

UPDATED
for American Taxpayer Relief Act
(enacted January 2, 2013)

Capital Gains & Losses

Making Sense of Investment Transactions & Options

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The Evolution of Math

- **Traditional Math (1960):** A logger sells lumber for \$100; cost of production is $\frac{4}{5}$ of the price. What is his profit?
- **Equal Opportunity Math (1980):** A logger sells a truckload of lumber for \$100. His (or her) cost of production is \$80 and his (or her) profit is \$20. Underline the number 20.
- **Entrepreneurial Math (2000):** By laying off 40% of its loggers, a company improves its stock price from \$80 to \$100. How much *capital gain* per share does the CEO make by exercising his stock options at \$80?

PART I

Capital Transactions



What we'll cover...

- Investment Transactions
- Mutual Funds
- Worthless Securities
- Short Sales & Margin Trading
- Wash Sales
- Small Business Stock
- Real Estate Transactions
- Foreclosures
- Demutualization
- Viatical Settlements
- ISOs & NOLs
- Tax Planning Strategies



CAPITAL ASSETS

Everything owned for personal or investment purposes, EXCEPT:

- Inventory held for resale to customers
- Depreciable property used in a trade or business
- Intellectual property
- Accounts receivable

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CAPITAL TRANSACTIONS

- Involve acquisition & disposition of capital assets

→ First you have it; then you don't



- Not necessarily in that order

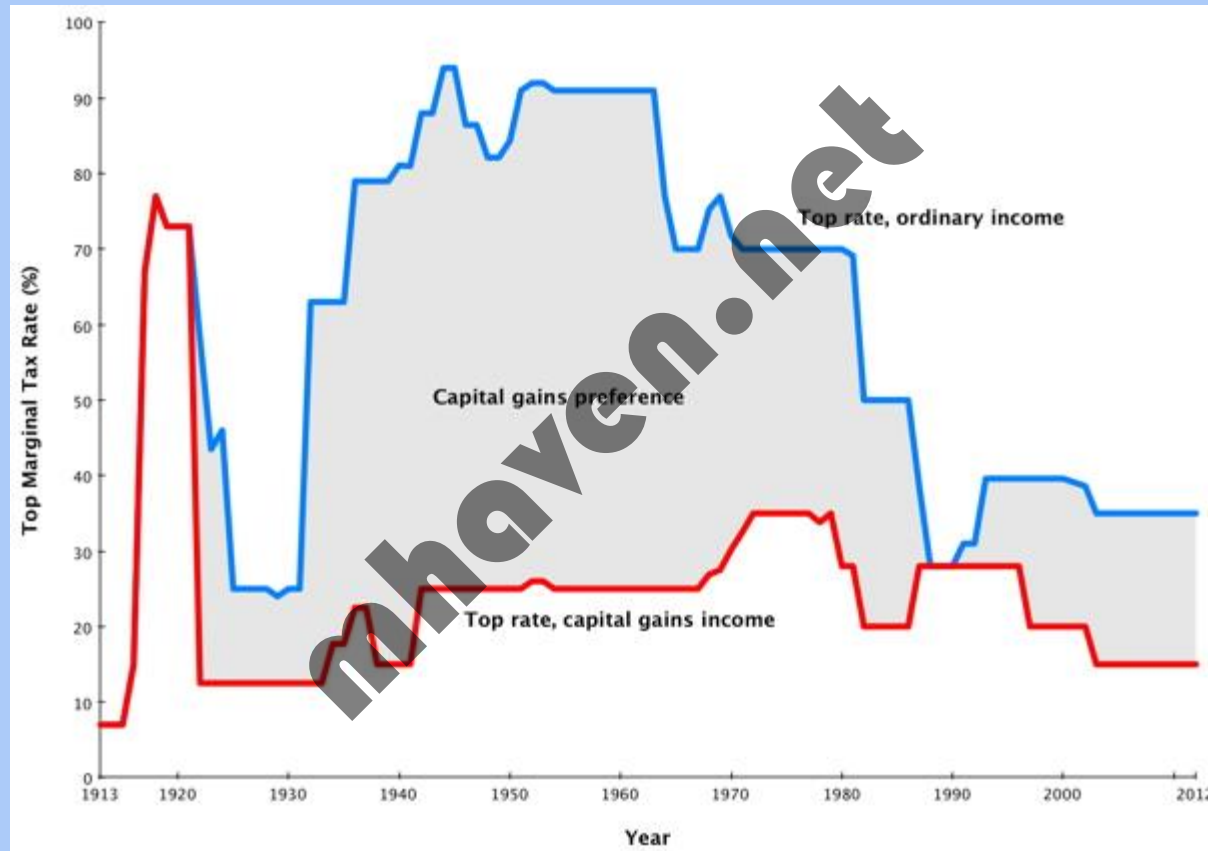
DISPOSITIONS

- **Sale = transfer of property for money**
- **Exchange = transfer of property for other property or services**
- **BOTH have a realization requirement**
- **Purpose of realization:**
 - **Reduce administrative burden**
 - **Have liquid funds available to pay the tax**
 - **Maintain ability to time the transaction**

NOTE: Mere exchange of property is insufficient – must have transfer of benefits & burdens of ownership

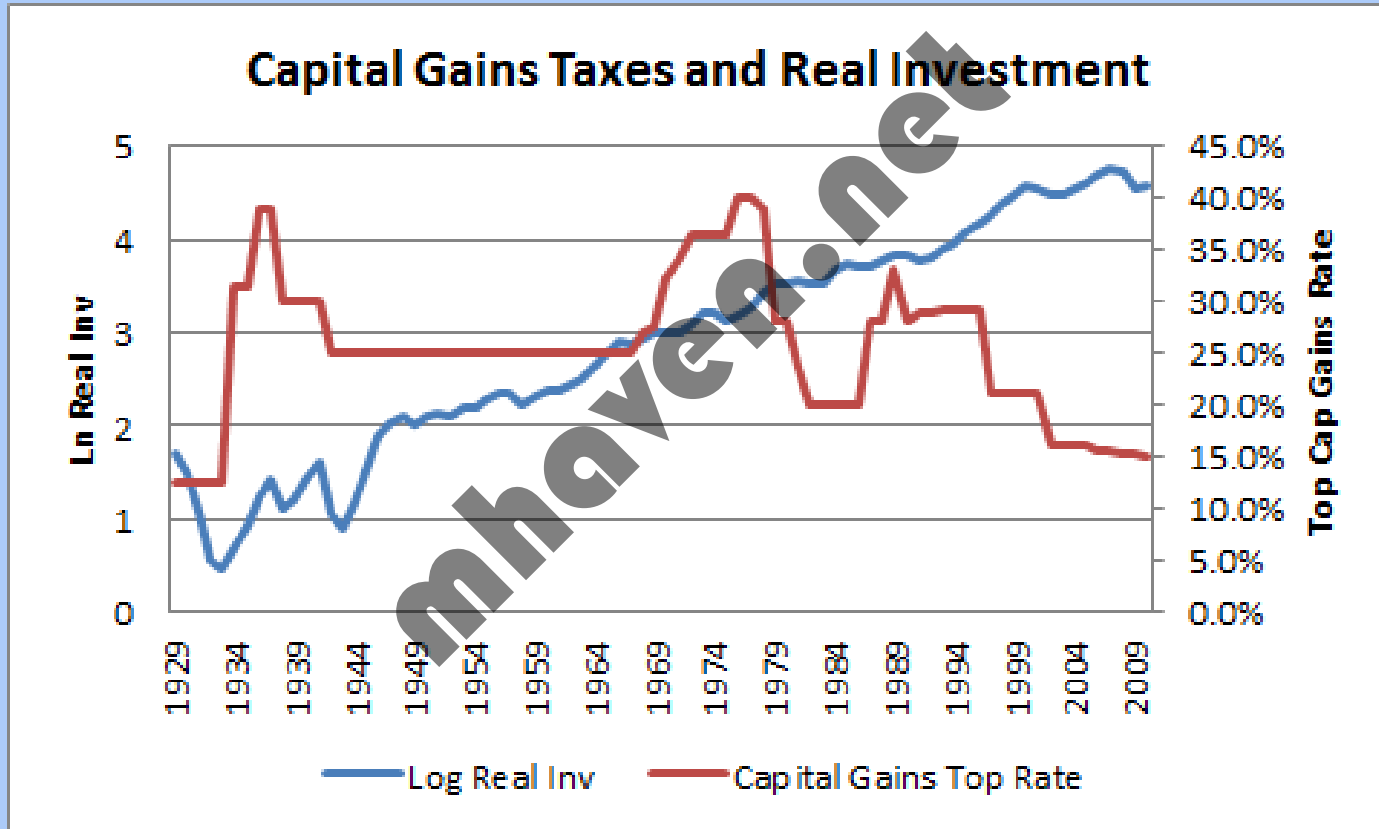
HISTORICAL TAX RATES

(Washington Post, September 24, 2012)



EFFECT ON INVESTMENTS

(Washington Post, January 19, 2012)



PURPOSE OF FAVORABLE RATES

- **Bunching of Income**
 - Realization of accrued profits force taxpayers into higher marginal brackets
 - BUT usually realized by high-income earners already in maximum bracket
- **Inflationary Effects**
 - Accumulated growth is not inflation-adjusted
 - BUT offer disproportionate benefit to taxpayers who realize gains in excess of inflation
- **Economic Incentive**
 - Stimulate investment in capital assets & encourage economic growth
 - BUT may encourage inefficient allocation of assets (away from income-producing assets)
- **Lock-in Effect**
 - Encourage sale of assets that would otherwise escape taxation
 - BUT taxes on realized gains; unrealized gains continue to escape taxation

CG RATES

(2012)

Taxpayer's Tax Bracket	STCG \leq 1 year	LTCG > 1 year & Qualified Dividends	§ 1250 Deprec. Recapture	Collectibles & § 1202 Sm. Bus. Stock
10 & 15%	10 or 15%	0% (through 12/31/12)	25%	28%
25 to 35%	25 to 35%	15% (through 12/31/12)	25%	28%

- **Collectibles = artwork, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, tangible personal property**
- **Certain U.S. gold and silver coins exempt from definition of § 5112 (a) of Title 31, United States Code**

COLLECTIBLES



- Artwork, rugs, antiques, metals, gems, stamps, coins, alcoholic beverages, alcoholic beverages, musical instruments (not used in the course of a trade or business), historical objects and documents, tangible personal property
- Special Rules to Note:
 1. ETFs that invest directly in precious metals will be subject to tax at 28%.
 2. Collectibles may not be held in IRA accounts – if purchased, cost will be treated as a distribution (subject to tax and penalties).

CG RATES (2013)

UPDATE!

Taxpayer's Tax Bracket	STCG ≤ 1 year	LTCG > 1 year & Qualified Dividends	§ 1250 Deprec. Recapture	Collectibles & § 1202 Sm. Bus. Stock
10 & 15%	10 or 15%	0% PERMANENT	25%	28%
25 to 35%	25 to 35%	20%	25%	28%

Another way of looking at it...

Single	MFJ	CG Tax Rate	Medicare Surtax (on investment income)	Combined Rate
\$0 - 36,250	\$0 - 72,500	0%	0%	0%
\$36,250 - 200,000	\$72,500 - 250,000	15%	0%	15%
\$200,000 - 400,000	\$250,000 - 450,000	15%	3.8%	18.8%
> \$400,000	> \$450,000	20%	3.8%	23.8%

MEDICARE SURTAXES

(IRC § 1411)

UPDATE!

- **Earned Income Surtax (0.9%)**
 - Applies to wage-earners and self-employed taxpayers with incomes > \$200K (\$250K MFJ, \$125K MFS)
 - Medicare portion of payroll tax increase rises from 2.9% to 3.8%
- **Investment Income Surtax (3.8%)**
 - Net investment income > \$200K (\$250K MFJ, \$125K MFS) subject to Medicare tax of 3.8%
 - Investment income: Dividends, interest, net capital gains, annuities, royalties, net rents, gain on sale of 1^o residence > §121 exclusion, income from flow-through entities if passive
 - Sources excluded: Tax-exempt interest, VA benefits, self-employed income, IRA, pension distributions

NOTE: Taxpayers may be subject to *both* surtaxes!

MEDICARE SURTAXES

Example # 1

UPDATE!

- In 2013, single taxpayer earns \$140K from wages & \$90K from interest income
- Taxpayer subject to surtax on lesser of investment income (\$90K) or amount over allowable threshold (\$30K = \$230K – 200K)
- Surtax \$1,140 = 3.8% on \$30K



MEDICARE SURTAXES

Example # 2

UPDATE!

- In 2013, single taxpayer earns \$220K from wages & \$100K from interest income
- Taxpayer subject to surtax on lesser of investment income (\$100K) or amount over allowable threshold (\$120K = \$320K – 200K) → Investment Surtax
 $\$3,800 = 3.8\%$ on \$100K
- Taxpayer subject to surtax on wages over allowable threshold (\$20K = \$220K – 200K) → Earned Income Surtax
 $\$180 = 0.9\%$ on \$20K



MEDICARE SURTAXES

Special Rules

UPDATE!

- Surtax does not apply to trade or business income (e.g. passive activities)
- Threshold amounts are not prorated for short taxable year due to death
- Threshold amounts are not indexed for inflation
- Child's investment income is included in parent's income for threshold computation if parents elect to report income using Form 8814



MEDICARE SURTAXES

Special Rules (continued)

UPDATE!

- **Net Investment Income may be reduced by allocable deductions**
 - Investment interest
 - Deductions from rents & royalties (e.g. depletion)
 - Investment advisory fees & other expenses
 - Penalty on early withdrawal of savings
 - Allocable state, local and foreign income taxes

NOTE

- **NOL carry-overs (even if attributable to investment income) may not be deducted**
- **Excess capital loss (\$3,000) may not be deducted**

SPECIAL RATE PERMANENT

UPDATE!

Amount of CGs taxed at 0% =
Top end of 15% marginal tax bracket – Taxable income less adjusted net capital gain

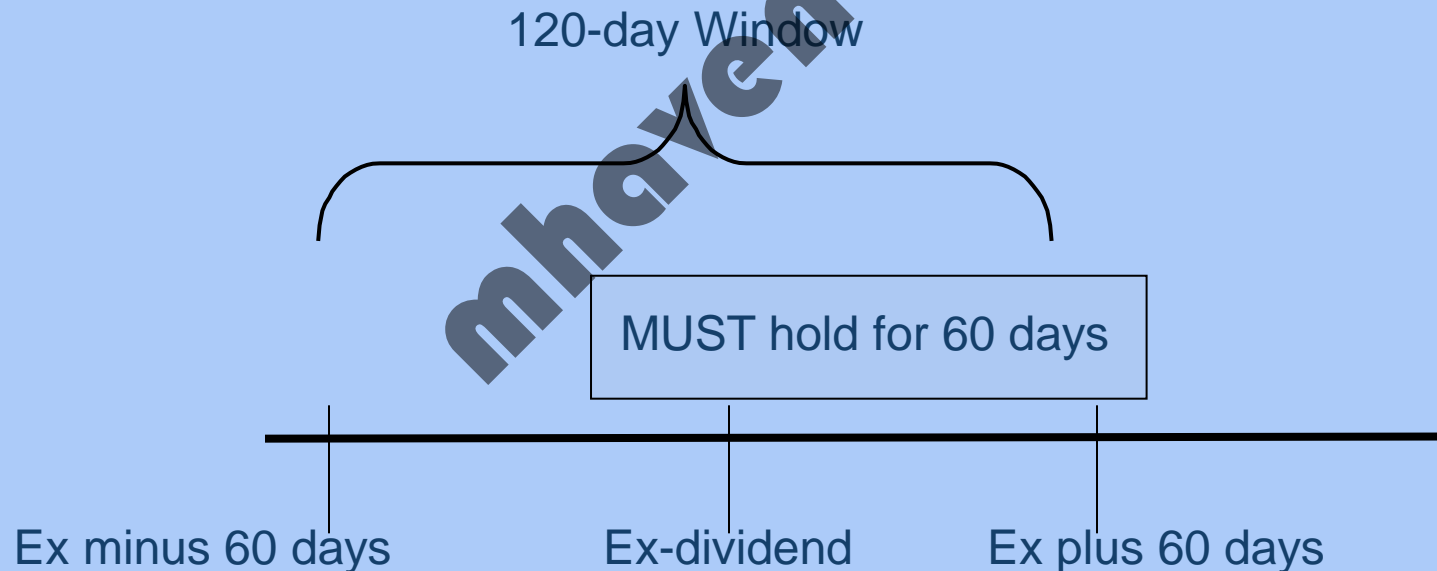
- Married couple has income of \$65,000 from qualified dividends. Falling below the top end of the marginal bracket, all of the couple's income will be taxed at 0%.
- Married couple has income of \$65,000, consisting of \$55,000 Ordinary Income and \$10,000 LTCG. \$10,100 of LTCGs (= \$65,100 – 55,000) are eligible for 0% tax and so all of the taxpayers' LTCGs will qualify.
- A single taxpayer has \$38,000 of income, consisting of \$32,000 Ordinary Income and \$6,000 LTCG. Only \$550 (= \$32,550 – 32,000) of taxpayer's LTCG is eligible for 0%; the remainder is taxed at 15%.
- Married couple has income of \$160,000, including \$140,000 LTCGs. The 0% rate will apply to \$45,100 of their LTCGs (= \$65,100 - \$20,000 regular taxable income).

QUALIFIED DIVIDENDS

PERMANENT

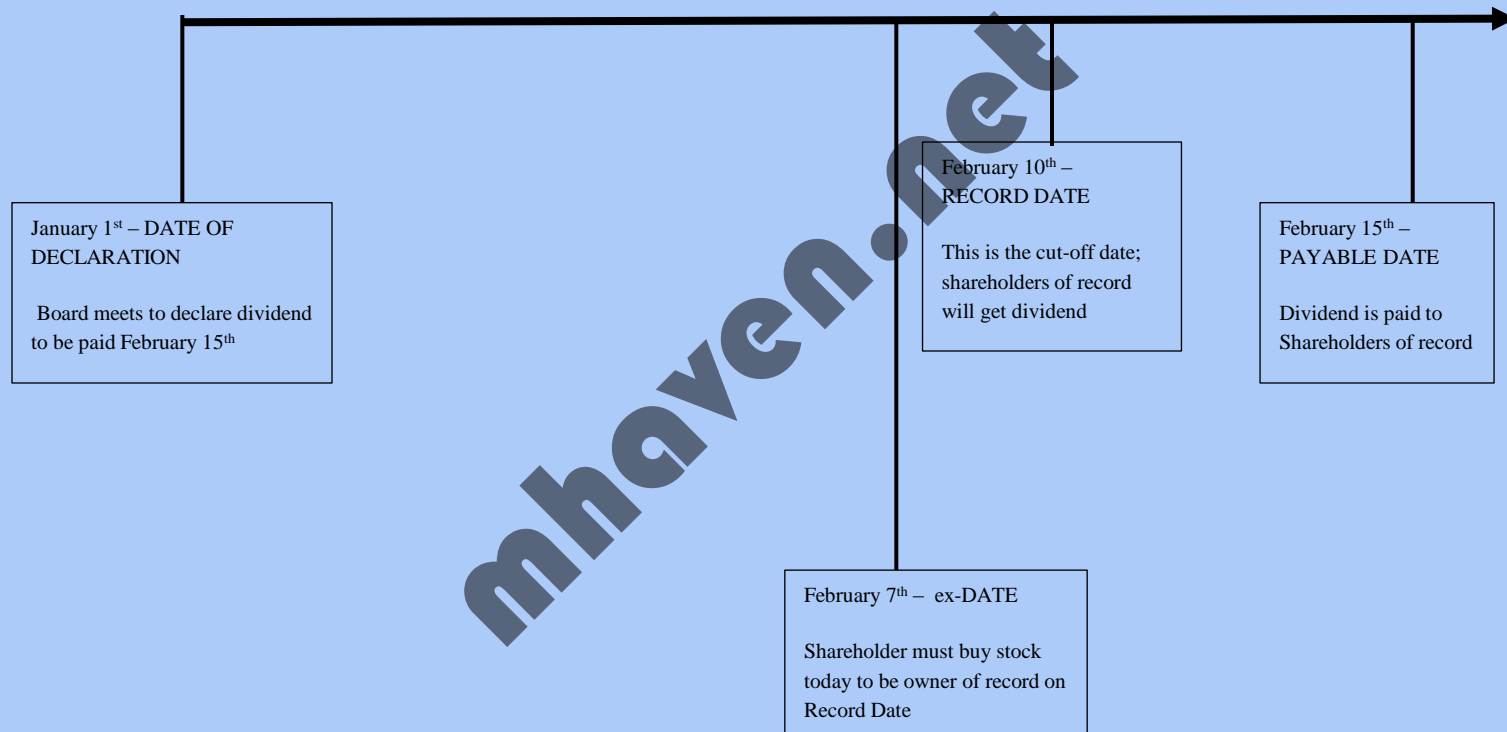
UPDATE!

- Taxed at LT capital gain rate
- Investor must hold common or preferred stock for > 60 days during 120-day period that began 60 days before ex-dividend date



DIVIDENDS

(Remember: “DeRP”)



QUALIFIED DIVIDENDS

Rules to Note

- Dividends the do *not* qualify:
 - REITs
 - S-Corps
 - STCGs from mutual funds
- Tax treatment is automatic

NOTE: To treat qualified dividends as investment income instead, affirmative election must be made on Form 4952



NON-RESIDENT ALIENS

- NRAs do not satisfy Green Card or Substantial Presence Tests
- Taxed only on US-sourced income
- NRA in US > 183 days is taxed on net capital gains (30% rate)
 - Do not net capital loss carry-forwards, § 1202 Small Business Stock or casualty losses
 - Do not net losses which are *not* effectively connected

NOTE: While losses may not be netted, gains from sources *not* effectively connected are still taxed (!)
- NRA in US < 183 days is taxed only on gains that are effectively connected (= derived from US trade or business)

NOTE: NRAs are not subject to Medicare Surtax on Investment Income

UPDATE!

REPORTING GAINS & LOSSES PERSONAL USE

Report on Schedule D:

- Part I for STCGs
- Part II for LTCGs

Except:

- Losses due to casualties and thefts on Form 4684
- If the property was partially used for business, gains and losses from business portion on Form 4797
- Condemnations on Form 4797
- Securities traders using mark-to-market election on Form 4797

NOTE: Losses incurred on personal property are non-deductible

SCHEDULE D

SCHEDULE D (Form 1040) **Capital Gains and Losses** OMB No. 1545-0074

Department of the Treasury Internal Revenue Service (99) **2011** Attachment Sequence No. 12

▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040). ▶ Use Form 8949 to list your transactions for lines 1, 2, 3, 8, 9, and 10.

Name(s) shown on return Your social security number

Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less

Complete Form 8949 before completing line 1, 2, or 3. This form may be easier to complete if you round off cents to whole dollars.

	(e) Sales price from Form(s) 8949, line 2, column (e)	(f) Cost or other basis from Form(s) 8949, line 2, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 2, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
1 Short-term totals from all Forms 8949 with box A checked in Part I		()		
2 Short-term totals from all Forms 8949 with box B checked in Part I		()		
3 Short-term totals from all Forms 8949 with box C checked in Part I		()		

4 Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824	4
5 Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1	5
6 Short-term capital loss carryover. Enter the amount, if any, from line 8 of your Capital Loss Carryover Worksheet in the instructions	6 ()
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (h). If you have any long-term capital gains or losses, go to Part II below. Otherwise, go to Part III on the back	7

Part II Long-Term Capital Gains and Losses—Assets Held More Than One Year

Complete Form 8949 before completing line 8, 9, or 10. This form may be easier to complete if you round off cents to whole dollars.

	(e) Sales price from Form(s) 8949, line 4, column (e)	(f) Cost or other basis from Form(s) 8949, line 4, column (f)	(g) Adjustments to gain or loss from Form(s) 8949, line 4, column (g)	(h) Gain or (loss) Combine columns (e), (f), and (g)
8 Long-term totals from all Forms 8949 with box A checked in Part II		()		
9 Long-term totals from all Forms 8949 with box B checked in Part II		()		
10 Long-term totals from all Forms 8949 with box C checked in Part II		()		
11 Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11
12 Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12
13 Capital gain distributions. See the instructions				13
14 Long-term capital loss carryover. Enter the amount, if any, from line 13 of your Capital Loss Carryover Worksheet in the instructions				14 ()
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (h). Then go to Part III on the back				15

For Paperwork Reduction Act Notice, see your tax return instructions. Cat. No. 11338H Schedule D (Form 1040) 2011

Part III Summary

16 Combine lines 7 and 15 and enter the result 16

- If line 16 is a gain, enter the amount from line 16 on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below.
- If line 16 is a loss, skip lines 17 through 20 below. Then go to line 21. Also be sure to complete line 22.
- If line 16 is zero, skip lines 17 through 21 below and enter -0- on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 22.

17 Are lines 15 and 16 both gains?
 Yes. Go to line 18.
 No. Skip lines 18 through 21, and go to line 22.

18 Enter the amount, if any, from line 7 of the 28% Rate Gain Worksheet in the instructions 18

19 Enter the amount, if any, from line 18 of the Unrecaptured Section 1250 Gain Worksheet in the instructions 19

20 Are lines 18 and 19 both zero or blank?
 Yes. Complete Form 1040 through line 43, or Form 1040NR through line 41. Then complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42). Do not complete lines 21 and 22 below.
 No. Complete Form 1040 through line 43, or Form 1040NR through line 41. Then complete the Schedule D Tax Worksheet in the instructions. Do not complete lines 21 and 22 below.

21 If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the smaller of:
 • The loss on line 16 or
 • (\$3,000), or if married filing separately, (\$1,500) 21 ()

Note. When figuring which amount is smaller, treat both amounts as positive numbers.

22 Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b?
 Yes. Complete Form 1040 through line 43, or Form 1040NR through line 41. Then complete the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040, line 44 (or in the instructions for Form 1040NR, line 42).
 No. Complete the rest of Form 1040 or Form 1040NR.

REPORTING GAINS & LOSSES BUSINESS USE

Report on:

- Long-term transactions are reported on Part I; short-term on Part II
- Transactions involving depreciable assets are reported on Part III to allow for the recapture of depreciation taken or allowable
- Part IV is used to calculate the depreciation recapture on listed property where business use has fallen below 50% or on property for which the §179 expense was taken
- Casualty losses are reported on Form 4684, Part B

FORM 4797

Form 4797 Department of the Treasury Internal Revenue Service (99)	Sales of Business Property (Also Involuntary Conversions and Recapture Amounts Under Sections 179 and 280F(b)(2)) ▶ Attach to your tax return. ▶ See separate instructions.	OMB No. 1545-0184 2011 Attachment Sequence No. 27					
Name(s) shown on return		Identifying number					
1 Enter the gross proceeds from sales or exchanges reported to you for 2011 on Form(s) 1099-B or 1099-S (or substitute statement) that you are including on line 2, 10, or 20 (see instructions)		1					
Part I Sales or Exchanges of Property Used in a Trade or Business and Involuntary Conversions From Other Than Casualty or Theft—Most Property Held More Than 1 Year (see instructions)							
2	(a) Description of property	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)	(d) Gross sales price	(e) Depreciation allowed or allowable since acquisition	(f) Cost or other basis, plus improvements and expense of sale	(g) Gain or (loss) Subtract (f) from the sum of (d) and (e)
3	Gain, if any, from Form 4684, line 39						3
4	Section 1231 gain from installment sales from Form 6252, line 26 or 37						4
5	Section 1231 gain or (loss) from like-kind exchanges from Form 8824						5
6	Gain, if any, from line 32, from other than casualty or theft						6
7	Combine lines 2 through 6. Enter the gain or (loss) here and on the appropriate line as follows: Partnerships (except electing large partnerships) and S corporations. Report the gain or (loss) following the instructions for Form 1065, Schedule K, line 10, or Form 1120S, Schedule K, line 9. Skip lines 8, 9, 11, and 12 below. Individuals, partners, S corporation shareholders, and all others. If line 7 is zero or a loss, enter the amount from line 7 on line 11 below and skip lines 8 and 9. If line 7 is a gain and you did not have any prior year section 1231 losses, or they were recaptured in an earlier year, enter the gain from line 7 as a long-term capital gain on the Schedule D filed with your return and skip lines 8, 9, 11, and 12 below.						7
8	Nonrecaptured net section 1231 losses from prior years (see instructions)						8
9	Subtract line 8 from line 7. If zero or less, enter -0-. If line 9 is zero, enter the gain from line 7 on line 12 below. If line 9 is more than zero, enter the amount from line 8 on line 12 below and enter the gain from line 9 as a long-term capital gain on the Schedule D filed with your return (see instructions)						9
Part II Ordinary Gains and Losses (see instructions)			10 Ordinary gains and losses not included on lines 11 through 16 (include property held 1 year or less):				
11	Loss, if any, from line 7						11
12	Gain, if any, from line 7 or amount from line 8, if applicable						12
13	Gain, if any, from line 31						13
14	Net gain or (loss) from Form 4684, lines 31 and 38a						14
15	Ordinary gain from installment sales from Form 6252, line 25 or 36						15
16	Ordinary gain or (loss) from like-kind exchanges from Form 8824						16
17	Combine lines 10 through 16						17
18	For all except individual returns, enter the amount from line 17 on the appropriate line of your return and skip lines a and b below. For individual returns, complete lines a and b below: a If the loss on line 11 includes a loss from Form 4684, line 35, column (b)(ii), enter that part of the loss here. Enter the part of the loss from income-producing property on Schedule A (Form 1040), line 28, and the part of the loss from property used as an employee on Schedule A (Form 1040), line 23. Identify as from "Form 4797, line 18a." See instructions b Redetermine the gain or (loss) on line 17 excluding the loss, if any, on line 18a. Enter here and on Form 1040, line 14						18a 18b

For Paperwork Reduction Act Notice, see separate instructions. Cat. No. 130868 Form 4797 (2011)

Form 4797 (2011)		Page 2			
Part III Gain From Disposition of Property Under Sections 1245, 1250, 1252, 1254, and 1255 (see instructions)					
19	(a) Description of section 1245, 1250, 1252, 1254, or 1255 property:	(b) Date acquired (mo., day, yr.)	(c) Date sold (mo., day, yr.)		
A					
B					
C					
D					
These columns relate to the properties on lines 19A through 19D.		Property A	Property B	Property C	Property D
20	Gross sales price (Note: See line 1 before completing)	20			
21	Cost or other basis plus expense of sale	21			
22	Depreciation (or depletion) allowed or allowable	22			
23	Adjusted basis. Subtract line 22 from line 21	23			
24	Total gain. Subtract line 23 from line 20	24			
25	If section 1245 property:				
a	Depreciation allowed or allowable from line 22	25a			
b	Enter the smaller of line 24 or 25a	25b			
26	If section 1250 property: If straight line depreciation was used, enter -0- on line 26g, except for a corporation subject to section 291.				
a	Additional depreciation after 1975 (see instructions)	26a			
b	Applicable percentage multiplied by the smaller of line 24 or line 26a (see instructions)	26b			
c	Subtract line 26a from line 24. If residential rental property or line 24 is not more than line 26a, skip lines 26d and 26e	26c			
d	Additional depreciation after 1969 and before 1976	26d			
e	Enter the smaller of line 26c or 26d	26e			
f	Section 291 amount (corporations only)	26f			
g	Add lines 26b, 26e, and 26f	26g			
27	If section 1252 property: Skip this section if you did not dispose of farmland or if this form is being completed for a partnership (other than an electing large partnership).				
a	Soil, water, and land clearing expenses	27a			
b	Line 27a multiplied by applicable percentage (see instructions)	27b			
c	Enter the smaller of line 24 or 27b	27c			
28	If section 1254 property:				
a	Intangible drilling and development costs, expenditures for development of mines and other natural deposits, mining exploration costs, and depletion (see instructions)	28a			
b	Enter the smaller of line 24 or 28a	28b			
29	If section 1255 property:				
a	Applicable percentage of payments excluded from income under section 126 (see instructions)	29a			
b	Enter the smaller of line 24 or 29a (see instructions)	29b			
Summary of Part III Gains. Complete property columns A through D through line 29b before going to line 30.					
30	Total gains for all properties. Add property columns A through D, line 24	30			
31	Add property columns A through D, lines 25b, 26g, 27c, 28b, and 29b. Enter here and on line 13	31			
32	Subtract line 31 from line 30. Enter the portion from casualty or theft on Form 4684, line 33. Enter the portion from other than casualty or theft on Form 4797, line 6	32			
Part IV Recapture Amounts Under Sections 179 and 280F(b)(2) When Business Use Drops to 50% or Less (see instructions)					
		(a) Section 179	(b) Section 280F(b)(2)		
33	Section 179 expense deduction or depreciation allowable in prior years	33			
34	Recaptured depreciation (see instructions)	34			
35	Recapture amount. Subtract line 34 from line 33. See the instructions for where to report	35			

Form 4797 (2011)



NEW FORMS FOR 2011 & BEYOND

- **Capital transactions are entered into ST and LT sections on Form 8949, totaled & then transferred to Schedule D**
- **Transactions are further segregated into:**
 - A. **Transactions reported on Form 1099-B with basis reported to the IRS**
 - B. **Transactions reported on Form 1099-B but basis not reported to the IRS**
 - C. **Transactions for which you cannot check box A or B**
- **Financial institutions are currently required to report basis only for sales of stock shares purchased on or after January 1, 2011**
- **Additional reporting requirements will follow:**
 - **Mutual funds (January 1, 2012)**
 - **Bonds & options (January 1, 2014)**

E-FILE REQUIREMENTS

In lieu of individual line entries on Form 8949, taxpayer may submit brokerage statement(s) of all transactions

- Must show sales price as well as basis of each asset sold
- Do not enter “Available on Request”
- Report totals from each broker on a separate line
- Submit with Form 8453 to IRS



FORM 8453

Declaration Control Number (DCN)		00 - [] - [] - 3		IRS Use Only - Do not write or staple in this space.
Form 8453		U.S. Individual Income Tax Transmittal for an IRS e-file Return		OMB No. 1545-0074
Department of the Treasury Internal Revenue Service		For the year January 1-December 31, 2012		2012
		▶ See instructions on back.		
Please print or type.	P R I N T C L E A R L Y	Your first name and initial	Last name	Your social security number
		If a joint return, spouse's first name and initial	Last name	Spouse's social security number
		Home address (number and street). If you have a P.O. box, see instructions.		Apt. no.
		City, town or post office, state, and ZIP code (if a foreign address also complete spaces below.)		
		Foreign country name	Foreign province/country	Foreign postal code
FILE THIS FORM ONLY IF YOU ARE ATTACHING ONE OR MORE OF THE FOLLOWING FORMS OR SUPPORTING DOCUMENTS.				
Check the applicable box(es) to identify the attachments.				
<input type="checkbox"/> Appendix A, Statement by Taxpayer Using the Procedures in Rev. Proc. 2009-20 to Determine a Theft Loss Deduction Related to a Fraudulent Investment Arrangement				
<input type="checkbox"/> Form 1098-C, Contributions of Motor Vehicles, Boats, and Airplanes (or equivalent contemporaneous written acknowledgement)				
<input type="checkbox"/> Form 2848, Power of Attorney and Declaration of Representative (or POA that states the agent is granted authority to sign the return)				
<input type="checkbox"/> Form 3115, Application for Change in Accounting Method				
<input type="checkbox"/> Form 3468 - attach a copy of the first page of NPS Form 10-168a, Historic Preservation Certification Application (Part 2—Description of Rehabilitation), with an indication that it was received by the Department of the Interior or the State Historic Preservation Officer, together with proof that the building is a certified historic structure (or that such status has been requested)				
<input type="checkbox"/> Form 4136 - attach the Certificate for Biodiesel and, if applicable, Statement of Biodiesel Reseller or a certificate from the provider identifying the product as renewable diesel and, if applicable, a statement from the reseller				
<input type="checkbox"/> Form 5713, International Boycott Report				
<input type="checkbox"/> Form 8283, Noncash Charitable Contributions, Section A, (if any statement or qualified appraisal is required) or Section B, Donated Property, and any related attachments (including any qualified appraisal or partnership Form 8283)				
<input type="checkbox"/> Form 8332, Release / Revocation of Release of Claim to Exemption for Child by Custodial Parent (or certain pages from a divorce decree or separation agreement, that went into effect after 1984 and before 2009) (see instructions)				
<input type="checkbox"/> Form 8858, Information Return of U.S. Persons With Respect to Foreign Disregarded Entities				
<input type="checkbox"/> Form 8864 - attach the Certificate for Biodiesel and, if applicable, Statement of Biodiesel Reseller or a certificate from the provider identifying the product as renewable diesel and, if applicable, a statement from the reseller				
<input type="checkbox"/> Form 8885, Health Coverage Tax Credit, and all required attachments				
<input type="checkbox"/> Form 8949, Sales and Other Dispositions of Capital Assets, (or a statement with the same information), if you elect not to report your transactions electronically on Form 8949				
DO NOT SIGN THIS FORM.				
For Paperwork Reduction Act Notice, see your tax return instructions.				
			Cat. No. 62786T	Form 8453 (2012)



HOLDING PERIOD

- Use trade date not settlement date [Rev Rul 93-14]
 - LT treatment begins 1 day after acquisition; ends on date of disposition
- Holding period = 1 year & 1 day

TAXPAYERS PREFER...

ST Losses; LT Gains

Short-term Gains (STG)

- Short-term Losses (STL)

= Net Short-Term

Long-term Gains (LTG)

- Long-term Losses (LTL)

= Net Long-Term

Net Gain or Loss

Character

- ST if Net ST > Net LT
- LT if Net ST < Net LT
- Retain character if Net ST cannot be netted against Net LT



ORDERING OF CAPITAL LOSSES

Losses must be used to offset gains in the following order:

STCLs must be used against...

1. STCGs
2. Net LTCGs taxed at 28% (collectibles & small business stock)
3. Net LTCGs taxed at 25% (recapture property)
4. Net CGs taxed at 0% or 15% (depending upon the taxpayer's marginal bracket)

LTCLs must be used against...

1. Net LTCLs from 28% rate against LTCGs from 25%
2. Net LTCLs from 28% rate against LTCGs from 0 or 15%
3. Net LTCLs from 0 or 15% against LTCGs from 28%
4. Net LTCLs from 0 or 15% against LTCGs from 25%

NOTE: Net losses are always applied to highest-rate gains first; then to lesser-rate gains from 28% down to 0 or 15%.

CAPITAL LOSSES

Special Rules

- **Excess Losses**
 - May deduct up to \$3,000 of net capital losses against ordinary income
 - Remainder is carried forward indefinitely & retains character
 - **Year of Death**
 - May be claimed on decedent's final tax return
 - Unused losses may not be carried forward
 - **Related Party Transactions**
 - Losses are disallowed
 - Cannot use distant relative as nominee for closer relative
- NOTE:** spouse, child, grandchild, parent, grandparent, great-grandparent, sibling and controlled entity

CAPITAL LOSS CARRY-FORWARDS & CA RESIDENCY

- When moving *into* CA:
 - CA-sourced loss carry-forwards may be used
 - Loss carry-forwards from securities sales cannot be used
- When moving *from* CA:
 - In-state loss carry-forwards cannot be taken out-of-state
- Part-year residents:
 - Capital loss carry-overs for current year must be pro-rated
 - Capital loss carry-overs for future years must be restated for residency status at end of current tax year

CLAIM OF RIGHT

RULE: Income is taxable when taxpayer has claim to it

- Oil royalties earned in 1916 were not released to taxpayer until 1917
- Ownership dispute was not settled until 1922
 - taxpayer reported earnings at that time
 - BUT Court held that taxpayer received taxable income in 1917
- Imagine if taxpayer was required to disgorge income in 1922...
- Imagine further if income had initially been “capital”...
 - then disgorgement would be “capital” but deduction limited to \$3K!

EXAMPLE: LANCE ARMSTRONG

- Armstrong may be required to return up to \$5 million of bonus payments previously received (already taxed as ordinary income at highest marginal rate when earned)
- Court-ordered repayments would be eligible for business expense deduction
- BUT... expenses may not reap same tax benefit if Armstrong forced to claim deduction in a future year with little (or no) current earnings



IRC § 1341 TO THE RESCUE!

- Taxpayers previously required to report income inclusion and subsequent deduction as *separate* events
- Relief provided in 1954...
 - Income required to be included when taxpayer has claim of right
 - Offsetting deduction from later year can now decrease tax as though inclusion/exclusion events occurred in *same* year
- Taxpayer may claim the lesser of:
 - The tax in the later year computed with the deduction, or
 - The tax in the later year computed without the deduction, but reduced by the amount that the tax in the earlier year had the disputed income not been included

COMPUTATION OF GAINS & LOSSES

$$\text{Sales Proceeds} - \text{Cost} = \text{Gain (Loss)}$$

- Sales proceeds typically reported on informational forms (1099s)
- Cost typically equals initial outlay
- Taxpayer is responsible for substantiation of cost & applicable adjustments



BASIS

Basis \approx original acquisition cost \pm certain adjustments

<u>Increases to Basis</u>	<u>Decreases to Basis</u>
Capital improvements: <ul style="list-style-type: none">• Building an addition• Replacing the roof• Paving the driveway• Installing central A/C• Rewiring your home	Exclusion from income of subsidies for energy conservation measures
Assessments for local improvements	Credit for qualified electric vehicles
Casualty losses and restoration of damaged property	Deduction for clean-fuel vehicles
Legal fees to defend or protect title	Nontaxable corporate distributions
Zoning costs	Casualty or theft loss deductions and insurance reimbursements
	§179 and depreciation

BASIS: NON-RESIDENT ALIEN

- **Equals acquisition cost in US dollars**
NOTE: Use exchange rates effective on dates of acquisition & disposition
- **Basis is not adjusted to FMV when NRA becomes US citizen or resident alien**
- **NRA may realize taxable gain from:**
 - **Post-acquisition increase in FMV**
 - **Currency fluctuations between purchase & sales dates**

BASIS ADJUSTMENT FOR REPAIRS

- **Cost of repairs – including betterment & restoration costs – must be capitalized**
 - Wood shingle roof repaired with asbestos shingles b/c wood unavailable ≠ Betterment (→ can be expensed)
 - Re-roofing with maintenance-free composite material = Betterment (→ must be capitalized)
 - Building owner converts 3 or 20 retail spaces into 1 large retail space = Restoration since not adapted to a *new* use (→ must be capitalized)
- **EXCEPTION: Routine maintenance performed at same time as unrelated improvement may be expensed**
 - Company replaces truck engines for entire fleet (→ must be capitalized)
 - Company repairs all broken taillights at same time (→ can be expensed)

UNIFORM CAPITALIZATION RULES

- **For real or tangible personal property used in business or for sale to customers**
- **All direct costs & allocable indirect costs incurred during production or resale must be capitalized**
- **EXCEPTIONS:**
 - **Qualified creative expenses (free-lance writer, photographer or artist)**
 - **Property produced under LT contract**
 - **R & D costs**

BASIS ALLOCATION

- Also known as Cost Segregation
- Buyers & Sellers of business assets must equitably allocate purchase price amongst multiple assets acquired simultaneously
- Use Form 8594
- Buyer hopes to allocate as much of the purchase price to asset classes with shortest useful life & accelerated depreciation

BASIS OTHER THAN COST: Adjusted Cost

Type of Transaction	Cost Basis	Amt. Includable as Income
Property Contributed to Partnership	Original cost + recognized gain	No gain or loss recognized
Property Contributed to Corporation	Original cost + recognized gain – recognized loss	No gain or loss recognized If services are rendered, then stock received for these services is considered compensation
Collectibles	Purchase price	Capital gain or loss unless taxpayer is a dealer of coins, stamps or stones (then ordinary)

BASIS OTHER THAN COST: Frequently FMV

Type of Transaction	Cost Basis	Amt. Includable as Income
Property for Services	FMV	FMV or agreed-upon value
Bargain Purchase	FMV	FMV – purchase price
Restricted Property	FMV upon vesting	FMV – price paid when vested
Easement	FMV – amount received	Amount received for easement
Related Parties	FMV relinquished + cash paid	<p>Gain must be recognized if either party disposes of asset before 2 years (except death or involuntary conversion)</p> <p>Gain is ordinary income if sale of depreciable property is involved</p> <p>Losses are not recognized</p>



BASIS OTHER THAN COST: Exchanges

Type of Transaction	Cost Basis	Amt. Includable as Income
Taxable Exchanges	FMV	FMV – basis of property relinquished
Nontaxable Exchanges	Basis of old property + boot paid	No gain or loss recognized at time of exchange
Partially Nontaxable Exchange	Basis of old property – moneys received – loss recognized + moneys spent + gain recognized	Recognized gain = FMV of the new property + cash spent – basis of old property Loss is never deductible if you receive unlike property or cash



BASIS OTHER THAN COST: Partially Non-taxable

Taxpayer traded a boat with an adjusted basis of \$16,000 for a new boat with a FMV of \$15,000 and received an additional \$1,500 in cash...

Realized & recognized gain = \$15,000 + 1,500 cash - 16,000 basis = \$500

New Basis = \$16,000 - 1,500 + 500 = \$15,000

[The basis of the new property is will equal that of the old.]

BASIS OTHER THAN COST: Conversions

Type of Transaction	Cost Basis	Amt. Includable as Income
Personal Converted to Business Use	<p>If later sold at a gain, use purchase price + acquisition costs</p> <p>If later sold at a loss, use lesser of FMV on date of conversion or adjusted basis</p>	No gain or loss recognized
Involuntary Conversions	$\text{Basis of old property} - \text{recognized loss} - \text{moneys received} + \text{recognized gain} + \text{moneys spent}$	Recognized gain = proceeds received – money's spent to replace property



BASIS OTHER THAN COST: Involuntary Conversion

The State paid Taxpayer \$51,000 for condemned property with a basis of \$46,000. Taxpayer then purchased a replacement property for \$49,000...

$$\text{Realized Gain} = \$51,000 - \$46,000 = \$5,000$$

$$\text{Recognized Gain} = \$51,000 - \$49,000 = \$2,000$$

$$\text{New Basis} = \$49,000 - \$3,000 = \$46,000 \text{ [same as Old Basis]}$$



BASIS OTHER THAN COST: Gifts & Inheritances

Type of Transaction	Cost Basis	Amt. Includable as Income
Transfers Between Spouses	Spouse's adjusted basis	No gain or loss recognized
Gifts	<p>If later sold at a gain, use donor's basis</p> <p>If later sold at a loss, use lesser of donor's basis or FMV</p> <p>Adjust basis for the amount of gift tax paid, if any</p>	No gain or loss recognized
Inheritance	FMV on date of death or alternate valuation date	No gain or loss recognized

BASIS OTHER THAN COST:

Gift

Basis of gifts depends if donee later sells the asset at a gain or a loss...

Gain Basis

- Mother bought stock for \$10/share and gifts the shares to Son when the stock is valued at \$18/share
- Since the asset has appreciated during Mother's tenure, Son will assume Mother's basis

Loss Basis

- Mother bought stock for \$10/share and gifts the shares to Son when the stock is valued at \$7/share
- If Son sells stock for less than \$7/share, his basis will be the FMV at the time of the gift (\$7)
- If Son later sells at any price between \$7 and \$10, he will not recognize any gain or loss

BASIS OTHER THAN COST: Inheritance

Community Property (in AZ, CA, ID, LA, NV, NM, TX, WA, and WI)

- Both halves of the property receive a full step-up in basis

Gay Marriage

- No step-up in basis, since these unions are not federally recognized
- Rights of survivorship are not implicit.

Joint Tenancy

- The property receives a partial step-up in basis



BASIS OTHER THAN COST: Miscellaneous

Type of Transaction	Cost Basis	Amt. Includable as Income
Timber	Adjusted basis for depletion (IRC §611)	Capital gain or loss is recognized if the timber is held for investment If held for resale, gain or loss is ordinary
Insurances & Annuities	N/A	No gain or loss recognized if §1035 exchange done (life policy or annuity for another annuity) If cash is received, gain must be recognized
Cancelled Debt	N/A	Amount of debt forgiven



SECURITIES TRANSACTIONS: Stock Rights

Investor bought 200 shares of XYZ at \$2,000 & received 20 rights to purchase an additional 20 shares at \$3/share. On the date of distribution, the stock is worth \$1,900 and the rights \$80...

Basis is allocated as follows:

$$\text{Basis of Stock} = \$1900 \div (\$1900 + \$80) \times \$2000 = \$1919$$

$$\text{Basis of Rights} = (\$80 \div \$1980) \times \$2000 = \$81$$

SECURITIES TRANSACTIONS: Fractional Shares

Investor owns 125 shares of XYZ which she bought for \$25/share. The company declared a 2% stock dividend (for an additional 2.5 shares). The company sold the fractional share and reported \$15 proceeds on 1099-B...

Basis of Fractional Share = $\$3125 \div 127.5 \times 0.5 = \12.25

Gain on Sale = $\$15 - 12.25 = 2.75$ (reported on Schedule D)

Basis of Remaining Shares = $(\$3125 - 12.25) \div 127 = \24.51

SECURITIES TRANSACTIONS: Corporate Spin-offs

- **Not a taxable event for the shareholder.**
- **Basis in the new shares must now be allocated between the stock of the original company and the stock in the new spin-off based on the ratio of their fair market values on the date of the spin-off.**
- **The issuing company will assist shareholders with the computations and will provide a statement which the shareholder must sign and attach to his tax return referring to IRC §355.**

SECURITIES TRANSACTIONS: Liquidation Distribution

100 shares were purchased in 1995 at \$3,000 and another 100 shares were purchased in 1996 for \$4,000. In 2000, investor received a liquidation distribution of \$7,000 which must be allocated amongst the two blocks of stock previously purchased...

$$(100 \text{ shares} \div 200 \text{ shares}) \times \$7,000 = \$3,500$$

- Realize \$500 LTCG on the first block of stock (= \$3,500 - \$3,000)
- Reduce basis of the second block to \$500 (= \$4,000 - \$3,500)

SECURITIES TRANSACTIONS: Demutualization

- Insurance company policyholders and annuitants received stock &/or cash in exchange for equity interests
- Basis in original equity interest = \$0 [Rev. Rul. 71-233: Proprietary interest arises solely because he is policyholder; premiums represent cost of insurance]
- Tax-free reorganization: No gain or loss recognized. Zero basis & holding period carry over to new stock.
- Non-qualified Demutualization: CG recognized on amount of cash & stock received. Holding period of new stock begins on date after demutualization.

SECURITIES TRANSACTIONS: Worthless Securities

- Securities without value may be reported as capital losses when there has been an identifiable event that establishes their worthlessness.
- If a nominal value remains, the taxpayer may:
 - (1) sell the securities and thereby fix the dates and amounts of the capital loss, or
 - (2) abandon the assets and claim an ordinary loss (although *proposed* Treasury Reg. requires that abandoned securities are only eligible for capital loss treatment)
- Worthless securities are deemed to have become worthless on the *last* day of the year in which the identifying event occurs.

SECURITIES TRANSACTIONS:

Stock

Event	Cost Basis	Holding Period Begins
Purchased Stock	FIFO unless taxpayer can identify specific shares sold & has trade confirmation with that id.	On date of purchase
Cash Dividend	Original cost of stock is increased by amount of dividends reinvested. If plan allows investor to reinvest at a discount from FMV, then this discount will be treated as reportable dividend income.	On day after dividend is issued
Stock Dividend	Basis of original shares is prorated amongst original & new shares. If shareholder elects cash in lieu of stock dividends or receives an increased ownership percentage, he will be taxed on FMV at time of distribution & receive new holding period.	Original purchase date
Fractional Shares	Basis is allocated between original stock & fractional shares received.	Original purchase date



SECURITIES TRANSACTIONS: Splits, Rights & Warrants

Event	Cost Basis	Holding Period Begins
Stock Split	Basis of original shares is prorated amongst original & new shares	Original purchase date
Stock Rights	<p>FMV on distribution date if rights are taxable.</p> <p>Otherwise, basis must be allocated between original stock & rights received.</p> <p>Basis is zero if rights are allowed to expire.</p>	Original purchase date for unexercised rights or date of exercise if new shares are acquired
Warrants	Purchase price of stock + cost of warrant + cost to exercise warrant	Date of exercise



SECURITIES TRANSACTIONS: Liquidations

Event	Cost Basis	Holding Period Begins
Liquidation Distributions	<p>Reduce basis by amount of distribution.</p> <p>If more is distributed than available basis, capital gain is realized.</p> <p>Upon final dissolution, taxpayer may claim capital loss if less than basis is recovered.</p>	Original purchase date
Spin-offs	<p>Basis is allocated between original stock & fractional shares received.</p> <p>Taxpayer must attach a statement provided by company to tax return as per IRC §355.</p>	Original purchase date
Worthless Securities	Considered sold on last day of tax year.	Original purchase date

SECURITIES TRANSACTIONS:

Bonds

Event	Cost Basis	Holding Period Begins
Convertible Bonds	Purchase price of stock + cost of convertible bond	Date of purchase of convertible bond
Bond Premiums	<p>Reduce basis by amount of amortization deducted.</p> <p>Post-1998: Taxpayer may elect to amortize and reduce taxable interest income by the amount of amortization – IRC §171 requires amortization for tax exempt bonds.</p>	Date of purchase
Bond Discounts	<p>Increase basis by amount of accretion claimed.</p> <p>Taxpayer may elect to accrete and include amounts accreted as taxable interest income – IRC §1272 requires a basis adjustment for OIDs.</p>	Date of purchase

INVESTMENT COMPANIES

- Regulated by the Investment Company Act of 1940
- Two types:
 1. Open-end (a.k.a. Mutual Funds)
 - Shares are issued on a continuous basis
 - No finite number of shares
 - All purchases & redemptions via fund company
 - Priced at Net Asset Value (NAV)
 2. Closed-end (a.k.a. Publicly Traded)
 - One-time initial public offering
 - Then traded on secondary market (like stock)
 - Priced via supply & demand

MUTUAL FUNDS: Tax Treatment

Triggering Event	Tax Treatment
<p>Fund Distribution:</p> <ul style="list-style-type: none">• Qualified Dividend, even if reinvested• Capital Gain Distribution	<p>LTCG (Declared by fund manager)</p>
<p>Share Redemption</p> <ul style="list-style-type: none">• Automatic Withdrawal• Sale• Exchange within Fund Family	<p>ST or LTCG (Gain = NAV – Basis)</p>



MUTUAL FUNDS: Tax-exempt Dividends

- Although not subject to taxation, they must nevertheless be reported

NOTE: *If shares are sold at a loss within 6 months from date of purchase, taxpayer may recognize only the loss that exceeds the tax-exempt dividends received*

February 1st: Investor bought Tax-Free Fund for \$1000

March 1st: Investor received \$24 tax-free dividend

April 30th: Investor sold his shares for \$960

- Realized Loss = \$40 ($\$1000 - 960$)
- Recognized Loss = \$16 ($\$40 - 24$)

MUTUAL FUNDS: Capital Gain Distributions

- **Subchapter M of the Code** applies the Pipeline or Conduit Theory and requires mutual funds to distribute gains annually.
- **CGDs are always reported as LTCGs.** These may be reported directly on Form 1040 rather than on Schedule D.

NOTE: If mutual fund does not distribute its LTCGs, the company must pay the tax.

Undistributed gains & tax paid by the fund are reported to taxpayer on Form 2439

→ Taxpayer reports LTCGs on Schedule D & taxes paid on his behalf on Form 1040 as a “payment”

FORM 2439

<input type="checkbox"/> VOID <input type="checkbox"/> CORRECTED (99)			
Name, address, and ZIP code of RIC or REIT	OMB No. 1545-0145 2012 Form 2439	Notice to Shareholder of Undistributed Long-Term Capital Gains For calendar year 2012, or other tax year of the regulated investment company (RIC) or the real estate investment trust (REIT) beginning _____, 2012, and ending _____, 20 _____.	
Identification number of RIC or REIT	1a Total undistributed long-term capital gains	Copy A Attach to Form 1120-RIC or Form 1120-REIT	
Shareholder's identifying number	1b Unrecaptured section 1250 gain		
Shareholder's name, address, and ZIP code	1c Section 1202 gain	1d Collectibles (28%) gain	
	2 Tax paid by the RIC or REIT on the box 1a gains		For Instructions and Paperwork Reduction Act Notice, see back of Copies A and D.
Form 2439	Cat. No. 11858E	www.irs.gov/form2439	Department of the Treasury - Internal Revenue Service

MUTUAL FUNDS: Year-end Planning

- **CGD represent growth (gains) accumulated within fund portfolio during past year**
- **All investors are required to include CGD as taxable income; even new investors who have not owned underlying portfolio & enjoyed attendant growth (!)**
- **Basis will be adjusted (increased) for amount of taxable distribution, but tax benefit is deferred until redemption**

TIP: Call fund to ask for anticipated distribution date (usually December); purchase shares after distribution

MUTUAL FUNDS: Redemptions

- Applies to sales, automatic withdrawals, fund family exchanges
- Transactions will be completed at the close of the *next* business day
- Gains & losses are computed even on tax-free funds (!)
- Basis may be computed using FIFO, specific identification, average cost (single or double category)
 - Taxpayer must attach statement to notify IRS of method selected

MUTUAL FUNDS

Example

Facts of the situation:

Date of Purchase	# of Shares	Cost/Share	Total Cost	Transaction Type	Holding Period thru 1/02
3/00	500	10.00	5,000	Orig. purchase	LT
12/00	30	10.50	315	Reinvested Div.	LT
5/01	200	9.75	1,950	Addtl. Contrib.	ST
12/01	40	10.25	410	Reinvested Div	ST
Totals	770		7,675		

In January 2002, sells 600 shares on 1/02 at \$10.30/share for a total of \$6,180, including:

- 70 shares held short-term → \$721 of total sales price
- 530 were held for the long-term → \$5,459 of total sales price

MUTUAL FUNDS

Basis Calculation: FIFO

The first shares bought are the first ones sold...

Date of Purchase	# of Shares	Cost/Share	Total Cost	Sales Proceeds (\$10.30/sh)	Net Gain
3/00	500	10.00	5,000		LT
12/00	30	10.50	315		LT
Subtotal	530		5,315	5,459	144 LTCG
5/01	70	9.75	683		
Subtotal	70		683	721	38 STCG

Although the LTCG and STCG would have to be reported separately on Schedule D, for comparison purposes, the **net gain would be \$182.**



MUTUAL FUNDS

Basis Calculation: Specific ID

Sell shares with highest cost first...

Date of Purchase	# of Shares	Cost/Share	Total Cost	Sales Proceeds (\$10.30/sh)	Net Gain
12/00	30	10.50	315		LT
3/00	500	10.00	5,000		LT
<i>Subtotal</i>	<i>530</i>		<i>5,315</i>	<i>5,459</i>	<i>144 LTCG</i>
12/01	40	10.25	410		
5/01	30	9.75	293		
<i>Subtotal</i>	<i>70</i>		<i>703</i>	<i>721</i>	<i>18 STCG</i>

Although the LTCG and STCG would have to be reported separately on Schedule D, for comparison purposes, the **net gain would be \$162.**

MUTUAL FUNDS

Basis Calculation: Avg. Cost Single

Basis will be calculated by dividing total cost of shares bought (\$7,675) by total number of shares bought (770 shares) & determining that average cost was \$9.97/share

Shares are then sold in the order they were originally purchased...

Date of Purchase	# of Shares	Cost/Share	Total Cost	Sales Proceeds (\$10.30/sh)	Net Gain
3/00	500	9.97	4,985		LT
12/00	30	9.97	299		LT
<i>Subtotal</i>	<i>530</i>		<i>5,284</i>	<i>5,459</i>	<i>175 LTCG</i>
5/01	70	9.97	698		
<i>Subtotal</i>	<i>70</i>		<i>698</i>	<i>721</i>	<i>23 STCG</i>

Although the LTCG and STCG would have to be reported separately on Schedule D, for comparison purposes, the **net gain would be \$198.**

MUTUAL FUNDS

Basis Calculation: Avg. Cost Double

Taxpayer calculates separate average costs for each category of ST (\$9.83/share = \$2,360 purchase price ÷ 240 shares) & LT holding periods (\$10.03/share = \$5,315 ÷ 530 shares)

Shares are then sold in the order they were originally purchased...

Date of Purchase	# of Shares	Cost/Share	Total Cost	Sales Proceeds (\$10.30/sh)	Net Gain
3/00	500	10.03	5,015		LT
12/00	30	10.03	301		LT
<i>Subtotal</i>	530		5,316	5,459	143 LTCG
5/01	70	9.83	688		
<i>Subtotal</i>	70		688	721	33 STCG

Although the LTCG and STCG would have to be reported separately on Schedule D, for comparison purposes, the **net gain would be \$177.**



MUTUAL FUNDS

Basis Calculation: Conclusion

Summary of resulting net taxable gains:

- **Specific Identification (\$162)**
- **Average Cost: Double-Category (\$177)**
- **FIFO (\$182)**
- **Average Cost: Single-Category (\$198)**



MUTUAL FUNDS: Advantages

- Average cost methods cannot be used by any other investment
- CG distributions are treated as LT regardless of investor's actual holding period
- Fund's capital losses do not flow through to investor → no \$3,000 capital loss limitation



SHORT SALES

Short selling is a bearish strategy

Example

1. Borrow neighbor's fancy car & sell it.
2. Hope market price drops before you buy same (or different) car
3. Return car to neighbor
4. Pocket profit

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SHORT SALES

Holding Period

Holding period determined by length of time that short seller (borrower) actually holds stock between dates of purchase & delivery to lender (B/D)

Example

March 15th, 2000: Investor borrows shares & sells short

April 3rd, 2001: Investor re-purchases shares

April 5th, 2001: Investor delivers shares to B/D

Although Investor was short for > 1 year, he only held shares for 2 days

→ Gain is short-term



SHORT SALES

Short-Against-the-Box

1. Estee Lauder trust shorted 5.5 million shares (valued at \$135 million) of borrowed stock
2. Trust later used existing family holdings to cover short after company went public



ESTÉE LAUDER

→ Trust deferred gain recognition into future year while locking in sales price in current year

1995: Constructive Sale Rule

- Stock is treated as though sold and *immediately* repurchased
→ STCG
- Gain recognition deferred only if position involves non-publicly traded securities which must be marked to market at year-end

SHORT SALES

Additional Rules

- Dividends received while position is open do not belong to short seller
 - Cost of repaid dividends must be added to basis of stock used to close the short sale unless position is open > 46 days (deductible currently)
- Lender will require cash deposit as collateral
 - If the interest earned < dividends repaid, repayments may be deducted as investment interest

MARGIN TRADING

= the purchase of securities with *borrowed* money or the sale of *borrowed* securities for cash (short sale)

- Use of leverage
- Must be done in a “margin” account
- Requires deposit (a.k.a. down-payment)

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MARGIN TRADING: Leverage

Leverage can magnify gains (as well as losses)...

Transaction	All Cash Purchase	Leveraged Purchase (10% Down)
Buy house for \$500K	\$500K	\$50K
Market Value rises to \$525K	$\$25/500 = 5\%$ Return	$\$25/50 = 50\%$ Return
Market Value drops to \$450K	$-\$50/500 = 10\%$ Loss	$-\$50/50 = 100\%$ Loss

MARGIN TRADING: Effects on Equity

$$MV - DB = EQ$$

Equity (EQ) rises when:

- Market Value (MV) increases
- Debit Balance (DB) is reduced
- Cash or securities are added to the account
- Dividends or interest are received

Equity falls when:

- Cash is withdrawn from the account
- Interest is charged on the Debit Balance
- Market Value decreases

MARGIN CALLS

- **Minimum equity levels set by FRB**
- **If equity falls below minimum, investor will receive a “call”**
- **Call must be answered immediately**
 - **Adding cash to the account**
 - **Adding fully paid securities to the account**
 - **Liquidating assets in the account**

MARGIN TRADING: Dangers

- Sudden market downturns
- B/D carelessly selects assets for liquidation
- Forced liquidations may cause the market to drop further
- Transactional costs and tax consequences may magnify losses
- Excess equity built up during market advances can be used to make additional purchases → investor may become dangerously over-leveraged

WASH SALES

Taxpayer may not claim loss if *substantially the same* security is purchased within 30 days before and 30 days after date of sale

Example

June 30th: Investor bought 100 shares of XYZ for \$4,000

August 4th: Investor sold 100 shares for \$3,300 (loss = \$700)

August 5th: Investor purchased another 100 shares of XYZ for \$3,900

- Realized loss is not deductible since he repurchased same security within 60-day window
- Taxpayer must add non-deductible loss to the cost basis of the new shares ($\$4,600 = \$3,900 + \$700$)
- Holding period of original stock is tacked on to holding period of new



WASH SALES: Substantially the Same?

Examples

- XYZ common stock for XYZ call option
- XYZ preferred stock for XYZ convertible bond
- XYZ bearer bond for XYZ registered bond
- XYZ stock for XYZ deep-in-the-money call option

NOTE: Even reinvested dividends will trigger rule

TIP: Beware of purchases and sales made by “day traders” and investment advisors who tout timing service!

WASH SALES: Additional Rules

- Applies to all of taxpayer's accounts (incl. IRAs)

NOTE: Basis of IRA is *not* increased by amount of disallowed was sale loss

- Husband and Wife are treated as one taxpayer
- FIFO must be applied when unequal numbers of shares are bought & sold
- Mark-to-Market trader is exempt

SMALL BUSINESS STOCK: Gain (§1202)

Taxpayer may exclude up to 50% of realized gain if...

- Stock issued by C-Corp, acquired as a new issue & held > 5 years
- Corp maintained qualified status throughout holding period:
 - Gross assets < \$50 million
 - > 80% of assets used in qualified trade or business; does NOT qualify if banking, consulting, engineering, leasing farming or natural resource extraction

NOTES: Exclusion was temporarily raised to 100% (xp. 12/31/13)

Maximum exclusion = \$10 million/year

Gain in excess of exclusion is taxed as capital gain AND subject to 3.8% Medicare Surtax (excluded gain ≠ “net investment income”)

Excluded gain ≠ AMT tax preference item

No estate tax exclusion for § 1202 stock

UPDATE!



PARTIAL CONFORMITY:

§1202 in CA

- CA does not conform – only 50% (not 100%) is excludable and is an AMT tax preference item
- Additionally, corp. must provide FTB Form 3565 to shareholder stating that stock qualifies as “small business stock”

BUT... due to recent Court ruling (*Cutler v FTB*, 208 Cal. APP. 4th 1247), **FTB will deny all exclusions of gain on sale of small business stock after January 1, 2008!**

Taxpayer won based on CA's unconstitutional requirement that claimants had to invest in domestic (in-state) corporations only. In retribution, FTB has decided to deny all claims for which the statute is still open.

UPDATE!

SMALL BUSINESS STOCK: Loss (§1244)

Treat as ordinary losses up to \$50K (Single) or \$100K (MFJ) if...

- Common stock issued by domestic corp (not LLC) with < \$1 million in contributed capital
- Issued in exchange for money (not other stock)
- Corp's gross receipts from royalties, rents or investments < 50% of total receipts

NOTES: Loss deductible against ordinary income & can produce NOL
Excess losses deductible as capital losses
No estate tax exclusion for § 1244 stock

SMALL BUSINESS STOCK: Rollover of Gain (§1045)

Investor may defer gain if...

- Small business stock (§ 1202) held > 6 months
- Sold at gain
- Reinvested within 60 days into another small business stock

NOTES: Gains on amounts not rolled over will be taxed
Basis of new stock decreased by amt. of gain rolled over
Holding period of new stock tacked on to old
No estate tax exclusion for § 1045 stock

CA: Requires all *sales proceeds* (not just gain) to be rolled over

PROPERTY USED IN TRADE OR BUSINESS (§1231)

Gains taxed as LTCGs; losses treated as ordinary if...

- Depreciable personal or real property used in trade or business
- Must be held > 1 year [does not include inventory]

NOTE: Unused losses may be carried forward & netted against future gain or loss – the resulting tax treatment:

- Net §1231 loss → ordinary loss
- Net §1231 gain → ordinary income up to any un-recaptured §1231 losses from previous 5 years
- Remainder taxed as LTCG

Example

Taxpayer has \$7K net §1231 loss (1999); net §1231 gains of \$4K (2000) & \$5K (2001)

- \$4K of \$7K from 1999 applied against gain in 2000 (treated as ordinary gain)
- \$3K balance of loss then netted against 2001 gain
- remaining \$2K reported as LTCG



PROPERTY USED IN TRADE OR BUSINESS (§1231)

Example # 1

Taxpayer has the following:

- \$7K net §1231 loss (1999)
- \$4K net §1231 gains (2000)
- \$5K net §1231 gains (2001)

TY 2000: \$4K of \$7K from 1999 applied against gain in 2000
→ treated as ordinary gain

TY 2001: \$3K balance of loss then netted against 2001 gain
→ remaining \$2K reported as LTCG



PROPERTY USED IN TRADE OR BUSINESS (§1231)

Example # 2

Taxpayer has no §1231 prior to 2004;
thereafter he has:

Tax Year	Loss	Gain
2004		\$18,000
2005	\$9,000	
2006		\$3,000
2007		\$2,000
2008	\$1,000	
2009		
2010		
2011		\$4,000
2012		

Computation of Nonrecaptured §1231
Losses (reported on Form 4797, Line 8):

Year	Ordinary Losses Taken	Amounts Recaptured	Amounts Expired	Cumulative Balance
2005	\$9,000			\$9,000
2006		(\$3,000)		\$6,000
2007		(\$2,000)		\$4,000
2008	\$1,000			\$5,000
2009				\$5,000
2010			(\$4,000)	\$1,000
2011		(\$1,000)		-
2012				-



SALE OF DEPRECIABLE PROPERTY (§1245)

- Recognized gain is lesser of depreciation previously deducted (incl. §179 expense) or realized gain
- Treated as ordinary income & reported on Form 4797
- §1245 property includes depreciable personal property, certain tangible assets, and certain real property

Example

Five-year business property purchased in 1999 for \$10,000

Sold in 2001 for \$4,500

Depreciation deductions taken totaled \$6,000

Amount Realized		\$4,500	
Original Cost	\$10,000		
Depreciation	<u>6,000</u>		
Adjusted Basis		<u>4,000</u>	
Gain Realized		\$500	→ ordinary income

SALE OF DEPRECIABLE REAL PROPERTY (§1250)

- **Recapture of depreciation allowed *or allowable* in excess of straight-line on most real property**

NOTE: Since straight-line depreciation has been mandated for most buildings since 1986, §1250 gains are almost non-existent

- **Report as ordinary income on Form 4797**



WHERE TO REPORT WHAT

Code §	Topic	Special Provision	Tax Treatment	Tax Form
1202	Gain on Sm. Bus. Stk.	50% exclusion	Capital	D
1244	Loss on Sm. Bus. Stk.	\$100K/yr = ordinary	Capital	4797, Part II
1045	Rollover of Sm. Bus. Stk.	w/i 60 days	N/A	N/A
1231	Trade or Bus. Prop.	Held > 1 year	Capital Gain Ordinary Loss	D 4797, Part I
1245	Gain on Depr. Prop.	Recapture Depreciation	Ordinary	4797, Part III
1250	Gain on Depr. Real	Recapture Excess Depreciation	Ordinary (if accelerated) Capital (if straight-line)	4797, Part III D

INTANGIBLE ASSETS

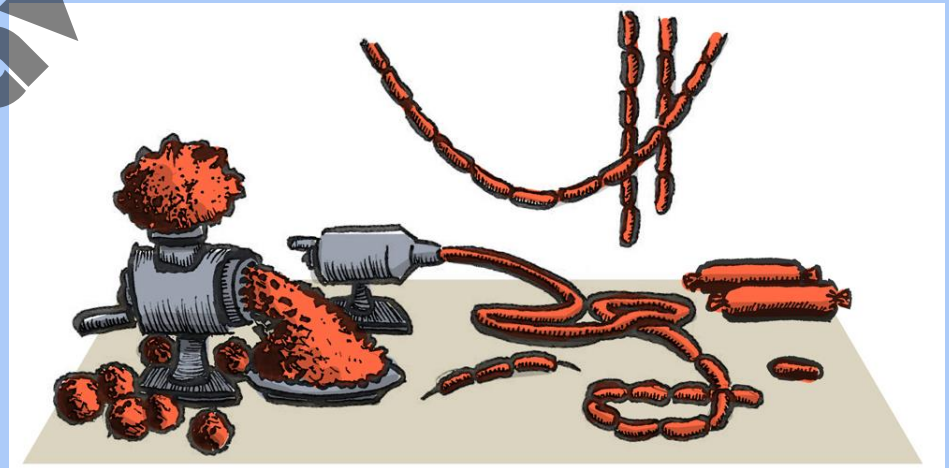
Patents

- Subject to capital gains treatment only if substantial rights or undivided interest transferred

Example

Ordinary income to C&F when Pizza Hut provided sausage-making secret to 3rd party w/o C&F's knowledge

*"Laws are like sausages, it is better not to see them being made."
- Otto von Bismarck*



INTANGIBLE ASSETS

Whistleblower Awards

- Informant's info ≠ “property” & cannot be “sold”

Example

Accountant who filed qui tam suit against former employer who demanded he prepare 2 sets of books, could not sell info to government under False Claims Act & was required to report ordinary income



INTANGIBLE ASSETS

Website Costs

- **What is purpose of website?**
 - **If used to expand existing business → deduct currently**
 - **If used to acquire new business → capitalize**
- **Internal or external costs?**
 - **Company employees → deduct currently**
 - **Consulting, auditing & legal fees → capitalize**
- **Use of website?**
 - **To promote product line (= advertising) → deduct currently**
 - **To provide informational database → capitalize**

HOME SALES

§121 Exclusion

- **Single taxpayer may exclude up to \$250,000 of realized gain if**
 - **Home owned & used as a principal residence for at least 2 of 5 years prior to sale**
 - **2 years need not be consecutive**
 - **Non-qualified use period is not excludable**
- **Married taxpayer may exclude up to \$500,000 if filing jointly if**
 - ***either or both* have owned home for at least 2 years and *both* have lived in home for at least 2 years**
 - **Divorce: Each spouse may claim \$250,000 on separate return if jointly-owned residence is sold & ownership/residency rules have been satisfied**

NOTE: Ownership through grantor trust okay

§121 EXCLUSION

Additional Rules

- Available only once every 2 years
- Reduced (pro-rated) exclusion may be available if ownership & use tests not satisfied due to job move, health issues or unforeseen circumstances
- If part of home used for business or rental within same dwelling unit, entire home is treated as principal residence – otherwise, must treat sale of home as sale of 2 separate properties
- Exclusion does not apply if home acquired in like-kind exchange & sold with 5 years of acquisition

§121 EXCLUSION

Reduced Exclusion Example

- Couple bought home & lived there for only 13 months
- Due to change of employment, they sell home & relocate
- Reduced exclusion is calculated:

Number of months owned & used as main home	13
Divided by 24 months	0.542
Multiplied by \$500,000 (max. exclusion)	\$ 271,000

LIKE-KIND EXCHANGES

- Both properties must be held for business or investment purposes
 - Stocks, bonds, notes, goodwill, trademarks ineligible
 - Personal residence given up eligible for exchange if:
 - Owned > 2 years and
 - Rented to others for >14 days in each of prior 2 years
- The new property must be:
 - Identified *in writing* within 45 days after surrender of old property
 - Received before earlier of
 - 180 days after old property is surrendered, or
 - Due date (including extensions) of tax return
- Basis of new property must be adjusted to ensure recognition of deferred gain
- Report § 1031 exchange on Form 8824

FORECLOSURES

- Report foreclosures & repossessions as if property sold
- Amount realized (used to compute gain or loss) depends on type of debt:
 - Non-recourse: Full amount of canceled debt
 - Recourse: FMV of property in excess of adjusted basis
- COD income:
 - Non-recourse: None
 - Recourse: Debt in excess of FMV
- COD reported as:
 - Other Income, if personal
 - Schedule C or E, if business

Example

Taxpayer bought home for \$250,000, subject to \$200,000 recourse mortgage

Taxpayer loses home in foreclosure proceeding; home is sold for \$180,000

Taxpayer is neither bankrupt nor insolvent

FORECLOSURE Example

Facts

Taxpayer bought home for \$250K subject to \$200K recourse loan

Taxpayer loses home in foreclosure proceeding

Home is sold for \$180,000

Taxpayer is not bankrupt or insolvent

Personal Loss:

\$70,000 (= \$250,000 basis - \$180,000 foreclosure proceeds)

COD income:

\$20,000 (= \$200,000 mortgage - \$180,000 FMV)



COD EXCLUSIONS

COD is not taxable if:

- Debt forgiveness occurs due to bankruptcy or insolvency
- Debt is qualified farm or qualified real property business debt
- To extent that COD would otherwise have been deductible interest
- Personal residence debt up to \$2 million [xp. 12/31/13]
 - Loan proceeds used to acquire, construct or improve home
 - 2nd mortgages eligible if proceeds used to buy, build or improve
 - Refinanced debt is okay but loans on 2nd homes do not qualify
 - COD due to loan modification, not foreclosure or short sale

UPDATE!

COD EXCLUSION: Personal Residence Debt

Taxpayer bought home for \$250,000, subject to \$200,000 recourse debt...

Foreclosure: Home is sold for \$180,000

- \$20,000 excludable COD income (before 12/31/13)**
- \$70,000 non-deductible personal loss**

Loan Restructure: Loan balance is reduced to \$180,000

- \$20,000 excludable COD income (before 12/31/13)**
- \$230,000 basis after reduction for COD exclusion**

Non-recourse Loan: Loan is purchase-money loan

- \$0 COD income**
- \$50,000 non-deductible personal loss**



COD EXCLUSION: Special Circumstances

- **Multiple Borrowers**

- Form 1099-C will be issued to *each* co-signer who is jointly & severally liable
- May allocate COD income amongst borrowers

Parents , who did not live in home or make mortgage payments, co-signed loan for Son who later defaulted. Okay to allocate all (not 1/3) of COD income to Son.

- **Investment Property**

- COD income may be used to increase limitation for deducting investment interest

SECONDARY LIFE INSURANCE

Life insurance policy is sold to 3rd party who has no insurable interest ...

•3 levels of taxation:

1. No tax on proceeds up to insured's basis
2. Ordinary income on cash surrender value (CSV) less basis
3. Capital gains on amounts in excess of CSV

•Potential pitfalls:

- Policy may be voided since applicant lied about intent to sell
- Insurance company may challenge death-claim
- Investor may sue insured's estate for forfeited insurance proceeds
- Insured's lifetime maximum amount of insurability may be used up
- Risk of foul play



CAPITAL GAINS & AMT: ISOs

- Exercise of Incentive Stock Option (ISO) is non-taxable but...
- Bargain element (= FMV of stock – Strike Price) is AMT tax preference item

NOTE: Basis of stock may differ under regular & AMT tax structures

- Regular Basis = Strike Price
- AMT Basis = Strike price + Includible AMT income

CAPITAL GAINS & AMT: NOLs

- NOL results when allowable deductions exceed gross income
- For AMT, taxpayers must re-compute NOL using preference items & adjustments
 - ➔ Alternative Tax Net Operating Loss (ATNOL)
- ATNOLs resulting from capital losses may not be carried back to offset AMT capital gains in earlier years
- Tax Relief and Health Care Act of 2006 offers refundable AMT credit for 2007 – 2012 **[NOT updated by ATRA 2012]**
NOTE: CA does not conform & does not offer AMT credit

MARK-TO-MARKET ELECTION

(MTM)

Active traders may elect to report all securities transactions as ordinary income on Form 4797:

- No capital loss limitations
- No Wash Sale restrictions
- But must treat all securities as sold & repurchased at FMV on 12/31



MAKING THE MTM ELECTION

- **Elect by attaching statement to previous year's return or current year's extension request by filing date (excluding extensions)**

Trader in Securities Election to Mark to Market

Taxpayer hereby elects under IRC § 475(f) to use the mark-to-market method of accounting for securities. The election will first be effective for the tax year ended [XXXX]. The election is made for the following trade or business: [Trade or business name, EIN].

- **Then, attach Form 3115 Change of Accounting Method to current return when filed**



LATE MTM ELECTION

- **Election for 2012 would have had to be filed by 4/15/12 [too late now!]**
- **USE PLR to request relief for late-filed elections**
- **Alternatives:**
 - **Create new pass-through entity**
 - **New taxpayer may elect by 15th day of 3rd month**

MTM REPORTING

Investor: Buys/sells for (long-term) growth
Trader: Buys/sells to profit from daily market movements
Dealer: Buys/sells to/from customers

	CL limited to \$3K	Subject to Wash Sale	Report Gain/Loss	Report Expenses	H. Office Deduction	SE Tax	Eligible for IRA
Investor	Yes	Yes	D	A	No	No	No
Dealer	No	No	C	C	Yes	Yes	Yes
Trader	Yes	Yes	D	C	Yes	No	No
Trader w/ MTM Election	No	No	4797, Part II	C	Yes	No	No

MTM: TRADER VS. INVESTOR

Question	Trader says...	Investor says...
What is a stock?	A chance to benefit from ST market movements	A small piece of ownership in a business
How long do you hold?	Short-term: As little as a few hours; no more than 3 – 6 months	Long-term: At least a year, sometimes much longer
When do you buy?	When the stock price nears its technical low point	When the stock price is low relative to the company's fundamentals
Important statistics?	Moving average, relative strength, support & resistance levels, trading volume	Price-to-earnings ratio, price-to-book, price-to-sales, cash flow, return on invested capital
Motto?	"The trend is your friend."	"Buy cheap."

Excerpted from "The Trader vs. The Investor: Two Views of the Market" [available at <http://seekingalpha.com/article/98174-the-trader-vs-the-investor-two-views-of-the-market>].

MTM: TRADER DEFINED

- Must engage with *continuity & regularity*
- Activity must be *substantial*
- Must seek *short-swing* profits
- Facts & circumstances include:
 - Holding periods
 - Time devoted to activity
 - Extent to which activity supports taxpayer
 - Business-like record keeping
 - Minimal dividends or interest earned
 - Trading frequency & volume
 - Profitability

NOTE: Presumption favors “Investor” – burden is upon taxpayer to prove that he is actively engaged in a trade or business

MTM: JUDICIAL RULINGS

Investor

- Taxpayer had firm name, business cards & bank account BUT traded only 5-12 days during each of 3 years. *Steffler*, TC Memo 1995-271. [→ infrequent activity]
- Taxpayer made > 2,000 transactions in 2 years BUT held most positions > 1 year. *Estate of Yeager*, 2nd Cir, 1989. [→ no short-swing profits]
- Taxpayer made 46 purchases & 16 sales in 1st year 109 purchases & 103 sales in 2nd year BUT never spent 5 days/week trading. *Cameron*, TC Memo 2007-260. [→ irregular activity]
- Taxpayer made 326 trades during 3 months of year. *Paoli*, TC Memo 1991-351. [→ activity not continuous]

Trader

- Trader spent most of working day doing research, identifying attractive trades & making transactions. *Levin*, Ct Cl, 1979. [→ substantial activity]



YEAR-END STRATEGIES

Avoid Investment Income Surtax by:

- Selling personal residence which has appreciated > §121 exclusion since excess is added to investment income

Example

- Couple earns combined salaries of \$260,000
- Plan to sell 1° residence for \$1.2 million
- Net a gain of \$700,000 → \$500,000 will be excluded as per §121
 - If sell in 2012, \$30,000 tax (= 15% X \$200,000 taxable gain)
 - If sell in 2013, \$37,600 tax (= [.15 + .038 surtax] × \$200,000)

NOTE: Additionally, capital gains rates may be higher in 2013 (?)

YEAR-END STRATEGIES

Cont'd.

Harvest gains & offset accumulated capital losses by:

- Selling stocks with built-in profits
- Selling depreciated rental property
- Selling appreciated vacation home
- Selling limited partnership interest with negative basis
- Accelerating installment sale collections

Shift family income by:

- Gifting appreciated assets to those in 0% tax bracket [Kiddie Tax does not apply if child provides $> \frac{1}{2}$ of his own support from earned income]

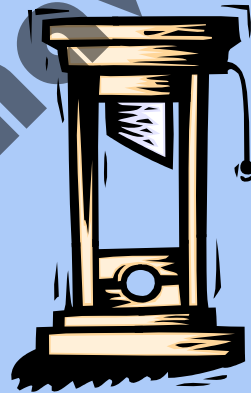
Beware of expiring IRC provisions:

- § 1202 Small Business Stock
- Qualified Personal Residence Indebtedness

UPDATE!

CAPITAL PUNISHMENT

Defined as the “penalty of death for the commission of a crime,” it may be the preferred alternative to all aforementioned code sections, which are in and of themselves cruel and unusual.



(Sorry about that!)

PART II

Options

What we'll cover...

- Options – What are they?
- Calls & Puts
- Strike Price vs. Premium
- Intrinsic Value
- Breakeven
- Trading Strategies
- Regulated Stock Options
- Futures & Forwards
- Employee Stock Option Plans
- Restricted Stock
- Mineral Rights
- Reporting Requirements



op-tion [op-shuh n]

noun

- 1.the power or right of choosing.
- 2.something that may be or is chosen; choice.
- 3.the act of choosing.

The Free On-line Dictionary of Computing,
Dictionary.com



It's a choice

- To state your preference
- To make a selection
- To come to a decision
- To “keep your options open”
- To choose not to decide
- To accept an “option of last resort”
- Or... to be out of options!



Grocery Store Coupon

Gives shopper choices:

1. Go shopping, buy cereal, save money OR
2. Ignore & not use coupon, buy another brand



Players

- Always TWO players required:
 1. Shopper: clips coupon to buy cereal
 2. Manufacturer: issues coupon & offers cereal
- Shopper = YOU = “Holder”
 - buys the option & is “long the position”
- Issuer = KELLOGG’s = “Writer”
 - sells the option & is “short the position”

For every holder, there is a writer.

Choices vs. Obligations

- Holder *always* has a choice
 - Can decide to shop & buy (or not)
- Writer *always* has obligation
 - Must honor coupon & sell cereal at discount

**Every option involves two parties;
one with a choice & one with an obligation.**

Coupons Expire

- **Holder of coupon must decide whether to shop (or not) before coupon becomes invalid**
- **If date passes, holder might as well discard coupon**

All options become worthless at expiration.

What's the bet on?

- Coupon gives choice to buy corn flakes → holder chooses destiny of cereal
 - Cereal = underlying “security” (1 box or 2?)
 - Newspaper company determines which coupons to offer
- NOTE:** In the investment world, underlying securities are selected by OCC

Options are derivative securities – one step removed from the actual security.

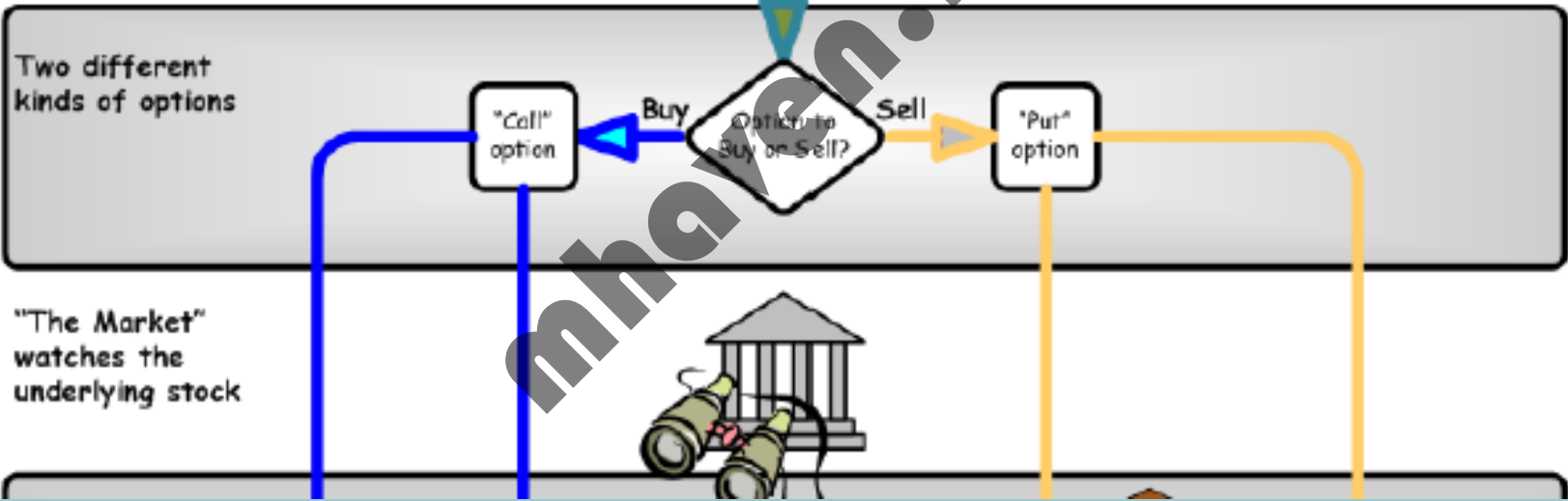


Understanding Stock Options

A stock option is not a stock! It's a contract agreeing to buy or sell a stock at a certain price.

Contract

[Regardless whether it is for buying or selling, the agreed upon price stated in the contract is called the "Strike Price".]



[Available at <http://fatfreemarketinggroup.com/portfolio/design-stock-options>]

Types of Options

- Calls & Puts
 - We have been talking about calls so far:
 - Holder [Shopper] *may* buy cereal
 - Writer [Kellogg's] *must* sell cereal
- 2 parties to
1 transaction

NOTE: Shopper is in driver's seat with the choice

**The holder has the choice;
the writer has the obligation.**

Flipping it around

- So far, it's been the shopper with the choice – now let's give the choice to Kellogg's
- But because holders always get the choice and writers always have an obligation, we now make:
 - Holder = Kellogg's (with *choice* to sell cereal)
 - Writer = Shopper (with *obligation* to buy cereal)
- This is known as a put

**The holder still has the choice;
the writer still has the obligation.**

What's changed?

Call:

Holder [**Shopper**] buys option & *may* then buy cereal

Writer [**Kellogg's**] sells option & *must* then sell cereal

Put:

Holder [**Kellogg's**] buys option & *may* then sell cereal

Writer [**Shopper**] sells option & *must* then buy cereal

NOTE: Nature of parties has not changed

Shopper still buys & Kellogg's still sells cereal

[only who gets choice has changed]

Puts are the “opposite” of calls.

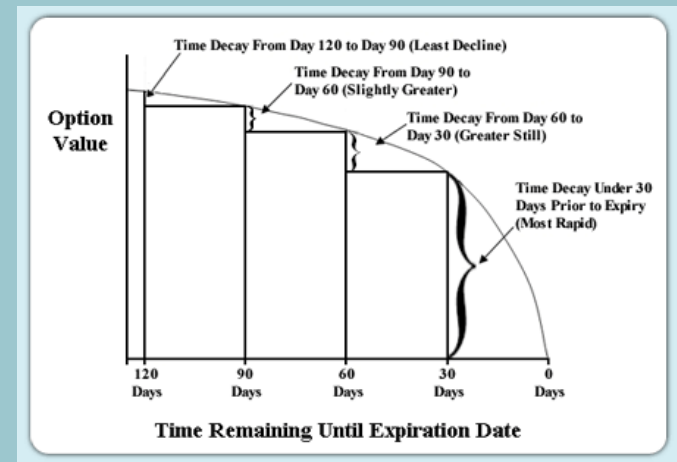


Coupons are not free

- Corn flakes coupon cost \$1.25 (= price of newspaper from which coupon was clipped)
- Premium = cost of the option
 - Intrinsic Value = amount of savings the option can offer (e.g. if shopper can buy cereal for \$3 when price on shelf is \$4 → coupon offers \$1 savings)

PLUS

- Time Value = time is money; if there's no time there's no value



Options are time sensitive.

Cereal costs money, too

- Coupon in investment world is not expressed as “50¢ off”
- Instead, coupon establishes a set price for cereal (e.g. “\$3/box”) known as strike price
- To make coupon attractive, strike price of call must be less than market price of underlying security
- Strike prices are set near market price of underlying security at outset and remain unchanged throughout life of option

**Premium of option will increase/decrease
as market price of underlying security fluctuates.**

Terms Reviewed

- Option is derivative security that offers investors a choice to buy (or sell) an underlying security on or before expiration
- Underlying security is financial instrument on which “bets” are placed
- Holder paid premium to buy the *option* from the writer – he is “long”
- Writer sold *option* & received the premium from holder – he is “short”
- Call gives holder the right to buy underlying security at strike price, thereby forcing writer to sell the security
- Put gives holder the right to sell underlying security at strike price, thereby forcing writer to buy the security



Intrinsic Value

= Bargain element

- Comparison btw. market price of stock & strike price of option
 - If $\text{Strike} < \text{Market}$, option offers good deal to Holder of call who can exercise & buy stock at discount
 - If $\text{Strike} > \text{Market}$, option offers good deal to Holder of put who can exercise & sell stock at premium
- ALWAYS from Holder's perspective since *he* has choice to exercise
- Intrinsic value allows Holder to establish if exercise is good deal
 - If yes, option will put money into Holder's pocket (IN-the-money)
 - If no, option will take money out of Holder's pocket (OUT-of-the-money)

Breakeven

≠ Intrinsic Value

- Intrinsic Value measures whether exercise would be *favorable*
- Breakeven (BE) measures whether exercise would be *profitable*
- Breakeven takes option premium (cost) into account

Example

Holder bought Call on XYZ with Strike Price of 25 for \$5 Premium

XYZ currently trading at \$28/share

→ Call is in-the-money since Strike < Market BUT...

→ Breakeven is at \$30/share

Cost of Option	\$ 5
Cost to buy Stock (with Option)	<u>25</u>
Price needed to sell Stock (to recoup costs)	\$ 30

BE is the minimum market price at which underlying security must trade for Holder to recoup all costs.

Calculating BE

Since options are a zero-sum game, Holder's BE = Writer's BE

	Call	Put
Holder	$BE = \text{Strike} + \text{Premium}$	$BE = \text{Strike} - \text{Premium}$
Writer	$BE = \text{Strike} - \text{Premium}$	$BE = \text{Strike} + \text{Premium}$

REMEMBER: “Call him UP to put him DOWN”
→ ADD Premium for Calls; SUBTRACT Premium for Puts

Maximum Gain (Loss)

- Option trader wants to know risk/reward trade-off *in advance*
 - Maximum Loss (ML) for Holder is ALWAYS premium since he has the choice to abandon his option if unfavorable
→ he will lose his entire investment but no more!
 - Maximum Gain (MG) for Writer is ALWAYS premium since he pocket what the Holder loses
- What about MG for Holder and ML for Writer?

MG for Holder of Call

- Holder has choice to exercise & purchase stock at strike price
- Holder wants market \uparrow so he can buy stock at bargain price
- If market \uparrow above BE, Holder will buy stock
- Holder can now sell or keep stock
- If he keeps stock & market \uparrow , he has opportunity for unlimited gain

HOLDER of Call:
MG = unlimited; ML = Premium

MG for Holder of Put

- Holder has choice to exercise & sell stock at strike price
- Holder wants market \downarrow so he can sell stock at high price
- If market \downarrow below BE, Holder will sell stock he already owns
- Holder's sales proceeds cannot exceed strike price
- Holder's profit will be limited to difference between strike price and cost of option

HOLDER of Put:
MG = Strike – Premium; ML = Premium

Contra-parties to each trade

- For every Holder there is a Writer
- Holder earns what Writer loses
Writer earns what Holder loses

	CALL Max Loss	CALL Max Gain	PUT Max Gain	PUT Max Loss
Holder	Premium	Unlimited	Strike - Premium	Premium
Writer	Unlimited	Premium	Premium	Strike - Premium



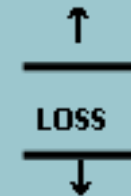
Advanced Option Strategies

- **Simultaneous purchase (sale) of several positions**
 - **Straddles**
 - **Combinations**
 - **Spreads**
 - **Hedges**
- **Purpose can be multi-fold & varied:**
 - **Bet both sides of the market**
 - **Protect against market volatility**
 - **Profit from price differentials**
 - **Protect a stock position**
 - **Generate an income stream**

Straddles

- Used when unsure of market direction
 - Like sitting in a “saddle”, investor has one leg on either side of the horse (market)

- Long Straddles – investor seeks market volatility



Example

Buy *both* call & put on XYZ with same strike price (50) & same expiration (year-end). Call is priced at 3; put is priced at 2 → investor spent a total of \$5 [= ML].

If market ↑, Holder will exercise call but allow put to expire [MG = unlimited].

If market ↓, Holder will exercise out but allow call to expire.

- Short Straddles – investor seeks market stability & hopes to profit from the combined total or premiums collected



Spreads

- **Involve the simultaneous purchase & sale of 2 calls (or 2 puts) on same security**
- **Types of Spreads**
 - **Calendar (a.k.a. Horizontal or Time) – different expirations**
 - **Price (a.k.a. Vertical or Cost) – different strike prices**
 - **Debit – net premiums cause investor to spend money**
 - **Credit – net premiums allow investor to pocket money**
 - **Others: Ratio, Butterfly, Weighted, Back, Strangles, Bull & Bear Ladders, Iron Condors, Crack, Spark, Crush**
- **Used to benefit from arbitrage by taking advantage of price differences between markets**

Hedges

Always involve stock position accompanied by a option position:

1. Long Stock + Long Put

- Put is used to protect against market ↓

2. Short Stock + Long Call

- Call is used to protect against market ↑

3. Short Stock + Short Put

- Put might protect against market ↑ but only if Holder exercises (unlikely)
- BUT Writer can use premium collected to minimize loss if market ↑

4. Long Stock + Short Call

- Call might protect against market ↓ but only if Holder exercises (unlikely)
- BUT Writer may keep premium & stock if market ↓ & write another call...

Covered Call Writing

Long Stock + Short Call

- **Owner of stock hopes market will ↑**
 - **If market ↑, Holder will allow option to expire**
 - **Writer keeps premium & still has stock**
 - **If market ↓, Holder will exercise and buy Writer's stock**
 - **Writer keeps premium & sells stock at strike price purposefully selected to be higher than original cost of stock**
- **This is a win-win situation!**
- **Least aggressive option strategy**

Uncovered Call Writing

- **Theory of Opposites:** If covered call writing is *least* aggressive strategy; uncovered call writing must be *most* aggressive
- **Writer of call option is “covered”** if he owns stock he will be required to deliver
- **Writer of “uncovered” call option will have to buy stock on open market when Holder chooses to exercise**
- **Holder will exercise only if market \uparrow , Writer will have to buy stock at very high price**
→ **ML = Unlimited**

Options vs. Stock

- **Certificate-less trading**
- **Position limits**
 - No finite number of options
 - No correlation to number of shares (few options are exercised)
- **Margin requirement**
 - Good faith performance deposit required
- **Exercise**
 - Options trade independently
 - Can be exercised even when stock is not trading
- **Time limit**
 - There's always hope for stock

OPTIONS



**Shed more light
on Options.**

Regulated Stock Options

- **Standardized contracts created & governed by Options Clearing Corp. (OCC)**
- **First introduced on CBOE in 1973 (911 contracts)**
 - > 1 billion now traded annually**

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OCC

- **Founded in 1973 to promote market stability & integrity**
- **“God”**
 - **Selects underlying securities (equities, indexes, debts instruments & foreign currencies)**
 - **Acts as contra-party to each transaction by severing relationship between holder & writer**
 - **Establishes strike price, contract size, expiration date**
 - **Does not set option premium (determined by supply & demand based on intrinsic & time values)**

Underlying Asset

- **Must be popular:** Vegas bookies offer odds on horse races & football games but *not* on extreme ironing or buzkashi



- **OCC selects based on trading volume & volatility**
- **Today's underlying securities: 2200 companies, 22 stock indices, 140 exchange-traded funds**

Nomenclature

- **Standardized to ensure all investors know to...**
 - **Multiply premiums & strike prices by standard contract size of 100 shares**
 - **All equity options expire 3rd Saturday of stated expiration month**
 - **Option was originally created 9 months before its expiration**

Example

Investor buys a JUL 14 Call on Yahoo for \$2.52

- **Investor spent \$252 (plus commissions) on contract that allows him to buy 100 shares of Yahoo stock for \$14/share any time between now & expiration date on July 20th, 2012**
- **Aggregate exercise price will be \$1,400**
- **Option was created & was first traded in October 2011**



Options & Taxes

- Always capital
- ➔ Report purchase, sale or expiration on Schedule D
- Always short-term
- ➔ Maximum duration is 9 months (except LEAPS)

SCHEDULE D-1 (Form 1040) Department of the Treasury Internal Revenue Service (33)	Continuation Sheet for Schedule D (Form 1040) ▶ See instructions for Schedule D (Form 1040). ▶ Attach to Schedule D to list additional transactions for lines 1 and 8.				OMB No. 1545-0074 2008 Attachment Sequence No. 12A
Name(s) shown on Form 1040 TAXPAYER				Your social security number 999-99-9999	
Part I Short-Term Capital Gains and Losses—Assets Held One Year or Less					
(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-6 of the instructions)	(e) Cost or other basis (see page D-6 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1 6 RAMBUS CALLS	1/20/2008		77	EXPIRED	77
4 HERCULES OFFSHORE CALLS	5/16/2008		267	EXPIRED	267
1 SANDISK CALL	12/21/2008		57	EXPIRED	57
400 SHS HERCULES OFFSHORE	VARIOUS	5/16/2008	11,990	11,816	174

Tax Consequences for Holder

- Buyer of option (whether call or put) pays premium + commissions → Holder's basis
- Holder's choices:
 1. Exercise (use call option to buy stock)
 2. Expire (hold option until worthless)
 3. Close out (sell option to new holder)

Closing Transactions: Holder

- Holder establishes option position by making a purchase
 - Money is spent & goes OUT
- Holder's choices
 - Exercise [but strike price may not be favorable]
 - Expire [premium is “wasted”]
- OR...
 - Holder can eliminate position by selling option
 - Money will be received & comes IN

Closing Transactions: Writer

- Writer establishes option position by making a sale
 - Money is received & comes IN
- Writer eliminates position by buying option back
 - Money will be spent & goes OUT
- To close a position, trader must do opposite of what he did to open position
 - Start by opening a door; finish by closing it
 - Or, close the door first; then open it

Holders *sell*, writers *buy* to close out option positions.

Example: Holder's Call

Bob bought JUL 14 Call on Yahoo for \$2.52 (+ \$50 commission) from Charlie when Yahoo stock at \$15.48/sh → Bob spent \$302 for contract that allows him to buy 100 shares of Yahoo stock for \$14/sh any time between now & July 20th [Bob is bullish]

1.Exercise: No immediate taxable event → add cost of \$302 to cost of newly purchased stock (\$1,400) for total of \$1,702 (= basis of Yahoo stock)

2.Expiration: \$302 STCL

3.Close: Sell option April 10th for \$0.96 when Yahoo at \$13.50/sh → \$256 STCL

46	Sales Price \$96 – Commissions \$50
<u>– 302</u>	Purchase Price \$252 + Commissions \$50
<u>= 256</u>	Realized Loss

**No tax until exercised, expired or closed,
even if deferred into following year.**

Tax Consequences for Writer

- **Seller of option (whether call or put) receives premium – commissions → no immediate tax consequence since outcome unknown**
- **Writer may close (eliminate) position by off-loading it onto 3rd party → recognize short-term gain (loss) on difference between premium received and premium paid**
- ***Holder* may choose to:**
 1. **Exercise (Writer must deliver stock)**
 2. **Expire (option becomes worthless) → short-term capital gain**

Example: Writer's Call

Charlie sold JUL 14 Call on Yahoo for \$2.52 (- \$50 commission) to Bob & received \$202 [Charlie is bearish] → no income recognition yet

At exercise: Charlie must deliver 100 shares of Yahoo; he'll receive \$1,400

- Charlie owns Yahoo shares (bought long ago at \$13.17/sh + \$50 commission) & is "covered"

1400	Sales Price of Stock
<u>- 1165</u>	Cost of Stock \$1317 + Commissions \$50 - Option Income \$202
<u>235</u>	Realized Gain

- Charlie doesn't own Yahoo, is "uncovered" & must buy at market (e.g. \$16/sh)

1400	Sales Price of Stock
<u>- 1448</u>	Cost of Stock \$1600 + Commissions \$50 - Option Income \$202
<u>-48</u>	Realized Loss

For every bull, there is a bear.



Summary of Tax Consequences

(*always capital*)

	Expiration	Exercise	Close Out
Call Holder [may buy stock]	STCL (= prem. out)	ST or LT after disposition of stock Basis of stock = strike + prem. out	ST or LT (= prem. in – prem. out)
Put Holder [may sell stock]	STCL (= prem. out)	ST or LT (= strike – basis) Basis of stock = cost + prem. Out	ST or LT (= prem. in – prem. out)
Call Writer [must sell stock]	STCG (= prem. in)	ST or LT (= strike – basis) Basis of stock = cost – prem. in	ST or LT (= prem. in – prem. out)
Put Writer [must buy stock]	STCG (= prem. in)	ST or LT after disposition of stock Basis of stock = strike – prem. in	ST or LT (= prem. in – prem. out)



Holding Period

General Rule

- ST if option closed or expired
- Tacked to holding period of underlying security if option exercised

Covered Call

- **Writer's holding period depends on whether option has intrinsic value**
($\text{Strike Price}_{\text{option}} < \text{Market Price}_{\text{stock}}$)
 - **Qualified (slightly in-the-money):** Stock holding period is temporarily suspended during life of option & tacked to holding period that begins at end of option
 - **Non-qualified (deep in-the-money):** Stock holding period is completely eliminated & only begins when option expires or is closed-out

**“In-the-money” always determined from
Holder’s point-of-view.**



Wash Sale Rule

- **Purpose:** To prevent taxpayer from claiming tax loss on illusionary sale
- Cannot re-purchase “substantially the same” security during 60-day window
- Applies to all securities, including options:
 - Holder of deep in-the-money call subject to wash sale rule since he could exercise & replace stock previously sold at loss
 - Writer of call is *not* subject to rule since unable to use option to reinstate stock position

Holder of call may buy stock; writer must sell stock.

Wash Sale Example

Facts

- Taxpayer sold stock at a loss
- Next day he sold put on same stock scheduled to expire in 1 month
- Put was in-the-money at the time of purchase

Rev. Rul. 85-87

- IRS found that Holder would very likely exercise & compel Writer to buy stock
 - Writer violated Wash Sale by buying substantially same security
- IRS evaluated:
 - Spread between value of underlying stock & exercise price
 - Term of put
 - Amount of premium paid
 - Historic price volatility of stock





§1256 Contracts

- Includes futures, foreign currency & regulated transactions
- Often remain “open” at year-end – not yet exercised or expired
- Treated as though sold at FMV on 12/31
→ resulting gain is treated 40% ST & 60% LT regardless of actual holding period
- Reported on Form 6781

FORM 6781

Form 6781 Department of the Treasury Internal Revenue Service	Gains and Losses From Section 1256 Contracts and Straddles Attach to your tax return.	OMB No. 1545-0644 2006 Attachment Sequence No. 82												
Name(s) shown on tax return TAXPAYER		Identifying number 999-99-9999												
Check all applicable boxes (see instructions). <table style="display: inline-table; margin-left: 20px;"> <tr> <td style="width: 30px;">A</td> <td><input type="checkbox"/></td> <td>Mixed straddle election</td> <td style="width: 30px;">C</td> <td><input type="checkbox"/></td> <td>Mixed straddle account election</td> </tr> <tr> <td>B</td> <td><input type="checkbox"/></td> <td>Straddle-by-straddle identification election</td> <td>D</td> <td><input type="checkbox"/></td> <td>Net section 1256 contracts loss election</td> </tr> </table>			A	<input type="checkbox"/>	Mixed straddle election	C	<input type="checkbox"/>	Mixed straddle account election	B	<input type="checkbox"/>	Straddle-by-straddle identification election	D	<input type="checkbox"/>	Net section 1256 contracts loss election
A	<input type="checkbox"/>	Mixed straddle election	C	<input type="checkbox"/>	Mixed straddle account election									
B	<input type="checkbox"/>	Straddle-by-straddle identification election	D	<input type="checkbox"/>	Net section 1256 contracts loss election									
Part I Section 1256 Contracts Marked to Market														
	(b) (Loss)	(c) Gain												
1 100 SPX JUNE 08 1250 CALLS		1,070,000												
2 Add the amounts on line 1 in columns (b) and (c)	2 (0)	1,070,000												
3 Net gain or (loss). Combine line 2, columns (b) and (c)		3 1,070,000												
4 Form 1099-B adjustments. See instructions and attach schedule		4												
5 Combine lines 3 and 4		5 1,070,000												
<i>Note: If line 5 shows a net gain, skip line 6 and enter the gain on line 7. Partnerships and S corporations, see instructions.</i>														
6 If you have a net section 1256 contracts loss and checked box D above, enter the amount of loss to be carried back. Enter the loss as a positive number		6												
7 Combine lines 5 and 6		7 1,070,000												
8 Short-term capital gain or (loss). Multiply line 7 by 40% (.40). Enter here and include on the appropriate line of Schedule D (see instructions). FLows TO SCH D LINE 4		8 428,000												
9 Long-term capital gain or (loss). Multiply line 7 by 60% (.60). Enter here and include on the appropriate line of Schedule D (see instructions). FLows TO SCH D LINE 11		9 642,000												

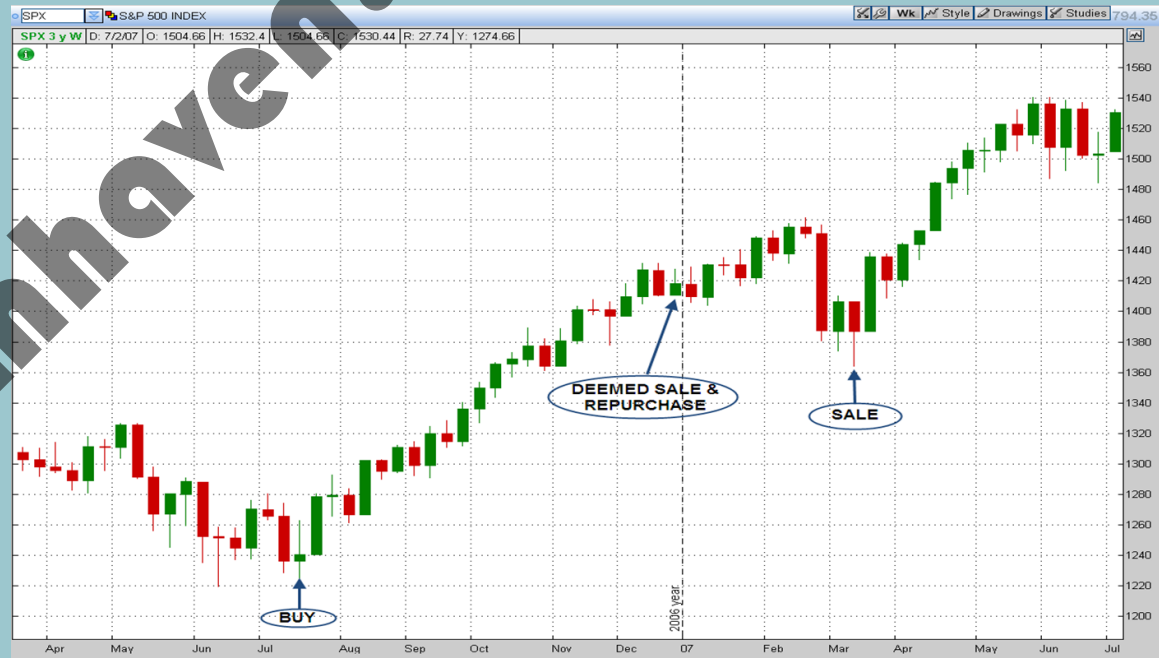
§1256 Contracts Example

Facts

- June 17th, 2006: bought 100 SPX Jun 08 1250 calls for 145
- December 31st, 2006: value of contract on 252

Mark-to-Market

- Contract deemed sold & repurchased on 12/31/06 at 252
- Gain: $252 - 145 = 107$
 - 40% ST = 42.80
 - 60% LT = 64.20



§1256 Contracts Example

(Cont'd.)

Facts

- March 12th, 2007: Contract sold at 228

Tax Reporting

- Deemed repurchase at 252 on 12/31/06

Sale 228

Basis 252

Loss (24)

→ 40% ST = 9.60

60% LTCL = 14.40

- Loss may be carried back three years



Futures



- Also known as “Forwards”
- Give holder right to buy commodities (e.g., oil, metals, grains & livestock)
- Pricing based on supply & demand
- Require physical delivery at expiration
EXCEPTION: Securities futures contracts allow holders to buy or sell single equity or narrow-based index → treated like regulated stock option

Looking Back at Futures

- **First created in Japan in 1600s**
 - Tenants paid rent in bushels of rice
 - Tenants concerned about price ↓; landlords about price ↑
 - Contracts sold to 3rd parties afforded price guarantees to tenants & landlords
 - Allowed speculators to increase market liquidity
- **Modern-day example = Real Estate contract**
 - Parties agree to buy/sell one house (commodity)
 - At fixed price (strike price)
 - On specific closing date in the future (expiration)

Foreign Currency Transactions

1. **Regulated (governed by IRC § 1256)**
 - Exchange-traded
 - Treat 40% ST & 60% LT capital regardless of actual holding
 - Report on Form 6781

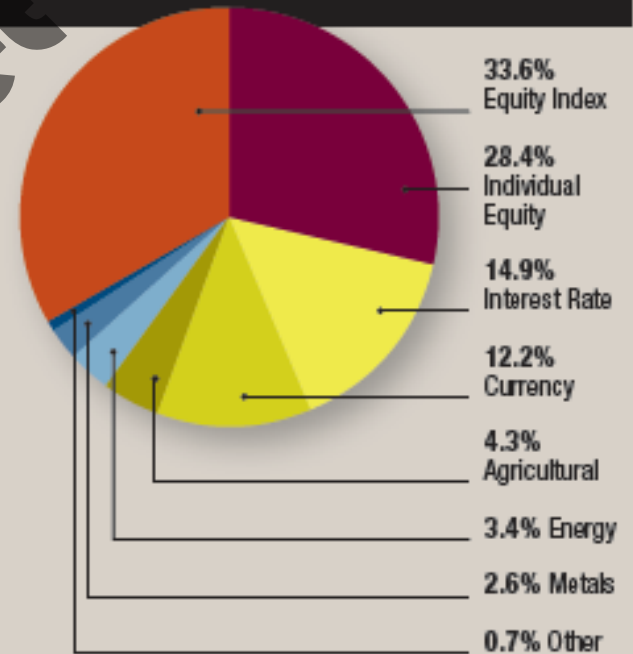
2. **Non-regulated (governed by IRC § 988)**
 - Cash forex & interbank trades
 - Gains & losses treated as ordinary
 - Losses not limited by \$3K rule
 - Not subject to Wash Sale Rule
 - Report on Line 21 of Form 1040

NOTE: Taxpayer can elect § 1256 treatment on a trade-by-trade basis [best if transaction results in taxable gain]

Global Futures and Options Volume by Category

Based on the number of contracts traded and/or cleared at 75 exchanges worldwide

Category	Jan-Jun 2010	Jan-Jun 2011	% Change
Equity Indices	3,652,436,829	4,165,573,156	14.0%
Individual Equities	3,321,680,770	3,525,365,778	6.1%
Interest Rate	1,659,822,751	1,853,103,765	11.6%
Currency	1,239,830,113	1,513,070,121	22.0%
Agricultural	582,725,097	529,586,361	-9.1%
Energy	358,956,748	416,243,993	16.0%
Non-Precious Metals	305,385,168	190,368,816	-37.7%
Precious Metals	85,081,442	127,485,550	49.8%
Other	47,711,354	81,739,555	71.3%
Total	11,253,630,272	12,402,537,095	10.2%



Employee Stock Option Plans (ESOPs)

- **Given to employees to motivate & reward without affecting current-year income statement**
- **Not regulated by OCC; not standardized**
- **2 types:**
 - **Statutory (ISOs & ESPPs)**
 - **Non-statutory**



Incentive Stock Options (ISOs)

- Granted to key employees (max. annual limit = \$100K/employee)
- Regular Tax: Income recognized upon disposition of stock (not when option granted or exercised)
 - LT gain (loss) if stock held > 1 year after exercise and held > 2 years after grant
 - Basis of stock = Exercise price
 - Ordinary income [reported W-2, Box 1] if disqualifying disposition before holding periods met
 - Basis of stock = Exercise price + compensation recognized
- AMT tax preference = $FMV_{\text{stock}} - \text{Strike Price}_{\text{option}}$ [reported W-2, Box 14]

Example of ISO

Holding Periods *not* Met

2/15/09: XYZ granted ISO to buy 100 shares at \$10/sh

10/1/11: Employee exercised when FMV of stock was \$15/sh

11/1/11: Employee sold stock for \$16/sh

2-yr holding period met

1-yr holding period not met

- W-2 inclusion in 2011 = \$500 (1500 - 1000)
- Form 1099-B issued for \$1,600 sales proceeds
- Basis of stock = \$1500 (1000 + 500 compensation recognized)
- STCG = \$100 (1600 - 1500).

If holding requirements met...

→ *No compensation recognized*

→ *LTCG = \$600 (1600 - 1000) if stock sold at \$16/sh
or LTCL if sold for < \$15/sh*



ISOs & AMT

- Bargain element is tax preference item which can be added to AMT basis, resulting in AMT gain < regular gain in year of sale
- Minimum Tax Credit [xp'd. 12/31/12; **no action taken under ATRA 2012**] from year of exercise can be used to reduce regular tax liability in year of sale BUT...
UPDATE!
- Beware if stock price falls:
 - Taxpayer used ISO to buy stock worth \$4.5 million for only \$128,000 & incurred huge AMT liability on bargain element
 - Taxpayer later sold stock for \$1.7 million, realizing economic gain (= 1.7 million – 128,000) & AMT tax loss (= 1.7 million – 4.5 million)
 - Subject to \$3K/year limitation on capital losses!!!



ISO: Tax Planning

- **Limit number of ISOs exercised annually to avoid triggering AMT**
- **Exercise ISOs early in year & then monitor stock price...**
 - **If stock price ↓, sell shares**
 - **disqualifying disposition but no AMT preference item & no AMT on phantom income**
 - **If stock price ↑, hold shares**
 - **pay AMT on phantom income but actual income will eventually be realized when stock is sold**

ESPPs

- **Must be exercised within 5 years after grant if strike price \geq 85% of market price**
- **No income recognized at grant or exercise**
- **No AMT adjustments**
- **If stock held > 1 year after exercise and held > 2 years after grant, gain (loss) will be LT**
[No compensation recognized]



Example of ESPP

Holding Periods *not* Met

2/15/09: XYZ granted ISO to buy 100 shares at \$10/sh
when stock at \$12/sh

10/1/11: Employee exercised when FMV of stock was \$15/sh

11/1/11: Employee sold stock for \$16/sh

2-yr holding period met

1-yr holding period not met

→ Ordinary income \$500 (= 1500 – 1000)

→ STCG \$100 (= 1600 – 1500)

If holding periods met...

→ Ordinary income \$200 (= 1200 – 1000)

→ LTCL \$400 (= 1600 – 1200)

If stock sold at \$7/sh

→ LTCL \$300 (= 1000 – 700)



Non-statutory Options

- Taxed as compensation on grant date if:
 - Readily determinable value
 - Income recognition postponed until exercise or transfer if no value available
- $\text{Income} = \text{Value of option} - \text{price paid for option (if any)}$
[reported W-2, Box 1]
- $\text{Basis of stock} = \text{Price paid for option (if any)} + \text{compensation recognized}$

Comparison of Tax Treatment

Taxpayer was granted 100 options with exercise price of \$10/sh...

	Tax at Exercise when Market Price = \$25/sh	Tax on Sale of Stock when Sales Price = \$45/sh
ISO	N/A	<p><u>Qualified Disposition:</u> $(45 - 10) \times 100\text{sh} = 3,500$ LTCG</p> <p><u>Disqualified Disposition:</u> $(25 - 10) \times 100\text{sh} = 1,500$ Ordinary AND $45 - 25 = 20 \times 100\text{sh} = 2,000$ Capital (LT or ST)</p>
Non-qualified	$(25 - 10) \times 100\text{sh} = 1,500$ Ordinary	$(45 - 25) \times 100\text{sh} = 2,000$ Capital (LT or ST)



Restricted Stock

Given to employee at no cost; subject to forfeiture for several years

Income Recognition

- **General Rule**
 - No recognition until vested or restriction lapses
 - $\text{Income} = \text{Amount paid for stock} - \text{FMV at vesting}$
 - Income & employment taxes are withheld
- **IRC §83(b) election**
 - Recognize income upon receipt of stock
 - Employee recognizes compensation income on date of transfer
 - BUT receives no cash with which to pay tax
 - Any FMV \uparrow taxed as capital gain when stock sold
 - Holding period begins on date of transfer

IRC § 83(b) ELECTION

General Rule	83(b) Election
Compensation income when vested [at higher value?]	Compensation income when received
	No cash received to pay tax
Holding period begins when vested	Holding period begins when received
Appreciation taxed when vested	Appreciation taxed when sold
Dividends taxed as compensation	Eligible for qualified dividend treatment
	No deduction for tax paid if stock is forfeited



Making the Election

Rev. Proc. 2012-29

- **Must file written statement with IRS Service Center within 30 days after receipt of stock**
 - **Include: Taxpayer's name, address & TIN; description & date of transfer; restrictions (if any); FMV at time of transfer; amount paid**
 - **Sample language available in revenue procedure**
- **Must attach duplicate copy of statement to tax return**



Example of Restricted Stock

Facts

- Taxpayer is granted 5,000 shares when FMV of stock @ \$10/sh
- Granted shares vest 5 years later when FMV @ \$30/sh
- Stock sold 3 years after vesting @ \$40/sh

	Without §83(b) Election	With §83(b) Election
Ordinary Income	150,000 (recognized at vesting)	50,000 (recognized at grant)
Capital Gain	50,000 (recognized when stock sold)	150,000 (recognized when stock sold)
Total	200,000	200,000



Mineral Rights

- Extraction by someone who is not land-owner is either “sale” or “lease”
- Test based on economic interest: Is land-owner paid whether extracted mineral is sold or not?
 - If yes, land-owner has no economic interest
 - ➔ treat as sale
 - If no, land-owner has retained economic interest
 - ➔ treat as lease
- Was surrounding land sold or rented?
 - ➔ May require bifurcated approach...

Mineral Rights: Tax Treatment

	Sale	Lease
Mineral Rights	ST or LTCG in year proceeds are received Basis of the mineral right is usually zero	Royalties reported on Schedule E Landowner may claim percentage depletion
Surface Land	Sale is reported on Schedule D if right-of-way or easement granting perpetual access without possibility of reversion involved	Rental income must be separately identified on Schedule E



Another Way of Looking at Options: A Practical Approach

Two Sets of Partners

- Set # 1 Student buys **CALL** → choice to buy CE units @ \$50 before 6/10
 School sells **CALL** → must provide CE units @ \$50 if Student exercises before 6/10
- Set # 2 School buys **PUT** → choice to provide CE units @ \$50 before 6/10
 Student sells **PUT** → must buy CE units @ \$50 each if School exercises before 6/10

Market Sides

- Side # 1 Student = Consumer of CE units
 Expects (or fears) the price of CE units will rise and is bullish
- Side # 2 School = Provider of CE units
 Expects (or fears) the price of CE units will fall and is bearish

A Practical Approach (Pricing)

Scenario # 1

- April 10th: Course catalog advertises regular price of CE units is \$75
- Market price of CE units remains fixed
- Price (or premium) of CALL will be...

On April 10 th	\$25 coupon savings + \$2 time value = \$27 total
On May 10 th	\$25 coupon savings + \$1 time value = \$26 total
On June 10 th	\$25 coupon savings + \$0 time value = \$25 total

Scenario # 2

- Price of CE units rises to \$100
- CALL guarantees a price of \$50
- Price (or premium) of CALL will be...

On April 10 th	\$50 coupon savings + \$2 time value = \$52 total
On May 10 th	\$50 coupon savings + \$1 time value = \$51 total
On June 10 th	\$50 coupon savings + \$0 time value = \$50 total

A Practical Approach

(Pricing Cont'd.)

Scenario # 3

- Price of CE units drops to \$40
- CALL guarantees a price of \$50
- Price (or premium) of CALL will be...

On April 10 th	\$0 coupon savings + \$2 time value = \$2 total
On May 10 th	\$0 coupon savings + \$1 time value = \$1 total
On June 10 th	\$0 coupon savings + \$0 time value = \$0 total

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A Practical Approach

(Holder's Choices)

Student who holds the CALL has choice to:

1. **Exercise:** Buy CE units @ \$50 if market value > \$50 + Premium Paid
→ Basis of CE units = Strike Price + Premium Paid
2. **Expire:** Forfeit CALL if market value ≤ \$50 + Premium Paid
→ STCL = Premium Paid
3. **Sell:** Close out position if unable or unwilling to exercise
→ STCG (or STCL) = Premium Rec'd – Premium Paid

**A “real” student might exercise but
speculator will close out to profit from premium differential.**

Options: Tricks & Rules

- Long = Buy = Hold
 - choice (Holder “may” buy/sell stock)
 - \$ out for premium
- Short = Sell = Write
 - obligation (Writer “must” sell/buy stock)
 - \$ in from premium

NOTE: Monica’s Rule of Opposites

Options:

Tricks & Rules (Cont'd.)

4 Basic Option Positions

	<u>Buy/Sell OPTION</u>	<u>Buy/Sell STOCK</u>
↑	LC = Long Call	(<i>may</i> buy stock)
↓	SC = Short Call	(<i>must</i> sell stock)
↓	LP = Long Put	(<i>may</i> sell stock)
↑	SP = Short Put	(<i>must</i> buy stock)

Bulls are on one side of market; bears on other side.



Options:

Tricks & Rules (Cont'd.)

Intrinsic Value

- **Call: Market Value > Strike Price**
- **Put: Market Value < Strike Price**

Maximum Loss

- **Max Loss when buying (long) an option = Premium**
- **Max Gain when selling (short) an option = Premium**

Option Strategies

- **Least aggressive strategy = Covered Call Writing**
- **Most aggressive strategy = Uncovered Call Writing**

“SHORT” DEFINED

“Short Selling”	“Short a Call (or Put)”
ALWAYS stock	ALWAYS an option
Possible transactions include: <ul style="list-style-type: none"> • Selling stock • Borrowing stock • Repurchasing stock to repay a loan → You are BEARISH	SC: Short Call Write Call Sell Call } → You are BEARISH SP: Short Put Write Put Sell Put } → You are BULLISH
Short Sale Up-tick Rule applies (Act of 1934)	N/A
MUST be done in a margin account b/c borrowing is involved	MAY be done in a cash or margin account, but NOT <u>on</u> margin “On” means that you would have borrowed money, which you can never do when dealing with options
Risky since there is a potential for unlimited loss if the market ↑ Risk could be mitigated by hedging the position with an option (either LC or SP)	Naked calls have unlimited risk exposure Should the holder of the call choose to exercise when the market increases, the writer will be called upon to deliver stock that he does not own but must now purchase at an inflated stock price

Steps to Solving Option Problems

Step 1

Step 1: Convert all word problems to short-hand:

- “Long” or “Short”? → L or S
- “Call” or “Put” or “Stock”? → C or P or STK
- **Strike Price?**
- **Premium or Stock Price?**

The result should look like

- LC 40 @ 2
- SP 60 @ 5
- LStk @ 73

REMEMBER: Market price in an option problem is always irrelevant!



Steps to Solving Option Problems

Steps 2 & 3

Step 2: Insert “+” or “-”

- “+” for money IN or received
- “-” for money OUT or spent

		<u>Strike</u>	<u>Premium</u>
LC	↑	-	-
	↓	+	+
	↓	+	-
SP	↑	-	+
	↑	LStk	-
	↓	SStk	+

Step 3: Decide which Solution Method to use

- Use +/- Game[®] if looking for “Maximum Gain”, “Maximum Loss” or “Breakeven”
- Use T-Chart (+/- Chart) for *all* other problems



Solving Option Problems

+/- Game®

Step	Options Only (Basic, Spreads, or Straddles)	Hedges (Stock + Option)
1	Identify position as Basic, Spread or Straddle	Identify option as either Call or Put
2	Assign "+" and "-"	Assign "+" and "-"
3	Add premiums → If sum is positive, then Max. Gain (MG) → If sum is negative, then Max. Loss (ML)	Add <u>Stock</u> Price and Premium → Sum is Breakeven
4	Add Strike Price to Subtotal from Step # 3 <ul style="list-style-type: none"> • If SPREAD, use Strike from option with highest Premium (=“favorite” option) → Sum is Breakeven • If STRADDLE, add Strike from each position separately to Step # 3 Subtotal → Sums will be <u>two</u> Breakevens 	If PUT, skip to Step # 5 If CALL, Step # 3 Subtotal will <u>also</u> be: → If sum is positive, then Max. Gain → If sum is negative, then Max. Loss Then add Strike Price to Step # 3 Subtotal to obtain <u>other</u> MG or ML → If sum is positive, then Max. Gain → If sum is negative, then Max. Loss
5	Add Unused Strike Price to Subtotal from Step # 4 (make sure to add both Premiums and both Strike Price into one grand total) → If sum is positive, then Max. Gain → If sum is negative, then Max. Loss → If result conflicts with (MG or ML) from Step # 3, then answer is “unlimited”	If PUT, add Strike Price to Step # 3 Subtotal → If sum is positive, then Max. Gain → If sum is negative, then Max. Loss Remaining unsolved MG or ML is “unlimited”

Steps to Solving Option Problems

T-Chart Problems

- **Buy/Sell (Trade or Close Out) OPTION @ Premium**
- **To “close out” a position means to do the opposite of the original transaction and so premium is entered into the opposite column of the T-chart (i.e. if you started by being “in” money, then you close by being “out” money)**
- **Buy/Sell (Exercise) STOCK @ Strike or Exercise Price**



Solving Option Problems

Example: MG, ML & BE

Situation

- Investor buys one DEF 155 call for \$4
- What is his maximum gain, maximum loss & breakeven?

Steps 1 & 2: Convert to short-hand & assign + & -

LC ⁻ 155 @ ⁻ 4

Step 3: Add Premium(s) → if negative, this is ML
Maximum Loss = \$400

Step 4: Add Strike Price → this is BE
Breakeven = \$159/share

Step 5: Add all numbers for “missing” MG or ML
→ If result conflicts with Step # 3, answer is “unlimited”
Maximum Gain = unlimited



Solving Option Problems

Example: MG, ML & BE

Situation

- Investor buys one MNO 50 call for \$6 & sells one MNO 40 call for \$8
- This is a Call Spread
- What is maximum gain, maximum loss & breakeven?

Steps 1 & 2:

Convert to short-hand & assign + & -

LC ⁻50 @ ⁻6

SC ⁺40 @ ⁺8

Step 3:

Add Premium(s) → if positive, this is MG

Maximum Gain = \$200

Step 4:

If SPREAD, add Strike from option with highest Premium → this is BE

Breakeven = \$42/share

Step 5:

Add all numbers for “missing” MG or ML

Maximum Loss = \$800



Solving Option Problems

Example: Basis

Situation

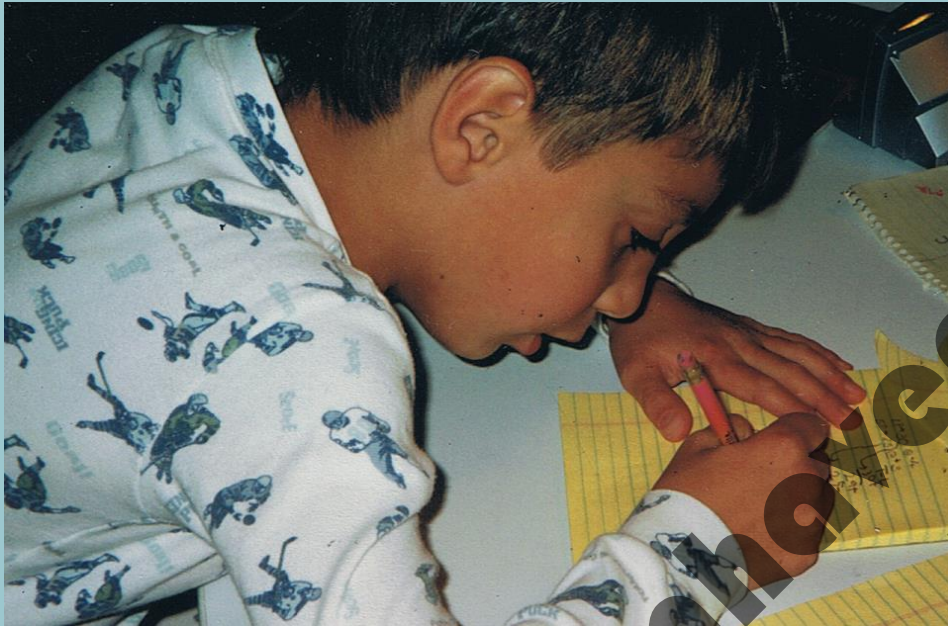
- Investor buys one XYZ 180 call for \$700
- Market price of XYZ is \$200/share
- Upon exercise, what is investor's cost basis?

RULE: Basis of stock = Strike + Premium OUT
\$700 + \$18,000 = \$18,700



Solving Option Problems

Think like a 7-year old!



October 21, 2001

To Whom it May Concern:

I attended a long and very detailed class about the history of the stock market taught by Monica. It was very interesting, but you can get bored. (Not always and not everyone.)

Monica was funny and told the class, "Think like a 7-year old" and I was the 7-year old when I learned to do the math she was teaching.

I would recommend Monica for teaching.

Sincerely:

Justin Semonsen

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