PART I: STOCKS

Dividends

7501. What is a dividend?

A dividend is a distribution of cash or property, made by a corporation to its shareholders out of accumulated or current earnings and profits. (Distributions are treated as coming out of earnings and profits to the extent the corporation has any.)[1] A dividend is a distribution made "with respect to" a corporation's common or preferred stock; that is, it is made because of stock ownership, not because of some other reason – such as compensation for services rendered or goods provided or in payment of a debt – even though it is made to a stockholder. While distribution by a company of its own stock or of stock rights is commonly called a stock dividend, it is generally not considered a dividend for tax purposes, because it is not treated as a distribution of property.[2] (That general rule is subject to exceptions, however, see Q 7509.)

For a discussion of "stock dividends" and distributions of stock rights see Q 7508 and Q 7509.

The amount received from a short-seller to reimburse the lender of stock in a short sale (see Q 7524) for dividends paid during the loan period is not a dividend to the lender.[3] For the treatment of such payments made to shareholders in lieu of dividends (i.e., "substitute payments") under JGTRRA 2003, see Q 608.

7502. How is a shareholder taxed on cash dividends received?

Ordinary cash dividends, whether paid on common or preferred stock, are generally included in the shareholder's gross income for the year in which they are actually received, regardless of the period for which they are paid. However, if there is an earlier constructive receipt, the shareholder will be taxed in the year in which the constructive receipt occurs.[4] Thus, dividends that have accumulated prior to an individual's purchase of cumulative preferred stock are taxed to the purchaser as dividends when actually or constructively received; accumulated dividends are not a return of a portion of purchase price and, thus, do not reduce tax basis.[5]

Under JGTRRA 2003, as extended by the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010) and the American Taxpayer Relief Act of 2012 ("ATRA"), "qualified dividend income" (generally, dividends paid by domestic corporations and certain foreign corporations to shareholders, see Q 608) is taxed at the lower rates applicable to net capital gain (although dividends are not taken into account in the capital gain and loss netting process used to compute net capital gain). Nonqualifying dividends continue to be treated as ordinary income subject to ordinary income tax rates.

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1. IRC Sec. 316(a); Treas. Reg. §1.316-1(a).
2. IRC Sec. 317(a); Treas. Reg. §1.317-1.
3. Rev. Rul. 60-177, 1960-1 CB 9.
4. IRC Secs. 61, 301(c); Treas. Regs. §§1.61-9, 1.301-1(b). See *Avery v. Comm.*, 292 U.S. 210 (1934).
5. Rev. Rul. 56-211, 1956-1 CB 155.

ATRA increased the tax rate for qualified dividend income and capital gains for certain higher income taxpayers. For tax years beginning after 2012, the maximum rate on qualified dividend income is 20 percent for taxpayers in the 39.6 percent income tax bracket; that is, qualified dividend income that would otherwise be taxed at a 39.6 percent rate will be subject to only a 20 percent tax. For taxpayers in the 25, 28, 33, or 35 percent income tax brackets (see Q 639), the maximum rate on qualified dividend income is 15 percent. For taxpayers in the 15 and 10 percent income tax brackets, the tax rate on qualified dividend income was reduced to 5 percent in 2003 through 2007, and to 0 percent for tax years beginning after 2007.[1]

ATRA eliminated the sunset provision that was included in prior legislation so that these tax rates will apply to qualified dividend income permanently (or until Congress again changes the rules).

If stock is sold (or otherwise assigned) and a dividend is both declared and paid after the sale, the dividend is included in the purchaser's, not the seller's, income. When stock is sold (or assigned) after the dividend is declared but before payment, it is ordinarily taxed to the purchaser if the sale occurred *before* the record date or the date the stock begins selling ex-dividend; however, it is ordinarily taxed to the seller if the sale occurred *after* the record date. The fact that the dividend is reflected in the sale price does not change these results.[2]

7503. How is a dividend paid in property taxed?

A dividend paid in property other than stock or stock rights of the distributing corporation is taxed in the same manner as a cash dividend (See Q 7502).[3] A dividend paid in property other than cash is often referred to as a dividend "in kind." For tax purposes, the amount of a dividend paid in kind is generally the fair market value of the property on the date of the distribution, with the value reduced by any liabilities encumbering the distributed property.[4] See also Revenue Ruling 80-292,[5] where the distribution by a wholly owned subsidiary of rights to acquire its stock to the shareholders of its parent was deemed for tax purposes to be a distribution *by the parent corporation* of a dividend "in kind" to its shareholders.

A dividend paid in rights to acquire stock in another corporation (i.e., not the distributing corporation) is a dividend in kind.[6]

The shareholder's tax basis in property (including stock or stock rights) distributed in a taxable dividend is generally equal to the fair market value of that property on the date of the dividend distribution.[7]

1. IRC Secs. 1(h)(11)., 1(h)(1), as amended by ATRA, Secs. 101, 102.
2. See Treas. Reg. §1.61-9(c); Rev. Rul. 74-562, 1974-2 CB 28.
3. IRC Secs. 301(a), 317(a).
4. IRC Sec. 301(b)(2); Treas. Reg. §1.301-1(g).
5. 1980-2 CB 104.
6. See Rev. Rul. 70-521, 1970-2 CB 72.
7. IRC Sec. 301(d); Treas. Reg. §1.301-1(a).

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If a dividend is paid in numismatic or bullion-type coins or currencies that have a fair market value in excess of their face values, the amount of the dividend is their aggregate fair market value.[1]

Proposed regulations – recovery of basis. The Service has proposed regulations providing guidance regarding the recovery of stock basis in distributions under IRC Section 301 to the extent the distributions are not treated as dividends (i.e., because the amount distributed exceeds the corporations' earnings and profits). The primary objective of the proposed regulations is to provide a single model for stock basis recovery by a shareholder who receives a constructive or actual distribution to which Section 301 applies. The cornerstone of the proposed regulations is that a share of stock is the basic unit of property that can be disposed of and, accordingly, the results of a transaction should generally derive from the consideration received in respect of that share. The proposed regulations would treat a Section 301 distribution as received on a pro rata, share-by-share basis with respect to the class of stock upon which the distribution is made. The regulations will apply to transactions that occur after the date the final regulations are published in the Federal Register.[2]

7504. How is a shareholder taxed if the corporation pays a dividend by distributing its own bonds, notes, or other obligations?

A dividend paid in bonds, notes, or other obligations of the distributing corporation is treated as a dividend "in kind" and the obligations are treated as property received in a dividend distribution.[3] See Q 7503 for the taxation of dividends "in kind."

7505. How should a shareholder report ordinary dividends on stocks held for the shareholder in street name by a broker?

A shareholder should report, *without itemization*, the total amount of dividends received on securities held in the broker's name for the taxpayer (i.e., held in "street name"), as shown on each statement furnished by the broker on Schedule B of Form 1040.[4]

7506. Can a shareholder reduce his taxable income by assigning or making a gift of future dividends to another individual?

No. Without the transfer of the underlying stock, a gift or gratuitous assignment of future dividends will not shift the taxability of the dividends away from the owner of the stock.[5]

The bona fide sale of future dividends for good and sufficient consideration will result in the dividends being taxed to the purchaser and not the shareholder; but this will accelerate rather than reduce the shareholder's tax since the net sales proceeds must be reported by the shareholder-seller as ordinary income in the year of the sale.[6]

1. See *Cordner v. U.S.*, 671 F.2d 367 (9th Cir. 1982).
2. Prop. Treas. Reg. §1.301-2, REG-143686-07, 74 Fed. Reg. 3509, 3510 (1-21-2009).
3. See IRC Sec. 317(a); Treas. Reg. §1.317-1.
4. Rev. Rul. 64-324, 1964-2 CB 463.
5. See *Van Brunt v. Comm.*, 11 BTA 406 (1928); *Lucas v. Earl*, 281 U.S. 111 (1930).
6. *Est. of Stranahan v. Comm.*, 472 F.2d 867 (6th Cir. 1973).

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7507. What is "stripped preferred stock"? How is "stripped preferred stock" taxed?

Stripped preferred stock is stock with respect to which there has been a separation of ownership between the stock and any dividend on it that has not become payable, if the stock (1) is limited and preferred as to dividends and does not participate in corporate growth to any significant extent; and (2) has a fixed redemption price.[1]

An individual who purchases stripped preferred stock generally must (while he holds the stock) treat the stock as though it were a bond issued on the purchase date with an original issue discount equal to the excess, if any, of the redemption price over the price at which he purchased the stock. This tax treatment also applies with respect to any holder of the stock whose basis is determined by reference to the basis in the hands of the purchaser (such as a donee or legatee).[2] (See Q 7635 for an explanation of the treatment of original issue discount).

An individual who strips the rights to one or more dividends from stock described above (i.e., stock that is limited and preferred as to dividends, does not participate in corporate growth to any significant extent and has a fixed redemption price) and disposes of those dividend rights generally will be treated as having purchased the stripped preferred stock on the date of the disposition, for a purchase price equal to the adjusted basis in the stripped preferred stock.[3]

The amounts includable in gross income under these provisions are treated as ordinary income, and the basis of the stock will be adjusted accordingly.[4]

"Purchase," for purposes of this provision, is defined as an acquisition of stock where the basis of such stock is not determined in whole or in part by reference to the adjusted basis of the stock in the hands of the person from whom the stock was acquired.[5]

7508. What is a "stock dividend"?

A *stock dividend* is a dividend paid in shares of stock of the distributing corporation to its shareholders with respect to its outstanding stock. A distribution of stock to compensate the recipient for services rendered, for goods provided, or in payment of a debt is not made with respect to the distributing corporation's outstanding stock and, therefore, is not a stock dividend.[6]

A distribution of stock warrants (or other rights to acquire stock of the distributing corporation) is treated in the same manner as a stock dividend so long as the distribution of such warrants is made with respect to the corporation's outstanding stock (and not as compensation for services, etc.).[7]

1. IRC Sec. 305(e)(5).
2. IRC Sec. 305(e)(1).
3. IRC Sec. 305(e)(3).
4. IRC Secs. 305(e)(2), 305(e)(4).
5. IRC Sec. 305(e)(6).
6. IRC Sec. 305(a); Treas. Reg. §1.305-1.
7. See IRC Sec. 305(d); Treas. Reg. §1.305-1(d).

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A distribution of stock of the distributing corporation made with respect to outstanding stock rights or convertible securities of that corporation to the owners thereof will also qualify as a stock dividend.[1]

7509. Is a stock dividend taxable?

The general rule is no, but it is subject to significant exceptions.[2] In the following cases, a stock dividend will be taxed under the rules applicable to dividends paid in cash or other property (see Q 7501 to Q 7503):[3]

(1) If *any* shareholder has an election or option to choose to receive the dividend (partly or completely) in cash or property other than stock or stock rights of the distributing corporation, then the dividend is taxable with respect to *all* shareholders.[4] The Tax Court has held that such an "election or option" did not exist where certain shareholders had the right to *request* redemption of a portion of their stock for cash subsequent to the distribution, and where the issuer retained complete discretion as to whether it would redeem the shares; but the court noted that "under different factual circumstances, a discretionary act of the board of directors of a shareholder corporation to redeem stock dividends might constitute an 'option' that arises after the distribution."[5]

(2) A stock dividend or dividend paid in stock rights is taxable if the dividend distribution (or series of distributions of which such dividend is a part) results in the receipt by some shareholders of cash or property other than stock or stock rights of the corporation and in an increase for other shareholders in their proportionate interests in the assets or earnings and profits of the corporation (i.e., a disproportionate distribution).[6] But this does not apply to the distribution of cash or scrip in lieu of fractional shares if the purpose of the cash or scrip is to save the expense and inconvenience of transferring fractional shares. (The treatment of cash or scrip received in lieu of a fractional share is explained in Q 7512.)[7]

(3) A stock dividend or dividend paid in stock rights of the distributing corporation is taxable if the dividend distribution (or series of distributions of which such dividend is a part) results in the receipt of preferred stock by some common stock shareholders and the receipt of common stock by other common stock shareholders.[8]

(4) Any dividend or dividend paid in stock rights of the distributing corporation paid with respect to the corporation's preferred stock is taxable unless it is a "deemed" (rather than actual) distribution made with respect to convertible preferred stock

1. IRC Sec. 305(d).
2. IRC Sec. 305(a).
3. IRC Sec. 305(b).
4. Treas. Reg. §1.305-2.
5. *Western Fed. Sav. & Loan Ass'n v. Comm.*, TC Memo 1988-107, *aff'd*, 880 F.2d 1005 (8th Cir. 1989).
6. Treas. Reg. §1.305-3.
7. Treas. Reg. §1.305-3(c); Rev. Rul. 69-202, 1969-1 CB 95.
8. Treas. Reg. §1.305-4.

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to take into account a stock dividend, stock split, or similar event that would otherwise result in dilution of the conversion right.[1]

(5) Any dividend paid in convertible preferred stock of the distributing corporation or in rights to acquire such convertible preferred stock is taxable unless the corporation establishes that the distribution will not result in a disproportionate distribution as described in (2), above.[2]

If a stock dividend or dividend paid in stock rights of the distributing corporation is taxable under (1) through (5), the dividend is treated as a dividend in kind so that the amount that generally must be included in the recipient-shareholder's income is the fair market value of such stock or rights on the date of distribution, (see Q 7503).[3]

For the rules applicable to REIT and mutual fund special stock dividends, see Q 7885.

7510. What is the tax basis of stock acquired in a stock dividend? When does the holding period of the stock begin?

If a shareholder acquires stock in a *nontaxable* stock dividend (see Q 7508), the shareholder's present tax basis in the "old" stock, with respect to which the stock dividend was paid, is reallocated between the old and the new shares in proportion to the fair market values of each on the date of distribution (not the declaration or record date).[4] If the stock with respect to which the dividend was paid was purchased at different times and for different prices, the shareholder may *not* use the overall average basis for purposes of this allocation. If the shareholder can adequately identify the various purchases, he or she may allocate the proportionate amount of the dividend stock to each lot and, with respect to each lot separately, reallocate the tax basis between the "old" and "new" shares according to the fair market value of each. If the shareholder cannot adequately identify the stock in each lot, the dividend stock is matched to the "old" stock in the order in which the "old" stock was acquired (i.e., a FIFO tracing approach), and the tax basis of those "old" shares is reallocated between the old and new matched shares according to their fair market values.[5]

The holding period of the "new" stock received in a nontaxable stock dividend includes the holding period of the stock with respect to which the stock dividend was paid (i.e., the holding period of the "old" stock is "tacked" (i.e., added) onto the holding period of the new stock).[6] If the "old" stock was purchased at different times, the "new" shares must be allocated to the individual lots of the "old" stock by adequate identification or a FIFO tracing approach as discussed above.

1. Treas. Reg. §1.305-5; Rev. Rul. 83-42, 1983-1 CB 76.
2. Treas. Reg. §1.305-6.
3. Treas. Reg. §1.305-1(b).
4. IRC Sec. 307; Treas. Regs. §§1.307-1, 1.307-2.
5. Rev. Rul. 71-350, 1971-2 CB 176; Rev. Rul. 56-653, 1956-2 CB 185; I.T. 2417, VII CB 59.
6. IRC Sec. 1223(5); Treas. Reg. §1.1223-1(e).

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7511. What is the tax basis of warrants or other stock rights received in a nontaxable stock dividend distribution from the issuing corporation?

If a shareholder acquires stock warrants or other stock rights of the distributing corporation in a nontaxable stock dividend distribution (see Q 7509) and either exercises or sells the warrants or rights, the tax basis in the "old" shares with respect to which the distribution of warrants or rights was made is generally reallocated (in the same manner as discussed in Q 7510 for stock dividends) between the old shares and the warrants or rights, in proportion to the fair market values of each on the date of distribution (not the declaration or record date). But if the fair market value of the warrants or rights is less than 15 percent of the fair market value of the "old" stock, the tax basis of the warrants will automatically be zero, unless the shareholder makes an irrevocable election to reallocate the basis of the old stock with respect to which the warrants or rights were distributed to *all* warrants or other rights received in the distribution.[1] Despite this, it has been held that where the subscription rights became valueless and the subscriptions received were refunded, no adjustment to the shareholders' basis was required.[2]

Apparently, if the warrants or rights are allowed to expire without exercise or sale, the tax basis of the warrants or rights is zero.

7512. How is a shareholder taxed when, as part of a stock dividend, the shareholder receives cash or scrip in lieu of fractional shares?

The distribution of cash or scrip in lieu of fractional shares in a stock dividend will generally not, in and of itself, cause the entire stock dividend to be taxable, see Q 7509.

If a shareholder receives cash in lieu of a fractional share, the Regulations state that the shareholder will be taxed as though the shareholder had actually received that fractional share and then the corporation had redeemed it.[3] Unfortunately, it is not clear whether all the redemption rules of IRC Section 302 apply for the purpose of determining whether the cash is treated as having been received in a distribution to which IRC Section 301 applies (i.e., as a dividend to the extent of the corporation's earnings and profits) or as proceeds from the sale or exchange of the fractional share (i.e., leading to capital gain or less, depending on the holder's basis in the fractional share).

But it is clear that if the corporation, with the approval of the shareholders, combines into whole shares the fractional shares due the shareholders, sells them in the market, and distributes the proceeds of the sale, the shareholders who receive the proceeds in lieu of a fractional share are treated as though they had received the fraction and made the sale themselves. Each such shareholder thus has a gain or loss to the extent of the difference between the cash received and the tax basis in the fractional share.[4] Similarly, if a shareholder is allowed to elect to have the corporation sell scrip certificates that would otherwise be distributed in lieu of a fractional share and pay the proceeds to the shareholder, the shareholder is treated as having sold the scrip

1. Treas. Regs. §§1.307-1, 1.307-2.
2. See Rev. Rul. 74-501, 1974-2 CB 98.
3. Treas. Reg. §1.305-3(c).
4. Rev. Rul. 69-15, 1969-1 CB 95. See the example on pp. 22-23 of IRS Pub. 550 (2013).

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for a capital gain or loss to the extent of the difference between the cash received and the tax basis in the scrip certificate.[1]

If a shareholder does receive scrip certificates in lieu of a fractional share, the shareholder realizes no taxable income on the receipt.[2] The shareholder will, however, be taxed on the sale or exchange of the scrip in the same manner as when the shareholder sells the whole shares of stock received in the stock dividend, see Q 7509.

The tax basis and holding period of fractional shares or scrip received in a nontaxable stock dividend are determined in the same manner as the whole shares received in that dividend, see Q 7510.

See Q 608 for an explanation of the treatment of capital gain.

7513. How is a shareholder taxed on a stock split?

A stock split is treated in the same manner as a stock dividend.[3] Therefore, a stock split is generally a nontaxable event for the shareholder (see Q 7509). The tax basis and holding period of the "new" stock received in a stock split is determined as discussed in Q 7510.

7514. How is a shareholder taxed if the corporation makes a distribution in excess of its earnings and profits? How is a "return of capital" taxed?

To the extent that a distribution paid with respect to its stock exceeds the corporation's accumulated and current earnings and profits, the shareholders will be deemed to have received a "return of capital."[4]

When a shareholder receives a "return of capital" distribution, the shareholder's tax basis in the stock is reduced (but not below zero) by the amount of the distribution. The shareholder is not taxed to the extent that basis is reduced. Any excess of "return of capital" over the shareholder's tax basis in the stock is generally treated as capital gain.[5]

7515. How is a shareholder taxed if the shareholder participates in a dividend reinvestment plan?

Although dividends received or credited under a dividend reinvestment plan will be taxed as dividend income, the specifics depend on which of the two basic types of plans is involved.

(1) If, under the plan, the corporation pays the cash dividends (that would otherwise be paid to the plan participants) to an independent agent who purchases shares of the distributing corporation's stock in the open market and credits them to the plan accounts of the individual shareholders, each participating shareholder is treated as though the cash had been distributed

1. Rev. Rul. 69-202, 1969-1 CB 95; IRS Pub. 550 (2013), pp. 22-23.
2. See Rev. Rul. 69-202, 1969-1 CB 95.
3. IRC Sec. 305(a).
4. IRC Sec. 301(c).
5. IRC Secs. 301(c), 316.

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directly to the shareholder in a cash dividend.[1] Thus, the total amount of the cash dividend paid on the shareholder's behalf to the agent must be included by the shareholder in ordinary income as discussed in Q 7502. The value of brokerage commissions paid by a corporation to an agent under a dividend reinvestment plan is a constructive dividend to each shareholder in the amount of each shareholder's pro rata share of the brokerage fees actually paid.[2] The shares credited to a shareholder under the plan are treated as though the shareholder had made the purchase. Where the corporation does not pay the brokerage commissions to an agent purchasing the shares, commissions paid by the agent are treated as if paid by the individual shareholder (i.e., added to the shareholder's tax basis in the new shares), see Q 7948.[3]

(2) If, under the plan, the corporation (a) manages the plan itself and credits the accounts of participating shareholders with shares, or (b) pays the cash dividends to an independent agent who purchases shares (often at a discount) from the distributing corporation, each participating shareholder is treated as if the shareholder had received a *taxable* stock dividend, see Q 7509. As a result, each participating shareholder must include as dividend income the fair market value (on the dividend payment date) of the shares credited to the shareholder's account in the plan *plus* any service charge paid to the agent (if one is used) out of the shareholder's portion of the cash dividend paid. Apparently, any service and administrative charges paid *by the corporation* need not be included in income by shareholders participating in the plan.[4] The shareholder's tax basis in the shares credited to the shareholder's account is the fair market value of those shares on the dividend payment date, even though the shares may have been purchased at a discount or premium.[5] The holding period of the shares credited to a participating shareholder's account begins on the day following the dividend payment date.[6]

If a service charge is paid to an independent agent out of the cash dividend under either type of plan, that service charge may be deductible by the participating shareholder.[7] See Q 7948 regarding the deduction of expenses paid in connection with the production of investment income.

A participating shareholder realizes no taxable income when the certificates are eventually received representing whole shares credited to the shareholder's account in the plan.[8] Upon withdrawal from or termination of the plan, if cash is distributed to a participating shareholder in lieu of fractional share interests, the shareholder is treated as though fractional shares had been received and redeemed, see Q 7512.[9] If on withdrawal from or termination of the plan, fractional shares and/or whole shares are sold or exchanged on behalf of the participating shareholders, each shareholder recognizes capital gain or loss as though the shareholder had received and sold the shares.[10]

1. Rev. Rul. 77-149, 1977-1 CB 82.
2. GCM 39482 (5-5-86).
3. Rev. Rul. 75-548, 1975-2 CB 331; Rev. Rul. 70-627, 1970-2 CB 159.
4. See Let. Rul. 7928066.
5. Rev. Rul. 79-42, 1979-1 CB 130; Rev. Rul. 78-375, 1978-2 CB 130; Rev. Rul. 76-53, 1976-1 CB 87.
6. Rev. Rul. 76-53, 1976-1 CB 87; Rev. Rul. 77-149, 1977-1 CB 82.
7. Rev. Rul. 78-375, 1978-2 CB 130; Rev. Rul. 70-627, 1970-2 CB 159.
8. See Rev. Rul. 76-53, 1976-1 CB 87; Rev. Rul. 78-375, 1978-2 CB 130.
9. Rev. Rul. 78-375, 1978-2 CB 130; Rev. Rul. 76-53, 1976-1 CB 87.
10. Rev. Rul. 78-375, 1978-2 CB 130.

7516. If a dividend reinvestment plan allows a participating shareholder to make additional purchases of stock at a discount, how is the purchase taxed?

Many dividend reinvestment plans offer participating shareholders an option to invest additional cash to purchase *at a discount* limited quantities of the distributing corporation's stock. If a shareholder elects to do so, he must include as dividend income on his federal income tax return the difference between the fair market value of the stock on the dividend payment date and the optional payment. (Apparently, this would normally be the amount of the discount.) A shareholder's tax basis in the shares purchased under this type of option is generally the shares' fair market value on the dividend payment date.[1]

The holding period of stock purchased under the optional aspect of a dividend reinvestment plan begins on the day following the date the shares are purchased.[2]

Sale of Exchange

7517. How is a shareholder taxed on the sale or exchange of stock?

Generally, a shareholder who sells or exchanges stock (other than IRC Section 1202 stock, see Q 7522) for other property realizes a *capital* gain or loss.[3] Whether such gain or loss is short-term or long-term usually depends on how long the shareholder held the stock before selling (or exchanging) it.[4] For an explanation of how the holding period is calculated, see Q 605; for the treatment of capital gains and losses, including the lower rates for capital gains, see Q 608.

Specific circumstances may result in the conversion of what appears to be a long-term capital gain to short-term, short-term capital loss to long-term, capital gain to ordinary income, or the disallowance of a loss. See Q 7507 concerning stripped preferred stock, Q 7605 concerning conversion transactions, and Q 607 concerning sales between related individuals. Also, certain derivative securities transactions may result in a *constructive sale* (see Q 7606 to Q 7608) with respect to an appreciated stock position, which may result in immediate recognition of gain, and the start of a new holding period. See Q 7525 concerning short sales and Q 7582 concerning futures and forward contracts.

For an explanation of the rollover of gain into specialized small business investment company stock, see Q 7520. For an explanation of the 50 percent (or 75 percent or 100 percent) exclusion for gain from the sale of qualified small business stock, see Q 7522.

Assuming none of the special rules described above applies, when shares of stock are sold, the amount of gain (or loss) is the difference between the selling price and the shareholder's tax basis in the shares at the time of sale. If the shares are exchanged for property, or for property and cash, the amount of gain (or loss) is the difference between the fair market value of the property

1. Rev. Rul. 78-375, 1978-2 CB 130.
2. Rev. Rul. 76-53, 1976-1 CB 87.
3. See IRC Secs. 1221, 1222.
4. See IRC Secs. 1222, 1223.

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plus the cash received in the exchange and the shareholder's tax basis.[1] But if common stock in a corporation is exchanged for common stock in the same corporation, or if preferred stock is exchanged for preferred stock in the same corporation, gain or loss is generally not recognized unless cash or other property is also received; that is, the exchange is taxed in substantially the same manner as a "like-kind" exchange. The exchange of shares of different corporations and exchanges of common for preferred do *not* qualify for the general "like-kind" exchange rules, even if the shares are similar in all respects.[2] The nonrecognition rules of IRC Section 1036 apply to exchanges of common stock for common stock in the same corporation, even though the shares are of a different class and have different voting, preemptive, or dividend rights.[3] For an explanation of "like-kind" exchanges, see Q 614.

Special rules apply to exchanges of stock made pursuant to a plan of corporate reorganization.[4] The IRS has released regulations under IRC Section 358 providing guidance regarding the determination of the basis of stock or securities received in exchange for, or with respect to, stock or securities in certain transactions(See Q 598).[5]

If a shareholder's holdings in a company's stock were all acquired on the same day and at the same price, the shareholder will have little difficulty in establishing the tax basis and holding period for the shares sold or exchanged. But where the shares were acquired at different times or prices and the shareholder sells less than all of the holdings in the stock, the process becomes more difficult while also becoming more significant. Unless the shareholder can "adequately identify" the lot from which the shares being sold originated, the shares sold will be deemed to have come from the earliest of such lots purchased or acquired (i.e., under a first-in, first-out (FIFO) method).[6] For an explanation of how lots can be "adequately identified," see Q 606 and Treasury Regulation Section 1.1012-1.

If the stock sold was acquired on the conversion of a market discount bond, a portion of the sales proceeds may have to be treated as interest income (See Q 7633).

7518. What is a demutualization? What is the tax treatment of stock sold by a taxpayer following a demutualization?

A "demutualization" occurs when a mutually-owned life insurance company (i.e., a company owned by its policyholders, or "members") converts into a publicly-owned company (i.e., a company owned by its shareholders). Essentially, the members exchange their rights in the mutual life insurance company (i.e., voting and dividend rights) for shares of stock in the "demutualized" company. Where a taxpayer (trust) was a former policy holder in a mutual life insurance company and received shares of stock when that company "demutualized," and the taxpayer sold its shares and then reported gain—based on the then prevalent belief that the "basis" of such stock was zero—the U.S. Court of Federal Claims held that the taxpayer was entitled

1. See IRC Sec. 1001.
2. IRC Sec. 1036; Treas. Reg. §1.1036-1. See IRC Sec. 1031(a).
3. Rev. Rul. 72-199, 1972-1 CB 228. See Treas. Reg. §1.1036-1.
4. See IRC Sec. 354.
5. See Treas. Regs. §§1.358-1, 1.358-2.
6. Treas. Reg. §1.1012-1(c).

to a refund of tax paid. The court analyzed the application of the "open transaction doctrine" to the transaction, and then determined that because the amount received by the trustee was less than the trust's cost basis in the policy as a whole, the taxpayer, in fact, did not realize any income on the sale of the shares.[1]

For guidance on determining the (1) holding period and (2) capital gain treatment of stock received by a policyholder in a demutualization transaction that does (or does not) qualify as a tax-free reorganization, see CCA 200131028.

7519. What are the new basis reporting rules that became effective in 2011? To which types of securities do the new rules apply?

Under current law, brokers are required to file with the IRS annual information returns showing the gross proceeds realized by customers from various sales transactions.[2] Under EIEA 2008, new requirements were enacted with respect to the reporting of a customer's basis in securities,[3] and new rules were put in place for determining the basis of certain securities subject to the new reporting requirements.[4] The reporting requirements and basis rules generally took effect on January 1, 2011.[5] Final regulations were released in October 2010.[6]

Under new Section 6045(g), every broker that is required to file a return from the sale of a "covered security" must include in the return (1) the customer's adjusted basis, *and* (2) whether any gain or loss with respect to the security is long-term or short-term.[7]

A "covered security" is any "specified security" acquired on or after the "applicable date" if the security was (1) acquired through a transaction in the account of which the security was held, or (2) transferred to that account from an account in which the security was a covered security (but only if the transferee broker received a statement under Section 6045A).[8]

A "specified security" is: (1) any share of stock in a corporation (including stock of a mutual fund); (2) any note, bond, debenture, or other evidence of indebtedness; (3) any commodity, or a contract or a derivative with respect to the commodity (if the Treasury Secretary determines that adjusted basis reporting is appropriate); or (4) any other financial instrument with respect to which the Treasury Secretary determines that adjusted basis reporting is appropriate.[9]

The "applicable dates" are as follows: stock in a corporation – January 1, 2011; stock in a mutual fund, or stock acquired in connection with a dividend reinvestment plan – January 1, 2012; any other specified security – January 1, 2013.[10] The Service announced,

1. Fisher v. U.S., 333 Fed. Appx. 572, 2008-2 USTC ¶50,481 (Ct. Cl. 2008), aff'd per curiam, 2010-1 USTC ¶50,289 (Fed. Cir. 2009).
2. See IRC Section 6045(a).
3. See IRC Secs. 6045(g), 6045(h), 6045A, 6045B, as added by EIEA 2008.
4. See IRC 1012, as amended by EIEA 2008.
5. Notice 2009-17, 2009-1 CB 575.
6. TD 9504, 75 Fed. Reg. 64072 (Oct. 18, 2010).
7. IRC Sec. 6045(g)(3)(A), as added by EIEA 2008; Notice 2009-17, 2009-1 CB 575.
8. IRC Sec. 6045(g)(3)(A), as added EIEA 2008; Notice 2009-17, 2009-1 CB 575.
9. IRC Sec. 6045(g)(3)(B), as added by EIEA 2008; Notice 2009-17, 2009-1 CB 575.
10. IRC Secs. 6045(g)(3)(C)(iii), as added by EIEA 2008; Notice 2009-17, 2009-1 CB 575.

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however, that the basis reporting requirement for debt instruments and options was not effective until January 1, 2014.[1]

Form 1099-B. Effective after December 31, 2008, EIEA extended the deadline for furnishing information statements to customers from January 31 to February 15.[2]

Basis Determination

EIEA 2008 also provided new rules for determining the basis of certain securities subject to the new reporting requirements.[3] The adjusted basis of any security (other than stock in a mutual fund, or stock acquired in connection with a dividend reinvestment plan) is determined under the first-in-first-out method unless the customer notifies the broker by making an adequate identification of the stock sold at the time of sale.[4] For any sale, exchange, or other disposition of a specified security on or after the applicable date, the conventions prescribed by the Treasury regulations for determining adjusted basis (i.e., the first-in-first-out, specific identification, and average basis conventions) must be applied on an account-by-account basis.[5]

7520. Under what circumstances may a taxpayer roll over and, thus, defer gain from the sale of publicly traded securities?

Individual taxpayers and C corporations may elect to roll over certain capital gain from the sale of publicly traded securities if the individual or corporation uses the amount realized from the sale to purchase common stock or a partnership interest in a *specialized small business investment company* within 60 days of the sale.[6] A specialized small business investment company (SSBIC) is any corporation or partnership that is licensed by the Small Business Administration under Section 301(d) of the Small Business Investment Act of 1958.[7] "Publicly traded securities" means securities traded on an established securities market.[8]

If the election is made, gain from the sale of the publicly traded securities is currently taxable only to the extent that the amount realized from the sale exceeds the cost of the SSBIC stock or interest.[9] IRC Section 1044(a)(2) states that the cost of the SSBIC stock or interest is to be reduced by any portion of such cost previously taken into account under IRC Section 1044.

The amount of gain that may be rolled over by an individual in a taxable year is generally limited to $50,000. But the aggregate amount of gain that may be rolled over during a taxpayer's lifetime is $500,000.[10] Thus, a taxpayer who had previously rolled over a total of $475,000 in gain in prior tax years, but who has $50,000 in gain in the current year, would be limited in the current year rollover to $25,000 of otherwise eligible gain. The $50,000 and $500,000 limits

1. Notice 2012-34, 2012-1 CB 937.
2. IRC Sec. 6045(b), as amended by EIEA 2008; Notice 2009-17, 2009-1 CB 575.
3. See IRC Sec. 1012, as amended by EIEA 2008; IRC Section 6045(g), as added by EIEA 2008; Notice 2009-17, 2009-1 CB 575.
4. IRC Sec. 6045(g)(2)(B)(i)(I), as added by EIEA 2008; Notice 2009-17, 2009-1 CB 575.
5. IRC Sec. 1012(c)(1), as added by EIEA 2008; Notice 2009-17, 2009-1 CB 575.
6. IRC Sec. 1044.
7. IRC Sec. 1044(c)(3).
8. IRC Sec. 1044(c)(1).
9. IRC Sec. 1044(a).
10. IRC Sec. 1044(b)(1).

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are reduced to $25,000 and $250,000, respectively, for married taxpayers filing separately. In the case of a C corporation, the gain that may be deferred in a taxable year may not exceed $250,000; the total amount of gain that may be rolled over during the corporation's existence is $1,000,000.[1]

A taxpayer's basis in the SSBIC stock or partnership interest is generally reduced by the amount of gain that is rolled over into the stock or interest. But the basis of any SSBIC common stock is not reduced for purposes of calculating the gain eligible for the 50 percent (or 75% or 100%) exclusion for qualified small business stock provided by IRC Section 1202 (see Q 7522).[2]

The election under IRC Section 1044 must be made on or before the due date (including extensions) for the income tax return for the year in which the publicly traded securities are sold.[3]

Estates, trusts, partnerships, and S corporations are ineligible to roll over gain under this section.[4]

7521. What is qualified small business stock?

IRC Section 1202 provides for special treatment of *qualified small business stock*, which generally means stock (a) in a C corporation that is a "qualified small business; (b) that meets the *active business* requirement (explained below); (c) that was originally issued after August 10, 1993; and (d) (except as otherwise provided) was acquired by the taxpayer at its original issue in exchange for money or other property (not including stock), or as compensation for services to the corporation.[5] For the tax treatment of qualified small business stock, see Q 7522.

An issuing corporation is a *qualified small business* if it is a domestic corporation with *aggregate gross assets* of $50,000,000 or less at all times after August 10, 1993. Generally, "aggregate gross assets" means the amount of cash and the aggregate adjusted bases of other property held by the corporation. Under certain circumstances, a parent corporation and its subsidiary corporations may be treated as one corporation for purposes of determining a corporation's aggregate gross assets.[6]

As a general rule, stock acquired by the taxpayer will not be treated as "qualified small business stock" if the issuing corporation has directly or indirectly purchased any of its stock from the taxpayer (or a related person) within two years before or after the date of issuance.[7] But an issuing corporation may redeem *de minimis* amounts of stock without the loss of qualified small business stock treatment. Stock redeemed from a taxpayer (or related person) exceeds a de minimis amount of stock only if the aggregate amount paid for the stock exceeds $10,000 and more than 2 percent of the stock held by the taxpayer and related persons is acquired.[8]

1. IRC Sec. 1044(b)(2).
2. IRC Sec. 1044(d).
3. Treas. Reg. §1.1044(a)-1.
4. IRC Sec. 1044(c)(4).
5. IRC Sec. 1202(c)(1).
6. IRC Sec. 1202(d).
7. IRC Sec. 1202(c)(3)(A).
8. Treas. Reg. §1.1202-2(a)(2).

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Similarly, stock issued by a corporation will generally not be treated as qualified small business stock if the issuing corporation makes a *significant redemption* of stock or, in other words, redeems stock with an aggregate value of more than 5 percent of the value of all of its stock within one year before or after the date of issuance.[1] But an issuing corporation may redeem *de minimis* amounts of stock without the loss of qualified small business stock treatment. Stock redeemed by an issuing corporation exceeds a de minimis amount only if the aggregate amount paid exceeds $10,000 and more than 2 percent of all outstanding stock is purchased.[2]

In addition, the following stock redemptions are disregarded in determining whether redemptions exceed de minimis amounts and will not result in the loss of qualified small business stock treatment: (1) a redemption of stock acquired in connection with the performance of services as an employee or director (or an option to acquire such stock) incident to the seller's retirement or other bona fide termination of such services; (2) a purchase from a deceased shareholder's estate, beneficiary, heir, surviving joint tenant, surviving spouse, or a trust established by the decedent or decedent's spouse, and the purchase is within three years and nine months of the decedent's death, provided that prior to the decedent's death, the stock (or an option to acquire the stock) was held by the decedent or decedent's spouse (or by both), by the decedent and joint tenant, or by a trust revocable by the decedent or decedent's spouse (or by both); (3) a purchase incident to the disability or mental incompetence of the selling shareholder; *or* (4) a purchase incident to the divorce (within the meaning of IRC Section 1041(c)) of the selling shareholder (See Q 660). Also, transfers by shareholders to an employee or independent contractor (or beneficiary thereof) in connection with the performance of services are generally not treated as redemptions.[3]

Stock acquired through the conversion of qualified small business stock of the same corporation will be considered qualified small business stock held for the same period that the converted stock was held by the taxpayer.[4]

In order to satisfy the *active business* requirement, at least 80 percent of the issuing corporation's assets must be committed to the active conduct of one or more "qualified trades or businesses," and the corporation must be an "eligible corporation."[5] (A specialized small business investment company is not subject to this requirement,[6] see Q 7520.) A "qualified trade or business" is a trade or business *other than* one that involves (a) the performance of services in a field where the principal asset of the trade or business is the reputation or skill of one or more employees, such as the fields of law, accounting, performing arts, or athletics; (b) any insurance, banking, financing, leasing, investing, or similar business; (c) any farming business; (d) any mining business for which a percentage depletion deduction is allowed under the IRC; or (e) any business operating a hotel, motel, restaurant, or similar business.[7]

1. IRC Sec. 1202(c)(3)(B).
2. Treas. Reg. §1.1202-2(b)(2).
3. Treas. Regs. §§1.1202-2(c), 1.1202-2(d).
4. IRC Sec. 1202(f).
5. IRC Sec. 1202(e)(1).
6. IRC Sec. 1202(c)(2)(B).
7. IRC Sec. 1202(e)(3).

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Regardless of whether the *active business* requirement is met, stock will not be treated as qualified small business stock unless the issuing corporation is an *eligible corporation*. An "eligible corporation" is a domestic corporation *other than* (a) a domestic international sales corporation ("DISC") or former DISC; (b) a regulated investment company ("RIC"), a real estate investment trust ("REIT"), or a real estate mortgage investment conduit ("REMIC"); (c) a cooperative; or (d) a corporation that has made an election under IRC Section 936 (relating to the U.S. possession tax credit).[1]

7522. How is qualified small business stock treated for tax purposes?

If certain requirements are met, a noncorporate taxpayer (including certain partnerships and S corporations) may exclude from gross income 50 percent (75 percent for qualifying stock acquired in 2009 and before September 28, 2010, under the American Recovery and Reinvestment Act of 2009,[2] or 100 percent for qualifying stock acquired after September 27, 2010, and before January 1, 2014, under the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (TRA 2010), as extended by the American Taxpayer Relief Act of 2012 (ATRA)[3]) of any gain from the sale or exchange of qualified small business stock held for more than five years.[4] (Note that the percentage exclusion is based on the date of acquisition of the stock and that, for any exclusion to apply, the five-year holding period must be met for the stock). For an explanation of what constitutes "qualified small business stock," see Q 7521. For the treatment of capital gains and losses, including IRC Section 1202 gain, see Q 608. Special rules provide an increased exclusion of gain from the sale of qualifying empowerment zone stock.[5]

The aggregate amount of eligible gain from the disposition of qualified small business stock issued by one corporation that may be taken into account in a tax year may not exceed the greater of (a) $10,000,000 ($5,000,000 in the case of married taxpayers filing separately) reduced by the aggregate amount of such gain taken into account in prior years, *or* (b) 10 times the aggregate bases of qualified stock of the issuer disposed of during the tax year. For purposes of the limitation in (b), the adjusted basis of any qualified stock will not include any additions to basis occurring after the stock was issued.[6]

Gain realized by a partner, shareholder, or other participant that is attributable to a disposition of qualified small business stock held by a pass-through entity (i.e., a partnership, S corporation, regulated investment company, or common trust fund) is eligible for the exclusion if the entity held the stock for more than five years, and if the taxpayer held an interest in the pass-through entity at the time of acquisition and at all times since the acquisition of the stock.[7]

IRC Section 1202 provides that if the taxpayer has an *offsetting short position* with respect to any qualified small business stock, the exclusion is unavailable unless (a) the stock was held for

1. IRC Sec. 1202(e)(4).
2. IRC Sec. 1202(a)(3), as added by ARRA 2009; Sec. 1241 of ARRA 2009.
3. TRA 2010 Sec. 760(a)(1)-(2), ATRA Sec. 324. The Obama administration once proposed making the 100 percent exclusion permanent, but no congressional action has been taken.
4. IRC Sec. 1202, as amended by ARRA 2009. See also IRC Sec. 1(h)(7).
5. See IRC Sec. 1202(a)(2).
6. IRC Sec. 1202(b).
7. IRC Sec. 1202(g).

more than five years as of the date of entering into the short position, *and* (b) the taxpayer elects to recognize gain as if the stock were sold at its fair market value on the first day the offsetting position was held.[1]

A taxpayer has an "offsetting short position" with respect to any qualified small business stock if he or she (or a related party) has (a) made a short sale of substantially identical property, (b) acquired an option to sell substantially identical property at a fixed price, or (c) to the extent provided in future regulations, entered into any other transaction that substantially reduces the risk of loss from holding the qualified small business stock.[2] (See Q 7524 for an explanation of short sales, Q 7528 for an explanation of "substantially identical property" for purposes of the short sale rules, and Q 7550 for a definition of options).

Obviously, some offsetting short positions (e.g., a short sale) may also result in constructive sale treatment under the rules of IRC Section 1259 (see Q 7606 to Q 7608). While the IRC does not specify the effect of IRC Section 1259 on IRC Section 1202, it would appear that if the requirements of IRC Section 1202(j) are otherwise met, the exclusion provided under IRC Section 1202 would not be lost merely because immediate gain recognition may be required under IRC Section 1259.

Any gain excluded under IRC Section 1202 by a married couple filing jointly must be allocated equally between the spouses for purposes of claiming the exclusion in subsequent tax years.[3]

Special rules apply to IRC Section 1202 stock for alternative minimum tax purposes. An amount equal to 7 percent of the amount excluded from gross income for the taxable year under IRC Section 1202 will be treated as a preference item.[4]

Individual taxpayers may not exclude any gain under IRC Section 1202 in determining net operating loss for the year.[5]

7523. Can a taxpayer elect to roll over gain from the sale or exchange of qualified small business stock?

Generally, a noncorporate taxpayer, including certain partnerships and S corporations, may elect to roll over gain from the sale or exchange of qualified small business stock held more than six months to the extent that the taxpayer purchases other qualifying small business stock within 60 days of the sale of the original stock.[6]

If the rollover election is made, gain will be recognized only to the extent that the amount realized on the sale exceeds (1) the cost of any qualified small business stock purchased by the taxpayer during the 60-day period beginning on the date of the sale, reduced by (2) any portion of such cost previously taken into account under this rollover provision.

1. IRC Sec. 1202(j)(1).
2. IRC Sec. 1202(j)(2).
3. IRC Sec. 1202(b)(3)(B).
4. IRC Sec. 57(a)(7).
5. IRC Sec. 172(d)(2).
6. See IRC Sec. 1045(a).

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The rollover provisions of IRC Section 1045 will not apply to any gain that is treated as ordinary income.[1]

Rules similar to those applicable to rollovers of gain by an individual from certain small business stock[2] will apply to the rollover of such gain by a partnership or S corporation.[3] Thus, for example, the benefit of a tax-free rollover with respect to the sale of small business stock by a partnership will flow through to an "eligible partner"—i.e., a partner who is not a corporation and who held a partnership interest at all times during which the partnership held the small business stock.[4] (A similar rule applies to S corporations.)[5] For the rules regarding, among other things, (1) the deferral of gain on a partnership's sale of qualified small business stock followed by an eligible partner's acquisition of qualified replacement stock, and (2) the deferral of gain on a partner's sale of qualified small business stock distributed by a partnership, see Treasury Regulation Section 1.1045-1, finalized in 2007.[6]

The amount of gain not recognized because of a rollover of qualified small business stock will be applied to reduce (in the order acquired) the basis for determining gain or loss of any qualified small business stock purchased by the taxpayer during the 60-day rollover period.[7]

Ordinarily, the holding period of qualified small business stock purchased in a rollover transaction will include the holding period of the stock sold; but for purposes of determining whether the nonrecognition of gain applies to the stock that is sold, the holding period for the replacement stock begins on the date of purchase. In addition, only the first six months of the taxpayer's holding period for the replacement stock will be taken into account for purposes of determining whether the active business requirement is met (See Q 7521).[8]

An IRC Section 1045 election must be made by the due date (including extensions) for filing the income tax return for the taxable year in which the qualified small business stock is sold.[9] The election is made by (1) reporting the entire gain from the sale of qualified small business stock on Schedule D; (2) writing "IRC Section 1045 rollover" directly below the line on which the gain is reported; *and* (3) entering the amount of the gain deferred under IRC Section 1045 on the same line as (2), above, as a loss, in accordance with the instructions for Schedule D.[10] If a taxpayer has more than one sale of qualified small business stock in a taxable year that qualifies for the IRC Section 1045 election, the election can be made for any one or more of those sales. An IRC Section 1045 election is revocable only with the Commissioner's consent.[11]

1. IRC Sec. 1045(a).
2. IRC Sec. 1202.
3. IRC Sec. 1045(b)(5).
4. See Treas. Reg. §§1.1045-1(b)(1), 1.1045-1(g)(3)(i).
5. General Explanation of Tax Legislation Enacted in 1998 (JCS-6-98), p. 167 (the 1998 Blue Book).
6. TD 9353, 2007-2 CB 721.
7. IRC Sec. 1045(b)(3).
8. IRC Secs. 1045(b)(4), 1223(15).
9. Rev. Proc. 98-48, 1998-2 CB 367.
10. Rev. Proc. 98-48, 1998-2 CB 367.
11. Rev. Proc. 98-48, 1998-2 CB 367.

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The Service has stated that in order to be granted approval to make a late Section 1045 election (when the requirements for an automatic extension are not met), the requesting taxpayer must provide evidence to establish that he or she acted reasonably and in good faith and that granting the relief would not prejudice the interests of the government. A taxpayer is deemed to have not acted reasonably and in good faith if the taxpayer either uses hindsight in requesting relief, or was informed in all material respects of the required election and related tax consequences but chose not to file the election. Furthermore, the taxpayer must provide a detailed affidavit from the individuals having knowledge or information about the events leading to the failure to make a valid regulatory election. The affidavit must describe the engagement and responsibilities of the individual as well as the advice that the individual provided to the taxpayer.[1]

7524. What is a "short sale"? What is meant by the expression "short against the box"?

In a "short sale" an individual contracts to sell stock (or other securities) that the individual "does not own or the certificates for which are not within his [or her] control so as to be available for delivery when, under the rules of the Exchange, delivery must be made."[2] Thus, in a short sale, the seller usually borrows the stock (or security) for delivery to the buyer. (The seller must generally pay a premium for the privilege of borrowing such stock and will usually be required to reimburse the lender for any dividends paid during the loan period.) At a later date, the short seller will repay the borrowed stock to the lender with shares the seller held (but that were not available) at the time of the short sale or with shares purchased in the market, whichever he or she chooses.[3]

The act of delivering stock (or securities) to the lender in repayment for the borrowed shares is referred to as "closing" the short sale. The date the sales agreement is made is considered to be the "date of the short sale."

In a sale "short against the box" the short seller already owns (on the date of the short sale) shares of stock (or securities) that are identical to those sold short, but chooses to borrow the necessary shares rather than deliver the shares owned.

A contract to sell stock or securities on a "when issued" basis is considered a short sale; the performance of the contract is considered to be the "closing" of that short sale.[4]

A transaction in which a taxpayer purchases convertible bonds and as nearly simultaneously as possible sells the stock into which the bonds are convertible at a price relatively higher than the price of the bonds, then converts the bonds and uses the stock received to close the stock sale, is a short sale.[5] (Such a transaction is also an arbitrage operation, see Q 7531.) See Q 7525 regarding the tax treatment of short sales.

1. Let. Rul. 200604004.
2. *Provost v. U.S.*, 269 U.S. 443, 450 (1926).
3. See also Rev. Rul. 72-478, 1972-2 CB 487.
4. See S. Rep. No. 2375 (Rev. Act of 1950), 1950-2 CB 545; Treas. Reg. §1.1233-1(c)(6), Ex. (6).
5. Rev. Rul. 53-154, 1953-2 CB 173.

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The purchase of a put option (see Q 7555, Q 7557) is treated as a short sale for some purposes.[1] It is unclear whether such treatment will be applied for purposes of the constructive sales rules of IRC Section 1259. See Q 7606 to Q 7608.

In applying the short sale rules, a *securities futures contract* (see Q 7580) to *acquire* property will be treated in a manner similar to the property itself.[2] Thus, for example, the holding of a securities futures contract to acquire property and the short sale of property that is substantially identical to the property under the contract will result in the application of the rules under IRC Section 1233(b) (regarding short-term gains and holding periods). (Because securities futures contracts are not treated as commodity futures contracts under IRC Section 1234B(d), the rule providing that commodity futures are not substantially identical if they call for delivery in different months does not apply.) In addition, a securities futures contract to *sell* is treated as a short sale of the property.[3]

The SEC has made permanent a rule that seeks to reduce the potential for abusive "naked" short selling in the securities market. Rule 204 requires broker-dealers to promptly purchase or borrow securities to deliver on a short sale. The rule became effective July 31, 2009.[4]

7525. When and how is a short sale taxed?

The timing of the taxable event depends on when the short sale occurs and whether it constitutes a *constructive sale of an appreciated financial position* (See Q 7606 to Q 7608). Special rules also govern the determination of the holding period of property subject to a short sale (and thus its tax treatment) as explained below.

Transactions Subject to Constructive Sale Treatment

Generally, if a taxpayer holds an appreciated financial position (see Q 7606) that is the same as or substantially identical to the property sold short, the short sale will be treated as a constructive sale of that position, unless certain requirements are met for closing out the short position.[5] Furthermore, if a taxpayer holds a short sale position that has appreciated, the acquisition of the same or substantially identical property (e.g., to cover the short sale) constitutes a constructive sale of the short sale position, which is subject to the same rules.[6]

Unless certain exceptions apply, a constructive sale results in immediate recognition of gain as if the position were sold, assigned, or otherwise terminated at its fair market value on the date of the constructive sale.[7] For an explanation of the constructive sale rules for appreciated financial positions under IRC Section 1259, see Q 7606 to Q 7608.

1. See, e.g., IRC Sec. 1233(b).
2. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000). See IRC Sec. 1233(e)(2)(D).
3. IRC Sec. 1233(e)(2)(E); H.R. Conf. Rep. No. 106-1033 (CRTRA 2000). See IRC Sec. 1234B(b).
4. Rule 204 of Regulation SHO (17 CFR 242.204); Release No. 34-60388, 74 Fed. Reg. 38266 (7-31-2009), SEC Press Release 2009-172 (7-27-2009).
5. See IRC Secs. 1259(c)(1)(A), 1259(c)(3).
6. IRC Sec. 1259(c)(1)(D).
7. See IRC Sec. 1259(a).

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A sale of appreciated stock "short against the box" constitutes a constructive sale of an appreciated financial position (See Q 7606 to Q 7608).[1] (Under earlier law, short sales against the box were taxed as a short sale.)[2]

The nature of capital gain recognized as a result of a constructive sale of an appreciated financial position may be subject to the rules of IRC Section 1233 and regulations thereunder, which generally govern the determination of a taxpayer's holding period for gain or loss on short sale transactions. (Those rules are described in Q 7525.) The treatment of capital gains and losses is explained in Q 608.

Transactions Not Subject to Constructive Sale Treatment

In the case of a short sale that, if terminated, would result in a loss, the taxable event following a short sale does not occur until the seller delivers stock to the lender to "close" the sale, not when the sales agreement was made, nor when the borrowed stock was delivered to the purchaser (See Q 7524).[3] If the seller's tax basis exceeds the sale proceeds, the seller will realize a capital loss.[4]

If the seller does not hold the same or substantially identical property, a short sale alone will not result in constructive sale treatment; but at such time as the seller acquires the same or substantially identical property to close the sale, a constructive sale takes place, under the rules described above, if the short position has appreciated.[5]

Miscellaneous Rules

For the tax treatment of the "premium" paid by the short seller to borrow the stock for delivery to the buyer, see Q 7529. The treatment of capital gain or loss on sales is subject to the rules set forth in Q 608.

Special rules are provided where a taxpayer holds an offsetting short position with respect to qualified small business stock, see Q 7522.

If a short sale is deemed to be part of a conversion transaction, a portion of the gain recognized upon the sale of stock sold short may be treated as ordinary income.[6] See Q 7604 to Q 7605 for an explanation of conversion transactions and the tax treatment of them.

No deduction is allowed for a loss incurred in a short sale if, within the 61-day period that begins 30 days before the date the short sale was closed and ends 30 days after such date, the short seller entered into a wash sale.[7]

1. IRC Secs. 1259(b)(1), 1259(c)(1)(A).
2. *DuPont v. Comm.*, 110 F.2d 641 (3d Cir.), *cert. den.*, 311 U.S. 657 (1940).
3. See Rev. Rul. 2002-44, 2002-2 CB 84.
4. Treas. Reg. §1.1233-1(a).
5. See IRC Sec. 1259(c)(1)(D).
6. IRC Sec. 1258(a).
7. See IRC Sec. 1091(e); AOD 1985-019.

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7526. In the context of a short sale, what are the rules for determining whether a capital gain (or loss) is taxed as a long-term or short-term gain (or loss)?

Ordinarily, whether capital gain or loss on a short sale is long-term or short-term will be determined by how long the seller held the stock used to close the sale.[1] For most purposes, the holding period requirement is "more than one year." (See Q 608 for the treatment of capital gains and losses.)

Under provisions predating the constructive sale rules (see Q 7606 to Q 7608), to prevent individuals from using short sales to convert short-term gains to long-term gains or long-term losses to short-term losses, and to prevent the creation of artificial losses, the IRC and regulations provide special rules as follows:

(1) If on the date the short sale is closed (see below), any "substantially identical property" (see Q 7528) has been held by the seller for a period of one year or less, any *gain* realized on property used to close the sale will, to the extent of the quantity of such substantially identical property, be *short-term* capital gain.[2] This is true even though the stock actually used to close the short sale has been held by the seller for more than one year. This rule does not apply to *losses* realized on the property used to close the sale.

(2) If *any* substantially identical property is acquired by the seller after the short sale and on or before the date the sale is closed, any *gain* realized on property used to close the sale will, to the extent of the quantity of such substantially identical property, be *short-term* capital gain.[3] This is true regardless of how long the substantially identical property has been held, how long the stock used to close the short sale has been held, and how much time has elapsed between the short sale and the date the sale is closed. This rule does not apply to *losses* realized on the property used to close the sale.

(3) The holding period of any substantially identical property held one year or less, or acquired after the short sale and on or before the date the short sale is closed will, to the extent of the quantity of stock sold short, be deemed to have begun on the date the sale is closed or the date such property is sold or otherwise disposed of, whichever is earlier. If the quantity of such substantially identical property held for one year or less or so acquired exceeds the quantity of stock sold short, the "renewed" holding period will normally be applied to individual units of such property in the order in which they were acquired (beginning with earliest acquisition), but only to so much of the property as does not exceed the quantity sold short. Any excess retains its original holding period.[4] But where the short sale is entered into as part of an *arbitrage operation* in stocks or securities (see Q 7531), this order of application is altered so that the "renewed" holding period will be applied first to substantially identical property acquired for arbitrage operations and held at the close of business on the day of the short sale and then in the order of acquisition

1. Treas. Reg. §1.1233-1(a)(3). See *Bingham*, 27 BTA 186 (1932), *acq*. 1933-1 CB 2.
2. IRC Sec. 1233(b)(1); Treas. Reg. §1.1233-1(c).
3. IRC Sec. 1233(b)(1); Treas. Reg. §1.1233-1(c).
4. IRC Sec. 1233(b)(2); Treas. Reg. §1.1233-1(c)(2).

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as described in the previous sentence. The holding period of substantially identical property *not* acquired for arbitrage operations will be affected only to the extent that the quantity sold short exceeds the amount of substantially identical property acquired for arbitrage operations.[1]

If substantially identical property acquired for arbitrage operations is disposed of without closing the short sale, see Q 7532.

(4) If on the date of a short sale *any* substantially identical property has been held by the seller for more than one year, any *loss* realized on property used to close the sale will, to the extent of the quantity of such substantially identical property, be *long-term* capital loss.[2] This is true even though the stock actually used to close the short sale has been held by the seller for a year or less. This rule does not apply to *gains* realized on the property used to close the sale.

Capital gain or loss from the sale or exchange of a *securities futures contract*—see Q 7580—to sell property (i.e., the short side of a futures contract) will generally be short-term capital gain or loss unless the position is part of a straddle, see Q 7593. In other words, a securities futures contract to sell property is treated as equivalent to a short sale of the underlying property.[3]

See Q 7528 and Q 7536 for a discussion of what constitutes substantially identical property for purposes of these rules.

7527. How is a short sale taxed when the property sold becomes substantially worthless?

If a taxpayer enters into a short sale of property and the property becomes substantially worthless, a special rule requires that the taxpayer recognize gain in the same manner as if the short sale were closed when the property became substantially worthless.[4] (To the extent provided in future regulations, this rule will also apply with respect to options and offsetting notional principal contracts with respect to property, any future or forward contract to deliver property, and any similar transaction.)

Special rules are provided regarding the statute of limitations for assessing a deficiency if property becomes substantially worthless during a taxable year and any short sale of property remains open at the time the property becomes substantially worthless.[5] For an explanation of the taxation of stock or other securities that become worthless, see Q 7537.

The definition of "substantially identical stock or securities" for purposes of the short sale rules is the same as that used for purposes of the wash sale rule, see Q 7528, Q 7536. It would appear that the same definition would be used for purposes of constructive sales of appreciated financial positions, see Q 7606 to Q 7608.

1. IRC Sec. 1233(f); Treas. Reg. §1.1233-1(f).
2. IRC Sec. 1233(d); Treas. Reg. §1.1233-1(c)(4).
3. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000). See IRC Sec. 1234B(b).
4. IRC Sec. 1233(h)(1).
5. IRC Sec. 1233(h)(2).

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7528. What is "substantially identical property"?

In the case of stocks and securities, "substantially identical property," for purposes of the short sale rules, has the meaning given to "substantially identical stock or securities" for purposes of the wash sale rule.[1] See Q 7536 for details. It would appear that the same definition should apply for purposes of constructive sales of appreciated financial positions under IRC Section 1259.

A *securities futures contract* (see Q 7580) to acquire substantially identical property will be treated as substantially identical property.[2]

In addition, for purposes of short sales entered into as part of an *arbitrage operation* (see Q 7531), a taxpayer will be deemed to hold substantially identical property for arbitrage operations at the close of any business day if he or she owns any other property acquired for arbitrage operations (whether or not substantially identical) or has entered any contract in an arbitrage operation which in either case, at the close of that day, gives the taxpayer the right to receive or acquire substantially identical property.[3]

7529. May an investor deduct the premium paid to borrow stock in connection with a short sale?

The premium paid by an investor to borrow the stock delivered to the buyer in a short sale is an expense incurred for the production of income.[4] But the amount is generally treated as interest expense (subject to the limitation on the deduction of investment interest).[5] As a result, a short seller may find that only a portion (or none) of the premium is deductible for income tax purposes.[6] See Q 7941 regarding the deduction of investment interest.

Furthermore, if the proceeds of a short sale are used to purchase or carry tax-exempt obligations, the amount of the premium is treated as interest for purposes of the general rule that prohibits the deduction of interest expense incurred or continued to purchase or carry tax-exempt obligations. (But this does not apply if the short seller provided cash as collateral for the short sale and does not receive material earnings on such cash.)[7] See Q 7943 and Q 7949 for an explanation of this rule.

If the proceeds of a short sale are used to purchase or carry short-term obligations or market discount bonds, an otherwise allowable deduction of the short sale premium may have to be deferred under the rules discussed in Q 7944 and Q 7945. (A short-term obligation is one which has a fixed maturity date not more than one year from the date of issue.)[8]

1. Treas. Reg. §1.1233-1(d).
2. IRC Sec. 1233(e)(2)(D).
3. IRC Sec. 1233(f)(3); Treas. Reg. §1.1233-1(f)(2).
4. Rev. Rul. 72-521, 1972-2 CB 128.
5. It is not, however, a miscellaneous itemized deduction subject to the limitations of IRC Section 67. IRC Sec. 67(b)(8).
6. IRC Sec. 163(d).
7. IRC Secs. 265(a)(2), 265(a)(5).
8. IRC Secs. 1277, 1282, 1283.

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7530. May an investor deduct expenses incurred in reimbursing the lender of stock in a short sale for dividends paid on the borrowed stock?

Cash Dividends

The answer generally depends on the period the short sale is open. If a short sale is held open less than 46 days, any amount paid by the short seller to reimburse the lender of stock for *cash* dividends paid on the borrowed stock during the period of the loan will not be deductible by the seller. Instead, the seller will be required to add such amount to the tax basis in the stock used to close the short sale (i.e., the short seller will be required to capitalize the expenditure).[1]

But if the amount of the *cash* dividends being reimbursed equals or exceeds 10 percent (5 percent in the case of a short sale of stock that is preferred as to dividends) of the amount realized by the short seller in the short sale, the expenditure must be capitalized (i.e., added to the basis of the stock used to close the short sale) *unless* the short sale is open for at least 366 days.[2] For this purpose, all dividends paid on the short sale stock that have ex-dividend dates within the same 85 consecutive day period must be treated as a single dividend.[3] (Dividends that equal or exceed the 10 percent (or 5 percent) threshold are referred to as "extraordinary dividends.")[4]

Assuming the short sale is open for a period of 46 days (366 days in the case of an extraordinary dividend) or more, the amount paid by the short seller to reimburse the lender for *cash* dividends is usually deductible as an expense incurred in the production of income.[5] But when it appears that the sole motive for the short sale was the reduction of income taxes (through the deduction or offset of capital losses), the Service has taken the position that such amounts are not deductible.[6]

If the short seller must report ordinary income as a result of receiving compensation for the use of collateral provided in connection with borrowing stock for the short sale, he or she will generally be permitted to deduct, to the extent of such income, the amounts paid to reimburse the lender for dividends even though the sale was not open more than 45 days. (This exception does not apply in the case of "extraordinary dividends.")[7]

For purposes of determining whether a short sale has been open for at least 46 (or 366) days, the running of such period must be suspended during any period in which (1) the seller holds, has an option to buy, or is under a contractual obligation to buy, stock or securities that are substantially identical to those sold short, or (2) as set forth in regulations, the seller has diminished his or her risk of loss by holding one or more other positions in substantially similar or related property.[8]

1. IRC Sec. 263(h)(1).
2. IRC Secs. 263(h)(2), (3); 1059(c)(1), (2).
3. IRC Sec. 1059(c)(3).
4. IRC Sec. 263(h)(2), (3).
5. See Rev. Rul. 72-521, 1972-2 CB 128.
6. See *Hart v. Comm.*, 338 F.2d 410 (2d Cir. 1964), agreeing with the Service.
7. IRC Sec. 263(h)(5).
8. IRC Sec. 263(h)(4).

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Even though an amount is deductible under the foregoing rules, a short seller may still find that the deduction is limited or must be deferred as follows:

(1) If the proceeds of the short sale are used to purchase or carry tax-exempt obligations, the deduction may be disallowed under the general rule prohibiting the deduction of interest expense incurred or continued to purchase or carry tax-exempts. (But this does not apply if the seller provided cash as collateral for the short sale and does not receive material earnings on such cash.) (See Q 7943, Q 7949).[1]

(2) If the proceeds of the short sale are used to purchase or carry market discount bonds or short-term obligations, an otherwise allowable deduction of amounts incurred to reimburse the lender of stock for cash dividends may have to be deferred under the rules discussed in Q 7944 and Q 7945. (A short-term obligation is a bond, note, debenture, certificate, or other evidence of indebtedness that has a fixed maturity date not more than one year from the date of issue.)[2]

(3) In any event, the amount of the otherwise deductible reimbursement must be treated as an investment interest expense and thus is subject (along with any other investment interest expense) to the general limitation on the deduction of investment interest (See Q 7941).[3]

The amount received by the lender of stock as a reimbursement for a cash dividend from the borrower is *not* a dividend,[4] and it is therefore not eligible for the preferential treatment applicable to qualified dividends. It is simply ordinary income.

Stock Dividends and Liquidating Dividends

The cost of purchasing additional shares of stock to reimburse the lender for nontaxable *stock* dividends and any amount paid to reimburse the lender for a liquidating dividend are always capital expenditures and not tax deductible.[5] As such, these amounts should be added to the investor's basis in the stock used to close the short sale.

7531. For purposes of the short sale rules, what are "arbitrage operations"?

"Arbitrage operations" are transactions involving the purchase and sale of stock or securities (or the right to acquire stock or securities) entered into for the purpose of profiting from a current difference between the price of the property purchased and the price of the property sold. The property purchased must either be identical to the property sold (e.g., stock X trading for different prices on different exchanges) or must entitle the owner to acquire property that is identical to the property sold (e.g., bonds convertible into stock X). To qualify as an arbitrage operation for purposes of the short sale rules, the taxpayer *must* properly identify the transaction as an arbitrage operation on the taxpayer's records as soon as he or she is able to do so;

1. IRC Sec. 265(a)(5).
2. IRC Secs. 1277, 1282, 1283.
3. IRC Sec. 163(d)(3)(C).
4. See Rev. Rul. 60-177, 1960-1 CB 9.
5. Rev. Rul. 72-521, 1972-2 CB 128.

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ordinarily, this must be done on the day of the transaction. Only property properly identified as such will be treated as property acquired for arbitrage operations.[1]

Property that has been properly identified as acquired for arbitrage operations will continue to be treated as such even though, because of subsequent events, the taxpayer sells the property outright rather than using it to complete the arbitrage operation.[2] But see Q 7532 as to the effects of disposing of such property without closing a short sale that was entered into as part of the arbitrage operation.

It is unclear whether an arbitrage operation may be subject to treatment as a conversion transaction (see Q 7604, Q 7605) or whether it may constitute a constructive sale of an appreciated financial position (see Q 7606 to Q 7608).

7532. What are the effects on the short sale rules if substantially identical property acquired for arbitrage operations is disposed of without closing a short sale that was part of arbitrage operations?

If substantially identical property acquired for arbitrage operations is sold or otherwise disposed of without closing the short sale that was entered into as part of the arbitrage operations so that a net short position in assets acquired for arbitrage is created, a short sale in the amount of the net short position will be deemed to have been made on the date that short position is created. The holding period of any substantially identical property *not* acquired for arbitrage operations will then be determined under the rules discussed in Q 7525 as though the "deemed" short sale was not entered into as part of an arbitrage operation.[3]

> *Example*: On August 13, Mr. Copeland buys 100 bonds of X corporation for purposes other than arbitrage operations. The bonds are convertible (one bond for one share) at Mr. Copeland's option into common stock of X corporation. On November 1, Mr. Copeland sells short 100 shares of X common stock, buys an additional 100 bonds of X corporation, and identifies both transactions as part of arbitrage operations. The bonds acquired on August 13 and November 1 are, on the basis of all the facts, substantially identical to the X common stock. On December 1, Mr. Copeland sells the bonds acquired on November 1, but does not close the short sale. Since a net short position in assets acquired for arbitrage operations is thus created, a short sale is deemed to have been made on December 1. Accordingly, the holding period of the bonds acquired on August 13 will, by application of the rule discussed in Q 7525, begin on the date that the "deemed" short sale is closed (or, if earlier, the date such bonds are disposed of or sold).[4]

It is unclear whether certain arbitrage operations may be subject to treatment as a constructive sale of an appreciated financial position (see Q 7606 to Q 7608).

7533. How is a short sale taxed if the seller dies shortly after making the short sale and the estate or a trust "closes" the sale?

If the short sale constitutes a constructive sale of an appreciated financial position, it will be subject to special rules explained in Q 7608. Otherwise, a short sale closed by a seller's estate

1. IRC Sec. 1233(f); Treas. Reg. §1.1233-1(f)(3).
2. Treas. Reg. §1.1233-1(f)(3).
3. Treas. Reg. §1.1233-1(f)(1)(ii).
4. See Treas. Reg. §1.1233-1(f)(1)(iii).

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will be taxed under the earlier rules for short sales, (see Q 7525). But for purposes of determining gain or loss, if the sale is closed with stock owned by the seller at his or her death, the tax basis in that stock will be its value for federal estate tax purposes – generally, fair market value on the date of the seller's death.[1]

It was determined (under a ruling pre-dating the constructive sales rules of IRC Section 1259) that where a trust established by a seller closed a short sale after the death of the seller with stock it held for the seller's benefit, the basis of such stock generally would be its fair market value either on the date of the seller's death or on an alternative valuation date determined under IRC Section 2032.[2]

For short sales that are not subject to the constructive sales rules of IRC Section 1259 (see Q 7525), the taxable event of the short sale occurred when the estate or trust "closed" the sale.[3] Thus, any gain recognized on the short sale would *not* constitute "income in respect of a decedent" (see Q 636). But special rules may apply to decedents who held an open short sale position within three years of death (see Q 7608).

7534. What is a "wash sale"?

A "wash sale" is a sale or other disposition of stock or securities in which the seller, within a 61-day period (beginning 30 days before and ending 30 days after the date of such sale or disposition), replaces the stock or securities by acquiring (by way of a purchase or an exchange on which the full gain or loss is recognized for tax purposes), or entering a contract or option to acquire, substantially identical stock or securities.[4] Typically, the objective of a wash sale – were it not subject to the special rules of IRC Section 1091(a) explained in Q 7535 – would be for the taxpayer to take advantage of the deduction for capital losses, while maintaining the taxpayer's position in the corporation by purchasing substantially identical stock or securities. From a tax standpoint, it is as if nothing has happened, and IRC Section 1091(a) treats the sale as a non-event.

The replacement of stock or securities by way of gift, inheritance, or tax-free exchange will not result in a wash sale.[5] For the definition of "substantially identical stock or securities," see Q 7536. Except as provided in regulations, the term "stock or securities" includes "contracts or options to acquire or sell stock or securities." For an explanation, see Q 7553.

If a taxpayer sells stock or securities for a loss, acquiring substantially identical stock or securities within a traditional IRA or Roth IRA within the 61-day period may constitute a wash sale.[6]

Where there is no substantial likelihood that a put option (see Q 7555) will *not* be exercised, its sale will be treated as a contract to acquire the stock.[7]

1. Rev. Rul. 73-524, 1973-2 CB 307.
2. Let. Rul. 9319005.
3. See Rev. Rul. 73-524 and Let. Rul. 9319005.
4. IRC Sec. 1091(a); Treas. Reg. §1.1091-1(a).
5. See Treas. Reg. §1.1091-1(f).
6. Rev. Rul. 2008-5, 2008-1 CB 271.
7. Rev. Rul. 85-87, 1985-1 CB 268.

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For purposes of the wash sale rules, a stock warrant is considered to be an option to acquire stock of the issuing corporation.[1] Preferred stock that is convertible into common stock of the same corporation *without restriction* is considered to be an option to acquire such common stock.[2]

A seller of stock who agrees at the time of the sale to repurchase that same stock after a minimum of 30 days has entered into a contract, and the sale is a wash sale. It is irrelevant whether the contract is enforceable under state law.[3]

A bona fide sale of a portion of the shares of stock purchased in a single lot for purposes of reducing the purchaser's holdings in that stock is *not* a wash sale even though the sale occurs within 30 days after the lot was acquired.[4]

A disposition of stock or securities may not be taken out of the definition of a "wash sale" by merely postponing delivery until more than 30 days after the date the shares of stock or securities are replaced.[5] A purchase of substantially identical stock or securities during the 61-day period will trigger the wash sale rules even though the purchase is made on margin or pursuant to subscription rights acquired prior to the beginning of the 61-day period.[6]

Where a taxpayer received 10 shares of stock as a bonus from his employer, sold them at a loss, and then within the 61-day period received another bonus of 10 shares of the same stock, the Service ruled that a wash sale had occurred; the tax basis of shares received as a bonus is their fair market value at the time of payment.[7] It appears that the sale or purchase of "when-issued" securities is deemed to occur on the date the final settlement is made.[8]

An employee who, under an employer-employee restricted stock option plan, was granted an option to purchase stock of his or her employer was deemed for purposes of the wash sale rules to have entered into an option to acquire that stock on the date the option was granted; the stock purchased pursuant to such option was deemed to have been acquired on the date the certificates were issued.[9] See Q 7543 to Q 7549 for the tax treatment of incentive stock options.

Securities futures contracts. "The wash sale rules apply to any loss from the sale, exchange, or termination of a securities futures contract (other than a dealer securities futures contract) if within a period beginning 30 days before the date of such sale, exchange, or termination and ending 30 days after such date: (1) stock that is substantially identical to the stock to which the contract relates is sold; (2) a short sale of substantially identical stock is entered into; or (3) another securities futures contract to sell substantially identical stock is entered into."[10]

1. Rev. Rul. 56-406, 1956-2 CB 523.
2. Rev. Rul. 77-201, 1977-1 CB 250.
3. *Est. of Estroff v. Comm.*, TC Memo 1983-666.
4. Rev. Rul. 56-602, 1956-2 CB 527.
5. Rev. Rul. 59-418, 1959-2 CB 184.
6. See respectively, Rev. Rul. 71-316, 1971-2 CB 311; Rev. Rul. 71-520, 1971-2 CB 311.
7. Rev. Rul. 73-329, 1973-2 CB 202.
8. See I.T. 3858, 1947-2 CB 71.
9. Rev. Rul. 56-452, 1956-2 CB 525.
10. See IRC Sec. 1091(e); Joint Committee on Taxation, Technical Explanation of the Job Creation and Worker Assistance Act of 2002 (JCX-12-02).

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The taxation of a wash sale is explained in Q 7535. For the application of the wash sale rules in the context of a short sale, see Q 7525.

7535. How is the sale or disposition of stock or securities in a wash sale taxed? What effect does a wash sale have on the replacement stock or securities?

Stock or Securities Sold

No special tax rules apply if an investor realizes a *gain* in a wash sale of stock or other securities; rather, the sale will be taxed under the rules peculiar to both the type of disposition and to the particular stock or security sold. For the taxation of gain on treasury bills, bonds and notes, and municipal bonds, see respectively Q 7613, Q 7619, and Q 7645. For taxation of gain on corporate obligations, see Q 7615 and Q 7622. For taxation of stock, see Q 7517 to Q 7522.

On the other hand, to the extent that shares of stock or securities sold are replaced in a wash sale (as defined in Q 7534), any *loss* realized on the stock or securities sold may *not* be recognized for income tax purposes and, therefore, may not be used to offset capital gains or otherwise deducted. However, if the quantity of the stock or securities sold at a loss exceeds the quantity replaced, the loss realized on the excess shares or securities may be recognized as a capital loss for income tax purposes.[1]

Replacement Stock or Securities

As part of a scheme to postpone the recognition of an economic wash sale loss, rather than disallow it permanently, the IRC provides that both the tax basis and holding period of the replacement stock or securities are to be adjusted. Specifically, the tax basis of the replacement stock or securities is deemed to be equal to the tax basis of the stock or securities disposed of in the wash sale 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 the substantially identical stock or securities were sold or otherwise disposed of. This generally has the effect of adding the amount of the unrecognized loss to the cost basis of the replacement stock or securities.[2] The loss is therefore deferred, not eliminated forever. It can be recognized when the stock or securities are sold or exchanged in a transaction that is not a wash sale.

Where a taxpayer sold stock or securities for a loss and acquired substantially identical stock or securities within his or her traditional IRA or Roth IRA within the 61-day period, the IRS found a wash sale. In this case, the taxpayer's basis in the traditional IRA or Roth IRA was not increased by virtue of IRC Section 1091(d).[3]

Furthermore, the investor's holding period in the stock or securities disposed of in the wash sale is "tacked" (i.e., added) onto his or her holding period in the replacement stock or securities.[4]

1. IRC Sec. 1091(b); Treas. Reg. §1.1091-1(c); Rev. Rul. 70-231, 1970-1 CB 171.
2. IRC Sec. 1091(d); Treas. Reg. §1.1091-2.
3. Rev. Rul. 2008-5, 2008-1 CB 271.
4. IRC Sec. 1223(4).

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Matching

Where identical quantities of stock or securities are sold and replaced in a wash sale, there is little problem in applying the rules discussed above. But where unequal quantities are sold and replaced or where sales and/or replacements are made in multiple lots (or transactions), the stock or securities sold and the replacement stock or securities must be matched on a chronological basis (beginning with the earliest loss and earliest replacement) before the rules can be properly applied.[1]

> *Example*: On March 1, Ms. Whalen sells 1000 shares of X stock (lot A) at a loss of $10,000 and a second lot of 1000 (lot B) on March 2 at a loss of $25,000. On March 10, Ms. Whalen purchases 1000 shares of X stock (lot C). This purchase will result in the nonrecognition for income tax purposes of the $10,000 loss on lot A and an increase of $10,000 in the tax basis of the replacement stock (lot C). In addition, the holding period of lot C will include the holding period of lot A (i.e., the holding period of lot A will be "tacked" onto the holding period of lot C).
>
> If, on March 20, Ms. Whalen purchases another lot (lot D) of 1000 shares of stock X, the $25,000 loss on the sale of lot B will not be recognized for income tax purposes. The tax basis of lot D will be increased by $25,000, and the holding period of lot B will be tacked onto the holding period of lot D.

7536. When are stocks and securities "substantially identical" for purposes of the wash sale rules?

Whether stocks or securities are substantially identical depends on the facts and circumstances of each case.[2] Beyond that, unfortunately, the IRC and the Regulations offer little guidance as to when stock or securities are substantially identical, but it is clear that "something less than precise correspondence will suffice."[3]

Ordinarily, shares or securities of one corporation are not substantially identical to shares or securities of another corporation. However, a different result may occur as, for example, in reorganization, where facts and circumstances indicate that the stock and securities of predecessor and successor corporations are substantially identical.[4] Where voting trust certificates eventually could be exchanged for common stock held by the trust, the certificates were held to be substantially identical to the common stock of the same corporation.[5]

When preferred stock is convertible into common stock of the same corporation, the relative values, price changes, and other circumstances may make the preferred and common stock substantially identical.[6] Also, when a sale of a stock warrant is followed within 30 days by a purchase of stock of the same corporation, the warrant and the newly acquired stock are substantially identical only if the relative values and price changes are similar.[7]

1. IRC Secs. 1091(b), 1091(c); Treas. Reg. §1.1091-1.
2. Treas. Reg. §1.1233-1(d)(1).
3. *Hanlin v. Comm.*, 108 F.2d 429 (3d Cir. 1939).
4. Treas. Reg. §1.1233-1(d)(1).
5. See *Kidder v. Comm.*, 30 BTA 59 (1934).
6. Treas. Reg. §1.1233-1(d)(1); Rev. Rul. 77-201, 1977-1 CB 250.
7. GCM 39036 (9-22-83).

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For purposes of the wash sale rules, options to buy stock or securities apparently can be considered substantially identical not only to the underlying stock, but also to other options or contracts to buy stock or securities.[1]

Under the wash sale rules, a contract or option to acquire or sell stock or securities will include options and contracts that are (or may be) settled in cash or property other than the stock or securities to which the contract relates.[2] Thus, for example, the acquisition within the period set forth in IRC Section 1091 of a *securities futures contract* (see Q 7580) to acquire stock of a corporation could cause the taxpayer's loss on the sale of stock in that corporation to be disallowed under the wash sale rules, notwithstanding that the contract may be settled in cash.[3]

Generally, *bonds* are substantially identical if they are not substantially different in any material feature and are not substantially different in several material features considered together (each of which, if considered alone, would not be regarded as substantial).[4] Although very few concrete criteria exist to aid in determining which features are material and when such material features alone or in conjunction will result in a substantial difference, the following may be of guidance:

…The interest rate of a bond is considered a material feature.[5]

…In determining whether bonds purchased are substantially identical to bonds sold, the bonds purchased must be compared as they existed when purchased with the bonds sold as they existed when sold.[6]

…Issue dates of bonds are not material features unless some material features are dependent on such dates.[7]

…Whether a difference in maturity dates is substantial or not is directly affected by the total time period to maturity (i.e., 6 months added to the duration of one year is vital; added to a duration of twenty years is negligible).[8]

Worthless Securities

7537. How is an investor taxed when stock or other security becomes worthless?

If an investor's security—whether it be stock in a corporation or another security—becomes worthless at any time during the year, the loss is treated as a capital loss realized in a sale or

1. See IRC Sec. 1091(a).
2. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000).
3. H.R. Conf. Rep. No. 106-1033 (CRTRA 2000). See IRC Sec. 1091(f).
4. Rev. Rul. 58-211, 1958-1 CB 529.
5. Rev. Rul. 60-195, 1960-1 CB 300.
6. Rev. Rul. 58-211, 1958-1 CB 529.
7. Rev. Rul. 58-210, 1958-1 CB 523.
8. *Hanlin v. Comm.*, 108 F.2d 429 (3rd Cir. 1939).

exchange of the worthless security on the last day of that year.[1] (But special rules apply to certain small business and small business investment company stocks.)[2]

The determination as to when a security becomes worthless is often very difficult and has been the subject of extensive litigation. The investor must be able to show that an identifiable event (or events) resulting in the worthlessness occurred in the year in which the investor claims the loss.[3] The investor must also be able to show that the security had some intrinsic or potential value at the close of the prior year.[4] In fact, the determination is often so difficult that the United States Court of Appeals for the Second Circuit has said that the "only safe practice ... is to claim a loss for the earliest year when it may possibly be allowed and to renew the claim in subsequent years if there is any reasonable chance of its being applicable ... in those years."[5]

In determining whether a security is, in fact, worthless, any potential future value must be considered.[6] (Although the taxpayer would have to demonstrate that the security has no present value, the concept of present value takes into account any projected future income stream.) The security must be totally worthless; a "paper" loss on a security that is partially worthless or that has declined in value is not realized and may not be recognized until the security is actually sold or exchanged.[7]

In Field Service Advice released in 2002, the IRS discussed at length several factors relating to worthless stock including (1) the factual nature of the inquiry into the worthlessness of stock; (2) the two-part test for the worthlessness of stock, and the application of the test; (3) identifiable events in general; (4) determining worthlessness without an identifiable event; (5) timing of the loss using identifiable events; (6) liquidation as an identifiable event, and liquidation as destroying potential worth; (7) the fact that stock is not worthless simply because nothing is received for it; (8) the potential worth of (a) stock disposed of by sale, (b) the investment after the election, (c) canceled stock, and (d) surrendered stock; and (9) the potential worth because of claims for reimbursement.[8]

According to the Tax Court, the principles for establishing the worthlessness of stock in a particular taxable year are virtually identical to the principles for establishing a worthless debt. Thus, as in the case of a bad debt deduction due to the worthlessness of a debt, to sustain a worthless stock loss the taxpayer must show an absence of potential as well as liquid value by year-end.[9]

Generally, the amount of the capital loss resulting from a security's becoming worthless is the shareholder's tax basis in the security as of the last day of the year in which it becomes worthless.[10]

1. IRC Secs. 165(g), 165(f); Treas. Reg. §1.165-5(c).
2. See IRC Secs. 1243, 1244; see also *Crigler v. Comm.*, TC Memo 2003-93, *aff'd per curiam*, No. 03-1861 (4th Cir. 2004).
3. Treas. Reg. §1.165-1(b); *Boehm v. Comm.*, 326 U.S. 287 (1945); see also *Bilthouse v. U.S.*, 553 F.3d 513 (7th Cir. 2009).
4. *Dunbar v. Comm.*, 119 F.2d 367 (8th Cir. 1941).
5. *Young v. Comm.*, 123 F.2d 597 (2d Cir. 1941).
6. See Rev. Rul. 77-17, 1977-1 CB 44.
7. Treas. Regs. §§1.165-1(b), 1.165-5(c).
8. See FSA 200226004.
9. See *Rendall v. Comm.*, TC Memo 2006-174, citing *Morton v. Comm.*, 38 BTA 1270 (1938), *aff'd*, 112 F.2d 320 (7th Circ. 1940).
10. IRC Sec. 165(b); Treas. Reg. §1.165-1(c).

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But capital loss treatment will be allowed only to the extent that the loss is not compensated for by insurance or otherwise.[1]

The loss from a capital asset that becomes worthless during a taxable year is determined as if the asset were sold or exchanged on the last day of the year; thus, the taxpayer's holding period would apparently be determined as of that date.[2]

Because of the difficulties in proving the "if" and "when" of worthlessness, it is often suggested that a security nearing worthlessness be sold to establish the loss. A loss on a such sale may nevertheless be disallowed if it can be shown that the security became worthless in a prior year.[3]

In the case of a capital loss claimed to have been sustained as a result of a security's becoming worthless, the normal three-year statute of limitations for amending federal income tax returns is extended to seven years.[4] In *Georgeff v. United States*,[5] the taxpayers filed their 1997 tax return on September 25, 2002, identifying an alleged worthless security loss and also claiming entitlement to a refund for that loss on the same return. The taxpayers argued that the special seven-year statute of limitations should apply. Rejecting the taxpayers' argument, the United States Court of Federal Claims stated that IRC Section 6511(d) was designed to provide protection for deductions attributable to bad debts freshly discovered or newly increased after the filing of an original tax return, not those identified before the tax return was filed. The court concluded that the taxpayers were not entitled to the benefit of an enlarged statute of limitations from three to seven years because the alleged loss based on the worthless security was known well in advance of the time that their 1997 tax return was due on April 15, 1998, and filed on September 25, 2002. Accordingly, the court dismissed the taxpayers' complaint and granted the United States' motion for summary judgment.

7538. How is a shareholder taxed when stock or other securities is abandoned?

The IRS issued regulations concerning the availability and character of a loss deduction under IRC Section 165 for losses sustained from abandoned securities. The term "worthless security" includes a security that is abandoned and that otherwise satisfies the requirements for a deductible loss (under IRC Section 165). If the abandoned security is a capital asset (and not a worthless security of certain affiliated corporations), the resulting loss is treated as loss from the sale or exchange of a capital asset on the last day of the taxable year. To abandon a security, a taxpayer must permanently surrender and relinquish all rights in the security and receive all consideration in exchange for the security. All the facts and circumstances determine whether the transaction is properly characterized as an abandonment rather than another type of transaction,

1. IRC Sec. 165(a).
2. See IRC Sec. 165(g)(1).
3. See *DeLoss v. Comm.*, 28 F.2d 803 (2d Cir. 1928), *cert. den.*, 279 U.S. 840 (1929); *Rand v. Helvering*, 116 F.2d 929 (8th Cir. 1941), *cert. den.*, 313 U.S. 594 (1941); *Heiss v. Comm.*, 36 BTA 833 (1937), *acq.*
4. IRC Sec. 6511(d)(1).
5. 2005-2 USTC ¶50,585 (Fed. Cl. 2005).

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such as an actual sale or exchange, a contribution to capital, a dividend, or a gift. The regulations apply to any abandonment of stock or other securities after March 12, 2008.[1]

Special rules apply in the case of a short sale of property that becomes substantially worthless[2] (See Q 7525). See Q 608 regarding the tax treatment of capital gains and losses.

Stock Warrants

7539. What is a stock warrant?

A stock warrant is an instrument issued by a corporation granting the owner the right to buy a certain amount of stock at a specified price, usually for a limited time. In the case of the holder, a stock warrant is generally treated like an option.[3]

7540. How is the acquisition of a stock warrant taxed? What is its tax basis?

If a warrant to acquire stock in the distributing corporation is acquired in a dividend distribution, taxation to the recipient-shareholder depends on whether the dividend is taxable or not (see Q 7509). If it is a nontaxable stock dividend, there is no immediate income taxation. See Q 7511 to determine the tax basis of a warrant acquired in a nontaxable stock dividend. If the dividend is taxable, it is treated as a dividend "in kind," so that the amount that generally must be included in the recipient-shareholder's income is the fair market value of the warrant on the date of distribution.[4] This is also the warrant's tax basis, (See Q 7503).

If a corporation distributes a warrant to acquire stock in another corporation, it is also taxed as a dividend in kind. The basis of the warrant to an individual shareholder is its fair market value, see Q 7503.

If a warrant is acquired through purchase, gift, or inheritance, there are no immediate income tax consequences. The tax basis of a warrant acquired in this manner is determined under general rules discussed in Q 598.

7541. How is the owner of a warrant taxed when the warrant is sold, exercised, or allowed to lapse?

The sale, exercise, or lapse of a stock warrant is taxed in the same general manner as an unlisted call option.[5]

Sale. If a warrant distributed in a nontaxable stock dividend is sold, the owner realizes a capital gain or loss to the extent of the difference between the tax basis in the warrant and the proceeds of the sale. (For the tax basis of a warrant acquired in a nontaxable stock dividend, see Q 7511.)[6] In determining the owner's holding period for the warrant, the holding period

1. Treas. Reg. §1.165-5; TD 9386, 73 Fed. Reg. 13124 (3-12-2008).
2. IRC Sec. 1233(h)(1).
3. See IRC Sec. 1234; Rev. Rul. 56-406, 1956-2 CB 523.
4. Treas. Reg. §1.305-1(b).
5. See IRC Sec. 1234.
6. See IRC Sec. 1234(a).

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of the stock with respect to which the dividend was paid is included.[1] See Q 608 for the tax treatment of capital gain or loss.

If a warrant distributed in a taxable dividend (or acquired by purchase, gift, or inheritance) is sold, the owner realizes a capital gain or loss to the extent of the difference between the tax basis in the warrant and the proceeds of the sale. (For the tax basis of a warrant distributed in a taxable dividend, see Q 7503. For the tax basis of a warrant acquired by purchase, gift, or inheritance, see Q 598.)

Exercise. The owner of a warrant will realize no capital gain or loss on exercise of the warrant and purchase of the stock. However, for purposes of determining gain or loss on a subsequent sale or exchange of that stock, the tax basis of the warrant is added to the subscription price paid for the stock.[2]

Lapse. If allowed to expire without exercise (i.e., lapse), a warrant is deemed to have been sold on the date of lapse.[3] The owner of the warrant will realize a loss only if he or she has a tax basis in the warrant. This occurs only when the owner acquired the warrant in a taxable stock dividend, or through purchase, gift, or inheritance. The basis of a warrant received in a nontaxable stock dividend is zero unless it is actually sold or exercised (See Q 7511).

Stock Options

7542. What is an incentive stock option?

An incentive stock option is an option to purchase stock of a corporation granted to an individual in connection with employment by that corporation (or its parent or subsidiary corporation), if all of the following requirements are met:

(1) The option is granted pursuant to a plan that specifies the number of shares to be issued and the employees or class of employees to receive the option. The plan must be approved by the stockholders of the corporation within 12 months before or after the date the plan is adopted;

(2) The option is granted within 10 years of the date the plan is adopted or approved by the shareholders, whichever occurs first;

(3) The option must, by its terms, be exercisable within 10 years of the date it is granted;

(4) The exercise price of the option is not less than the fair market value of the stock at the time it is granted;

(5) The option is nontransferable and exercisable only by the transferee (except that it may be transferred by will or the laws of descent and distribution); and

1. IRC Sec. 1223(5).
2. See Treas. Reg. §1.307-1(b).
3. See IRC Sec. 1234(a)(2).

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(6) The grantee of the option may not own stock representing more than 10 percent of the voting power of all classes of stock of the employer corporation, or its parent or subsidiary corporation. There is an exception to this rule where (i) the option price is at least 110 percent of the fair market value of the stock subject to the option, and (ii) the option is exercisable only within five years after it is granted.[1]

In determining the extent of an individual's ownership of stock for purposes of the 10 percent limitation, an individual will be considered to own stock of the employer corporation or of a related corporation that is owned (directly or indirectly) by the individual's brothers, sisters, spouse, ancestors, and lineal descendants.[2]

If the stock covered by options that *may be exercised* by any individual employee for the first time in a calendar year (under all plans of the employer corporation, and its parent and subsidiary corporations) has an aggregate fair market value that exceeds $100,000, the excess options may not be treated as incentive stock options. For purposes of the $100,000 limitation, the options are taken into account in the order in which they were granted, and their fair market value is determined as of the date the option was granted.[3]

An employee exercising an ISO may pay for the stock with stock of the corporation granting the option.[4] In determining whether the exercise price of the option is not less than the fair market value of the shares at the time the option is granted, a down payment required prior to exercise may be aggregated with the price to be paid at the time of exercise.[5]

7543. How is the grant of an incentive stock option taxed? How is the exercise of the option taxed?

No income is realized by the employee upon the grant of an incentive stock option. If the transfer of stock pursuant to exercise of an incentive stock option is a *qualifying transfer*, no income will be realized by the employee at the time the option is exercised.[6] The transfer will be a qualifying transfer if both of the following requirements are met:

(1) *Holding period requirement*: no *disposition* (defined below) of the stock may be made by the employee within two years of the date the option was granted, nor within one year of the date the stock was transferred to him or her pursuant to the option; and

(2) *Employment requirement*: the transferee must be employed by the corporation granting the option (or its parent or subsidiary) at all times from the date the option was granted until three months before the date of exercise.[7]

1. IRC Secs. 422(b), 422(c)(5); Treas. Reg. §1.422-2.
2. Treas. Reg. §1.424-1(d).
3. IRC Sec. 422(d).
4. IRC Sec. 422(c)(4)(A).
5. Let. Rul. 9109026.
6. IRC Sec. 421(a); Treas. Reg. §1.422-1(a)(1).
7. IRC Sec. 422(a).

If an employee becomes permanently and totally disabled, the three-month employment period is extended to 12 months.[1] In the case of the death of an employee, the employment and holding requirements are waived.[2]

If an incentive stock option is exercised by an individual who does not meet the employment requirement described above (except in the event of the employee's death), there will *not* be a qualifying transfer and the individual will recognize compensation income in the year the option is exercised. The amount of compensation income realized will be the excess, if any, of the fair market value of the stock over the exercise price of the option[3] (See Q 7547 regarding disqualifying transfers.).

In other words, if the employment requirement is met, the question of whether a transfer is a *qualifying transfer* can be answered with certainty only after the holding periods have been satisfied. If the holding periods and employment requirement are met, the taxpayer's subsequent disposition of the stock will be taxed as explained in Q 7546. If the one-year and two-year holding periods are not eventually satisfied, ordinary income is realized as of the date the option is exercised, which is *recognized* (i.e., taxed), in the year of the disposition, as explained in Q 7547.

For purposes of the holding period requirement, "disposition" includes sales, exchanges, gifts, and transfers of legal title. But the following will not constitute a disposition: (i) a transfer from a decedent to an estate or a transfer by bequest or inheritance; (ii) certain exchanges pursuant to a corporate reorganization or exchanges of stock for stock of the same corporation or a controlled corporation; or (iii) the making of a mere pledge or hypothecation. Additionally, the acquisition of stock as a joint tenant with right of survivorship or transfer of stock to joint ownership will not constitute a disposition until the joint tenancy is terminated.[4] A transfer between spouses or former spouses incident to divorce also will not be considered a disposition, and the transferee spouse will receive the same tax treatment that would have applied to the transferor.[5] The IRS determined that a transfer to a grantor trust, resulting in ownership of stock by a husband and wife with right of survivorship, did not constitute a disposition.[6]

For purposes of the one-year and two-year holding period requirements, a transfer resulting from bankruptcy proceedings will not be considered a disposition.[7] But such a transfer will be considered a disposition for purposes of the recognition of capital gain or loss.[8]

Generally, an individual's basis in stock acquired in a qualifying transfer upon exercise of an incentive stock option is the amount paid to exercise the option. (If there is a *disqualifying disposition*, the individual's basis is increased by amounts includable as compensation income (see Q 7547).

1. IRC Sec. 422(c)(6).
2. IRC Sec. 421(c)(1).
3. Treas. Reg. §1.422-1(c); IRC Sec. 83(a).
4. IRC Sec. 424(c).
5. IRC Sec. 424(c)(4).
6. Let Rul. 9021046.
7. IRC Sec. 422(c)(3).
8. Treas. Reg. §1.422-1(a)(2)(ii).

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In informational guidance released in 2002, the IRS analyzed whether the "deemed sale" election under Section 311(e) of TRA '97 (see Q 608) is a "disposition" within the meaning of IRC Section 424(c) under two circumstances: (1) where employees are holding incentive stock options that were granted to them prior to 2001, but that were not exercised as of January 1, 2001, and (2) where employees were granted incentive stock options and exercised those options during November 2000. In the first situation, the IRS stated that there is no provision in Section 311(e) or the incentive stock option rules providing for a "deemed exercise" of the option in order to have the holding period start in 2001. In the second situation, the Service stated it appeared that any deemed sale of the stock acquired upon exercise of an incentive stock option would be treated as a disqualifying disposition for purposes of the incentive stock option rules, thus triggering the application of IRC Section 83. The Service concluded by stating that the informational guidance did not constitute a ruling on any issue. The Service also recognized that the interaction of the incentive stock option rules with the Section 311(e) election is a novel issue that the Service has not yet addressed.[1]

The Service released regulations relating to the required return and information statements under IRC Section 6039.[2]

7544. Does the exercise of a stock option generate "wages" for FICA and FUTA tax purposes?

The term "wages" excludes remuneration received on account of the following: (1) a transfer of a share of stock to any individual pursuant to an exercise of an incentive stock option; or (2) any disposition by the individual of such stock. The exclusion applies to stock acquired pursuant to options exercised after October 22, 2004.[3]

Proposed regulations had provided that an individual exercising an incentive stock option would receive wages for FICA and FUTA purposes. But in 2002, the IRS announced that until further guidance was issued, the Service would not assess the FICA or FUTA tax, or apply federal income tax withholding obligations, upon the exercise of the option or upon the disposition of the stock acquired by an employee pursuant to the exercise of an option.[4] In AJCA 2004, Congress codified the exclusionary rule, above.

7545. How are stock options treated for alternative minimum tax purposes?

For purposes of the alternative minimum tax, the excess of the fair market value of the stock on the date of exercise of the option over the exercise price will be added to alternative minimum taxable income in the year the option is exercised, provided the taxpayer's rights are not subject to a substantial risk of forfeiture. But if the taxpayer is subject to the alternative minimum tax, the basis in the stock for alternative minimum tax purposes will be increased by the amount included in income.[5] A taxpayer with unvested stock may wish to make a special

1. INFO 2002-0137 (7-5-2002).
2. Treas. Regs. §§1.6039-1, 1.6039-2; TD 9470, 74 Fed. Reg. 59087 (11-17-2009).
3. IRC Sec. 3121(a)(22); Act Sec. 251(d), AJCA 2004.
4. REG-142686-01, 66 Fed. Reg. 57023 (11-14-2001); Notice 2002-47, 2002-2 CB 97. See also Notice 2001-72, 2001-2 CB 548, Notice 2001-73, 2001-2 CB 549.
5. IRC Sec. 56(b)(3).

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election under IRC Section 83(b) to include in gross income for the taxable year an amount equal to the excess of the fair market value of the property at the time it was transferred over the amount (if any) paid for such property. By making the special election, the adjustment for AMT purposes will be reported in the year the election is made instead of the year the stock actually vests. This may be beneficial if the stock price is expected to significantly appreciate before the stock vests.

The Service has stated that for tax years in which a taxpayer is liable for both incentive stock option AMT and non-incentive stock option AMT, it would apply the taxpayer's payments first to the non-incentive stock option liabilities and related interest and penalties (if any).[1]

2008 legislative relief for incentive stock options. As noted above, under the AMT a taxpayer must pay tax on the stock value when the option is exercised. The economic downturn in 2000 resulted in many individuals having to pay tax on "phantom income" because the stock prices dropped dramatically after the date of exercise. Congress provided relief for these situations in 2006, but recognized that additional relief was still needed to correct this problem. The Tax Extenders and Alternative Minimum Tax Relief Act of 2008 addressed problems concerning the treatment of certain underpayments, interest, and penalties attributable to the treatment of incentive stock options. The Act provided relief by (1) abating any underpayment of tax outstanding on the date of enactment related to incentive stock options and the AMT, including interest; (2) eliminating the income phase-out; and (3) extending and modifying the AMT credit allowance against incentive stock options. For details, see Q 653.[2]

7546. How is a disposition of stock acquired pursuant to the exercise of an incentive stock option taxed if the transfer of the stock to the individual was a qualifying transfer?

If the transfer of stock to an individual upon exercise of an incentive stock option was a *qualifying transfer* (see Q 7543), then no taxable event occurs until the stock is disposed of.[3] At the time of disposition, the general rules for treatment of a sale of stock will apply; thus, the taxpayer will recognize capital gain or loss to the extent of the difference between the sale price of the stock and its adjusted basis. See Q 7517 regarding the sale of stock, and Q 608 for an explanation of the treatment of capital gains and losses.

7547. What is the tax on disposition of stock acquired pursuant to the exercise of an incentive stock option if the requisite holding periods are not met?

If exercise of an incentive stock option would otherwise qualify as a nontaxable event except that the one-year or two-year holding requirement is not met (i.e., there is a *disqualifying disposition*), the employee's gain (if any) on the disposition will be treated as follows:

1. PMTA 2009-027 (2-12-2009).
2. IRC Sec. 53(f), as added by TEAMTRA 2008.
3. IRC Sec. 421(a).

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(i) Any gain that is *compensation attributable to the exercise of the option* will be taxed as ordinary income (and the employer will have a corresponding deduction) in the year the disposition occurs. "Compensation attributable to the exercise of the option" means the excess of the fair market value of the stock on the date the option was exercised over the amount paid for the share at the time of exercise. The employee's basis in the stock is then increased by the amount included as income.[1]

(ii) Any gain in excess of compensation attributable to the exercise of the option will be treated as capital gain. See Q 608 for the treatment of capital gains and losses.[2]

If, in a disqualifying disposition, the employee recognizes a loss, then the compensation income attributable to exercise of the option will be limited to the excess of the amount realized on disposition over the adjusted basis of the stock (i.e., generally the amount paid to exercise the option). This rule applies only to transactions in which loss would otherwise be allowable; it does not apply, for example, to losses on related party sales or wash sales. Thus, in the event that the disqualifying disposition is a related party sale, wash sale, or other transaction on which loss would be disallowed, the transferor will be required to recognize gain in the amount of the excess of the fair market value of the stock at the time the option was exercised *over* the option price. The income includable as a result of such a disposition will generally be treated as compensation.[3] It has been determined that where stock acquired through the exercise of an incentive stock option is transferred to a charitable remainder trust before the one-year holding period is up, the transfer will be treated as if a loss on a related party sale occurred. Thus, the transferor must include in gross income in the year of transfer the difference between the fair market value of the stock at the date the option was exercised *over* the option price.[4] In 2002, the Service announced an exception from reporting on Form 1099-B for transactions involving an employee, former employee, or other service provider who has obtained a stock option. Where the employee purchases stock through the exercise of the stock option, and then sells that stock on the same day through a broker, the broker executing such a sale is not required to report the sale on Form 1099-B provided certain conditions are met.[5]

Example 1: On June 1, 2014, CB Corporation grants an incentive stock option to Mr. Stephens, an employee of CB Corporation, entitling him to purchase one share of CB stock for $100, its fair market value on that date. Mr. Stephens exercises the option on August 1, 2014, and the stock is transferred to him the same day. Its fair market value on the date of exercise is $125. In order to meet the holding period requirements of IRC Section 422(a)(1), Mr. Stephens must not dispose of the stock before June 1, 2016. But Mr. Stephens transfers the stock on September 1, 2014, for $150 (the stock is transferable and not subject to a substantial risk of forfeiture). The amount of compensation attributable to Mr. Stephens' exercise of the option will be $25 (the excess of the fair market value on the date of exercise over the exercise price). On his 2014 return, as a result of the disposition of the stock, Mr. Stephens' will include $25 as compensation income and $25 as capital gain income. CB Corporation will be permitted a deduction of $25 for compensation attributable to Mr. Stephens' exercise of the option (assuming that no capital expenditure is involved).

1. IRC Sec. 421(b); Treas. Reg. §1.421-2(b)(1).
2. Treas. Reg. §1.421-2(b)(1)(ii), Example (2).
3. IRC Sec. 422(c)(2); Treas. Reg. §1.422-1(b)(2).
4. Let. Rul. 9308021.
5. See Rev. Proc. 2002-50, 2002-2 CB 173.

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If Mr. Stephens sold the stock in 2015 instead of 2014, he would include the $25 compensation income and the $25 capital gain as income on his 2015 return.

Example 2: Assume the same facts as example (1), except that instead of selling the stock on September 1, 2014, for $150, Mr. Stephens sells it for $75. The rule in IRC Section 422(c)(2) applies to limit the amount of income attributable to the exercise of the option to the excess (if any) of the sale price ($75) over the adjusted basis of the stock ($100). Mr. Stephens will not be required to recognize any compensation income, and he will be permitted a capital loss of $25 (the adjusted basis of the share minus the amount realized on the sale). CB Corporation will not be permitted any deduction for compensation attributable to Mr. Stephens' exercise of the option. If Mr. Stephens had, instead, sold the stock for $115, he would realize compensation income of $15 (the sale price minus his adjusted basis), but he would realize no capital gain income since the sale price was less than the amount that was the fair market value of the stock on the date he exercised the option.

Example 3: Assume the same facts as example (2), except that the sale on September 1, 2014, is to Mr. Stephens' daughter, Janice. Under the related party sale rules of IRC Section 267, no loss sustained on such a sale may be recognized. Thus, Mr. Stephens must recognize compensation income of $25 (the excess of the fair market value on the date of exercise over the exercise price) and will not recognize a capital gain or loss on the transaction. CB Corporation will be permitted a deduction of $25 for compensation attributable to Mr. Stephens' exercise of the option, provided certain withholding requirements are met.

Alternative Minimum Tax

If there is a recognizable loss on a disqualifying disposition in the same year as the exercise of the option, the taxpayer's alternative minimum taxable income will be increased only by the excess of the amount realized on disposition over the adjusted basis of the stock.[1] For a definition of "disposition," see Q 7543.

7548. What is the tax effect of modification, renewal, or extension of an incentive stock option?

The modification, renewal or extension of an incentive stock option is, for tax purposes, the equivalent of the granting of a new option; therefore, the requirements explained in Q 7542 will apply.[2] Thus a new option price is required if the fair market value of the stock is greater than the price of the original option, since the option price must equal at least 100 percent of the fair market value of the stock at the time the option is granted.

"Modification" generally means any change in the terms of the option that gives the employee additional benefits under the option. For example, a change that shortens the period during which the option is exercisable is not a modification. But a change that provides more favorable terms for the payment for the stock purchased under the option *is* a modification. A change in the number of shares subject to the option will not be considered a modification of the existing option, but it will constitute the grant of a new option with respect to the additional shares. But a change in the number or price of shares of stock subject to an option merely to reflect a stock dividend or stock split-up is not a modification of the option.[3]

1. IRC Sec. 56(b)(3).
2. IRC Sec. 424(h).
3. IRC Sec. 424(h)(1); Treas. Reg. §1.424-1(e)(4).

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The IRC states that the following changes in the terms of an option will not be considered a "modification": (i) changes attributable to certain corporate reorganizations and liquidations; and (ii) in the case of an option not immediately exercisable in full, changes that accelerate the time at which the option may be exercised.[1] For examples of reorganizations that did not result in modifications of options, see Letter Rulings 9810024 and 9849002.

The Service has privately ruled that a downward adjustment to the exercise price of a company's outstanding stock options, made to reflect a return of capital to the company's shareholders, was a "corporate transaction," and not a modification, extension, or renewal of those options.[2] A company's failure to adjust options to reflect a reverse stock split did not result in a modification.[3]

The IRS has determined that modification did not take place where the exercise of incentive stock options was conditioned on the achievement of performance-related goals which changed from time to time.[4]

The Service has also determined that an amendment to a plan, which would allow payment for option stock through constructive delivery (rather than physical delivery) of previously owned shares of company stock, would not result in modification of the options.[5]

7549. Is the special tax treatment for incentive stock options available if an incentive stock option and a stock appreciation right are granted together?

Under long-standing rules (the status of which, as discussed below, is not clear), the tax treatment provided for incentive stock options has been available for the combination of an incentive stock option (ISO) and a stock appreciation right (SAR) even though the right to exercise one affects the right to exercise the other, provided the SAR, by its terms, meets certain requirements:

(1) The SAR will expire no later than the expiration of the underlying ISO.

(2) The SAR may be for no more than 100 percent of the spread (i.e., the difference between the exercise price of the underlying option and the market price of the stock subject to the underlying option at the time the SAR is exercised).

(3) The SAR is transferable only when the underlying ISO is transferable, and under the same conditions.

(4) The SAR may be exercised only when the underlying ISO is eligible to be exercised.

1. IRC Sec. 424(h)(3).
2. Let. Rul. 9801030.
3. Let. Rul. 200007033.
4. Let. Rul. 8444071.
5. See Let. Ruls. 9809025, 200207005.

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(5) The SAR may be exercised only when there is a positive spread (i.e., when the market price of the stock subject to the option exceeds the exercise price of the option).

The SAR could be paid in either cash or property or a combination thereof, so long as any amounts paid are includable in income under IRC Section 83.[1]

When the IRS issued final ISO regulations in August 2004, however, it removed the previous rules, apparently without comment. It is unclear whether the pre-existing rules are still valid.

A SAR granted after an ISO as a matter of right upon satisfaction of a condition and pursuant to a common plan or plans will be considered to have been granted at the same time as the ISO for purposes of IRC Section 422 so long as the SAR otherwise meets the above requirements.[2]

1. Temp. Treas. Reg. §14a.422A-1, A-39, removed by T.D. 9144, 69 Fed. Reg. 46401 (August 3, 2004).
2. Let. Rul. 9032016.

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