

Part Three.

Gains and Losses

The four chapters in this part discuss investment gains and losses, including how to figure your basis in property. A gain from selling or trading stocks, bonds, or other investment property may be taxed or it may be tax free, at least in part. A loss may or may not be deductible. These chapters also discuss gains from selling property you personally use — including the special rules for selling your home. Nonbusiness casualty and theft losses are discussed in chapter 25 in Part Five.

13.

Basis of Property

Introduction

This chapter discusses how to figure your basis in property. It is divided into the following sections.

- Cost basis.
- Adjusted basis.
- Basis other than cost.

Your basis is the amount of your investment in property for tax purposes. Use the basis to figure gain or loss on the sale, exchange, or other disposition of property. Also use it to figure deductions for depreciation, amortization, depletion, and casualty losses.

If you use property for both business or investment purposes and for personal purposes, you must allocate the basis based on the use. Only the basis allocated to the business or investment use of the property can be depreciated.

Your original basis in property is adjusted (increased or decreased) by certain events. For example, if you make improvements to the property, increase your basis. If you take deductions for depreciation or casualty losses, or claim certain credits, reduce your basis.



Keep accurate records of all items that affect the basis of your property. For more information on keeping records, see chapter 1.

Useful Items

You may want to see:

Publication

- 15-B Employer's Tax Guide to Fringe Benefits
- 525 Taxable and Nontaxable Income
- 535 Business Expenses
- 537 Installment Sales
- 544 Sales and Other Dispositions of Assets

- 550 Investment Income and Expenses
- 551 Basis of Assets
- 564 Mutual Fund Distributions
- 946 How To Depreciate Property

Cost Basis

The basis of property you buy is usually its cost. The cost is the amount you pay in cash, debt obligations, other property, or services. Your cost also includes amounts you pay for the following items:

- Sales tax,
- Freight,
- Installation and testing,
- Excise taxes,
- Legal and accounting fees (when they must be capitalized),
- Revenue stamps,
- Recording fees, and
- Real estate taxes (if you assume liability for the seller).

In addition, the basis of real estate and business assets may include other items.

Loans with low or no interest. If you buy property on a time-payment plan that charges little or no interest, the basis of your property is your stated purchase price minus any amount considered to be unstated interest. You generally have unstated interest if your interest rate is less than the applicable federal rate.

For more information, see *Unstated Interest and Original Issue Discount (OID)* in Publication 537.

Real Property

Real property, also called real estate, is land and generally anything built on, growing on, or attached to land.

If you buy real property, certain fees and other expenses you pay are part of your cost basis in the property.

Lump sum purchase. If you buy buildings and the land on which they stand for a lump sum, allocate the cost basis among the land and the buildings. Allocate the cost basis according to the respective fair market values (FMVs) of the land and buildings at the time of purchase. Figure the basis of each asset by multiplying the

lump sum by a fraction. The numerator is the FMV of that asset and the denominator is the FMV of the whole property at the time of purchase.



If you are not certain of the FMVs of the land and buildings, you can allocate the basis according to their assessed values for real estate tax purposes.

Fair market value (FMV). FMV is the price at which the property would change hands between a willing buyer and a willing seller, neither having to buy or sell, and both having reasonable knowledge of all the necessary facts. Sales of similar property on or about the same date may be helpful in figuring the FMV of the property.

Assumption of mortgage. If you buy property and assume (or buy the property subject to) an existing mortgage on the property, your basis includes the amount you pay for the property plus the amount to be paid on the mortgage.

Settlement costs. Your basis includes the settlement fees and closing costs you paid for buying the property. (A fee for buying property is a cost that must be paid even if you buy the property for cash.) Do not include fees and costs for getting a loan on the property in your basis.

The following are some of the settlement fees or closing costs you can include in the basis of your property.

- Abstract fees (abstract of title fees).
- Charges for installing utility services.
- Legal fees (including fees for the title search and preparation of the sales contract and deed).
- Recording fees.
- Survey fees.
- Transfer taxes.
- Owner's title insurance.
- Any amounts the seller owes that you agree to pay, such as back taxes or interest, recording or mortgage fees, charges for improvements or repairs, and sales commissions.

Settlement costs do not include amounts placed in escrow for the future payment of items such as taxes and insurance.

The following are some of the settlement fees and closing costs you cannot include in the basis of property.

- Casualty insurance premiums.
- Rent for occupancy of the property before closing.

- Charges for utilities or other services related to occupancy of the property before closing.
- Charges connected with getting a loan, such as points (discount points, loan origination fees), mortgage insurance premiums, loan assumption fees, cost of a credit report, and fees for an appraisal required by a lender.
- Fees for refinancing a mortgage.

Real estate taxes. If you pay real estate taxes the seller owed on real property you bought, and the seller did not reimburse you, treat those taxes as part of your basis. You cannot deduct them as an expense.

If you reimburse the seller for taxes the seller paid for you, you can usually deduct that amount as an expense in the year of purchase. Do not include that amount in the basis of your property. If you did not reimburse the seller, you must reduce your basis by the amount of those taxes.

Points. If you pay points to get a loan (including a mortgage, second mortgage, line of credit, or a home equity loan), do not add the points to the basis of the related property. Generally, you deduct the points over the term of the loan. For more information on how to deduct points, see chapter 23.

Points on home mortgage. Special rules may apply to points you and the seller pay when you get a mortgage to buy your main home. If certain requirements are met, you can deduct the points in full for the year in which they are paid. Reduce the basis of your home by any seller-paid points.

Adjusted Basis

Before figuring gain or loss on a sale, exchange, or other disposition of property or figuring allowable depreciation, depletion, or amortization, you must usually make certain adjustments (increases and decreases) to the cost of the property. The result is the adjusted basis.

Increases to Basis

Increase the basis of any property by all items properly added to a capital account. Examples of items that increase basis are shown in Table 13-1. These include the items discussed below.

Improvements. Add to your basis in property the cost of improvements having a useful life of more than 1 year, that increase the value of the property, lengthen its life, or adapt it to a different use. For example, improvements include putting a recreation room in your unfinished basement, adding another bathroom or bedroom, putting up a fence, putting in new plumbing or wiring, installing a new roof, or paving your driveway.

Assessments for local improvements. Add to the basis of property assessments for improvements such as streets and sidewalks if they increase the value of the property assessed. Do not deduct them as taxes. However,

Table 13-1. Examples of Adjustments to Basis

<u>Increases to Basis</u>	<u>Decreases to Basis</u>
<ul style="list-style-type: none"> • Capital improvements: <ul style="list-style-type: none"> Putting an addition on your home Replacing an entire roof Paving your driveway Installing central air conditioning Rewiring your home • Assessments for local improvements: <ul style="list-style-type: none"> Water connections Extending utility service lines to the property Sidewalks Roads • Casualty losses: <ul style="list-style-type: none"> Restoring damaged property • Legal fees: <ul style="list-style-type: none"> Cost of defending and perfecting a title Fees for getting a reduction of an assessment • Zoning costs 	<ul style="list-style-type: none"> • Exclusion from income of subsidies for energy conservation measures • Casualty or theft loss deductions and insurance reimbursements • Qualified electric vehicle credit (Form 8834) • Postponed gain from the sale of a home • Alternative motor vehicle credit (Form 8910) • Alternative fuel vehicle refueling property credit (Form 8911) • Residential energy credits (Form 5695) • Depreciation and section 179 deduction • Nontaxable corporate distributions • Certain canceled debt excluded from income • Easements • Adoption tax benefits

you can deduct as taxes assessments for maintenance or repairs, or for meeting interest charges related to the improvements.

Example. Your city changes the street in front of your store into an enclosed pedestrian mall and assesses you and other affected property owners for the cost of the conversion. Add the assessment to your property's basis. In this example, the assessment is a depreciable asset.

Decreases to Basis

Decrease the basis of any property by all items that represent a return of capital for the period during which you held the property. Examples of items that decrease basis are shown in Table 13-1. These include the items discussed below.

Casualty and theft losses. If you have a casualty or theft loss, decrease the basis in your property by any insurance proceeds or other reimbursement and by any deductible loss not covered by insurance.

You must increase your basis in the property by the amount you spend on repairs that substantially prolong the life of the property, increase its value, or adapt it to a different use. To make this determination, compare the repaired property to the property before the casualty.

For more information on casualty and theft losses, see chapter 25.

Depreciation and section 179 deduction. Decrease the basis of your qualifying business property by any section 179 deduction you take

and the depreciation you deducted, or could have deducted (including any special depreciation allowance), on your tax returns under the method of depreciation you selected.

For more information about depreciation and the section 179 deduction, see Publication 946 and the Instructions for Form 4562.

Example. You owned a duplex used as rental property that cost you \$40,000, of which \$35,000 was allocated to the building and \$5,000 to the land. You added an improvement to the duplex that cost \$10,000. In February last year, the duplex was damaged by fire. Up to that time, you had been allowed depreciation of \$23,000. You sold some salvaged material for \$1,300 and collected \$19,700 from your insurance company. You deducted a casualty loss of \$1,000 on your income tax return for last year. You spent \$19,000 of the insurance proceeds for restoration of the duplex, which was completed this year. You must use the duplex's adjusted basis after the restoration to determine depreciation for the rest of the property's recovery period. Figure the adjusted basis of the duplex as follows:

Original cost of duplex	\$35,000	
Addition to duplex	10,000	
Total cost of duplex	\$45,000	
Minus: Depreciation	23,000	
Adjusted basis before casualty	\$22,000	
Minus: Insurance proceeds	\$19,700	
Deducted casualty loss	1,000	
Salvage proceeds	1,300	22,000

Adjusted basis after casualty	\$0-
Add: Cost of restoring duplex	19,000
Adjusted basis after restoration	<u>\$19,000</u>

Note. Your basis in the land is its original cost of \$5,000.

Easements. The amount you receive for granting an easement is generally considered to be proceeds from the sale of an interest in real property. It reduces the basis of the affected part of the property. If the amount received is more than the basis of the part of the property affected by the easement, reduce your basis in that part to zero and treat the excess as a recognized gain.

If the gain is on a capital asset, see chapter 16 for information about how to report it. If the gain is on property used in a trade or business, see Publication 544 for information about how to report it.

Exclusion of subsidies for energy conservation measures. You can exclude from gross income any subsidy you received from a public utility company for the purchase or installation of an energy conservation measure for a dwelling unit. Reduce the basis of the property for which you received the subsidy by the excluded amount. For more information about this subsidy, see chapter 12.

Postponed gain from sale of home. If you postponed gain from the sale of your main home under rules in effect before May 7, 1997, you must reduce the basis of the home you acquired as a replacement by the amount of the postponed gain. For more information on the rules for the sale of a home, see chapter 15.

Basis Other Than Cost

There are many times when you cannot use cost as basis. In these cases, the fair market value or the adjusted basis of the property can be used. Fair market value (FMV) and adjusted basis were discussed earlier.

Property Received for Services

If you receive property for your services, include its FMV in income. The amount you include in income becomes your basis. If the services were performed for a price agreed on beforehand, it will be accepted as the FMV of the property if there is no evidence to the contrary.

Restricted property. If you receive property for your services and the property is subject to certain restrictions, your basis in the property is its FMV when it becomes substantially vested. However, this rule does not apply if you make an election to include in income the FMV of the property at the time it is transferred to you, less any amount you paid for it. Property is substantially vested when it is transferable or when it is not subject to a substantial risk of forfeiture (you do not have a good chance of losing it). For more information, see *Restricted Property* in Publication 525.

Bargain purchases. A bargain purchase is a purchase of an item for less than its FMV. If, as

compensation for services, you buy goods or other property at less than FMV, include the difference between the purchase price and the property's FMV in your income. Your basis in the property is its FMV (your purchase price plus the amount you include in income).

If the difference between your purchase price and the FMV is a qualified employee discount, do not include the difference in income. However, your basis in the property is still its FMV. See *Employee Discounts* in Publication 15-B.

Taxable Exchanges

A taxable exchange is one in which the gain is taxable or the loss is deductible. A taxable gain or deductible loss also is known as a recognized gain or loss. If you receive property in exchange for other property in a taxable exchange, the basis of the property you receive is usually its FMV at the time of the exchange.

Involuntary Conversions

If you receive replacement property as a result of an involuntary conversion, such as a casualty, theft, or condemnation, figure the basis of the replacement property using the basis of the converted property.

Similar or related property. If you receive replacement property similar or related in service or use to the converted property, the replacement property's basis is the same as the converted property's basis on the date of the conversion, with the following adjustments.

1. Decrease the basis by the following.
 - a. Any loss you recognize on the involuntary conversion.
 - b. Any money you receive that you do not spend on similar property.
2. Increase the basis by the following.
 - a. Any gain you recognize on the involuntary conversion.
 - b. Any cost of acquiring the replacement property.

Money or property not similar or related. If you receive money or property not similar or related in service or use to the converted property, and you buy replacement property similar or related in service or use to the converted property, the basis of the replacement property is its cost decreased by the gain not recognized on the conversion.

Example. The state condemned your property. The adjusted basis of the property was \$26,000 and the state paid you \$31,000 for it. You realized a gain of \$5,000 (\$31,000 – \$26,000). You bought replacement property similar in use to the converted property for \$29,000. You recognize a gain of \$2,000 (\$31,000 – \$29,000), the unspent part of the payment from the state. Your unrecognized gain is \$3,000, the difference between the \$5,000 realized gain and the \$2,000 recognized gain. The basis of the replacement property is figured as follows:

Cost of replacement property	\$29,000
Minus: Gain not recognized	3,000
Basis of replacement property	<u>\$26,000</u>

Allocating the basis. If you buy more than one piece of replacement property, allocate your basis among the properties based on their respective costs.

Basis for depreciation. Special rules apply in determining and depreciating the basis of MACRS property acquired in an involuntary conversion. For information, see *What Is the Basis of Your Depreciable Property?* in chapter 1 of Publication 946.

Nontaxable Exchanges

A nontaxable exchange is an exchange in which you are not taxed on any gain and you cannot deduct any loss. If you receive property in a nontaxable exchange, its basis is generally the same as the basis of the property you transferred. See *Nontaxable Trades* in chapter 14.

Like-Kind Exchanges

The exchange of property for the same kind of property is the most common type of nontaxable exchange. To qualify as a like-kind exchange, the property traded and the property received must be both of the following.

- Qualifying property.
- Like-kind property.

The basis of the property you receive is generally the same as the adjusted basis of the property you gave up. If you trade property in a like-kind exchange and also pay money, the basis of the property received is the adjusted basis of the property you gave up increased by the money you paid.

Qualifying property. In a like-kind exchange, you must hold for investment or for productive use in your trade or business both the property you give up and the property you receive.

Like-kind property. There must be an exchange of like-kind property. Like-kind properties are properties of the same nature or character, even if they differ in grade or quality. The exchange of real estate for real estate and personal property for similar personal property are exchanges of like-kind property.

Example. You trade in an old truck used in your business with an adjusted basis of \$1,700 for a new one costing \$6,800. The dealer allows you \$2,000 on the old truck, and you pay \$4,800. This is a like-kind exchange. The basis of the new truck is \$6,500 (the adjusted basis of the old one, \$1,700, plus the amount you paid, \$4,800).

If you sell your old truck to a third party for \$2,000 instead of trading it in and then buy a new one from the dealer, you have a taxable gain of \$300 on the sale (the \$2,000 sale price minus the \$1,700 adjusted basis). The basis of the new truck is the price you pay the dealer.

Partially nontaxable exchanges. A partially nontaxable exchange is an exchange in which you receive unlike property or money in addition to like-kind property. The basis of the property you receive is the same as the adjusted basis of

the property you gave up, with the following adjustments.

1. Decrease the basis by the following amounts.
 - a. Any money you receive.
 - b. Any loss you recognize on the exchange.
2. Increase the basis by the following amounts.
 - a. Any additional costs you incur.
 - b. Any gain you recognize on the exchange.

If the other party to the exchange assumes your liabilities, treat the debt assumption as money you received in the exchange.

Allocation of basis. If you receive like-kind and unlike properties in the exchange, allocate the basis first to the unlike property, other than money, up to its FMV on the date of the exchange. The rest is the basis of the like-kind property.

More information. See *Like-Kind Exchanges* in chapter 1 of Publication 544 for more information.

Basis for depreciation. Special rules apply in determining and depreciating the basis of MACRS property acquired in a like-kind exchange. For information, see *What Is the Basis of Your Depreciable Property?* in chapter 1 of Publication 946.

Property Transferred From a Spouse

The basis of property transferred to you or transferred in trust for your benefit by your spouse is the same as your spouse's adjusted basis. The same rule applies to a transfer by your former spouse that is incident to divorce. However, for property transferred in trust, adjust your basis for any gain recognized by your spouse or former spouse if the liabilities assumed, plus the liabilities to which the property is subject, are more than the adjusted basis of the property transferred.

If the property transferred to you is a series E, series EE, or series I U.S. savings bond, the transferor must include in income the interest accrued to the date of transfer. Your basis in the bond immediately after the transfer is equal to the transferor's basis increased by the interest income includible in the transferor's income. For more information on these bonds, see chapter 7.

At the time of the transfer, the transferor must give you the records needed to determine the adjusted basis and holding period of the property as of the date of the transfer.

For more information about the transfer of property from a spouse, see chapter 14.

Property Received as a Gift

To figure the basis of property you receive as a gift, you must know its adjusted basis to the

donor just before it was given to you, its FMV at the time it was given to you, and any gift tax paid on it.

FMV less than donor's adjusted basis. If the FMV of the property at the time of the gift is less than the donor's adjusted basis, your basis depends on whether you have a gain or a loss when you dispose of the property. Your basis for figuring gain is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you held the property. Your basis for figuring loss is its FMV when you received the gift plus or minus any required adjustments to basis while you held the property. See *Adjusted Basis*, earlier.

Example. You received an acre of land as a gift. At the time of the gift, the land had an FMV of \$8,000. The donor's adjusted basis was \$10,000. After you received the property, no events occurred to increase or decrease your basis. If you later sell the property for \$12,000, you will have a \$2,000 gain because you must use the donor's adjusted basis at the time of the gift (\$10,000) as your basis to figure gain. If you sell the property for \$7,000, you will have a \$1,000 loss because you must use the FMV at the time of the gift (\$8,000) as your basis to figure loss.

If the sales price is between \$8,000 and \$10,000, you have neither gain nor loss.

Business property. If you hold the gift as business property, your basis for figuring any depreciation, depletion, or amortization deductions is the same as the donor's adjusted basis plus or minus any required adjustments to basis while you hold the property.

FMV equal to or greater than donor's adjusted basis. If the FMV of the property is equal to or greater than the donor's adjusted basis, your basis is the donor's adjusted basis at the time you received the gift. Increase your basis by all or part of any gift tax paid, depending on the date of the gift, explained later.

Also, for figuring gain or loss from a sale or other disposition or for figuring depreciation, depletion, or amortization deductions on business property, you must increase or decrease your basis (the donor's adjusted basis) by any required adjustments to basis while you held the property. See *Adjusted Basis*, earlier.

If you received a gift during the tax year, increase your basis in the gift (the donor's adjusted basis) by the part of the gift tax paid on it due to the net increase in value of the gift. Figure the increase by multiplying the gift tax paid by a fraction. The numerator of the fraction is the net increase in value of the gift and the denominator is the amount of the gift.

The net increase in value of the gift is the FMV of the gift minus the donor's adjusted basis. The amount of the gift is its value for gift tax purposes after reduction by any annual exclusion and marital or charitable deduction that applies to the gift. For information on the gift tax, see Publication 950, *Introduction to Estate and Gift Taxes*.

Example. In 2006, you received a gift of property from your mother that had an FMV of \$50,000. Her adjusted basis was \$20,000. The amount of the gift for gift tax purposes was \$38,000 (\$50,000 minus the \$12,000 annual

exclusion). She paid a gift tax of \$9,000 on the property. Your basis is \$27,110, figured as follows:

Fair market value	\$50,000
Minus: Adjusted basis	-20,000
Net increase in value	<u>\$30,000</u>
Gift tax paid	\$9,000
Multiplied by (\$30,000 ÷ \$38,000)	× .79
Gift tax due to net increase in value	<u>\$7,110</u>
Adjusted basis of property to your mother	+20,000
Your basis in the property	<u>\$27,110</u>

Note. If you received a gift before 1977, your basis in the gift (the donor's adjusted basis) includes any gift tax paid on it. However, your basis cannot exceed the FMV of the gift at the time it was given to you.

Inherited Property

Your basis in property you inherit from a decedent is generally one of the following.

- The FMV of the property at the date of the decedent's death.
- The FMV on the alternate valuation date if the personal representative for the estate elects to use alternate valuation.
- The value under the special-use valuation method for real property used in farming or a closely held business if elected for estate tax purposes.
- The decedent's adjusted basis in land to the extent of the value excluded from the decedent's taxable estate as a qualified conservation easement.

If a federal estate tax return does not have to be filed, your basis in the inherited property is its appraised value at the date of death for state inheritance or transmission taxes.

For more information, see the instructions for Form 706, *United States Estate (and Generation-Skipping Transfer) Tax Return*.

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

Example. You and your spouse owned community property that had a basis of \$80,000. When your spouse died, half the FMV of the community interest was includible in your spouse's estate. The FMV of the community interest was \$100,000. The basis of your half of the property after the death of your spouse is \$50,000 (half of the \$100,000 FMV). The basis of the other half to your spouse's heirs is also \$50,000.

For more information about community property, see Publication 555, *Community Property*.

Property Changed From Personal to Business or Rental Use

If you hold property for personal use and then change it to business use or use it to produce rent, you can begin to depreciate the property at the time of the change. To do so, you must figure its basis for depreciation. An example of changing property held for personal use to business or rental use would be renting out your former personal residence.

Basis for depreciation. The basis for depreciation is the lesser of the following amounts.

- The FMV of the property on the date of the change.
- Your adjusted basis on the date of the change.

Example. Several years ago, you paid \$160,000 to have your house built on a lot that cost \$25,000. You paid \$20,000 for permanent improvements to the house and claimed a \$2,000 casualty loss deduction for damage to the house before changing the property to rental use last year. Because land is not depreciable, you include only the cost of the house when figuring the basis for depreciation.

Your adjusted basis in the house when you changed its use was \$178,000 (\$160,000 + \$20,000 – \$2,000). On the same date, your property had an FMV of \$180,000, of which \$15,000 was for the land and \$165,000 was for the house. The basis for figuring depreciation on the house is its FMV on the date of the change (\$165,000) because it is less than your adjusted basis (\$178,000).

Sale of property. If you later sell or dispose of property changed to business or rental use, the basis you use will depend on whether you are figuring gain or loss.

Gain. The basis for figuring a gain is your adjusted basis in the property when you sell the property.

Example. Assume the same facts as in the previous example except that you sell the property at a gain after being allowed depreciation deductions of \$37,500. Your adjusted basis for figuring gain is \$165,500 (\$178,000 + \$25,000 (land) – \$37,500).

Loss. Figure the basis for a loss starting with the smaller of your adjusted basis or the FMV of the property at the time of the change to business or rental use. Then make adjustments (increases and decreases) for the period after the change in the property's use, as discussed earlier under *Adjusted Basis*.

Example. Assume the same facts as in the previous example, except that you sell the property at a loss after being allowed depreciation deductions of \$37,500. In this case, you would start with the FMV on the date of the change to rental use (\$180,000), because it is less than the adjusted basis of \$203,000 (\$178,000 + \$25,000 (land)) on that date. Reduce that amount (\$180,000) by the depreciation deductions (\$37,500). The basis for loss is \$142,500 (\$180,000 – \$37,500).

Stocks and Bonds

The basis of stocks or bonds you buy generally is the purchase price plus any costs of purchase, such as commissions and recording or transfer fees. If you get stocks or bonds other than by purchase, your basis is usually determined by the FMV or the previous owner's adjusted basis, as discussed earlier.

You must adjust the basis of stocks for certain events that occur after purchase. For example, if you receive additional stock from nontaxable stock dividends or stock splits, reduce your basis for each share of stock by dividing the adjusted basis of the old stock by the number of shares of old and new stock. This rule applies only when the additional stock received is identical to the stock held. Also reduce your basis when you receive nontaxable distributions. They are a return of capital.

Example. In 2004 you bought 100 shares of XYZ stock for \$1,000 or \$10 a share. In 2005 you bought 100 shares of XYZ stock for \$1,600 or \$16 a share. In 2006 XYZ declared a 2-for-1 stock split. You now have 200 shares of stock with a basis of \$5 a share and 200 shares with a basis of \$8 a share.

Other basis. There are other ways to figure the basis of stocks or bonds depending on how you acquired them. For detailed information, see *Stocks and Bonds* under *Basis of Investment Property* in chapter 4 of Publication 550.

Identifying stocks or bonds sold. If you can adequately identify the shares of stock or the bonds you sold, their basis is the cost or other basis of the particular shares of stocks or bonds. If you buy and sell securities at various times in varying quantities and you cannot adequately identify the shares you sell, the basis of the securities you sell is the basis of the securities you acquired first. For more information about identifying securities you sell, see *Stocks and Bonds* under *Basis of Investment Property* in chapter 4 of Publication 550.

Mutual fund shares. If you sell mutual fund shares you acquired at various times and prices and left on deposit in an account kept by a custodian or agent, you can elect to use an average basis. For more information, see Publication 564.

Bond premium. If you buy a taxable bond at a premium and elect to amortize the premium, reduce the basis of the bond by the amortized premium you deduct each year. See *Bond Premium Amortization* in chapter 3 of Publication 550 for more information. Although you cannot deduct the premium on a tax-exempt bond, you must amortize the premium each year and reduce your basis in the bond by the amortized amount.

Original issue discount (OID) on debt instruments. You must increase your basis in an OID debt instrument by the OID you include in income for that instrument. See *Original Issue Discount (OID)* in chapter 7 and Publication 1212, *Guide To Original Issue Discount (OID) Instruments*.

Tax-exempt obligations. OID on tax-exempt obligations is generally not taxable. However, when you dispose of a tax-exempt

obligation issued after September 3, 1982, and acquired after March 1, 1984, you must accrue OID on the obligation to determine its adjusted basis. The accrued OID is added to the basis of the obligation to determine your gain or loss. See chapter 4 of Publication 550.

14.

Sale of Property

Reminder

Foreign income. If you are a U.S. citizen who sells property located outside the United States, you must report all gains and losses from the sale of that property on your tax return unless it is exempt by U.S. law. This is true whether you reside inside or outside the United States and whether or not you receive a Form 1099 from the payer.

Introduction

This chapter discusses the tax consequences of selling or trading investment property. It explains the following.

- What a sale or trade is.
- Figuring gain or loss.
- Nontaxable trades.
- Related party transactions.
- Capital gains or losses.
- Capital assets and noncapital assets.
- Holding period.
- Rollover of gain from publicly traded securities.

Other property transactions. Certain transfers of property are not discussed here. They are discussed in other IRS publications. These include the following.

- Installment sales, covered in Publication 537, *Installment Sales*.
- Transfers of property at death, covered in Publication 559, *Survivors, Executors, and Administrators*.
- Transactions involving business property, covered in Publication 544, *Sales and Other Dispositions of Assets*.
- Dispositions of an interest in a passive activity, covered in Publication 925, *Passive Activity and At-Risk Rules*.
- Sales of a main home, covered in chapter 15.

Publication 550, *Investment Income and Expenses (Including Capital Gains and Losses)*,

provides a more detailed discussion about sales and trades of investment property. Publication 550 includes information about the rules covering nonbusiness bad debts, straddles, section 1256 contracts, puts and calls, commodity futures, short sales, and wash sales. It also discusses investment-related expenses.

Useful Items

You may want to see:

Publication

- 550** Investment Income and Expenses
- 564** Mutual Fund Distributions

Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 8824** Like-Kind Exchanges

Sales and Trades

If you sold property such as stocks, bonds, or certain commodities through a broker during the year, you should receive, for each sale, a Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, or an equivalent statement from the broker. You should receive the statement by January 31 of the next year. It will show the gross proceeds from the sale. The IRS will also get a copy of Form 1099-B from the broker.

Use Form 1099-B (or an equivalent statement received from your broker) to complete Schedule D (Form 1040).

What Is a Sale or Trade?

This section explains what is a sale or trade. It also explains certain transactions and events that are treated as sales or trades.

A sale is generally a transfer of property for money or a mortgage, note, or other promise to pay money.

A trade is a transfer of property for other property or services and may be taxed in the same way as a sale.

Sale and purchase. Ordinarily, a transaction is not a trade when you voluntarily sell property for cash and immediately buy similar property to replace it. The sale and purchase are two separate transactions. But see *Like-kind exchanges* under *Nontaxable Trades*, later.

Redemption of stock. A redemption of stock is treated as a sale or trade and is subject to the capital gain or loss provisions unless the redemption is a dividend or other distribution on stock.

Dividend versus sale or trade. Whether a redemption is treated as a sale, trade, dividend, or other distribution depends on the circumstances in each case. Both direct and indirect ownership of stock will be considered. The redemption is treated as a sale or trade of stock if:

- The redemption is not essentially equivalent to a dividend (see chapter 8),

- There is a substantially disproportionate redemption of stock,
- There is a complete redemption of all the stock of the corporation owned by the shareholder, or
- The redemption is a distribution in partial liquidation of a corporation.

Redemption or retirement of bonds. A redemption or retirement of bonds or notes at their maturity is generally treated as a sale or trade.

Surrender of stock. A surrender of stock by a dominant shareholder who retains control of the corporation is treated as a contribution to capital rather than as an immediate loss deductible from taxable income. The surrendering shareholder must reallocate his or her basis in the surrendered shares to the shares he or she retains.

Worthless securities. Stocks, stock rights, and bonds (other than those held for sale by a securities dealer) that became worthless during the tax year are treated as though they were sold on the last day of the tax year. This affects whether your capital loss is long-term or short-term. See *Holding Period*, later.

If you are a cash basis taxpayer and make payments on a negotiable promissory note that you issued for stock that became worthless, you can deduct these payments as losses in the years you actually make the payments. Do not deduct them in the year the stock became worthless.

How to report loss. Report worthless securities on Schedule D (Form 1040), line 1 or line 8, whichever applies. In columns (c) and (d), enter "Worthless." Enter the amount of your loss in parentheses in column (f).

Filing a claim for refund. If you do not claim a loss for a worthless security on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the loss. You must use Form 1040X, Amended U.S. Individual Income Tax Return, to amend your return for the year the security became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in chapter 1.

How To Figure Gain or Loss

You figure gain or loss on a sale or trade of property by comparing the amount you realize with the adjusted basis of the property.

Gain. If the amount you realize from a sale or trade is more than the adjusted basis of the property you transfer, the difference is a gain.

Loss. If the adjusted basis of the property you transfer is more than the amount you realize, the difference is a loss.

Adjusted basis. The adjusted basis of property is your original cost or other original basis properly adjusted (increased or decreased) for

certain items. See chapter 13 for more information about determining the adjusted basis of property.

Amount realized. The amount you realize from a sale or trade of property is everything you receive for the property. This includes the money you receive plus the fair market value of any property or services you receive. If you received a note or other debt instrument for the property, see *How To Figure Gain or Loss* in chapter 4 of Publication 550 to figure the amount realized.

If you finance the buyer's purchase of your property and the debt instrument does not provide for adequate stated interest, the unstated interest that you must report as ordinary income will reduce the amount realized from the sale. For more information, see Publication 537.

Fair market value. Fair market value is the price at which the property would change hands between a buyer and a seller, neither being forced to buy or sell and both having reasonable knowledge of all the relevant facts.

Example. You trade A Company stock with an adjusted basis of \$7,000 for B Company stock with a fair market value of \$10,000, which is your amount realized. Your gain is \$3,000 (\$10,000 – \$7,000).

Debt paid off. A debt against the property, or against you, that is paid off as a part of the transaction, or that is assumed by the buyer, must be included in the amount realized. This is true even if neither you nor the buyer is personally liable for the debt. For example, if you sell or trade property that is subject to a nonrecourse loan, the amount you realize generally includes the full amount of the note assumed by the buyer even if the amount of the note is more than the fair market value of the property.

Example. You sell stock that you had pledged as security for a bank loan of \$8,000. Your basis in the stock is \$6,000. The buyer pays off your bank loan and pays you \$20,000 in cash. The amount realized is \$28,000 (\$20,000 + \$8,000). Your gain is \$22,000 (\$28,000 – \$6,000).

Payment of cash. If you trade property and cash for other property, the amount you realize is the fair market value of the property you receive. Determine your gain or loss by subtracting the cash you pay plus the adjusted basis of the property you trade in from the amount you realize. If the result is a positive number, it is a gain. If the result is a negative number, it is a loss.

No gain or loss. You may have to use a basis for figuring gain that is different from the basis used for figuring loss. In this case, you may have neither a gain nor a loss. See *Basis Other Than Cost* in chapter 13.

Nontaxable Trades

This section discusses trades that generally do not result in a taxable gain or deductible loss. For more information on nontaxable trades, see chapter 1 of Publication 544.

Like-kind exchanges. If you trade business or investment property for other business or

investment property of a like kind, you do not pay tax on any gain or deduct any loss until you sell or dispose of the property you receive. To be nontaxable, a trade must meet all six of the following conditions.

1. The property must be business or investment property. You must hold both the property you trade and the property you receive for productive use in your trade or business or for investment. Neither property may be property used for personal purposes, such as your home or family car.
2. The property must not be held primarily for sale. The property you trade and the property you receive must not be property you sell to customers, such as merchandise.
3. The property must not be stocks, bonds, notes, choses in action, certificates of trust or beneficial interest, or other securities or evidences of indebtedness or interest, including partnership interests. However, you can have a nontaxable trade of corporate stocks under a different rule, as discussed later.
4. There must be a trade of like property. The trade of real estate for real estate, or personal property for similar personal property, is a trade of like property. The trade of an apartment house for a store building, or a panel truck for a pickup truck, is a trade of like property. The trade of a piece of machinery for a store building is not a trade of like property. Real property located in the United States and real property located outside the United States are not like property. Also, personal property used predominantly within the United States and personal property used predominantly outside the United States are not like property.
5. The property to be received must be identified in writing within 45 days after the date you transfer the property given up in the trade.
6. The property to be received must be received by the earlier of:
 - a. The 180th day after the date on which you transfer the property given up in the trade, or
 - b. The due date, including extensions, for your tax return for the year in which the transfer of the property given up occurs.

If you trade property with a related party in a like-kind exchange, a special rule may apply. See *Related Party Transactions*, later in this chapter. Also, see chapter 1 of Publication 544 for more information on exchanges of business property and special rules for exchanges using qualified intermediaries or involving multiple properties.

Partly nontaxable exchange. If you receive money or unlike property in addition to like property, and the above six conditions are met, you have a partly nontaxable trade. You are taxed on any gain you realize, but only up to the amount of the money and the fair market value of the unlike property you receive. You cannot deduct a loss.

Like property and unlike property transferred. If you give up unlike property in addition to the like property, you must recognize gain or loss on the unlike property you give up. The gain or loss is the difference between the adjusted basis of the unlike property and its fair market value.

Like property and money transferred. If conditions (1) – (6) are met, you have a nontaxable trade even if you pay money in addition to the like property.

Basis of property received. To figure the basis of the property received, see *Nontaxable Exchanges* in chapter 13.

How to report. You must report the trade of like property on Form 8824. If you figure a recognized gain or loss on Form 8824, report it on Schedule D (Form 1040), or on Form 4797, Sales of Business Property, whichever applies.

For information on using Form 4797, see chapter 4 of Publication 544.

Corporate stocks. The following trades of corporate stocks generally do not result in a taxable gain or a deductible loss.

Corporate reorganizations. In some instances, a company will give you common stock for preferred stock, preferred stock for common stock, or stock in one corporation for stock in another corporation. If this is a result of a merger, recapitalization, transfer to a controlled corporation, bankruptcy, corporate division, corporate acquisition, or other corporate reorganization, you do not recognize gain or loss.

Stock for stock of the same corporation. You can exchange common stock for common stock or preferred stock for preferred stock in the same corporation without having a recognized gain or loss. This is true for a trade between two stockholders as well as a trade between a stockholder and the corporation.

Convertible stocks and bonds. You generally will not have a recognized gain or loss if you convert bonds into stock or preferred stock into common stock of the same corporation according to a conversion privilege in the terms of the bond or the preferred stock certificate.

Property for stock of a controlled corporation. If you transfer property to a corporation solely in exchange for stock in that corporation, and immediately after the trade you are in control of the corporation, you ordinarily will not recognize a gain or loss. This rule applies both to individuals and to groups who transfer property to a corporation. It does not apply if the corporation is an investment company.

For this purpose, to be in control of a corporation, you or your group of transferors must own, immediately after the exchange, at least 80% of the total combined voting power of all classes of stock entitled to vote and at least 80% of the outstanding shares of each class of non-voting stock of the corporation.

If this provision applies to you, you may have to attach to your return a complete statement of all facts pertinent to the exchange. For details, see Temporary Regulations section 1.351-3T.

Additional information. For more information on trades of stock, see *Nontaxable Trades* in chapter 4 of Publication 550.

Insurance policies and annuities. You will not have a recognized gain or loss if the insured or annuitant is the same under both contracts and you trade:

- A life insurance contract for another life insurance contract or for an endowment or annuity contract,
- An endowment contract for an annuity contract or for another endowment contract that provides for regular payments beginning at a date not later than the beginning date under the old contract, or
- An annuity contract for another annuity contract.

You also may not have to recognize gain or loss on an exchange of a portion of an annuity contract for another annuity contract. See Revenue Ruling 2003-76 and Notice 2003-51 in Internal Revenue Bulletin 2003-33. This bulletin is available at www.irs.gov/pub/irs-irbs/irb03-33.pdf.

Exchanges of contracts not included in this list, such as an annuity contract for an endowment contract, or an annuity or endowment contract for a life insurance contract, are taxable.

Demutualization of life insurance companies. If you received stock in exchange for your equity interest as a policyholder or an annuitant, you generally will not have a recognized gain or loss. See *Demutualization of Life Insurance Companies* in Publication 550.

U.S. Treasury notes or bonds. You can trade certain issues of U.S. Treasury obligations for other issues designated by the Secretary of the Treasury, with no gain or loss recognized on the trade.

Transfers Between Spouses

Generally, no gain or loss is recognized on a transfer of property from an individual to (or in trust for the benefit of) a spouse, or if incident to a divorce, a former spouse. This nonrecognition rule does not apply in the following situations.

- The recipient spouse or former spouse is a nonresident alien.
- Property is transferred in trust. Gain must be recognized to the extent the amount of the liabilities assumed by the trust, plus any liabilities on the property, exceed the adjusted basis of the property.

For other situations, see Publication 550.

Any transfer of property to a spouse or former spouse on which gain or loss is not recognized is treated by the recipient as a gift and is not considered a sale or exchange. The recipient's basis in the property will be the same as the adjusted basis of the giver immediately before the transfer. This carryover basis rule applies whether the adjusted basis of the transferred property is less than, equal to, or greater than either its fair market value at the time of transfer or any consideration paid by the recipient. This rule applies for purposes of determining loss as well as gain. Any gain recognized on a transfer in trust increases the basis.

A transfer of property is incident to a divorce if the transfer occurs within 1 year after the date on which the marriage ends, or if the transfer is related to the ending of the marriage.

Related Party Transactions

Special rules apply to the sale or trade of property between related parties.

Gain on sale or trade of depreciable property. Your gain from the sale or trade of property to a related party may be ordinary income, rather than capital gain, if the property can be depreciated by the party receiving it. See chapter 3 of Publication 544 for more information.

Like-kind exchanges. Generally, if you trade business or investment property for other business or investment property of a like kind, no gain or loss is recognized. See *Like-kind exchanges* earlier under *Nontaxable Trades*.

This rule also applies to trades of property between related parties, defined next under *Losses on sales or trades of property*. However, if either you or the related party disposes of the like property within 2 years after the trade, you both must report any gain or loss not recognized on the original trade on your return filed for the year in which the later disposition occurs.

Losses on sales or trades of property. You cannot deduct a loss on the sale or trade of property, other than a distribution in complete liquidation of a corporation, if the transaction is directly or indirectly between you and the following related parties.

- Members of your family. This includes only your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.).
- A partnership in which you directly or indirectly own more than 50% of the capital interest or the profits interest.
- A corporation in which you directly or indirectly own more than 50% in value of the outstanding stock. (See *Constructive ownership of stock*, later.)
- A tax-exempt charitable or educational organization that is directly or indirectly controlled, in any manner or by any method, by you or by a member of your family, whether or not this control is legally enforceable.

In addition, a loss on the sale or trade of property is not deductible if the transaction is directly or indirectly between the following related parties.

- A grantor and fiduciary, or the fiduciary and beneficiary, of any trust.
- Fiduciaries of two different trusts, or the fiduciary and beneficiary of two different trusts, if the same person is the grantor of both trusts.
- A trust fiduciary and a corporation of which more than 50% in value of the outstanding stock is directly or indirectly owned by or for the trust, or by or for the grantor of the trust.

- A corporation and a partnership if the same persons own more than 50% in value of the outstanding stock of the corporation and more than 50% of the capital interest, or the profits interest, in the partnership.
- Two S corporations if the same persons own more than 50% in value of the outstanding stock of each corporation.
- Two corporations, one of which is an S corporation, if the same persons own more than 50% in value of the outstanding stock of each corporation.
- An executor and a beneficiary of an estate (except in the case of a sale or trade to satisfy a pecuniary bequest).
- Two corporations that are members of the same controlled group. (Under certain conditions, however, these losses are not disallowed but must be deferred.)
- Two partnerships if the same persons own, directly or indirectly, more than 50% of the capital interests or the profit interests in both partnerships.

Multiple property sales or trades. If you sell or trade to a related party a number of blocks of stock or pieces of property in a lump sum, you must figure the gain or loss separately for each block of stock or piece of property. The gain on each item may be taxable. However, you cannot deduct the loss on any item. Also, you cannot reduce gains from the sales of any of these items by losses on the sales of any of the other items.

Indirect transactions. You cannot deduct your loss on the sale of stock through your broker if, under a prearranged plan, a related party buys the same stock you had owned. This does not apply to a trade between related parties through an exchange that is purely coincidental and is not prearranged.

Constructive ownership of stock. In determining whether a person directly or indirectly owns any of the outstanding stock of a corporation, the following rules apply.

Rule 1. Stock directly or indirectly owned by or for a corporation, partnership, estate, or trust is considered owned proportionately by or for its shareholders, partners, or beneficiaries.

Rule 2. An individual is considered to own the stock that is directly or indirectly owned by or for his or her family. Family includes only brothers and sisters, half-brothers and half-sisters, spouse, ancestors, and lineal descendants.

Rule 3. An individual owning, other than by applying rule 2, any stock in a corporation is considered to own the stock that is directly or indirectly owned by or for his or her partner.

Rule 4. When applying rule 1, 2, or 3, stock constructively owned by a person under rule 1 is treated as actually owned by that person. But stock constructively owned by an individual under rule 2 or rule 3 is not treated as owned by that individual for again applying either rule 2 or rule 3 to make another person the constructive owner of the stock.

Property received from a related party. If you sell or trade at a gain property that you acquired from a related party, you recognize the gain only to the extent it is more than the loss previously disallowed to the related party. This rule applies only if you are the original transferee and you acquired the property by purchase or exchange. This rule does not apply if the related party's loss was disallowed because of the wash sale rules described in chapter 4 of Publication 550 under *Wash Sales*.

If you sell or trade at a loss property that you acquired from a related party, you cannot recognize the loss that was not allowed to the related party.

Example 1. Your brother sells you stock for \$7,600. His cost basis is \$10,000. Your brother cannot deduct the loss of \$2,400. Later, you sell the same stock to an unrelated party for \$10,500, realizing a gain of \$2,900. Your reportable gain is \$500 — the \$2,900 gain minus the \$2,400 loss not allowed to your brother.

Example 2. If, in *Example 1*, you sold the stock for \$6,900 instead of \$10,500, your recognized loss is only \$700 (your \$7,600 basis minus \$6,900). You cannot deduct the loss that was not allowed to your brother.

Capital Gains and Losses

This section discusses the tax treatment of gains and losses from different types of investment transactions.

Character of gain or loss. You need to classify your gains and losses as either ordinary or capital gains or losses. You then need to classify your capital gains and losses as either short term or long term. If you have long-term gains and losses, you must identify your 28% rate gains and losses. If you have a net capital gain, you must also identify any unrecaptured section 1250 gain.

The correct classification and identification helps you figure the limit on capital losses and the correct tax on capital gains. Reporting capital gains and losses is explained in chapter 16.

Capital or Ordinary Gain or Loss

If you have a taxable gain or a deductible loss from a transaction, it may be either a capital gain or loss or an ordinary gain or loss, depending on the circumstances. Generally, a sale or trade of a capital asset (defined next) results in a capital gain or loss. A sale or trade of a noncapital asset generally results in ordinary gain or loss. Depending on the circumstances, a gain or loss on a sale or trade of property used in a trade or business may be treated as either capital or ordinary, as explained in Publication 544. In some situations, part of your gain or loss may be a capital gain or loss and part may be an ordinary gain or loss.

Capital Assets and Noncapital Assets

For the most part, everything you own and use for personal purposes, pleasure, or investment is a capital asset. Some examples are:

- Stocks or bonds held in your personal account,
- A house owned and used by you and your family,
- Household furnishings,
- A car used for pleasure or commuting,
- Coin or stamp collections,
- Gems and jewelry, and
- Gold, silver, or any other metal.

Any property you own is a capital asset, except the following noncapital assets.

1. Property held mainly for sale to customers or property that will physically become a part of the merchandise that is for sale to customers.
2. Depreciable property used in your trade or business, even if fully depreciated.
3. Real property used in your trade or business.
4. A copyright, a literary, musical, or artistic composition, a letter or memorandum, or similar property:
 - a. Created by your personal efforts,
 - b. Prepared or produced for you (in the case of a letter, memorandum, or similar property), or
 - c. Acquired under circumstances (for example, by gift) entitling you to the basis of the person who created the property or for whom it was prepared or produced.
5. Accounts or notes receivable acquired in the ordinary course of a trade or business for services rendered or from the sale of property described in (1).
6. U.S. Government publications that you received from the government for free or for less than the normal sales price, or that you acquired under circumstances entitling you to the basis of someone who received the publications for free or for less than the normal sales price.
7. Certain commodities derivative financial instruments held by commodities derivatives dealers.
8. Hedging transactions, but only if the transaction is clearly identified as a hedging transaction before the close of the day on which it was acquired, originated, or entered into.
9. Supplies of a type you regularly use or consume in the ordinary course of your trade or business.

Investment Property

Investment property is a capital asset. Any gain or loss from its sale or trade is generally a capital gain or loss.

Gold, silver, stamps, coins, gems, etc. These are capital assets except when they are held for sale by a dealer. Any gain or loss you have from their sale or trade generally is a capital gain or loss.

Stocks, stock rights, and bonds. All of these (including stock received as a dividend) are capital assets except when held for sale by a securities dealer. However, if you own small business stock, see *Losses on Section 1244 (Small Business) Stock and Losses on Small Business Investment Company Stock* in chapter 4 of Publication 550.

Personal Use Property

Property held for personal use only, rather than for investment, is a capital asset, and you must report a gain from its sale as a capital gain. However, you cannot deduct a loss from selling personal use property.

Discounted Debt Instruments

Treat your gain or loss on the sale, redemption, or retirement of a bond or other debt instrument originally issued at a discount or bought at a discount as capital gain or loss, except as explained in the following discussions.

Short-term government obligations. Treat gains on short-term federal, state, or local government obligations (other than tax-exempt obligations) as ordinary income up to your ratable share of the acquisition discount. This treatment applies to obligations that have a fixed maturity date not more than 1 year from the date of issue. Acquisition discount is the stated redemption price at maturity minus your basis in the obligation.

However, do not treat these gains as income to the extent you previously included the discount in income. See *Discount on Short-Term Obligations* in chapter 1 of Publication 550.

Short-term nongovernment obligations. Treat gains on short-term nongovernment obligations as ordinary income up to your ratable share of original issue discount (OID). This treatment applies to obligations that have a fixed maturity date of not more than 1 year from the date of issue.

However, to the extent you previously included the discount in income, you do not have to include it in income again. See *Discount on Short-Term Obligations* in chapter 1 of Publication 550.

Tax-exempt state and local government bonds. If these bonds were originally issued at a discount before September 4, 1982, or you acquired them before March 2, 1984, treat your part of the OID as tax-exempt interest. To figure your gain or loss on the sale or trade of these bonds, reduce the amount realized by your part of the OID.

If the bonds were issued after September 3, 1982, and acquired after March 1, 1984, increase the adjusted basis by your part of the OID to figure gain or loss. For more information on the basis of these bonds, see *Discounted Debt Instruments* in chapter 4 of Publication 550.

Any gain from market discount is usually taxable on disposition or redemption of tax-exempt bonds. If you bought the bonds before May 1, 1993, the gain from market discount is capital gain. If you bought the bonds after April 30, 1993, the gain is ordinary income.

You figure the market discount by subtracting the price you paid for the bond from the sum of the original issue price of the bond and the amount of accumulated OID from the date of issue that represented interest to any earlier holders. For more information, see *Market Discount Bonds* in chapter 1 of Publication 550.

A loss on the sale or other disposition of a tax-exempt state or local government bond is deductible as a capital loss.

Redeemed before maturity. If a state or local bond that was issued before June 9, 1980, is redeemed before it matures, the OID is not taxable to you.

If a state or local bond issued after June 8, 1980, is redeemed before it matures, the part of the OID that is earned while you hold the bond is not taxable to you. However, you must report the unearned part of the OID as a capital gain.

Example. On July 1, 1995, the date of issue, you bought a 20-year, 6% municipal bond for \$800. The face amount of the bond was \$1,000. The \$200 discount was OID. At the time the bond was issued, the issuer had no intention of redeeming it before it matured. The bond was callable at its face amount beginning 10 years after the issue date.

The issuer redeemed the bond at the end of 11 years (July 1, 2006) for its face amount of \$1,000 plus accrued annual interest of \$60. The OID earned during the time you held the bond, \$73, is not taxable. The \$60 accrued annual interest also is not taxable. However, you must report the unearned part of the OID (\$127) as a capital gain.

Long-term debt instruments issued after 1954 and before May 28, 1969 (or before July 2, 1982, if a government instrument). If you sell, trade, or redeem for a gain one of these debt instruments, the part of your gain that is not more than your ratable share of the OID at the time of the sale or redemption is ordinary income. The rest of the gain is capital gain. If, however, there was an intention to call the debt instrument before maturity, all of your gain that is not more than the entire OID is treated as ordinary income at the time of the sale. This treatment of taxable gain also applies to corporate instruments issued after May 27, 1969, under a written commitment that was binding on May 27, 1969, and at all times thereafter.

Long-term debt instruments issued after May 27, 1969 (or after July 1, 1982, if a government instrument). If you hold one of these debt instruments, you must include a part of the OID in your gross income each year that you own the instrument. Your basis in that debt instrument is increased by the amount of OID that you have included in your gross income. See

Original Issue Discount (OID) in chapter 7 for information about the OID that you must report on your tax return.

If you sell or trade the debt instrument before maturity, your gain is a capital gain. However, if at the time the instrument was originally issued there was an intention to call it before its maturity, your gain generally is ordinary income to the extent of the entire OID reduced by any amounts of OID previously includible in your income. In this case, the rest of the gain is a capital gain.

Market discount bonds. If the debt instrument has market discount and you chose to include the discount in income as it accrued, increase your basis in the debt instrument by the accrued discount to figure capital gain or loss on its disposition. If you did not choose to include the discount in income as it accrued, you must report gain as ordinary interest income up to the instrument's accrued market discount. The rest of the gain is capital gain. See *Market Discount Bonds* in chapter 1 of Publication 550.

A different rule applies to market discount bonds issued before July 19, 1984, and purchased by you before May 1, 1993. See *Market discount bonds* under *Discounted Debt Instruments* in chapter 4 of Publication 550.

Retirement of debt instrument. Any amount that you receive on the retirement of a debt instrument is treated in the same way as if you had sold or traded that instrument.

Notes of individuals. If you hold an obligation of an individual that was issued with OID after March 1, 1984, you generally must include the OID in your income currently, and your gain or loss on its sale or retirement is generally capital gain or loss. An exception to this treatment applies if the obligation is a loan between individuals and all of the following requirements are met.

- The lender is not in the business of lending money.
- The amount of the loan, plus the amount of any outstanding prior loans, is \$10,000 or less.
- Avoiding federal tax is not one of the principal purposes of the loan.

If the exception applies, or the obligation was issued before March 2, 1984, you do not include the OID in your income currently. When you sell or redeem the obligation, the part of your gain that is not more than your accrued share of the OID at that time is ordinary income. The rest of the gain, if any, is capital gain. Any loss on the sale or redemption is capital loss.

Deposit in Insolvent or Bankrupt Financial Institution

If you lose money you have on deposit in a qualified financial institution that becomes insolvent or bankrupt, you may be able to deduct your loss in one of three ways.

- Ordinary loss.
- Casualty loss.
- Nonbusiness bad debt (short-term capital loss).

For more information, see *Deposit in Insolvent*

or *Bankrupt Financial Institution*, in chapter 4 of Publication 550.

Sale of Annuity

The part of any gain on the sale of an annuity contract before its maturity date that is based on interest accumulated on the contract is ordinary income.

Losses on Section 1244 (Small Business) Stock

You can deduct as an ordinary loss, rather than as a capital loss, your loss on the sale, trade, or worthlessness of section 1244 stock. Report the loss on Form 4797, line 10.

Any gain on section 1244 stock is a capital gain if the stock is a capital asset in your hands. Report the gain on Schedule D (Form 1040). See *Losses on Section 1244 (Small Business) Stock* in chapter 4 of Publication 550.

Losses on Small Business Investment Company Stock

See *Losses on Small Business Investment Company Stock* in chapter 4 of Publication 550.

Holding Period

If you sold or traded investment property, you must determine your holding period for the property. Your holding period determines whether any capital gain or loss was a short-term or long-term capital gain or loss.

Long term or short term. If you hold investment property more than 1 year, any capital gain or loss is a long-term capital gain or loss. If you hold the property 1 year or less, any capital gain or loss is a short-term capital gain or loss.

To determine how long you held the investment property, begin counting on the date after the day you acquired the property. The day you disposed of the property is part of your holding period.

Example. If you bought investment property on February 5, 2005, and sold it on February 5, 2006, your holding period is not more than 1 year and you have a short-term capital gain or loss. If you sold it on February 6, 2006, your holding period is more than 1 year and you will have a long-term capital gain or loss.

Securities traded on established market. For securities traded on an established securities market, your holding period begins the day after the trade date you bought the securities, and ends on the trade date you sold them.



Do not confuse the trade date with the settlement date, which is the date by which the stock must be delivered and payment must be made.

Example. You are a cash method, calendar year taxpayer. You sold stock at a gain on December 29, 2006. According to the rules of the stock exchange, the sale was closed by delivery of the stock 3 trading days after the sale, on

January 4, 2007. You received payment of the sales price on that same day. Report your gain on your 2006 return, even though you received the payment in 2007. The gain is long term or short term depending on whether you held the stock more than 1 year. Your holding period ended on December 29. If you had sold the stock at a loss, you would also report it on your 2006 return.

Automatic investment service. In determining your holding period for shares bought by the bank or other agent, full shares are considered bought first and any fractional shares are considered bought last. Your holding period starts on the day after the bank's purchase date. If a share was bought over more than one purchase date, your holding period for that share is a split holding period. A part of the share is considered to have been bought on each date that stock was bought by the bank with the proceeds of available funds.

Nontaxable trades. If you acquire investment property in a trade for other investment property and your basis for the new property is determined, in whole or in part, by your basis in the old property, your holding period for the new property begins on the day following the date you acquired the old property.

Property received as a gift. If you receive a gift of property and your basis is determined by the donor's adjusted basis, your holding period is considered to have started on the same day the donor's holding period started.

If your basis is determined by the fair market value of the property, your holding period starts on the day after the date of the gift.

Inherited property. If you inherit investment property, your capital gain or loss on any later disposition of that property is treated as a long-term capital gain or loss. This is true regardless of how long you actually held the property.

Real property bought. To figure how long you have held real property bought under an unconditional contract, begin counting on the day after you received title to it or on the day after you took possession of it and assumed the burdens and privileges of ownership, whichever happened first. However, taking delivery or possession of real property under an option agreement is not enough to start the holding period. The holding period cannot start until there is an actual contract of sale. The holding period of the seller cannot end before that time.

Stock dividends. The holding period for stock you received as a taxable stock dividend begins on the date of distribution.

The holding period for new stock you received as a nontaxable stock dividend begins on the same day as the holding period of the old stock. This rule also applies to stock acquired in a "spin-off," which is a distribution of stock or securities in a controlled corporation.

Nontaxable stock rights. Your holding period for nontaxable stock rights begins on the same day as the holding period of the underlying stock. The holding period for stock acquired through the exercise of stock rights begins on the date the right was exercised.

Nonbusiness Bad Debts

If someone owes you money that you cannot collect, you have a bad debt. You may be able to deduct the amount owed to you when you figure your tax for the year the debt becomes worthless.

Bad debts that did not come from operating your trade or business are nonbusiness bad debts and are deductible as short-term capital losses. To be deductible, nonbusiness bad debts must be totally worthless. You cannot deduct a partly worthless nonbusiness debt.

Genuine debt required. A debt must be genuine for you to deduct a loss. A debt is genuine if it arises from a debtor-creditor relationship based on a valid and enforceable obligation to repay a fixed or determinable sum of money.

Basis in bad debt required. To deduct a bad debt, you must have a basis in it — that is, you must have already included the amount in your income or loaned out your cash. For example, you cannot claim a bad debt deduction for court-ordered child support not paid to you by your former spouse. If you are a cash method taxpayer (as most individuals are), you generally cannot take a bad debt deduction for unpaid salaries, wages, rents, fees, interest, dividends, and similar items.

How to report bad debts. Deduct nonbusiness bad debts as short-term capital losses on Schedule D (Form 1040).

On Schedule D, Part I, line 1, enter the name of the debtor and “statement attached” in column (a). Enter the amount of the bad debt in parentheses in column (f). Use a separate line for each bad debt.

For each bad debt, attach a statement to your return that contains:

- A description of the debt, including the amount, and the date it became due,
- The name of the debtor, and any business or family relationship between you and the debtor,
- The efforts you made to collect the debt, and
- Why you decided the debt was worthless. For example, you could show that the borrower has declared bankruptcy, or that legal action to collect would probably not result in payment of any part of the debt.

Filing a claim for refund. If you do not deduct a bad debt on your original return for the year it becomes worthless, you can file a claim for a credit or refund due to the bad debt. To do this, use Form 1040X to amend your return for the year the debt became worthless. You must file it within 7 years from the date your original return for that year had to be filed, or 2 years from the date you paid the tax, whichever is later. For more information about filing a claim, see *Amended Returns and Claims for Refund* in chapter 1.

Additional information. For more information, see *Nonbusiness Bad Debts* in Publication 550. For information on business bad debts, see chapter 10 of Publication 535, *Business Expenses*.

Wash Sales

You cannot deduct losses from sales or trades of stock or securities in a wash sale.

A wash sale occurs when you sell or trade stock or securities at a loss and within 30 days before or after the sale you:

- Buy substantially identical stock or securities,
- Acquire substantially identical stock or securities in a fully taxable trade, or
- Acquire a contract or option to buy substantially identical stock or securities.

If your loss was disallowed because of the wash sale rules, add the disallowed loss to the cost of the new stock or securities. The result is your basis in the new stock or securities. This adjustment postpones the loss deduction until the disposition of the new stock or securities.

For more information, see *Wash Sales*, in chapter 4 of Publication 550.

Rollover of Gain From Publicly Traded Securities

You may qualify for a tax-free rollover of certain gains from the sale of publicly traded securities. This means that if you buy certain replacement property and make the choice described in this section, you postpone part or all of your gain.

You postpone the gain by adjusting the basis of the replacement property as described in *Basis of replacement property*, later. This postpones your gain until the year you dispose of the replacement property.

You qualify to make this choice if you meet all the following tests.

- You sell publicly traded securities at a gain. Publicly traded securities are securities traded on an established securities market.
- Your gain from the sale is a capital gain.
- During the 60-day period beginning on the date of the sale, you buy replacement property. This replacement property must be either common stock or a partnership interest in a specialized small business investment company (SSBIC). This is any partnership or corporation licensed by the Small Business Administration under section 301(d) of the Small Business Investment Act of 1958, as in effect on May 13, 1993.

Amount of gain recognized. If you make the choice described in this section, you must recognize gain only up to the following amount.

- The amount realized on the sale, minus
- The cost of any common stock or partnership interest in an SSBIC that you bought during the 60-day period beginning on the date of sale (and did not previously take into account on an earlier sale of publicly traded securities).

If this amount is less than the amount of your gain, you can postpone the rest of your gain,

subject to the limit described next. If this amount is equal to or more than the amount of your gain, you must recognize the full amount of your gain.

Limit on gain postponed. The amount of gain you can postpone each year is limited to the smaller of:

- \$50,000 (\$25,000 if you are married and file a separate return), or
- \$500,000 (\$250,000 if you are married and file a separate return), minus the amount of gain you postponed for all earlier years.

Basis of replacement property. You must subtract the amount of postponed gain from the basis of your replacement property.

How to report and postpone gain. See chapter 4 of Publication 550 for details on how to report and postpone the gain.

15.

Selling Your Home

What's New

Gulf Opportunity Zone Act of 2005 (Act). This Act provides tax relief for persons affected by Hurricanes Katrina, Rita, and Wilma. Under this Act, the rules for recapture of a federal mortgage subsidy have changed if you received a qualified home improvement loan (QHIL) funded by a qualified mortgage bond that is a qualified Gulf Opportunity Zone Bond or a QHIL for an owner-occupied home in the Gulf Opportunity Zone (GO Zone), Rita GO Zone, or Wilma GO Zone. For more information, see *Recapturing (Paying Back) a Federal Mortgage Subsidy*, later.

New credits affecting the basis of a home. If you claim the nonbusiness energy property credit or the residential energy efficient property credit in 2006, you must decrease the basis of your home by the amount of the credit claimed. See *Adjusted Basis*, later. For more information about these credits, see also Form 5695, *Residential Energy Credits*.

Reminders

Change of address. If you change your mailing address, be sure to notify the IRS using Form 8822, *Change of Address*. Mail it to the Internal Revenue Service Center for your old address. (Addresses for the Service Centers are on the back of the form.)

Home sold with undeducted points. If you have not deducted all the points you paid to secure a mortgage on your old home, you may be able to deduct the remaining points in the year of the sale. See *Mortgage ending early* under *Points* in chapter 23.

Introduction

This chapter explains the tax rules that apply when you sell your main home. Generally, your main home is the one in which you live most of the time.

If you sold your main home in 2006, you may be able to exclude from income any gain up to a limit of \$250,000 (\$500,000 on a joint return in most cases). See *Excluding the Gain*, later. If you can exclude all of the gain, you do not need to report the sale on your tax return.

If you have gain that cannot be excluded, it is taxable. Report it on Schedule D (Form 1040). You may also have to include Form 4797, Sales of Business Property. See *Reporting the Sale*, later.

If you have a loss on the sale, you cannot deduct it on your return.

The following are main topics in this chapter.

- Figuring gain or loss.
- Basis.
- Excluding the gain.
- Ownership and use tests.
- Reporting the sale.

Other topics include the following.

- Business use or rental of home.
- Recapturing a federal mortgage subsidy.

Useful Items

You may want to see:

Publication

- 523** Selling Your Home
- 530** Tax Information for First-Time Homeowners

Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 8822** Change of Address
- 8828** Recapture of Federal Mortgage Subsidy

Main Home

This section explains the term “main home.” Usually, the home you live in most of the time is your main home and can be a:

- House,
- Houseboat,
- Mobile home,
- Cooperative apartment, or

- Condominium.

To exclude gain under the rules of this chapter, you generally must have owned and lived in the property as your main home for at least 2 years during the 5-year period ending on the date of sale.

Land. If you sell the land on which your main home is located, but not the house itself, you cannot exclude any gain you have from the sale of the land.

Example. On March 4, 2006, you sell the land on which your main home is located. You buy another piece of land and move your house to it. This sale is not considered a sale of your main home, and you cannot exclude any gain on the sale of the land.

More than one home. If you have more than one home, you can exclude gain only from the sale of your main home. You must include in income gain from the sale of any other home. If you have two homes and live in both of them, your main home is ordinarily the one you live in most of the time.

Example 1. You own and live in a house in the city. You also own a beach house, which you use during summer months. The house in the city is your main home.

Example 2. You own a house, but you live in another house that you rent. The rented house is your main home.

Property used partly as your main home. If you use only part of the property as your main home, the rules discussed in this chapter apply only to the gain or loss on the sale of that part of the property. For details, see *Business Use or Rental of Home*, later.

Figuring Gain or Loss

To figure the gain or loss on the sale of your main home, you must know the selling price, the amount realized, and the adjusted basis. Subtract the adjusted basis from the amount realized to get your gain or loss.

Selling price
– Selling expenses
Amount realized
– Amount realized
– Adjusted basis
Gain or loss

Selling Price

The selling price is the total amount you receive for your home. It includes money, all notes, mortgages, or other debts assumed by the buyer as part of the sale, and the fair market value of any other property or any services you receive.

Payment by employer. You may have to sell your home because of a job transfer. If your employer pays you for a loss on the sale or for

your selling expenses, do not include the payment as part of the selling price. Your employer will include it as wages in box 1 of your Form W-2 and you will include it on Form 1040, line 7, or on Form 1040NR, line 8.

Option to buy. If you grant an option to buy your home and the option is exercised, add the amount you receive for the option to the selling price of your home. If the option is not exercised, you must report the amount as ordinary income in the year the option expires. Report this amount on Form 1040, line 21, or on Form 1040NR, line 21.

Form 1099-S. If you received Form 1099-S, Proceeds From Real Estate Transactions, box 2 (gross proceeds) should show the total amount you received for your home.

However, box 2 will not include the fair market value of any property other than cash or notes, or any services, you received or will receive. Instead, box 4 will be checked to indicate your receipt or expected receipt of these items.

If you can exclude the entire gain, the person responsible for closing the sale generally will not have to report it on Form 1099-S. If you do not receive Form 1099-S, use sale documents and other records to figure the total amount you received for your home.

Amount Realized

The amount realized is the selling price minus selling expenses.

Selling expenses. Selling expenses include:

- Commissions,
- Advertising fees,
- Legal fees, and
- Loan charges paid by the seller, such as loan placement fees or “points.”

Adjusted Basis

While you owned your home, you may have made adjustments (increases or decreases) to the basis. This adjusted basis must be determined before you can figure gain or loss on the sale of your home. For information on how to figure your home’s adjusted basis, see *Determining Basis*, later.

Amount of Gain or Loss

To figure the amount of gain or loss, compare the amount realized to the adjusted basis.

Gain on sale. If the amount realized is more than the adjusted basis, the difference is a gain and, except for any part you can exclude, generally is taxable.

Loss on sale. If the amount realized is less than the adjusted basis, the difference is a loss. A loss on the sale of your main home cannot be deducted.

Jointly owned home. If you and your spouse sell your jointly owned home and file a joint return, you figure your gain or loss as one taxpayer.

Separate returns. If you file separate returns, each of you must figure your own gain or

loss according to your ownership interest in the home. Your ownership interest is determined by state law.

Joint owners not married. If you and a joint owner other than your spouse sell your jointly owned home, each of you must figure your own gain or loss according to your ownership interest in the home. Each of you applies the rules discussed in this chapter on an individual basis.

Other Dispositions

The following rules apply to foreclosures and repossessions, abandonments, trades, and transfers to a spouse.

Foreclosure or repossession. If your home was foreclosed on or repossessed, you have a sale.

You figure the gain or loss from the sale in generally the same way as gain or loss from any sale. But the selling price of your home used to figure the amount of your gain or loss depends, in part, on whether you were personally liable for repaying the debt secured by the home. See Publication 523 for more information.

Form 1099-A and Form 1099-C. Generally, you will receive Form 1099-A, Acquisition or Abandonment of Secured Property, from your lender. This form will have the information you need to determine the amount of your gain or loss and any ordinary income from cancellation of debt. If your debt is canceled, you may receive Form 1099-C, Cancellation of Debt.

Abandonment. If you abandon your home, you may have ordinary income. If the abandoned home secures a debt for which you are personally liable and the debt is canceled, you have ordinary income equal to the amount of the canceled debt. See Publication 523 for more information.

Trading homes. If you trade your old home for another home, treat the trade as a sale and a purchase.

Example. You owned and lived in a home with an adjusted basis of \$41,000. A real estate dealer accepted your old home as a trade-in and allowed you \$50,000 toward a new home priced at \$80,000. This is treated as a sale of your old home for \$50,000 with a gain of \$9,000 (\$50,000 – \$41,000).

If the dealer had allowed you \$27,000 and assumed your unpaid mortgage of \$23,000 on your old home, your sales price would still be \$50,000 (the \$27,000 trade-in allowed plus the \$23,000 mortgage assumed).

Transfer to spouse. If you transfer your home to your spouse, or to your former spouse incident to your divorce, you generally have no gain or loss. This is true even if you receive cash or other consideration for the home. Therefore, the rules in this chapter do not apply.

More information. If you need more information, see *Transfer to spouse* in Publication 523 and *Property Settlements* in Publication 504, Divorced or Separated Individuals.

Determining Basis

You need to know your basis in your home to determine any gain or loss when you sell it. Your basis in your home is determined by how you got the home. Your basis is its cost if you bought it or built it. If you got it in some other way (inheritance, gift, etc.), its basis is either its fair market value when you got it or the adjusted basis of the person you got it from.

While you owned your home, you may have made adjustments (increases or decreases) to your home's basis. The result of these adjustments is your home's adjusted basis, which is used to figure gain or loss on the sale of your home. See *Adjusted Basis*, later.

You can find more information on basis and adjusted basis in chapter 13 of this publication and in Publication 523.

Cost As Basis

The cost of property is the amount you pay for it in cash, debt obligations, other property, or services.

Purchase. If you buy your home, your basis is its cost to you. This includes the purchase price and certain settlement or closing costs. Generally, your purchase price includes your down payment and any debt, such as a first or second mortgage or notes you gave the seller in payment for the home. If you build, or contract to build, a new home, your purchase price can include costs of construction, as discussed in Publication 523.

Settlement fees or closing costs. When you bought your home, you may have paid settlement fees or closing costs in addition to the contract price of the property. You can include in your basis some of the settlement fees and closing costs you paid for buying the home. You cannot include in your basis the fees and costs for getting a mortgage loan. A fee paid for buying the home is any fee you would have had to pay even if you paid cash for the home (that is, without the need for financing).

Chapter 13 lists some of the settlement fees and closing costs that you can include in the basis of property, including your home. It also lists some settlement costs that cannot be included in basis.

Also see Publication 523 for additional items and a discussion of basis other than cost.

Adjusted Basis

Adjusted basis is your basis increased or decreased by certain amounts.

Increases to basis. These include any:

- Additions and other improvements that have a useful life of more than 1 year,
- Special assessments for local improvements, and
- Amounts you spent after a casualty to restore damaged property.

Decreases to basis. These include any:

- Gain you postponed from the sale of a previous home before May 7, 1997,

- Deductible casualty losses,
- Insurance payments you received or expect to receive for casualty losses,
- Payments you received for granting an easement or right-of-way,
- Depreciation allowed or allowable if you used your home for business or rental purposes,
- Residential energy credit (generally allowed from 1977 through 1987) claimed for the cost of energy improvements that you added to the basis of your home,
- Nonbusiness energy property credit (allowed beginning in 2006) claimed for making certain energy saving improvements that you added to the basis of your home,
- Residential energy efficient property credit (allowed beginning in 2006) claimed for making certain energy saving improvements that you added to the basis of your home,
- Adoption credit you claimed for improvements added to the basis of your home,
- Nontaxable payments from an adoption assistance program of your employer that you used for improvements you added to the basis of your home,
- Energy conservation subsidy excluded from your gross income because you received it (directly or indirectly) from a public utility after 1992 to buy or install any energy conservation measure. An energy conservation measure is an installation or modification that is primarily designed either to reduce consumption of electricity or natural gas or to improve the management of energy demand for a home, and
- District of Columbia first-time homebuyer credit (allowed on the purchase of a principal residence in the District of Columbia from August 5, 1997, through December 31, 2005).



*At the time this publication went to print, Congress was considering legislation that would extend the District of Columbia first-time homebuyer credit that expired for homes purchased after 2005. To find out if this legislation was enacted, and for more details, go to www.irs.gov, click on More Forms and Publications, and then on What's Hot in forms and publications, or see Publication 553, *Highlights of 2006 Tax Changes*.*

Improvements. These add to the value of your home, prolong its useful life, or adapt it to new uses. You add the cost of additions and other improvements to the basis of your property.

Examples. Putting a recreation room or another bathroom in your unfinished basement, putting up a new fence, putting in new plumbing or wiring, putting on a new roof, or paving your unpaved driveway are improvements. An addition to your house, such as a new deck, a sunroom, or a new garage, is also an improvement.

Repairs. These maintain your home in good condition but do not add to its value or prolong

its life. You do not add their cost to the basis of your property.

Examples. Repainting your house inside or outside, fixing your gutters or floors, repairing leaks or plastering, and replacing broken window panes are examples of repairs.



Recordkeeping. You should keep records to prove your home's adjusted basis. Ordinarily, you must keep records for 3 years after the due date for filing your return for the tax year in which you sold your home. But if you sold a home before May 7, 1997, and postponed tax on any gain, the basis of that home affects the basis of the new home you bought. Keep records proving the basis of both homes as long as they are needed for tax purposes.

The records you should keep include:

- Proof of the home's purchase price and purchase expenses,
- Receipts and other records for all improvements, additions, and other items that affect the home's adjusted basis,
- Any worksheets you used to figure the adjusted basis of the home you sold, the gain or loss on the sale, the exclusion, and the taxable gain,
- Any Form 2119, Sale of Your Home, that you filed to postpone gain from the sale of a previous home before May 7, 1997, and
- Any worksheets you used to prepare Form 2119, such as the *Adjusted Basis of Home Sold Worksheet* or the *Capital Improvements Worksheet* from the Form 2119 instructions.

Excluding the Gain

You may qualify to exclude from your income all or part of any gain from the sale of your main home. This means that, if you qualify, you will not have to pay tax on the gain up to the limit described under *Maximum Exclusion*, next. To qualify, you must meet the ownership and use tests described later.

You can choose not to take the exclusion by including the gain from the sale in your gross income on your tax return for the year of the sale.

Maximum Exclusion

You can exclude up to \$250,000 of the gain on the sale of your main home if all of the following are true.

- You meet the ownership test.
- You meet the use test.
- During the 2-year period ending on the date of the sale, you did not exclude gain from the sale of another home.

You can exclude up to \$500,000 of the gain on the sale of your main home if all of the following are true.

- You are married and file a joint return for the year.
- Either you or your spouse meets the ownership test.
- Both you and your spouse meet the use test.
- During the 2-year period ending on the date of the sale, neither you nor your spouse excluded gain from the sale of another home.

Ownership and Use Tests

To claim the exclusion, you must meet the ownership and use tests. This means that during the 5-year period ending on the date of the sale, you must have:

- Owned the home for at least 2 years (the ownership test), and
- Lived in the home as your main home for at least 2 years (the use test).

Exception. If you owned and lived in the property as your main home for less than 2 years, you can still claim an exclusion in some cases. The maximum amount you can claim will be reduced. See *Reduced Maximum Exclusion*, later.

Example 1—home owned and occupied for 3 years. Amanda bought and moved into her main home in September 2003. She sold the home at a gain on September 15, 2006. During the 5-year period ending on the date of sale (September 16, 2001 – September 15, 2006), she owned and lived in the home for 3 years. She meets the ownership and use tests.

Example 2—met ownership test but not use test. Dan bought a home in 2000. After living in it for 6 months, he moved out. He never lived in the home again and sold it at a gain on June 28, 2006. He owned the home during the entire 5-year period ending on the date of sale (June 29, 2001 – June 28, 2006). However, he did not live in it for the required 2 years. He meets the ownership test but not the use test. He cannot exclude any part of his gain on the sale, unless he qualified for a reduced maximum exclusion (explained later).

Period of Ownership and Use

The required 2 years of ownership and use during the 5-year period ending on the date of the sale do not have to be continuous.

You meet the tests if you can show that you owned and lived in the property as your main home for either 24 full months or 730 days (365 × 2) during the 5-year period ending on the date of sale.

Temporary absence. Short temporary absences for vacations or other seasonal absences, even if you rent out the property during the absences, are counted as periods of use. The following examples assume that the reduced maximum exclusion (discussed later) does not apply to the sales.

Example 1. David Johnson, who is single, bought and moved into his home on February 1, 2004. Each year during 2004 and 2005, David left his home for a 2-month summer vacation. David sold the house on March 1, 2006. Although the total time David used his home is less than 2 years (21 months), he may exclude any gain up to \$250,000. The 2-month vacations are short temporary absences and are counted as periods of use in determining whether David used the home for the required 2 years.

Example 2. Professor Paul Beard, who is single, bought and moved into a house on August 28, 2003. He lived in it as his main home continuously until January 5, 2005, when he went abroad for a 1-year sabbatical leave. On February 6, 2006, 1 month after returning from the leave, Paul sold the house at a gain. Because his leave was not a short temporary absence, he cannot include the period of leave to meet the 2-year use test. He cannot exclude any part of his gain, because he did not use the residence for the required 2 years.

Ownership and use tests met at different times. You can meet the ownership and use tests during different 2-year periods. However, you must meet both tests during the 5-year period ending on the date of the sale.

Example. In 1997, Helen Jones lived in a rented apartment. The apartment building was later changed to a condominium, and she bought her apartment on December 3, 2003. In 2004, Helen became ill and on April 14 of that year she moved to her daughter's home. On July 12, 2006, while still living in her daughter's home, she sold her apartment.

Helen can exclude gain on the sale of her apartment because she met the ownership and use tests during the 5-year period from July 13, 2001, to July 12, 2006, the date she sold the apartment. She owned her apartment from December 3, 2003, to July 12, 2006 (more than 2 years). She lived in the apartment from July 13, 2001 (the beginning of the 5-year period), to April 14, 2004 (more than 2 years).

The time Helen lived in her daughter's home during the 5-year period can be counted as a period of ownership, and the time she lived in her rented apartment during the 5-year period can be counted as a period of use.

Cooperative apartment. If you sold stock in a cooperative housing corporation, the ownership and use tests are met if, during the 5-year period ending on the date of sale, you:

- Owned the stock for at least 2 years, and
- Lived in the house or apartment that the stock entitles you to occupy as your main home for at least 2 years.

Members of the uniformed services or Foreign Service. You can choose to have the 5-year test period for ownership and use suspended during any period you or your spouse serve on "qualified official extended duty" as a member of the uniformed services or Foreign Service of the United States. This means that you may be able to meet the 2-year use test even if, because of your service, you did not

actually live in your home for at least the required 2 years during the 5-year period ending on the date of sale.

If this helps you qualify to exclude gain, you can choose to have the 5-year test period suspended by filing a return for the year of sale that does not include the gain.

Example. David bought and moved into a home in 1998. He lived in it as his main home for 2½ years. For the next 6 years, he did not live in it because he was on qualified official extended duty with the Army. He then sold the home at a gain in 2006. To meet the use test, David chooses to suspend the 5-year test period for the 6 years he was on qualified official extended duty. This means he can disregard those 6 years. Therefore, David's 5-year test period consists of the 5 years before he went on qualified official extended duty. He meets the ownership and use tests because he owned and lived in the home for 2½ years during this test period.

Period of suspension. The period of suspension cannot last more than 10 years. Together, the 10-year suspension period and the 5-year test period can be as long as, but no more than, 15 years. You cannot suspend the 5-year period for more than one property at a time. You can revoke your choice to suspend the 5-year period at any time.

For more information about the suspension of the 5-year test period, see *Uniformed services or Foreign Service member* in Publication 523.

Exception for individuals with a disability. There is an exception to the use test if during the 5-year period before the sale of your home:

- You become physically or mentally unable to care for yourself, and
- You owned and lived in your home as your main home for a total of at least 1 year.

Under this exception, you are considered to live in your home during any time that you own the home and live in a facility (including a nursing home) that is licensed by a state or political subdivision to care for persons in your condition.

If you meet this exception to the use test, you still have to meet the 2-out-of-5-year ownership test to claim the exclusion.

Previous home destroyed or condemned. For the ownership and use tests, you add the time you owned and lived in a previous home that was destroyed or condemned to the time you owned and lived in the home on which you wish to exclude gain. This rule applies if any part of the basis of the home you sold depended on the basis of the destroyed or condemned home. Otherwise, you must have owned and lived in the same home for 2 of the 5 years before the sale to qualify for the exclusion.

Married Persons

If you and your spouse file a joint return for the year of sale, you can exclude gain if either spouse meets the ownership and use tests. (But see *Maximum Exclusion*, earlier.)

Example 1 — one spouse sells a home. Emily sells her home in June 2006. She marries

Jamie later in the year. She meets the ownership and use tests, but Jamie does not. Emily can exclude up to \$250,000 of gain on a separate or joint return for 2006. The \$500,000 maximum exclusion for certain joint returns does not apply because Jamie does not meet the use test.

Example 2 — each spouse sells a home.

The facts are the same as in *Example 1* except that Jamie also sells a home in 2006 before he marries Emily. He meets the ownership and use tests on his home, but Emily does not. Emily and Jamie can each exclude up to \$250,000 of gain. The \$500,000 maximum exclusion for certain joint returns does not apply because Emily and Jamie do not jointly meet the use test for the same home.

Death of spouse before sale. If your spouse died and you did not remarry before the date of sale, you are considered to have owned and lived in the property as your main home during any period of time when your spouse owned and lived in it as a main home.

Home transferred from spouse. If your home was transferred to you by your spouse (or former spouse if the transfer was incident to divorce), you are considered to have owned it during any period of time when your spouse owned it.

Use of home after divorce. You are considered to have used property as your main home during any period when:

- You owned it, and
- Your spouse or former spouse is allowed to live in it under a divorce or separation instrument and uses it as his or her main home.

Reduced Maximum Exclusion

You can claim an exclusion, but the maximum amount of gain you can exclude will be reduced, if either of the following is true.

1. You did not meet the ownership and use tests, but the reason you sold the home was:
 - a. A change in place of employment,
 - b. Health, or
 - c. Unforeseen circumstances (as defined later).
2. Your exclusion would have been disallowed because of the rule described in *More Than One Home Sold During 2-Year Period*, later, except that the reason you sold the home was:
 - a. A change in place of employment,
 - b. Health, or
 - c. Unforeseen circumstances (as defined next).

Use *Worksheet 3* in Publication 523 to figure your reduced maximum exclusion.

Unforeseen circumstances. The sale of your main home is because of an unforeseen circumstance if your primary reason for the sale is the occurrence of an event that you could not reasonably have anticipated before buying and occupying your main home. For more information on unforeseen circumstances, see Publication 523.

More Than One Home Sold During 2-Year Period

You generally cannot exclude gain on the sale of your home if, during the 2-year period ending on the date of the sale, you sold another home at a gain and excluded all or part of that gain. If you cannot exclude the gain, you must include it in your income.

Exception. You still can claim an exclusion, but the maximum amount of gain you can exclude will be reduced, if the reason you sold the home was:

- A change in place of employment,
- Health, or
- Unforeseen circumstances (as defined earlier).

For more information about this exception, see *More Than One Home Sold During 2-Year Period* in Publication 523.

Business Use or Rental of Home

You may be able to exclude gain from the sale of a home that you have used for business or to produce rental income. But you must meet the ownership and use tests.

Example 1. On May 29, 2000, Amy bought a house. She moved in on that date and lived in it until May 31, 2002, when she moved out of the house and put it up for rent. The house was rented from June 1, 2002, to March 31, 2004. Amy moved back into the house on April 1, 2004, and lived there until she sold it on January 30, 2006. During the 5-year period ending on the date of the sale (January 31, 2001 – January 30, 2006), Amy owned and lived in the house for more than 2 years as shown in the following table.

Five Year Period	Used as Home	Used as Rental
1/31/01 – 5/31/02	16 months	
6/1/02 – 3/31/04		22 months
4/1/04 – 1/30/06	22 months 38 months	22 months

Amy can exclude gain up to \$250,000. However, she cannot exclude the part of the gain equal to the depreciation she claimed or could have claimed for renting the house, as explained after *Example 2*.

Example 2. William owned and used a house as his main home from 2000 through 2003. On January 1, 2004, he moved to another state. He rented his house from that date until April 30, 2006, when he sold it. During the 5-year period ending on the date of sale (May 1, 2001 – April 30, 2006), William owned and lived in the house for 32 months (more than 2 years). He must report the sale on Form 4797. He can exclude gain up to \$250,000. However, he cannot exclude the part of the gain equal to the depreciation he claimed or could have claimed for renting the house, as explained next.

Depreciation after May 6, 1997. If you were entitled to take depreciation deductions because you used your home for business purposes or as rental property, you cannot exclude the part of your gain equal to any depreciation allowed or allowable as a deduction for periods after May 6, 1997. If you can show by adequate records or other evidence that the depreciation allowed was less than the amount allowable, the amount you cannot exclude is the amount allowed.

Property used partly for business or rental. If you used property partly as a home and partly for business or to produce rental income, see Publication 523.

Reporting the Sale

Do not report the 2006 sale of your main home on your tax return unless:

- You have a gain and you do not qualify to exclude all of it, or
- You have a gain and you choose not to exclude it.

If you have any taxable gain on the sale of your main home that cannot be excluded, report the entire gain realized on Schedule D (Form 1040). Report it in column (f) of line 1 or line 8 of Schedule D, as short term or long term capital gain depending on how long you owned the home. If you qualify for an exclusion, show it on the line directly below the line on which you report the gain. Write "Section 121 exclusion" in column (a) of that line and show the amount of the exclusion in column (f) as a loss (in parentheses).

If you used the home for business or to produce rental income, you may have to use Form 4797 to report the sale of the business or rental part (or the sale of the entire property if used entirely for business or rental). See *Business Use or Rental of Home* in Publication 523.

Installment sale. Some sales are made under arrangements that provide for part or all of the selling price to be paid in a later year. These sales are called "installment sales." If you finance the buyer's purchase of your home yourself, instead of having the buyer get a loan or mortgage from a bank, you probably have an installment sale. You may be able to report the part of the gain you cannot exclude on the installment basis.

Use Form 6252, Installment Sale Income, to report the sale. Enter your exclusion on line 15 of Form 6252.

Seller-financed mortgage. If you sell your home and hold a note, mortgage, or other financial agreement, the payments you receive generally consist of both interest and principal. You must separately report as interest income the interest you receive as part of each payment. If the buyer of your home uses the property as a main or second home, you must also report the name, address, and social security number (SSN) of the buyer on line 1 of either Schedule B (Form 1040) or Schedule 1 (Form 1040A). The buyer must give you his or her SSN and you must give the buyer your SSN. Failure to meet these requirements may result in a \$50 penalty for each failure. If you or the buyer does not have and is not eligible to get an SSN, see *Social Security Number* in chapter 1.

More information. For more information on installment sales, see Publication 537, *Installment Sales*.

Special Situations

The situations that follow may affect your exclusion.

Sale of home acquired in like-kind exchange. You cannot claim the exclusion if:

- You acquired your home in a like-kind exchange (also known as a section 1031 exchange); or your basis in your home is determined by reference to the basis of the home in the hands of the person who acquired the property in a like-kind exchange (for example, you received the home from that person as a gift), and
- You sold the home during the 5-year period beginning with the date your home was acquired in the like-kind exchange.

Gain from a like-kind exchange is not taxable. This means that gain will not be recognized until you sell the property you receive. To defer gain from a like-kind exchange, you must have exchanged business or investment property for business or investment property of a like kind. For more information about like-kind exchanges, see Publication 544, *Sales and Other Dispositions of Assets*.

Home relinquished in an like-kind exchange. If you use your main home partly for business or rental purposes and then exchange the home for another property, see Publication 523.

Expatriates. You cannot claim the exclusion if the expatriation tax applies to you. The expatriation tax applies to U.S. citizens who have renounced their citizenship (and long-term residents who have ended their residency). For more information about the expatriation tax, see chapter 4 of Publication 519, *U.S. Tax Guide for Aliens*.

Home destroyed or condemned. If your home was destroyed or condemned, any gain (for example, because of insurance proceeds you received) qualifies for the exclusion.

Any part of the gain that cannot be excluded (because it is more than the maximum exclusion) can be postponed under the rules explained in:

- Publication 547, *Casualties, Disasters, and Thefts*, in the case of a home that was destroyed, or
- Chapter 1 of Publication 544, in the case of a home that was condemned.

Sale of remainder interest. Subject to the other rules in this chapter, you can choose to exclude gain from the sale of a remainder interest in your home. If you make this choice, you cannot choose to exclude gain from your sale of any other interest in the home that you sell separately.

Exception for sales to related persons. You cannot exclude gain from the sale of a remainder interest in your home to a related person. Related persons include your brothers and sisters, half-brothers and half-sisters, spouse, ancestors (parents, grandparents, etc.), and lineal descendants (children, grandchildren, etc.). Related persons also include certain corporations, partnerships, trusts, and exempt organizations.

Recapturing (Paying Back) a Federal Mortgage Subsidy

If you financed your home under a federally subsidized program (loans from tax-exempt qualified mortgage bonds or loans with mortgage credit certificates), you may have to recapture all or part of the benefit you received from that program when you sell or otherwise dispose of your home. You recapture the benefit by increasing your federal income tax for the year of the sale. You may have to pay this recapture tax even if you can exclude your gain from income under the rules discussed earlier; that exclusion does not affect the recapture tax.

Loans subject to recapture rules. The recapture applies to loans that:

1. Came from the proceeds of qualified mortgage bonds, or
2. Were based on mortgage credit certificates.

The recapture also applies to assumptions of these loans.

When the recapture applies. The recapture of the federal mortgage subsidy applies only if you meet both of the following conditions.

- Within the first 9 years after the date you close your mortgage loan, you sell or otherwise dispose of your home at a gain.
- Your income for the year of disposition is more than that year's adjusted qualifying income for your family size for that year (related to the income requirements a person must meet to qualify for the federally subsidized program).

When recapture does not apply. The recapture does not apply if any of the following situations apply to you.

- Your mortgage loan was a qualified home improvement loan (QHIL) of not more than \$15,000 (\$150,000 for a QHIL used to repair damage from Hurricane Katrina to homes in the hurricane disaster area; for a QHIL funded by a qualified mortgage bond that is a qualified Gulf Opportunity Zone Bond; or for a QHIL for an owner-occupied

home in the Gulf Opportunity Zone (GO Zone), Rita GO Zone, or Wilma GO Zone. See Publication 4492, Information for Taxpayers Affected by Hurricanes Katrina, Rita, and Wilma, for more information).

- The home is disposed of as a result of your death.
- You dispose of the home more than 9 years after the date you closed your mortgage loan.
- You transfer the home to your spouse, or to your former spouse incident to a divorce, where no gain is included in your income.
- You dispose of the home at a loss.
- Your home is destroyed by a casualty, and you replace it on its original site within 2 years after the end of the tax year when the destruction happened (within 5 years if the home was in the Hurricane Katrina disaster area and was destroyed by reason of the hurricane after August 24, 2005).
- You refinance your mortgage loan (unless you later meet the conditions listed previously under *When the recapture applies*).

Notice of amounts. At or near the time of settlement of your mortgage loan, you should receive a notice that provides the federally subsidized amount and other information you will need to figure your recapture tax.

How to figure and report the recapture. The recapture tax is figured on Form 8828, Recapture of Federal Mortgage Subsidy. If you sell your home and your mortgage is subject to recapture rules, you must file Form 8828 even if you do not owe a recapture tax. Attach Form 8828 to your Form 1040. For more information, see Form 8828 and its instructions.

16.

Reporting Gains and Losses

Introduction

This chapter discusses how to report capital gains and losses from sales, exchanges, and other dispositions of investment property on Schedule D of Form 1040. The discussion includes the following topics.

- How to report short-term gains and losses.
- How to report long-term gains and losses.
- How to figure capital loss carryovers.
- How to figure your tax on a net capital gain.
- An illustrated example of how to complete Schedule D.

If you sell or otherwise dispose of property used in a trade or business or for the production of income, see Publication 544, Sales and Other

Dispositions of Assets, before completing Schedule D.

Useful Items

You may want to see:

Publication

- 537** Installment Sales
- 544** Sales and Other Dispositions of Assets
- 550** Investment Income and Expenses

Form (and Instructions)

- Schedule D (Form 1040)** Capital Gains and Losses
- 4797** Sales of Business Property
- 6252** Installment Sale Income
- 8582** Passive Activity Loss Limitations

Reporting Capital Gains and Losses

Report capital gains and losses on Schedule D (Form 1040). Enter your sales and trades of stocks, bonds, etc., and real estate (if not reported on Form 4684, 4797, 6252, 6781, or 8824) on line 1 of Part I or line 8 of Part II, as appropriate. Include all these transactions even if you did not receive a Form 1099-B, Proceeds From Broker and Barter Exchange Transactions, or Form 1099-S, Proceeds From Real Estate Transactions (or substitute statement). You can use Schedule D-1 as a continuation schedule to report more transactions.

Be sure to add all sales price entries in column (d) of lines 1 and 2 and enter the total on line 3. Also add all sales price entries in column (d) of lines 8 and 9 and enter the total on line 10. Then add the following amounts reported to you for 2006 on Forms 1099-B and Forms 1099-S (or on substitute statements):

- Proceeds from transactions involving stocks, bonds, and other securities, and
- Gross proceeds from real estate transactions (other than the sale of your main home if you had no taxable gain) not reported on another form or schedule.

If this total is more than the total of lines 3 and 10, attach a statement to your return explaining the difference.

Installment sales. You cannot use the installment method to report a gain from the sale of stock or securities traded on an established securities market. You must report the entire gain in the year of sale (the year in which the trade date occurs).

Passive activity gains and losses. If you have gains or losses from a passive activity, you may also have to report them on Form 8582. In some cases, the loss may be limited under the passive activity rules. Refer to Form 8582 and its separate instructions for more information about reporting capital gains and losses from a passive activity.

Form 1099-B transactions. If you sold property, such as stocks, bonds, or certain commodities, through a broker, you should receive Form 1099-B or equivalent statement from the broker. Use the Form 1099-B or the equivalent statement to complete Schedule D.

Report the gross proceeds shown in box 2 of Form 1099-B as the gross sales price in column (d) of either line 1 or line 8 of Schedule D, whichever applies. However, if the broker advises you, in box 2 of Form 1099-B, that gross proceeds (gross sales price) less commissions and option premiums were reported to the IRS, enter that net sales price in column (d) of either line 1 or line 8 of Schedule D, whichever applies.

If the net sales price is entered in column (d), do not include the commissions and option premiums in column (e).

Form 1099-S transactions. If you sold or traded reportable real estate, you generally should receive from the real estate reporting person a Form 1099-S showing the gross proceeds.

“Reportable real estate” is defined as any present or future ownership interest in any of the following:

- Improved or unimproved land, including air space,
- Inherently permanent structures, including any residential, commercial, or industrial building,
- A condominium unit and its accessory fixtures and common elements, including land, and
- Stock in a cooperative housing corporation (as defined in section 216 of the Internal Revenue Code).

A “real estate reporting person” could include the buyer’s attorney, your attorney, the title or escrow company, a mortgage lender, your broker, the buyer’s broker, or the person acquiring the biggest interest in the property.

Your Form 1099-S will show the gross proceeds from the sale or exchange in box 2. Follow the instructions for Schedule D to report these transactions and include them on line 1 or 8 as appropriate.

Nominees. If you receive gross proceeds as a nominee (that is, the gross proceeds are in your name but actually belong to someone else), report on Schedule D, lines 3 and 10, only the proceeds that belong to you. Then add the following amounts reported to you for 2006 on Forms 1099-B and 1099-S (or substitute statements) that you are not reporting on another form or schedule included with your return:

1. Proceeds from transactions involving stocks, bonds, and other securities, and
2. Gross proceeds from real estate transactions (other than the sale of your main home if you are not required to report it).

If the total of (1) and (2) is more than the total of lines 3 and 10, attach a statement to your return explaining the reason for the difference.

File Form 1099-B or Form 1099-S with the IRS. If you received gross proceeds as a nominee in 2006, you must file a Form 1099-B or Form 1099-S for those proceeds with the IRS. Send the Form 1099-B or Form 1099-S with a Form 1096, Annual Summary and Transmittal of U.S. Information Returns, to your Internal Revenue Service Center by February 28, 2007 (April 2, 2007, if you file Form 1099-B or Form 1099-S electronically). Give the actual owner of the proceeds Copy B of the Form 1099-B or Form 1099-S by January 31, 2007. On Form 1099-B, you should be listed as the “Payer.” The other owner should be listed as the “Recipient.” On Form 1099-S, you should be listed as the “Filer.”

Table 16-1. What Is Your Maximum Capital Gain Rate?

IF your net capital gain is from ...	THEN your maximum capital gain rate is ...
collectibles gain	28%
gain on qualified small business stock minus the section 1202 exclusion	28%
unrecaptured section 1250 gain	25%
other gain ¹ and the regular tax rate that would apply is 25% or higher	15%
other gain ¹ and the regular tax rate that would apply is lower than 25%	5%

¹ Other gain means any gain that is not collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain.

The other owner should be listed as the “Transferor.” You do not, however, have to file a Form 1099-B or Form 1099-S to show proceeds for your spouse. For more information about the reporting requirements and the penalties for failure to file (or furnish) certain information returns, see the General Instructions for Forms 1099, 1098, 5498, and W-2G.

Sale of property bought at various times. If you sell a block of stock or other property that you bought at various times, report the short-term gain or loss from the sale on one line in Part I of Schedule D and the long-term gain or loss on one line in Part II. Write “Various” in column (b) for the “Date acquired.” See *Comprehensive Example* later in this chapter.

Sale expenses. Add to your cost or other basis any expense of sale such as brokers’ fees, commissions, state and local transfer taxes, and option premiums. Enter this adjusted amount in column (e) of either Part I or Part II of Schedule D, whichever applies, unless you reported the net sales price amount in column (d).

For more information about adjustments to basis, see chapter 13.

Short-term gains and losses. Capital gain or loss on the sale or trade of investment property held 1 year or less is a short-term capital gain or loss. You report it in Part I of Schedule D. If the amount you report in column (f) is a loss, show it in parentheses.

You combine your share of short-term capital gain or loss from partnerships, S corporations, and fiduciaries, and any short-term capital loss carryover, with your other short-term capital gains and losses to figure your net short-term capital gain or loss on line 7 of Schedule D.

Long-term gains and losses. A capital gain or loss on the sale or trade of investment property held more than 1 year is a long-term capital gain or loss. You report it in Part II of Schedule D. If the amount you report in column (f) is a loss, show it in parentheses.

You also report the following in Part II of Schedule D:

- Undistributed long-term capital gains from a regulated investment company (mutual fund) or real estate investment trust (REIT),
- Your share of long-term capital gains or losses from partnerships, S corporations, and fiduciaries,

- All capital gain distributions from mutual funds and REITs not reported directly on line 10 of Form 1040A or line 13 of Form 1040, and
- Long-term capital loss carryovers.

The result after combining these items with your other long-term capital gains and losses is your net long-term capital gain or loss (line 15 of Schedule D).

Capital gain distributions only. You do not have to file Schedule D if both of the following are true.

- The only amounts you would have to report on Schedule D are capital gain distributions from box 2a of Form 1099-DIV (or substitute statement).
- You do not have an amount in box 2b, 2c, or 2d of any Form 1099-DIV (or substitute statement).

If both of the above statements are true, report your capital gain distributions directly on line 13 of Form 1040 and check the box on line 13. Also, use the Qualified Dividends and Capital Gain Tax Worksheet in the Form 1040 instructions to figure your tax.

You can report your capital gain distributions on line 10 of Form 1040A, instead of on Form 1040, if both of the following are true.

- None of the Forms 1099-DIV (or substitute statements) you received have an amount in box 2b, 2c, or 2d.
- You do not have to file Form 1040 for any other capital gains or losses.

Total net gain or loss. To figure your total net gain or loss, combine your net short-term capital gain or loss (line 7) with your net long-term capital gain or loss (line 15). Enter the result on Schedule D, Part III, line 16. If your losses are more than your gains, see *Capital Losses*, next. If both lines 15 and 16 are gains and line 43 of Form 1040 is more than zero, see *Capital Gain Tax Rates*, later.

Capital Losses

If your capital losses are more than your capital gains, you can claim a capital loss deduction. Report the deduction on line 13 of Form 1040, enclosed in parentheses.

Limit on deduction. Your allowable capital loss deduction, figured on Schedule D, is the lesser of:

- \$3,000 (\$1,500 if you are married and file a separate return), or
- Your total net loss as shown on line 16 of Schedule D.

You can use your total net loss to reduce your income dollar for dollar, up to the \$3,000 limit.

Capital loss carryover. If you have a total net loss on line 16 of Schedule D that is more than the yearly limit on capital loss deductions, you can carry over the unused part to the next year and treat it as if you had incurred it in that next year. If part of the loss is still unused, you can carry it over to later years until it is completely used up.

When you figure the amount of any capital loss carryover to the next year, you must take the current year’s allowable deduction into account, whether or not you claimed it.

When you carry over a loss, it remains long term or short term. A long-term capital loss you carry over to the next tax year will reduce that year’s long-term capital gains before it reduces that year’s short-term capital gains.

Figuring your carryover. The amount of your capital loss carryover is the amount of your total net loss that is more than the lesser of:

1. Your allowable capital loss deduction for the year, or
2. Your taxable income increased by your allowable capital loss deduction for the year and your deduction for personal exemptions.

If your deductions are more than your gross income for the tax year, use your negative taxable income in computing the amount in item (2).

Complete the Capital Loss Carryover Worksheet in Publication 550 to determine the part of your capital loss for 2006 that you can carry over to 2007.

Example. Bob and Gloria sold securities in 2006. The sales resulted in a capital loss of \$7,000. They had no other capital transactions. Their taxable income was \$26,000. On their joint 2006 return, they can deduct \$3,000. The unused part of the loss, \$4,000 (\$7,000 – \$3,000), can be carried over to 2007.

If their capital loss had been \$2,000, their capital loss deduction would have been \$2,000. They would have no carryover.

Use short-term losses first. When you figure your capital loss carryover, use your short-term capital losses first, even if you incurred them after a long-term capital loss. If you have not reached the limit on the capital loss deduction after using the short-term capital losses, use the long-term capital losses until you reach the limit.

Decedent’s capital loss. A capital loss sustained by a decedent during his or her last tax year (or carried over to that year from an earlier year) can be deducted only on the final income tax return filed for the decedent. The capital loss limits discussed earlier still apply in this situation. The decedent’s estate cannot deduct any of the loss or carry it over to following years.

Joint and separate returns. If you and your spouse once filed separate returns and are now filing a joint return, combine your separate capital loss carryovers. However, if you and your

spouse once filed a joint return and are now filing separate returns, any capital loss carryover from the joint return can be deducted only on the return of the spouse who actually had the loss.

Capital Gain Tax Rates

The tax rates that apply to a net capital gain are generally lower than the tax rates that apply to other income. These lower rates are called the maximum capital gain rates.

The term "net capital gain" means the amount by which your net long-term capital gain for the year is more than your net short-term capital loss.

For 2006, the maximum capital gain rates are 5%, 15%, 25%, or 28%. See Table 16-1 for details.



If you figure your tax using the maximum capital gain rates and the regular tax computation results in a lower tax, the regular tax computation applies.

Example. All of your net capital gain is from selling collectibles, so the capital gain rate would be 28%. Because you are single and your taxable income is \$25,000, none of your taxable income will be taxed above the 15% rate. The 28% rate does not apply.

Investment interest deducted. If you claim a deduction for investment interest, you may have to reduce the amount of your net capital gain that is eligible for the capital gain tax rates. Reduce it by the amount of the net capital gain you choose to include in investment income when figuring the limit on your investment interest deduction. This is done on the Schedule D Tax Worksheet or the Qualified Dividends and Capital Gain Tax Worksheet. For more information about the limit on investment interest, see chapter 3 of Publication 550.

Collectibles gain or loss. This is gain or loss from the sale or trade of a work of art, rug, antique, metal (such as gold, silver, and platinum bullion), gem, stamp, coin, or alcoholic beverage held more than 1 year.

Gain on qualified small business stock. If you realized a gain from qualified small business stock that you held more than 5 years, you generally can exclude up to 50% of your gain from income. The exclusion can be up to 60% for certain empowerment zone business stock.

The eligible gain minus your section 1202 exclusion is a 28% rate gain. See *Gains on Qualified Small Business Stock* in chapter 4 of Publication 550.

Unrecaptured section 1250 gain. Generally, this is any part of your capital gain from selling section 1250 property (real property) that is due to depreciation (but not more than your net section 1231 gain), reduced by any net loss in the 28% group. Use the Unrecaptured Section 1250 Gain Worksheet in the Schedule D instructions to figure your unrecaptured section 1250 gain. For more information about section 1250 property and section 1231 gain, see chapter 3 of Publication 544.

Tax computation using maximum capital gains rates. Use the Qualified Dividends and Capital Gain Tax Worksheet or the Schedule D Tax Worksheet (whichever applies) to figure your tax if you have qualified dividends or net capital gain. You have net capital gain if Schedule D, lines 15 and 16, are both gains.

Schedule D Tax Worksheet. You must use the Schedule D Tax Worksheet in the Schedule D instructions to figure your tax if:

- You have to file Schedule D, and
- Schedule D, line 18 (28% rate gain) or line 19 (unrecaptured section 1250 gain), is more than zero.

See *Comprehensive Example*, later, for an example of how to figure your tax using the Schedule D Tax Worksheet.

Qualified Dividends and Capital Gain Tax Worksheet. If you do not have to use the Schedule D Tax Worksheet (as explained above) and any of the following apply, use the Qualified Dividends and Capital Gain Tax Worksheet in the instructions for Form 1040 or Form 1040A (whichever you file) to figure your tax.

- You received qualified dividends. (See *Qualified Dividends* in chapter 8.)
- You do not have to file Schedule D and you received capital gain distributions. (See *Capital gain distributions only*, earlier.)
- Schedule D, lines 15 and 16, are both more than zero.

Comprehensive Example

Emily Jones is single and, in addition to wages from her job, she has income from stocks and other securities. For the 2006 tax year, she had the following capital gains and losses, which she reports on Schedule D. All the Forms 1099 she received showed net sales prices. Her filled-in Schedule D is shown in this chapter.

Capital gains and losses — Schedule D. Emily sold stock in two different companies that she held for less than a year. In June, she sold 100 shares of Trucking Co. stock that she had bought in February. She had an adjusted basis of \$650 in the stock and sold it for \$900, for a gain of \$250. In July, she sold 25 shares of Computer Co. stock that she bought in June. She had an adjusted basis in the stock of \$2,500 and she sold it for \$2,000, for a loss of \$500. She reports these short-term transactions on line 1 in Part I of Schedule D.

Emily had three other stock sales that she reports as long-term transactions on line 8 in Part II of Schedule D. In February, she sold 60 shares of Car Co. for \$2,100. She had inherited the Car Co. stock from her father. Its fair market value at the time of his death was \$2,500, which became her basis. Her loss on the sale is \$400. Because she had inherited the stock, her loss is a long-term loss, regardless of how long she and her father actually held the stock. She enters the loss in column (f) of line 8.

In June, she sold 500 shares of Furniture Co. stock for \$14,000. She had bought 100 of those shares in 1995, for \$1,000. She had bought 100 more shares in 1997 for \$2,200, and an additional 300 shares in 2000 for \$1,500. Her total basis in the stock is \$4,700. She has a \$9,300 (\$14,000 – \$4,700) gain on this sale, which she enters in column (f) of line 8.

In December, she sold 20 shares of Toy Co. for \$4,100. This was qualified small business stock that she had bought in September 2001. Her basis is \$1,100, so she has a \$3,000 gain which she enters in column (f) of line 8. Because she held the stock more than 5 years, she has a \$1,500 section 1202 exclusion. She claims the exclusion on the line below by entering \$1,500 as a loss in column (f). She also enters the exclusion as a positive amount on line 2 of the 28% Rate Gain Worksheet.

28% Rate Gain Worksheet for Emily Jones—Line 18

1. Enter the total of all collectibles gain or (loss) from items you reported on line 8, column (f), of Schedules D and D-1	1.	0
2. Enter as a positive number the amount of any section 1202 exclusion you reported on line 8, column (f), of Schedules D and D-1, for which you excluded 50% of the gain, plus $\frac{2}{3}$ of any section 1202 exclusion you reported on line 8, column (f), of Schedules D and D-1, for which you excluded 60% of the gain	2.	1,500
3. Enter the total of all collectibles gain or (loss) from Form 4684, line 4 (but only if Form 4684, line 15, is more than zero); Form 6252; Form 6781, Part II; and Form 8824	3.	
4. Enter the total of any collectibles gain reported to you on: <ul style="list-style-type: none"> • Form 1099-DIV, box 2d; • Form 2439, box 1d; and • Schedule K-1 from a partnership, S corporation, estate, or trust. 	4.	
5. Enter your long-term capital loss carryovers from Schedule D, line 14, and Schedule K-1 (Form 1041), box 11, code C	5.	(500)
6. If Schedule D, line 7, is a (loss), enter that (loss) here. Otherwise, enter -0-	6.	(550)
7. Combine lines 1 through 6. If zero or less, enter -0-. If more than zero, also enter this amount on Schedule D, line 18	7.	450

She received a Form 1099-B (not shown) from her broker for each of these transactions.

Reconciliation of Forms 1099-B. Emily makes sure that the total of the amounts reported in column (d) of lines 3 and 10 of Schedule D is not less than the total of the amounts shown on the Forms 1099-B she received from her broker. For 2006, the total is \$23,100.

Capital loss carryover from 2005. Emily has a capital loss carryover to 2006 of \$800, of which \$300 is short-term capital loss, and \$500 is long-term capital loss. She enters these amounts on lines 6 and 14 of Schedule D. She

also enters the \$500 long-term capital loss carryover on line 5 of the 28% Rate Gain Worksheet. Her filled-in 28% Rate Gain Worksheet is shown below.

She kept the completed Capital Loss Carryover Worksheet (not illustrated) in her 2005 edition of Publication 550, so she could properly report her loss carryover for the 2006 tax year without refiguring it.

Tax computation. Because Emily has gains on both lines 15 and 16 of Schedule D, she checks the "Yes" box on line 17 and goes to line 18. On line 18 she enters \$450 from line 7 of

the 28% Rate Gain Worksheet. Because line 18 is greater than zero, she checks the "No" box on line 20 and uses the Schedule D Tax Worksheet to figure her tax.

After entering the gain from line 16 on line 13 of her Form 1040, she completes the rest of Form 1040 through line 43. She enters the amount from that line, \$30,000, on line 1 of the Schedule D Tax Worksheet. After filling out the rest of that worksheet, she figures her tax is \$3,236. This is less than the \$4,126 tax she would have figured without the capital gain tax rates.

Schedule D Tax Worksheet

Complete this worksheet only if line 18 or line 19 of Schedule D is more than zero. Otherwise, complete the Qualified Dividends and Capital Gain Tax Worksheet on page 38 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR) to figure your tax.

Exception: Do not use the Qualified Dividends and Capital Gain Tax Worksheet or this worksheet to figure your tax if:

- Line 15 or line 16 of Schedule D is zero or less and you have no qualified dividends on Form 1040, line 9b (or Form 1040NR, line 10b); or
- Form 1040, line 43 (or Form 1040NR, line 40) is zero or less.

Instead, see the instructions for Form 1040, line 44 (or Form 1040NR, line 41).

1. Enter your taxable income from Form 1040, line 43 (or Form 1040NR, line 40)	1.	30,000
2. Enter your qualified dividends from Form 1040, line 9b (or Form 1040NR, line 10b)	2.	
3. Enter the amount from Form 4952, line 4g	3.	
4. Enter the amount from Form 4952, line 4e*	4.	
5. Subtract line 4 from line 3. If zero or less, enter -0-	5.	
6. Subtract line 5 from line 2. If zero or less, enter -0-	6.	
7. Enter the smaller of line 15 or line 16 of Schedule D	7.	9,350
8. Enter the smaller of line 3 or line 4	8.	
9. Subtract line 8 from line 7. If zero or less, enter -0-	9.	9,350
10. Add lines 6 and 9	10.	9,350
11. Add lines 18 and 19 of Schedule D	11.	450
12. Enter the smaller of line 9 or line 11	12.	450
13. Subtract line 12 from line 10.	13.	8,900
14. Subtract line 13 from line 1. If zero or less, enter -0-	14.	21,100
15. Enter the smaller of:		
• The amount on line 1 or		
• \$30,650 if single or married filing separately;		
• \$61,300 if married filing jointly or qualifying widow(er); or		
• \$41,050 if head of household	15.	30,000
16. Enter the smaller of line 14 or line 15	16.	21,100
17. Subtract line 10 from line 1. If zero or less, enter -0-	17.	20,650
18. Enter the larger of line 16 or line 17	▶ 18.	21,100
If lines 15 and 16 are the same, skip lines 19 and 20 and go to line 21. Otherwise, go to line 19.		
19. Subtract line 16 from line 15	▶ 19.	8,900
20. Multiply line 19 by 5% (.05)	20.	445
If lines 1 and 15 are the same, skip lines 21 through 33 and go to line 34. Otherwise, go to line 21.		
21. Enter the smaller of line 1 or line 13	21.	
22. Enter the amount from line 19 (if line 19 is blank, enter -0-)	22.	
23. Subtract line 22 from line 21. If zero or less, enter -0-	▶ 23.	
24. Multiply line 23 by 15% (.15)	24.	
If Schedule D, line 19, is zero or blank, skip lines 25 through 30 and go to line 31. Otherwise, go to line 25.		
25. Enter the smaller of line 9 above or Schedule D, line 19	25.	
26. Add lines 10 and 18	26.	
27. Enter the amount from line 1 above	27.	
28. Subtract line 27 from line 26. If zero or less, enter -0-	28.	
29. Subtract line 28 from line 25. If zero or less, enter -0-	▶ 29.	
30. Multiply line 29 by 25% (.25)	30.	
If Schedule D, line 18, is zero or blank, skip lines 31 through 33 and go to line 34. Otherwise, go to line 31.		
31. Add lines 18, 19, 23, and 29	31.	
32. Subtract line 31 from line 1	32.	
33. Multiply line 32 by 28% (.28)	33.	
34. Figure the tax on the amount on line 18 . Use the Tax Table or Tax Computation Worksheet, whichever applies	34.	2,791
35. Add lines 20, 24, 30, 33, and 34	35.	3,236
36. Figure the tax on the amount on line 1 . Use the Tax Table or Tax Computation Worksheet, whichever applies	36.	4,126
37. Tax on all taxable income (including capital gains and qualified dividends). Enter the smaller of line 35 or line 36. Also enter this amount on Form 1040, line 44 (or Form 1040NR, line 41)	37.	3,236

*If applicable, enter instead the smaller amount you entered on the dotted line next to line 4e of Form 4952.

**SCHEDULE D
(Form 1040)**

Department of the Treasury
Internal Revenue Service (99)

Capital Gains and Losses

▶ Attach to Form 1040 or Form 1040NR. ▶ See Instructions for Schedule D (Form 1040).

▶ Use Schedule D-1 to list additional transactions for lines 1 and 8.

OMB No. 1545-0074

2006

Attachment
Sequence No. **12**

Name(s) shown on return

Emily Jones

Your social security number

111 00 1111

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-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1 100 sh Trucking Co.	2-11-06	6-12-06	900	650	250
25 sh Computer Co.	6-30-06	7-30-06	2,000	2,500	(500)
2 Enter your short-term totals, if any, from Schedule D-1, line 2			2		
3 Total short-term sales price amounts. Add lines 1 and 2 in column (d)			3	2,900	
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 10 of your Capital Loss Carryover Worksheet on page D-7 of the instructions			6		(300)
7 Net short-term capital gain or (loss). Combine lines 1 through 6 in column (f)			7		(550)

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

(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-7 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
8 60 sh Car Co.	INHERITED	2-3-06	2,100	2,500	(400)
500 sh Furniture Co.	VARIOUS	6-30-06	14,000	4,700	9,300
20 sh Toy Co.	9-28-01	12-15-06	4,100	1,100	3,000
Section 1202 exclusion					(1,500)
9 Enter your long-term totals, if any, from Schedule D-1, line 9			9		
10 Total long-term sales price amounts. Add lines 8 and 9 in column (d)			10	20,200	
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 page D-2 of the instructions			13		
14 Long-term capital loss carryover. Enter the amount, if any, from line 15 of your Capital Loss Carryover Worksheet on page D-7 of the instructions			14		(500)
15 Net long-term capital gain or (loss). Combine lines 8 through 14 in column (f). Then go to Part III on the back			15		9,900

For Paperwork Reduction Act Notice, see Form 1040 or Form 1040NR instructions. Cat. No. 11338H Schedule D (Form 1040) 2006

Part III Summary

<p>16 Combine lines 7 and 15 and enter the result. If line 16 is a loss, skip lines 17 through 20, and go to line 21. If a gain, enter the gain on Form 1040, line 13, or Form 1040NR, line 14. Then go to line 17 below</p>	16	9,350	
<p>17 Are lines 15 and 16 both gains? <input checked="" type="checkbox"/> Yes. Go to line 18. <input type="checkbox"/> No. Skip lines 18 through 21, and go to line 22.</p>			
<p>18 Enter the amount, if any, from line 7 of the 28% Rate Gain Worksheet on page D-8 of the instructions ▶</p>	18	450	
<p>19 Enter the amount, if any, from line 18 of the Unrecaptured Section 1250 Gain Worksheet on page D-9 of the instructions ▶</p>	19		
<p>20 Are lines 18 and 19 both zero or blank? <input type="checkbox"/> Yes. Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the Qualified Dividends and Capital Gain Tax Worksheet on page 38 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR). Do not complete lines 21 and 22 below. <input checked="" type="checkbox"/> No. Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the Schedule D Tax Worksheet on page D-10 of the instructions. Do not complete lines 21 and 22 below.</p>			
<p>21 If line 16 is a loss, enter here and on Form 1040, line 13, or Form 1040NR, line 14, the smaller of:</p> <ul style="list-style-type: none"> • The loss on line 16 or • (\$3,000), or if married filing separately, (\$1,500) } 	21	()	
<p>Note. When figuring which amount is smaller, treat both amounts as positive numbers.</p>			
<p>22 Do you have qualified dividends on Form 1040, line 9b, or Form 1040NR, line 10b? <input type="checkbox"/> Yes. Complete Form 1040 through line 43, or Form 1040NR through line 40. Then complete the Qualified Dividends and Capital Gain Tax Worksheet on page 38 of the Instructions for Form 1040 (or in the Instructions for Form 1040NR). <input type="checkbox"/> No. Complete the rest of Form 1040 or Form 1040NR.</p>			