

## Items for Special Treatment

- Transactions by a securities dealer. See section 1236.
- Bonds and other debt instruments. See **Pub. 550**.
- Certain real estate subdivided for sale that may be considered a capital asset. See section 1237.
- Gain on the sale of depreciable property to a more than 50% owned entity or to a trust of which you are a beneficiary. See **Pub. 544**.
- Gain on the disposition of stock in an interest charge domestic international sales corporation. See section 995(c).
- Gain on the sale or exchange of stock in certain foreign corporations. See section 1248.
- Transfer of property to a partnership that would be treated as an investment company if it were incorporated. See **Pub. 541**.
- Sales of stock received under a qualified public utility dividend reinvestment plan. See **Pub. 550**.
- Transfer of appreciated property to a political organization. See section 84.
- In general, no gain or loss is recognized on the transfer of property from an individual to a spouse or a former spouse if the transfer is incident to a divorce. See **Pub. 504**.
- Amounts received on the retirement of a debt instrument generally are treated as received in exchange for the debt instrument. See **Pub. 550**.
- Any loss on the disposition of converted wetland or highly erodible cropland that is first used for farming after March 1, 1986, is reported as a long-term capital loss on Schedule D, but any gain is reported as ordinary income on **Form 4797**.
- Amounts received by shareholders in corporate liquidations. See **Pub. 550**.
- Cash received in lieu of fractional shares of stock as a result of a stock split or stock dividend. See **Pub. 550**.
- Mutual fund load charges may not be taken into account in determining gain or loss on certain dispositions of stock in mutual funds if reinvestment rights were exercised. See **Pub. 564**.
- The sale or exchange of S corporation stock or an interest in a trust held for more than 1 year may result in collectibles gain (28% rate gain). See page D-6.
- Gain or loss on the disposition of securities futures contracts. See **Pub. 550**.
- Gain on the constructive sale of certain appreciated financial positions. See **Pub. 550**.
- The receipt of cash or stock (that you later sold) upon the demutualization of an insurance company. See **Pub. 550** or use TeleTax topic 430 (see page 11 of the Form 1040 instructions).

- Certain constructive ownership transactions. Gain in excess of the gain you would have recognized if you had held a financial asset directly during the term of a derivative contract must be treated as ordinary income. See section 1260. If any portion of the constructive ownership transaction was open in any prior year, you may have to pay interest. See section 1260(b) for details, including how to figure the interest. Include the interest as an additional tax on Form 1040, line 58. Write "Section 1260(b) interest" and the amount of the interest to the left of line 58. This interest is not deductible.

- The sale of publicly traded securities, if you elect to postpone gain by purchasing common stock or a partnership interest in a specialized small business investment company during the 60-day period that began on the date of the sale. See **Pub. 550**.

- The sale of qualified securities held for at least 3 years to an employee stock ownership plan or eligible worker-owned cooperative, if you elect to postpone gain by purchasing qualified replacement property. See **Pub. 550**.

- The sale of qualified empowerment zone assets acquired after December 21, 2000, that you held for more than 1 year, if you elect to postpone gain by purchasing other qualified empowerment zone assets during the 60-day period that began on the date of the sale. See **Pub. 550** and **Pub. 954**.

## Wash Sales

A wash sale occurs when you sell or otherwise dispose of stock or securities (including a contract or option to acquire or sell stock or securities) at a loss and, within 30 days before or after the sale or disposition, you directly or indirectly:

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

You **cannot** deduct losses from wash sales unless the loss was incurred in the ordinary course of your business as a dealer in stock or securities. The basis of the substantially identical property (or contract or option to acquire such property) is its cost increased by the disallowed loss. For more details on wash sales, see **Pub. 550**.

Report a wash sale transaction on line 1 or 8. Enter the full amount of the (loss) in column (f). Directly below the line on which you reported the loss, enter "Wash Sale" in column (a), and enter as a positive amount in column (f) the amount of the loss not allowed.

## Special Rules for Traders in Securities

You are a **trader in securities** if you are engaged in the **business** of buying and selling securities for your own account. To be engaged in business as a trader in securities:

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

The following facts and circumstances should be considered in determining if your activity is a business.

- Typical holding periods for securities bought and sold.
- The frequency and dollar amount of your trades during the year.
- The extent to which you pursue the activity to produce income for a livelihood.
- The amount of time you devote to the activity.

You are considered an investor, and not a trader, if your activity does not meet the above definition of a business. It does not matter whether you call yourself a trader or a "day trader."

Like an investor, a trader must report each sale of securities (taking into account commissions and any other costs of acquiring or disposing of the securities) on Schedule D or D-1 or on an attached statement containing all the same information for each sale in a similar format. However, if a trader previously made the mark-to-market election (see below), each transaction is reported in Part II of **Form 4797** instead of Schedules D and D-1. Regardless of whether a trader reports his or her gains and losses on Schedules D and D-1 or Form 4797, the gain or loss from the disposition of securities is **not** taken into account when figuring net earnings from self-employment on Schedule SE. See the Instructions for Schedule SE for an exception that applies to section 1256 contracts.

The limitation on investment interest expense that applies to investors does not apply to interest paid or incurred in a trading business. A trader reports interest expense and other expenses (excluding commissions and other costs of acquiring or disposing of securities) from a trading business on Schedule C (instead of Schedule A).

A trader also may hold securities for investment. The rules for investors generally will apply to those securities. Allocate interest and other expenses between your trading business and your investment securities.

## Mark-To-Market Election for Traders

A trader may make an election under section 475(f) to report all gains and losses from

securities held in connection with a trading business as ordinary income (or loss), including securities held at the end of the year. Securities held at the end of the year are "marked to market" by treating them as if they were sold (and reacquired) for fair market value on the last business day of the year. Generally, the election must be made by the due date (**not** including extensions) of the tax return for the year **prior** to the year for which the election becomes effective. To be effective for 2001, the election must have been made by April 16, **2001**.

Starting with the year the election becomes effective, a trader reports all gains and losses from securities held in connection with the trading business, including securities held at the end of the year, in Part II of Form 4797. If you previously made the election, see the Instructions for Form 4797. For details on making the mark-to-market election for 2002, see Pub. 550 or Rev. Proc. 99-17, 1999-1 C.B. 503. You can find Rev. Proc. 99-17 on page 52 of Internal Revenue Bulletin 1999-7 at [www.irs.gov](http://www.irs.gov).

If you hold securities for investment, they must be identified as such in your records on the day they are acquired (for example, by holding the securities in a separate brokerage account). Securities held for investment are not marked-to-market.

## Short Sales

A short sale is a contract to sell property you borrowed for delivery to a buyer. At a later date, you either buy substantially identical property and deliver it to the lender or deliver property that you held but did not want to transfer at the time of the sale. Usually, your holding period is the amount of time you actually held the property eventually delivered to the lender to close the short sale. However, your gain when closing a short sale is short term if you (a) held substantially identical property for 1 year or less on the date of the short sale or (b) acquired property substantially identical to the property sold short after the short sale but on or before the date you close the short sale. If you held substantially identical property for more than 1 year on the date of a short sale, any loss realized on the short sale is a long-term capital loss, even if the property used to close the short sale was held 1 year or less.

## Gain or Loss From Options

Report on Schedule D gain or loss from the closing or expiration of an option that is not a section 1256 contract but is a capital asset in your hands. If an option you purchased expired, enter the expiration date in column (c) and enter "**EXPIRED**" in column (d). If an option that was granted (written) expired, enter the expiration date in column (b) and enter "**EXPIRED**" in column (e). Fill in the other columns as appropriate. See **Pub. 550** for details.

## Undistributed Capital Gains

Include on line 11, column (f), the amount from box 1a of **Form 2439**. This represents your share of the undistributed long-term capital gains of the regulated investment company (including a mutual fund) or real estate investment trust.

If there is an amount in box 1b of Form 2439, include that amount on line 11, column (g).

If there is an amount in box 1c, include that amount on line 2 of the **Qualified 5-Year Gain Worksheet** on page D-8 if you are required to complete line 29 of Schedule D.

If there is an amount in box 1d, include that amount on line 11 of the **Unrecaptured Section 1250 Gain Worksheet** on page D-7 if you are required to complete line 19 of Schedule D.

If there is an amount in box 1e, see **Exclusion of Gain on Qualified Small Business (QSB) Stock** on this page.

Enter on Form 1040, line 65, the tax paid as shown in box 2 of Form 2439. Also on line 65, check the box for Form 2439. Add to the basis of your stock the excess of the amount included in income over the amount of the credit for the tax paid. See **Pub. 550** for details.

## Installment Sales

If you sold property (other than publicly traded stocks or securities) at a gain and you will receive a payment in a tax year after the year of sale, you generally must report the sale on the installment method unless you elect not to. Use **Form 6252** to report the sale on the installment method. Also use Form 6252 to report any payment received in 2001 from a sale made in an earlier year that you reported on the installment method.

To elect out of the installment method, report the full amount of the gain on Schedule D on a timely filed return (including extensions) for the year of the sale. If your original return was filed on time, you may make the election on an amended return filed no later than 6 months after the due date of your return (excluding extensions). Write "Filed pursuant to section 301.9100-2" at the top of the amended return.

## Exclusion of Gain on Qualified Small Business (QSB) Stock

Section 1202 allows for an exclusion of up to 50% of the eligible gain on the sale or exchange of QSB stock. The section 1202 exclusion applies only to QSB stock held for more than 5 years.

To be **QSB stock**, the stock must meet **all** of the following tests.

- It must be stock in a C corporation (that is, not S corporation stock).

- It must have been originally issued after August 10, 1993.

- As of the date the stock was issued, the corporation was a domestic C corporation with total gross assets of \$50 million or less (a) at all times after August 9, 1993, and before the stock was issued and (b) immediately after the stock was issued. Gross assets include those of any predecessor of the corporation. All corporations that are members of the same parent-subsidiary controlled group are treated as one corporation.

- You must have acquired the stock at its original issue (either directly or through an underwriter), either in exchange for money or other property or as pay for services (other than as an underwriter) to the corporation. In certain cases, you may meet the test if you acquired the stock from another person who met the test (such as by gift or inheritance) or through a conversion or exchange of QSB stock you held.

- During substantially all the time you held the stock:

1. The corporation was a C corporation,
2. At least 80% of the value of the corporation's assets were used in the active conduct of one or more qualified businesses (defined below), and
3. The corporation was **not** a foreign corporation, DISC, former DISC, regulated investment company, real estate investment trust, REMIC, FASIT, cooperative, or a corporation that has made (or that has a subsidiary that has made) a section 936 election.

**Note.** A specialized small business investment company (SSBIC) is treated as having met test 2 above.

A **qualified business** is any business **other than a—**

- Business involving services performed in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, consulting, athletics, financial services, or brokerage services.

- Business whose principal asset is the reputation or skill of one or more employees.

- Banking, insurance, financing, leasing, investing, or similar business.

- Farming business (including the raising or harvesting of trees).

- Business involving the production of products for which percentage depletion can be claimed.

- Business of operating a hotel, motel, restaurant, or similar business.

For more details about limits and additional requirements that may apply, see section 1202.

## Pass-Through Entities

If you held an interest in a pass-through entity (a partnership, S corporation, or mutual fund or other regulated investment