usually not lower than 15%. A mutual fund may throw off short term gains that are taxed at a higher rate as well. It becomes obvious that some mutual funds probably are more tax efficient than annuities because of the capital gains rate advantage. However, the taxpayer must be invested in a fund that is tax efficient, i.e., turns over stocks infrequently.

The tax deferral available in the annuity for sales of mutual funds is a pro for annuities unless the taxpayer is invested in mutual funds that he has bought for the long haul. The assumption cannot necessarily be made that people do not change mutual fund investments often and therefore the tax deferral available in the annuity is not necessary.

The early withdrawal penalty is an obvious drawback to an annuity but only if it is cashed in early.

Generally speaking, the client profile that works best with an annuity is:

1. A client already contributing the maximum amount to a 401-(k) or IRA arrangement. (i.e., all deferred compensation or qualified plans).

2. Clients who don't need the money until they are past 59 1/2 years of age.

3. Clients in 25% tax bracket or higher. The lower brackets do not produce enough tax deferral to justify the hefty fees of an annuity.

   Note: Some clients in the 33% or 35% bracket would however rather have the 15% rate on capital gains in a non annuity investment and forget the tax deferral.

4. Clients who will use the money before death. Otherwise, the accumulated earnings in the annuity create income in respect of a decedent that will be taxed to the beneficiaries.

BONDS

Bonds are debt instruments which are issued by corporations as a way of raising capital and produce taxable interest income. Municipal bonds are promissory obligations issued by states and local governments. They can also be issued by housing authorities, port authorities and other political subdivisions. Municipal bonds are a way for these governmental units to raise money to support the infrastructure of our country. Most of these bonds produce tax free income.

Investors not looking for a tax advantage and who need portfolio diversification are prime candidates for corporate bonds that pay a higher rate of interest than municipal bonds. Bonds are rated according to risk factors that could effect them. They are rated by Moody's Investor's Service and Standard and Poor's, two major rating agencies that evaluate the likelihood of default by issuers of corporate and municipal bonds.

Municipal bonds generally mature between. one and 30 years. Interest is paid semi-annually and principal at maturity. They may also be subject to call if the issuing agency decides to retire them before maturity.

Tax Issues

Municipal Bonds

The tax treatment of municipal bonds depends on the purpose of the bonds. Public purpose bonds are issued directly by state or local governments and provide funds for essential government functions. The interest on these bonds is tax exempt federally and to residents of the state where the bonds are issued.

Non governmental purpose bonds - Bonds issued to finance such things as low income housing and student loans. The interest is tax free for regular income tax purposes but is included in the calculation of AMT. These bonds usually carry a higher rate of interest than governmental municipal bonds because of their exposure to the AMT.

Who Should Invest in Municipal Bonds?

Muni bonds produce a lower rate of interest because the interest is tax exempt. However, for high tax bracket taxpayers these bonds can produce a higher after tax yield than investments in taxable corporate government and other interest bearing accounts.

Formula For Calculating After Tax Return

Step One - Subtract Client's Marginal Tax Bracket from "1 ".

Step Two - Divide Muni bond rate of return by results above

Step Three - Compare result of above calculation with taxable rate of return

Example

Tax Bracket of Client = 35%
Rate of Return on Muni B9nd = 6%

1-.35 = .65

6% divided by .65 = 9.231

Interpretation: It will take a taxable investment returning 9.231 % to get the same after tax return as a 6% Muni bond fund for a taxpayer in the 35% tax bracket.

Note: Municipal bond interest can increase the amount of taxable social security for retirees. Although the interest is not included for the regular tax calculation, it is included for calculating AGI for taxable social security purposes.

Original, Issue Discount Bonds

Original Issue Discount Bonds are bonds that are issued at a discount from their face value. The discount is interest income and is recognized as it is earned (accrues economically [§ 1272(a)] over the term of the security). When the discounts are taken into income (taxed as interest) the basis of the bond must be adjusted. A 1099 OID is provided to taxpayers who buy OID bonds at issue. (It is also possible to acquire an OID bond in the secondary market - see below - in which case different rules apply and the 1099 OID must be adjusted).

Under § 1272(a)(2) some bonds are exempt from the OID rules. These bonds include tax exempt bonds, treasury bills (of one year or less), savings bonds and bonds with de minimis OID.

Market Discount Bonds

A market discount bond contains a discount that can occur anytime after issuance based on market factors. Generally the market discount is not recognized (taxed as interest income) until the bond is sold or matures. Gain is recharacterized at disposition as ordinary income to the extent of its accrued market discount. (§ 1276 (a)(1)).

Note: Taxpayers can elect to include the discount in interest income each year as it accrues. (§ 1276 (b)).

There are two methods for computing accrued market discount

1. Ratable Inclusion Method (Default Method)

$$\frac{\text{Total Mkt Discount X Days Held}}{\text{Days Until Maturity as of Date Acquired}}$$

Example:

Noelle bought a Widget Bond with a face value of $25,OOO for $22,500 on September 1, 2006. The maturity date of the bond is December 31st 2014. On January 1, 2008, Noelle sells the bond for $23,750 .

$$\frac{\$2500 \times 487}{3042} = \$400$$

Sales Price =	$23,750
Cost Basis =	22,500
	1,250
Interest Inc	(400)
Capital Gain	$850

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2. A taxpayer can also elect to calculate accrued market discount by applying the OID rules as if the bond had been originally issued on the date the taxpayer acquired it (§ 1276(b)(2)).

OID Bonds Purchased At Market Discount

Reportable interest income on an OID bond purchased at a market discount is based on the OID remaining when the bond is purchased plus any market discount the taxpayer elects to recognize currently.

The market discount on an OID bond purchased in the secondary market is the excess of the revised issue price over the bond's basis immediately after it is acquired which is usually cost. The revised issue price is the original issue amount increased by the OID that accrued in all the previous holders' hands.

Example

Jordan purchased an OID bond on January 1, 2007. It matures on December 31, 2010. He paid $19,200 for a $20,000 bond. OID is $800. He held the bond on 12/31/07 and the 1099 OID reported $136 of OID for 2007. The value of the bond has declined by January 1,2008 because of rising interest rates. Jordan sells the bond to Samantha for $18,800. Jordan's basis in the bond is $19,200 + $136 or $19,336. He recognizes a capital loss of $536. ($18,800 sales proceeds less $19,336 basis)

Samantha now has a bond with both a market discount and OID. The bond's revised issue price is $19,336. The excess of the revised issue price over the bond's basis of $18,800 is $536. This is the market discount. Samantha will not make the election to report market discount annually and so will only report OID. The OID is reported on a form 1099 and she reports OID for 2008 of $158 and for 2009 of $172. She then sells the bond to Claire on January 1, 2010 for $19,800. Her adjusted basis for the bond is ($18,800 + 158 +172 = $19,130). Gain is: ($19,800 - $19,136 = $664).

Interest Income = $536 x 730/1093 = $358
Capital Gain = ($664-$358) = $306

C. IMPORTANCE OF ASSET ALLOCATION IN MAXIMIZING TAX BENEFITS

Taxable Accounts vs. Retirement Accounts

Some of the same tax issues addressed above in deciding between an annuity or a mutual fund apply to this discussion as well. The issue here is what type of investment should be placed in a taxable account vs. a retirement account which allows for tax deferral but does not allow for capital gains or qualified dividend treatment on distributions. The answer is as usual in the tax arena -" It depends."

Factors to Consider

- New rate reductions for both ordinary income and long term capital gains and qualified dividends;
- Rate reduction is temporary without further action from Congress;
- Client's Income Profile;
- Age of Client;
- Client's Asset Allocation Strategy;
- Assumptions on rate of return of various investments and future tax rates and;
- Client's Investment profile, i.e., buy and hold, short term trader, etc.

Because of all of the above variables it is obvious that the correct allocation between taxable accounts and deferred income accounts will vary from client to client. Generally speaking, allocating growth stocks and high paying dividend stocks to the taxable accounts and fixed income assets to the retirement accounts will result in the highest after tax return on investments. At least this is the conventional wisdom currently being espoused by various financial writers.

> **Note**: Actual results will depend on the client's tax rate at retirement and how well stocks perform as opposed to fixed-income investments for the accumulation period.

For taxpayers who frequently turn over their stock investments the profit is short term capital gain taxed as ordinary income. Because there is no capital gain advantage, trading in a retirement account will at least produce tax deferral.

There are two other factors that should be considered before making a decision as to a taxable or retirement account for asset placement.

1. If a taxable account is inherited there is a step-up in basis under § 1014 for the beneficiary. The retirement account produces income in respect of a decedent taxable to the beneficiary at the death of the investor.

2. Stock losses are recognizable in a taxable account, but not in a retirement account.