Sales and Trades of Investment Property

This exception also applies to successive short sales of an entire appreciated financial position. For more information, see Revenue Ruling 2003-1 in Internal Revenue Bulletin 2003-3. This bulletin is available at www.irs.gov/pub/irs-irbs/irb03-03.pdf.

Appreciated financial position. This is any interest in stock, a partnership interest, or a debt instrument (including a futures or forward contract, a short sale, or an option) if disposing of the interest would result in a gain.
Exceptions. An appreciated financial position does not include the following.

1. Any position from which all of the appreciation is accounted for under marked-to-market rules, including section 1256 contracts (described later under *Section 1256 Contracts Marked to Market*).
2. Any position in a debt instrument if:
    a. The position unconditionally entitles the holder to receive a specified principal amount,
    b. The interest payments (or other similar amounts) with respect to the position are payable at a fixed rate or a variable rate described in Regulations section 1.860G-1(a)(3), and
    c. The position is not convertible, either directly or indirectly, into stock of the issuer (or any related person).
3. Any hedge with respect to a position described in (2).

Certain trust instruments treated as stock. For the constructive sale rules, an interest in an actively traded trust is treated as stock unless substantially all of the value of the property held by the trust is debt that qualifies for the exception to the definition of an appreciated financial position (explained in (2) above).
Sale of appreciated financial position. A transaction treated as a constructive sale of an appreciated financial position is not treated as a constructive sale of any other appreciated financial position, as long as you continue to hold the original position. However, if you hold another appreciated financial position and dispose of the original position before closing the transaction that resulted in the constructive sale, you are treated as if, at the same time, you constructively sold the other appreciated financial position.

Section 1256 Contracts Marked to Market

If you hold a section 1256 contract at the end of the tax year, you generally must treat it as sold at its fair market value on the last business day of the tax year.

Section 1256 Contract

A section 1256 contract is any:

- Regulated futures contract,
- Foreign currency contract,
- Nonequity option,
- Dealer equity option, or
- Dealer securities futures contract.

Exceptions. A section 1256 contract does not include:

- Interest rate swaps,
- Currency swaps,
- Basis swaps,
- Interest rate caps,
- Interest rate floors,
- Commodity swaps,
- Equity swaps,
- Equity index swaps,
- Credit default swaps, or
- Similar agreements.

For more details, including definitions of these terms, see section 1256.

Regulated futures contract. This is a contract that:

- Provides that amounts which must be deposited to, or can be withdrawn from, your margin account depend on daily market conditions (a system of marking to market), and
- Is traded on, or subject to the rules of, a qualified board of exchange. A qualified board of exchange is a domestic board of trade designated as a contract market by the Commodity Futures Trading Commission, any board of trade or exchange approved by the Secretary of the Treasury, or a national securities exchange registered with the Securities and Exchange Commission.

The loss is carried to the earliest carryback year first, and any unabsorbed loss amount can then be carried to each of the next 2 tax years. In each carryback year, treat 60% of the carryback amount as a long-term capital loss and 40% as a short-term capital loss from section 1256 contracts.

If only a portion of the net section 1256 contracts loss is absorbed by carrying the loss back, the unabsorbed portion can be carried forward, under the capital loss carryover rules, to the year following the loss. (See *Capital Losses* under *Reporting Capital Gains and Losses,* later.) Figure your capital loss carryover as if, for the loss year, you had an additional short-term capital gain of 40% of the amount of net section 1256 contracts loss absorbed in the carryback years and an additional long-term capital gain of 60% of the absorbed loss. In the carryover year, treat any capital loss carryover from losses on section 1256 contracts as if it were a loss from section 1256 contracts for that year.

Net section 1256 contracts loss. This loss is the lesser of:

- The net capital loss for your tax year determined by taking into account only the gains and losses from section 1256 contracts, or
- The capital loss carryover to the next tax year determined without this election.

Net section 1256 contracts gain. This gain is the lesser of:

- The capital gain net income for the carryback year determined by taking into account only gains and losses from section 1256 contracts, or
- The capital gain net income for that year.

Figure your net section 1256 contracts gain for any carryback year without regard to the net section 1256 contracts loss for the loss year or any later tax year.

Traders in section 1256 contracts. Gain or loss from the trading of section 1256 contracts is capital gain or loss subject to the marked-to-market rules. However, this does not apply to contracts held for purposes of hedging property if any loss from the property would be an ordinary loss.

Treatment of underlying property. The determination of whether an individual's gain or loss from any property is ordinary or capital gain or loss is made without regard to the fact that the individual is actively engaged in dealing in or trading section 1256 contracts related to that property.

How To Report

If you disposed of regulated futures or foreign currency contracts in 2013 (or had unrealized profit or loss on these contracts that were open at the end of 2012 or 2013), you should receive Form 1099-B, or substitute statement, from your broker.

Form 6781. Use Part I of Form 6781 to report your gains and losses from all section 1256 contracts that are open at the end of the year or that were closed out during the year. This includes the amount shown in box 10 of Form 1099-B. Then enter the net amount of these gains and losses on Schedule D (Form 1040), line 4 or line 11, as appropriate. Include a copy of Form 6781 with your income tax return.

If the Form 1099-B you receive includes a straddle or hedging transaction, defined later, it may be necessary to show certain adjustments on Form 6781. Follow the Form 6781 instructions for completing Part I.

Loss carryback election. To carry back your loss under the election procedures described earlier, file Form 1040X or Form 1045, Application for Tentative Refund, for the year to which you are carrying the loss with an amended Form 6781 and an amended Schedule D (Form 1040) attached. Follow the instructions for completing Form 6781 for the loss year to make this election.

Hedging Transactions

The marked-to-market rules, described earlier, do not apply to hedging transactions. A transaction is a hedging transaction if both of the following conditions are met.

1. You entered into the transaction in the normal course of your trade or business primarily to manage the risk of:
   a. Price changes or currency fluctuations on ordinary property you hold (or will hold), or
   b. Interest rate or price changes, or currency fluctuations, on your current or future borrowings or ordinary obligations.
2. You clearly identified the transaction as being a hedging transaction before the close of the day on which you entered into it.

This hedging transaction exception does not apply to transactions entered into by or for any syndicate. A syndicate is a partnership, S corporation, or other entity (other than a regular corporation) that allocates more than 35% of its losses to limited partners or limited entrepreneurs. A limited entrepreneur is a person who has an interest in an enterprise (but not as a limited partner) and who does not actively participate in its management. However, an interest is not considered held by a limited partner or entrepreneur if the interest holder actively participates (or did so for at least 5 full years) in the management of the entity, or is the spouse, child (including a legally adopted child), grandchild, or parent of an individual who actively participates in the management of the entity.

Hedging loss limit. If you are a limited partner or entrepreneur in a syndicate, the amount of a hedging loss you can claim is limited. A "hedging loss" is the amount by which the allowable deductions in a tax year that resulted from a hedging transaction (determined without regard to the limit) are more than the income received or accrued during the tax year from this transaction.
Any hedging loss allocated to you for the tax year is limited to your taxable income for that year from the trade or business in which the hedging transaction occurred. Ignore any hedging transaction items in determining this taxable income. If you have a hedging loss that is disallowed because of this limit, you can carry it over to the next tax year as a deduction resulting from a hedging transaction.
If the hedging transaction relates to property other than stock or securities, the limit on hedging losses applies if the limited partner or entrepreneur is an individual.
The limit on hedging losses does not apply to any hedging loss to the extent that it is more than all your unrecognized gains from hedging transactions at the end of the tax year that are from the trade or business in which the hedging transaction occurred. The term "unrecognized gain" has the same meaning as defined under *Loss Deferral Rules* in *Straddles*, later.
Sale of property used in a hedge. Once you identify personal property as being part of a hedging transaction, you must treat gain from its sale or exchange as ordinary income, not capital gain.

Property Received as a Gift

To figure your basis in property that you received as a gift, you must know its adjusted basis to the donor just before it was given to you, its fair market value at the time it was given to you, the amount of any gift tax paid on it, and the date it was given to you.

Fair market value less than donor's adjusted basis. If the fair market value of the property at the time of the gift was less than the donor's adjusted basis just before the gift, your basis for gain on its sale or other disposition is the same as the donor's adjusted basis plus or minus any required adjustments to basis during the period you hold the property. Your basis for loss is its fair market value at the time of the gift plus or minus any required adjustments to basis during the period you hold the property.
No gain or loss. If you use the basis for figuring a gain and the result is a loss, and then use the basis for figuring a loss and the result is a gain, you will have neither a gain nor a loss.

Example.

You receive a gift of investment property having an adjusted basis of $10,000 at the time of the gift. The fair market value at the time of the gift is $9,000. You later sell the property for $9,500. You have neither gain nor loss. Your basis for figuring gain is $10,000, and $9,500 minus $10,000 results in a $500 loss. Your basis for figuring loss is $9,000, and $9,500 minus $9,000 results in a $500 gain.

Fair market value equal to or more than donor's adjusted basis. If the fair market value of the property at the time of the gift was equal to or more than the donor's adjusted basis just before the gift, your basis for gain or loss on its sale or other

disposition is the donor's adjusted basis plus or minus any required adjustments to basis during the period you hold the property. Also, you may be allowed to add to the donor's adjusted basis all or part of any gift tax paid, depending on the date of the gift.
Gift received before 1977. If you received property as a gift before 1977, your basis in the property is the donor's adjusted basis increased by the total gift tax paid on the gift. However, your basis cannot be more than the fair market value of the gift at the time it was given to you.

Example 1.

You were given XYZ Company stock in 1976. At the time of the gift, the stock had a fair market value of $21,000. The donor's adjusted basis was $20,000. The donor paid a gift tax of $500 on the gift. Your basis for gain or loss is $20,500, the donor's adjusted basis plus the amount of gift tax paid.

Example 2.

The facts are the same as in *Example 1* except that the gift tax paid was $1,500. Your basis is $21,000, the donor's adjusted basis plus the gift tax paid, but limited to the fair market value of the stock at the time of the gift.

Gift received after 1976. If you received property as a gift after 1976, your basis is the donor's adjusted basis increased by the part of the gift tax paid that was for the net increase in value of the gift. You figure this part by multiplying the gift tax paid on the gift by a fraction. The numerator (top part) is the net increase in value of the gift and the denominator (bottom part) is the amount of the gift.

The net increase in value of the gift is the fair market value 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.

Example.

In 2013, you received a gift of property from your mother. At the time of the gift, the property had a fair market value of $101,000 and an adjusted basis to her of $40,000. The amount of the gift for gift tax purposes was $87,000 ($101,000 minus the $14,000 annual exclusion), and your mother paid a gift tax of $21,000. You figure your basis in the following way:

Fair market value	$101,000
Minus: Adjusted basis	40,000
Net increase in value of gift	$61,000
Gift tax paid	$21,000
Multiplied by .701 ($61,000 ÷ $87,000)	.701
Gift tax due to net increase in value	$14,721
Plus: Adjusted basis of property to your mother	40,000
Your basis in the property	$54,721

Part sale, part gift. If you get property in a transfer that is partly a sale and partly a gift, your basis is the larger of the amount you paid for the property or the transferor's adjusted basis in the property at the time of the transfer. Add to that amount the amount of any gift tax paid on the gift, as described in the preceding discussion. For figuring loss, your basis is limited to the property's fair market value at the time of the transfer.
Gift tax information. For information on gift tax, see Publication 950, Introduction to Estate and Gift Taxes. For information on figuring the amount of gift tax to add to your basis, see *Property Received as a Gift* in Publication 551.

Property Received as Inheritance

Before or after 2010. If you inherited property from a decedent who died before or after 2010, or who died in 2010 and the executor of the decedent's estate elected not to file Form 8939, Allocation of Increase in Basis for Property Acquired From a Decedent, your basis in that property generally is its fair market value (its appraised value on Form 706, United States Estate (and Generation-Skipping Transfer) Tax Return) on:

- The date of the decedent's death, or
- The later alternate valuation date if the estate qualifies for, and elects to use, alternate valuation.

If no Form 706 was filed, use the appraised value on the date of death for state inheritance or transmission taxes. For stocks and bonds, if no Form 706 was filed and there are no state inheritance or transmission taxes, see the Form 706 instructions for figuring the fair market value of the stocks and bonds on the date of the decedent's death.

Appreciated property you gave the decedent. Your basis in certain appreciated property that you inherited is the decedent's adjusted basis in the property immediately before death rather than its fair market value. This applies to appreciated property that you or your spouse gave the decedent as a gift during the 1-year period ending on the date of death. Appreciated property is any property whose fair market value on the day you gave it to the decedent was more than its adjusted basis.

More information. See Publication 551 for more information on the basis of inherited property, including community property, property held by a surviving tenant in a joint tenancy or tenancy by the entirety, a qualified joint interest, and a farm or closely held business.

The amount of the original fee or charge in excess of the reduction in (3) is added to the cost of the original shares. The rest of the original fee or charge is added to the cost basis of the new shares (unless all three conditions above also apply to the purchase of the new shares).

Choosing average basis for mutual fund shares. You can choose to use the average basis of mutual fund shares if you acquired the identical shares at various times and prices, or you acquired the shares after 2010 in connection with a dividend reinvestment plan, and left them on deposit in an account kept by a custodian or agent. The methods you can use to figure average basis are explained later.

Undistributed capital gains. If you had to include in your income any undistributed capital gains of the mutual fund or REIT, increase your basis in the stock by the difference between the amount you included and the amount of tax paid for you by the fund or REIT. See *Undistributed capital gains of mutual funds and REITs* under *Capital Gain Distributions* in chapter 1.

Reinvestment right. This is the right to acquire mutual fund shares in the same or another mutual fund without paying a fee or load charge, or by paying a reduced fee or load charge.

The original cost basis of mutual fund shares you acquire by reinvesting your distributions is the amount of the distributions used to purchase each full or fractional share. This rule applies even if the distribution is an exempt-interest dividend that you do not report as income.

[Table 4-1.](#) This is a worksheet you can use to keep track of the adjusted basis of your mutual fund shares. Enter the cost per share when you acquire new shares and any adjustments to their basis when the adjustment occurs. This worksheet will help you figure the adjusted basis when you sell or redeem shares.

Table 4-1. Mutual Fund Record

Mutual Fund	Acquired[1]			Adjustment to Basis Per Share					Adjusted[2] Basis Per Share	Sold or redeemed	
	Date	Number of Shares	Cost Per Share							Date	Number of Shares

[1] Include share received from reinvestment of distributions.

[2] Cost plus or minus adjustments.

Automatic investment service. If you participate in an automatic investment service, your basis for each share of stock, including fractional shares, bought by the bank or other agent is the purchase price plus a share of the broker's commission.

Dividend reinvestment plans. If you participate in a dividend reinvestment plan and receive stock from the corporation at a discount, your basis is the full fair market value of the stock on the dividend payment date. You must include the amount of the discount in your income.

Public utilities. If, before 1986, you excluded from income the value of stock you had received under a qualified public utility reinvestment plan, your basis in that stock is zero.

Stock dividends. Stock dividends are distributions made by a corporation of its own stock. Generally, stock dividends are not taxable to you. However, see *Distributions of Stock and Stock Rights* under *Dividends and Other Distributions* in chapter 1 for some exceptions. If the stock dividends are not taxable, you must divide your basis for the old stock between the old and new stock.

New and old stock identical. If the new stock you received as a nontaxable dividend is identical to the old stock on which the dividend was declared, divide the adjusted basis of the old stock by the number of shares of old and new stock. The result is your basis for each share of stock.

Example 1.

You owned one share of common stock that you bought for $45. The corporation distributed two new shares of common stock for each share held. You then had three shares of common stock. Your basis in each share is $15 ($45 ÷ 3).

Example 2.

You owned two shares of common stock. You bought one for $30 and the other for $45. The corporation distributed two new shares of common stock for each share held. You had six shares after the distribution—three with a basis of $10 each ($30 ÷ 3) and three with a basis of $15 each ($45 ÷ 3).

New and old stock not identical. If the new stock you received as a nontaxable dividend is not identical to the old stock on which it was declared, the basis of the new stock is calculated differently. Divide the adjusted basis of the old stock between the old and the new stock in the ratio of the fair market value of each lot of stock to the total fair market value of both lots on the date of distribution of the new stock.

Example.

You bought a share of common stock for $100. Later, the corporation distributed a share of preferred stock for each share of common stock held. At the date of distribution, your common stock had a fair market value of $150 and the preferred stock had a fair market value of $50. You figure the basis of the old and new stock by dividing your $100 basis between them. The basis of your common stock is $75 (($150 ÷ $200) × $100), and the basis of the new preferred stock is $25 (($50 ÷ $200) × $100).

Bonds purchased at par value. A bond purchased at par value (face amount) has no premium or discount. When you sell or otherwise dispose of the bond, you figure the gain or loss by comparing the bond proceeds to the purchase price of the bond.

Example.

You purchased a bond several years ago for its par value of $10,000. You sold the bond this year for $10,100. You have a gain of $100. However, if you had sold the bond for $9,900, you would have a loss of $100.

Acquisition discount on short-term obligations. If you include acquisition discount on a short-term obligation in your income currently, increase the basis of the obligation by the amount of acquisition discount you include in your income. See *Discount on Short-Term Obligations* in chapter 1 for more information.

Original issue discount (OID) on debt instruments. Increase the basis of a debt instrument by the OID you include in your income. See *Original Issue Discount (OID)* in chapter 1.

Discounted 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, that you 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.

For information on determining OID on a long-term obligation, see *Debt Instruments Issued After July 1, 1982, and Before 1985* or *Debt Instruments Issued After 1984*, whichever applies, in Publication 1212 under *Figuring OID on Long-Term Debt Instruments*.

If the tax-exempt obligation has a maturity of 1 year or less, accrue OID under the rules for acquisition discount on short-term obligations. See *Discount on Short-Term Obligations* in chapter 1.

Stripped tax-exempt obligation. If you acquired a stripped tax-exempt bond or coupon after October 22, 1986, you must accrue OID on it to determine its adjusted basis when you dispose of it. For stripped tax-exempt bonds or coupons acquired after June 10, 1987, part of this OID may be taxable. You accrue the OID on these obligations in the manner described in chapter 1 under *Stripped Bonds and Coupons* .

Increase your basis in the stripped tax-exempt bond or coupon by the taxable and nontaxable accrued OID. Also increase your basis by the interest that accrued (but was not paid and was not previously reflected in your basis) before the date you sold the bond or coupon. In addition, for bonds acquired after June 10, 1987, add to your basis any accrued market discount not previously reflected in basis.

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.
Amount realized. The amount you realize from a sale or trade of property is everything you receive for the property minus your expenses of sale (such as redemption fees, sales commissions, sales charges, or exit fees). Amount realized includes the money you receive plus the fair market value of any property or services you receive.

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.

If a buyer of property issues a debt instrument to the seller of the property, the amount realized is determined by reference to the issue price of the debt instrument, which may or may not be the fair market value of the debt instrument. See Regulations section 1.1001-1(g). However, if the debt instrument was previously issued by a third party (one not part of the sale transaction), the fair market value of the debt instrument is used to determine the amount realized.
Fair market value. Fair market value is the price at which 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). If you also receive a note for $6,000 that has an issue price of $6,000, your gain is $9,000 ($10,000 + $6,000 – $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 and 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 *No gain or loss* in the discussion on the basis of property you received as a gift under *Basis Other Than Cost,* earlier.

Special Rules for Mutual Funds

To figure your gain or loss when you dispose of mutual fund shares, you need to determine which shares were sold and the basis of those shares. If your shares in a mutual fund were acquired all on the same day and for the same price, figuring their basis is not difficult. However, shares are generally acquired at various times, in various quantities, and at various prices. Therefore, figuring your basis can be more difficult. You can choose to use either a cost basis or an average basis to figure your gain or loss.