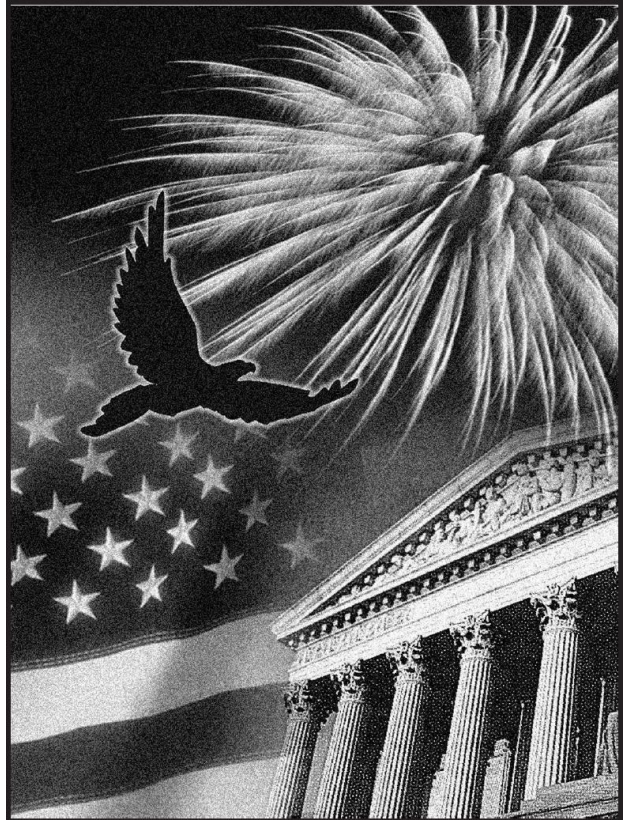


# Publication 550

## Investment Income and Expenses ((Including Capital Gains and Losses))

For use in preparing  
**2024** Returns

Volume 3 of 9



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**Undistributed capital gains of mutual funds and REITs.** Some mutual funds and REITs keep their long-term capital gains and pay tax on them. You must treat your share of these gains as distributions, even though you did not actually receive them. However, they are not included on Form 1099-DIV. Instead, they are reported to you in Form 2439, box 1a.

Form 2439 also will show how much, if any, of the undistributed capital gains is:

- Unrecaptured section 1250 gain (box 1b),
- Gain from qualified small business stock (section 1202 gain, box 1c), or
- Collectibles (28%) gain (box 1d).

For information about these terms, see *Capital Gain Tax Rates* in chapter 4.

The tax paid on these gains by the mutual fund or REIT is shown in Form 2439, box 2.

***Basis adjustment.*** Increase your basis in your mutual fund, or your interest in a REIT, by the difference between the gain you report and the credit you claim for the tax paid.

## **Nondividend Distributions**

A nondividend distribution is a distribution that is not paid out of the earnings and profits of a corporation or a mutual fund. You should receive a Form 1099-DIV or other statement showing you the nondividend distribution. A nondividend distribution will be shown in Form 1099-DIV, box 3. If you do not receive such a statement, you report the distribution as an ordinary dividend.

***Basis adjustment.*** A nondividend distribution reduces the basis of your stock. It is not taxed until your basis in the stock is fully recovered. This nontaxable portion also is called a return of capital; it is a return of your investment in the stock of the company.

If you buy stock in a corporation in different lots at different times, and you cannot definitely identify the shares subject to the nondividend distribution, reduce the basis of your earliest purchases first.

When the basis of your stock has been reduced to zero, report any additional nondividend distribution you receive as a capital gain. Whether you report it as a long-term or short-term capital gain depends on how long you have held the stock. See *Holding Period* in chapter 4.

**Example 1.** You bought stock in 2011 for \$100. In 2014, you received a nondividend distribution of \$80. You did not include this amount in your income, but you reduced the basis of your stock to \$20. You received a nondividend distribution of \$30 in 2024. The first \$20 of this amount reduced your basis to zero. You report the other \$10 as a long-term capital gain for 2024.

You must report as a long-term capital gain any nondividend distribution you receive on this stock in later years.

**Example 2.** You bought shares in XYZ Mutual Fund in 2020 for \$12 per share. In 2021, you received a nondividend distribution of \$5 per share. You reduced your basis in each share by \$5 to an adjusted basis of \$7. In 2022, you received a nondividend distribution of \$1 per share and further reduced your basis in each share to \$6. In 2023, you received a nondividend distribution of \$2 per share. Your basis was reduced to \$4 per share. In 2024, the nondividend distribution from the mutual fund was \$5 per share. You reduce your basis in each share to zero and report \$1 of gain per share. See the Instructions for Form 8949 for details and more information.



*For more information on Form 8949 and Schedule D (Form 1040), see Reporting Capital Gains and Losses in chapter 4. Also, see the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040).*

## **Liquidating Distributions**

Liquidating distributions, sometimes called liquidating dividends, are distributions you receive during a partial or complete liquidation of a corporation. These distributions are, at least in part, one form of a return of capital. They may be paid in one or more installments. You will receive Form 1099-DIV from the corporation showing you the amount of the liquidating distribution in box 9 or 10.

Any liquidating distribution you receive is not taxable to you until you have recovered the basis of your stock.

After the basis of your stock has been reduced to zero, you must report the liquidating distribution as a capital gain. Whether you report the gain as a long-term or short-term capital gain depends on how long you have held the stock. See Holding Period in chapter 4.

***Stock acquired at different times.*** If you acquired stock in the same corporation in more than one transaction, you own more than one block of stock in the corporation. If you receive distributions from the corporation in complete liquidation, you must divide the distribution among the blocks of stock you own in the following proportion: the number of shares in that block over the total number of shares you own. Divide distributions in partial liquidation among that part of the stock redeemed in the partial liquidation. After the basis of a block of stock is reduced to zero, you must report the part of any later distribution for that block as a capital gain.



***Distributions less than basis.*** If the total liquidating distributions you receive are less than the basis of your stock, you may have a capital loss. You can report a capital loss only after you have received the final distribution in liquidation that results in the redemption or cancellation of the stock. Whether you report the loss as a long-term or short-term capital loss depends on how long you held the stock. See *Holding Period* in chapter 4.

## **Distributions of Stock and Stock Rights**

Distributions by a corporation of its own stock are commonly known as stock dividends. Stock rights (also known as “stock options”) are distributions by a corporation of rights to acquire the corporation's stock. Generally, stock dividends and stock rights are not taxable to you, and you do not report them on your return.

## **Taxable stock dividends and stock rights.**

Distributions of stock dividends and stock rights are taxable to you if any of the following apply.

1. You or any other shareholder have the choice to receive cash or other property instead of stock or stock rights.
2. The distribution gives cash or other property to some shareholders and an increase in the percentage interest in the corporation's assets or earnings and profits to other shareholders.
3. The distribution is in convertible preferred stock and has the same result as in (2).
4. The distribution gives preferred stock to some common stock shareholders and common stock to other common stock shareholders.

5. The distribution is on preferred stock. (The distribution, however, is not taxable if it is an increase in the conversion ratio of convertible preferred stock made solely to take into account a stock dividend, stock split, or similar event that would otherwise result in reducing the conversion right.)

The term “stock” includes rights to acquire stock, and the term “shareholder” includes a holder of rights or convertible securities.

If you receive taxable stock dividends or stock rights, include their fair market value at the time of distribution in your income.

**Constructive distributions.** You must treat certain transactions that increase your proportionate interest in the earnings and profits or assets of a corporation as if they were distributions of stock or stock rights.

These constructive distributions are taxable if they have the same result as a distribution described in (2), (3), (4), or (5) of the above discussion.

This treatment applies to a change in your stock's conversion ratio or redemption price, a difference between your stock's redemption price and issue price, a redemption not treated as a sale or exchange of your stock, and any other transaction having a similar effect on your interest in the corporation.

***Preferred stock redeemable at a premium.*** If you receive preferred stock having a redemption price higher than its issue price, the difference (the redemption premium) generally is taxable as a constructive distribution of additional stock on the preferred stock.

For stock issued before October 10, 1990, you include the redemption premium in your income ratably over the period during which the stock cannot be redeemed.

For stock issued after October 9, 1990, you include the redemption premium on the basis of its economic accrual over the period during which the stock cannot be redeemed, as if it were original issue discount on a debt instrument. See Original Issue Discount (OID), earlier in this chapter.

The redemption premium is not a constructive distribution, and is not taxable as a result, in the following situations.

1. The stock was issued before October 10, 1990 (before December 20, 1995, if redeemable solely at the option of the issuer), and the redemption premium is "reasonable." (For stock issued before October 10, 1990, only the part of the redemption premium that is not "reasonable" is a constructive distribution.) The redemption premium is reasonable if it is not more than 10% of the issue price on stock not redeemable for 5

years from the issue date or is in the nature of a penalty for making a premature redemption.

2. The stock was issued after October 9, 1990 (after December 19, 1995, if redeemable solely at the option of the issuer), and the redemption premium is de minimis. The redemption premium is de minimis if it is less than one-fourth of 1% (0.0025) of the redemption price multiplied by the number of full years from the date of issue to the date redeemable.
3. The stock was issued after October 9, 1990, and must be redeemed at a specified time or is redeemable at your option, but the redemption is unlikely because it is subject to a contingency outside your control (not including the possibility of default, insolvency, etc.).

4. The stock was issued after December 19, 1995, and is redeemable solely at the option of the issuer, but the redemption premium is in the nature of a penalty for premature redemption or redemption is not more likely than not to occur. The redemption will be treated under a "safe harbor" as not more likely than not to occur if all of the following are true.
  - a. You and the issuer are not related under the rules discussed in chapter 4 under Losses on Sales or Trades of Property, substituting "20%" for "50%."
  - b. There are no plans, arrangements, or agreements that effectively require or are intended to compel the issuer to redeem the stock.
  - c. The redemption would not reduce the stock's yield.

**Basis.** Your basis in stock or stock rights received in a taxable distribution is their fair market value when distributed. If you receive stock or stock rights that are not taxable to you, see *Stocks and Bonds*, later, for information on how to figure their basis.

**Fractional shares.** You may not own enough stock in a corporation to receive a full share of stock if the corporation declares a stock dividend. However, with the approval of the shareholders, the corporation may set up a plan in which fractional shares are not issued but instead are sold, and the cash proceeds are given to the shareholders. Any cash you receive for fractional shares under such a plan is treated as an amount realized on the sale of the fractional shares. Report this transaction on Form 8949. Enter your gain or loss, the difference between the cash you receive and the basis of the fractional shares



sold, in column (h) of Schedule D (Form 1040) in Part I or Part II, whichever is appropriate.



*Report these transactions on Form 8949 with the correct box checked.*

For more information on Form 8949 and Schedule D (Form 1040), see Reporting Capital Gains and Losses in chapter 4. Also, see the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040).

**Example.** You own one share of common stock that you bought on January 6, 2015, for \$100. The corporation declared a common stock dividend of 5% on July 1, 2024. The fair market value of the stock at the time the stock dividend was declared was \$200. You were paid \$10 for the fractional-share stock dividend under a plan described in the discussion above. You figure your gain or loss as follows.

Fair market value of old stock ...	\$200.00
Fair market value of stock dividend(cash received) .....	<u>+ 10.00</u>
Fair market value of old stock and stock dividend ...	<u>\$210.00</u>
Basis (cost) of old stockafter the stock dividend( $(\$200 \div \$210) \times$ $\$100$ ) .....	\$95.24
Basis (cost) of stock dividend( $(\$10 \div \$210) \times \$100$ )	<u>+ 4.76</u>
Total .....	<u>\$100.00</u>
Cash received .....	\$10.00
Basis (cost) of stock dividend ...	<u>- 4.76</u>
<b>Gain</b>	<u>\$5.24</u>

## Gain

Because you had held the share of stock for more than 1 year at the time the stock dividend was declared, your gain on the stock dividend is a long-term capital gain.

***Scrip dividends.*** A corporation that declares a stock dividend may issue you a scrip certificate that entitles you to a fractional share. The certificate generally is nontaxable when you receive it. If you choose to have the corporation sell the certificate for you and give you the proceeds, your gain or loss is the difference between the proceeds and the part of your basis in the corporation's stock allocated to the certificate.

However, if you receive a scrip certificate that you can choose to redeem for cash instead of stock, the certificate is taxable when you receive it. You must include its fair market value in income on the date you receive it.

## Other Distributions

You may receive any of the following distributions during the year.

**Exempt-interest dividends.** Exempt-interest dividends you receive from a mutual fund or other RIC are not included in your taxable income. (However, see Information reporting requirement, next.) Exempt-interest dividends should be shown in Form 1099-DIV, box 12.

***Information reporting requirement.***

Although exempt-interest dividends are not taxable, you must show them on your tax return if you have to file a return. See Reporting tax-exempt interest, earlier.

***Alternative minimum tax treatment.***

Exempt-interest dividends paid from specified private activity bonds may be subject to the AMT.

The exempt-interest dividends subject to the AMT should be shown in Form 1099-DIV, box 13. See Form 6251 and its instructions for more information.

**Dividends on insurance policies.** Insurance policy dividends the insurer keeps and uses to pay your premiums are not taxable. However, you must report as taxable interest income the interest that is paid or credited on dividends left with the insurance company.

If dividends on an insurance contract (other than a modified endowment contract) are distributed to you, they are a partial return of the premiums you paid. Do not include them in your gross income until they are more than the total of all net premiums you paid for the contract.

**Dividends on veterans' insurance.**

Dividends you receive on veterans' insurance policies are not taxable. In addition, interest on dividends left with the Department of Veterans Affairs is not taxable.

**Patronage dividends.** Generally, patronage dividends you receive in money from a cooperative organization are included in your income. You should receive Form 1099-PATR.

Do not include in your income patronage dividends you receive on:

- Property bought for your personal use, or
- Capital assets or depreciable property bought for use in your business. But you must reduce the basis (cost) of the items bought. If the dividend is more than the adjusted basis of the assets, you must report the excess as income.

These rules are the same whether the cooperative paying the dividend is a taxable or tax-exempt cooperative.

**Alaska Permanent Fund dividends.** Do not report these amounts as dividends. Instead, include these amounts on Schedule 1 (Form 1040), line 8g.

# How To Report Dividend Income

## Terms you may need to know (see Glossary):

Nominee

Restricted stock

Report the total of your ordinary dividends on Form 1040 or 1040-SR, line 3b. Report qualified dividends on Form 1040 or 1040-SR, line 3a.

**Form 1099-DIV.** If you owned stock on which you received \$10 or more in dividends and other distributions, you should receive a Form 1099-DIV. Even if you do not receive a Form 1099-DIV, you must report all your dividend income.

See Form 1099-DIV and its instructions for more information on how to report dividend income.

**Form 1040 or 1040-SR.** You must complete Schedule B (Form 1040), Part II, and attach it to your Form 1040 or 1040-SR, if:

- Your ordinary dividends (Form 1099-DIV, box 1a) are more than \$1,500, or
- You received, as a nominee, dividends that actually belong to someone else.

See Instructions for Schedule B (Form 1040) for more information.

List on Schedule B (Form 1040), Part II, line 5, each payer's name and the ordinary dividends you received. If your securities are held by a brokerage firm (in "street name"), list the name of the brokerage firm shown on Form 1099-DIV as the payer. If your stock is held by a nominee who is the owner of record, and the nominee credited or paid you dividends on the stock, show the name of the nominee and the dividends you received or for which you were credited.



Enter on Schedule B (Form 1040), Part II, line 6 the total of the amounts listed on Schedule B (Form 1040), Part II, line 5. (However, if you hold stock as a nominee, see Nominees, later.).

### **Dividends received on restricted stock.**

Restricted stock is stock you get from your employer for services you perform and that is nontransferable and subject to a substantial risk of forfeiture. You do not have to include the value of the stock in your income when you receive it. However, if you get dividends on restricted stock, you must include them in your income as wages, not dividends. See *Restricted Property* in Pub. 525 for information on restricted stock dividends.

Your employer should include these dividends in the wages shown on your Form W-2. If you also get a Form 1099-DIV for these dividends, list them on Schedule B (Form 1040), Part II, line 5, with the other dividends you received.

Enter a subtotal of all your dividend income several rows above Schedule B (Form 1040), Part II, line 6. Below the subtotal, enter "Dividends on restricted stock reported as wages on Form 1040 or 1040-SR, line 1," and include the dividends included in your wages on Form 1040 or 1040-SR, line 1. Subtract this amount from the subtotal and enter the result on Schedule B (Form 1040), Part II, line 6.

***Election.*** You can choose to include the value of restricted stock in gross income as pay for services. If you made this choice, report the dividends on the stock like any other dividends. If you receive both a Form 1099-DIV and a Form W-2 showing these dividends, do not include the dividends in your wages reported on Form 1040 or 1040-SR, line 1. Attach a statement to your Form 1040 or 1040-SR explaining why the amount

shown on your Form 1040 or 1040-SR, line 1 is different from the amount shown on your Form W-2.

***Independent contractor.*** If you received restricted stock for services as an independent contractor, the rules in the previous discussion apply. Generally, you must treat dividends you receive on the stock as income from self-employment.

**Qualified dividends.** Report qualified dividends (Form 1099-DIV, box 1b) on Form 1040 or 1040-SR, line 3a. The amount in Form 1099-DIV, box 1b is already included in box 1a. Do not add the amount in box 1b to, or subtract it from, the amount in box 1a. Do not include any of the following on Form 1040 or 1040-SR, line 3a.

- Qualified dividends you received as a nominee. See *Nominees*, later.

- Dividends on stock for which you did not meet the holding period. See Holding period, earlier, under *Qualified Dividends*.
- Dividends on any share of stock to the extent you are obligated (whether under a short sale or otherwise) to make related payments for positions in substantially similar or related property.
- Payments in lieu of dividends, but only if you know or have reason to know the payments are not qualified dividends.
- Payments shown on Form 1099-DIV, box 1b, from a foreign corporation to the extent you know or have reason to know the payments are not qualified dividends.

If you have qualified dividends, you must figure your tax by completing the Qualified Dividends and Capital Gain Tax Worksheet in the Form 1040 or 1040-SR instructions or the Schedule D Tax Worksheet in the Schedule D (Form 1040) instructions, whichever applies.

***Investment interest deducted.*** If you claim a deduction for investment interest, you may have to reduce the amount of your qualified dividends that are eligible for the 0%, 15%, or 20% tax rate. Reduce it by the qualified dividends you choose to include in investment income when figuring the limit on your investment interest deduction.

This is done on the Qualified Dividends and Capital Gain Tax Worksheet or the Schedule D Tax Worksheet. For more information about the limit on investment interest, see *Interest Expenses* in chapter 3.

**Capital gain distributions.** If you received capital gain distributions, you report them directly on Form 1040 or 1040-SR, line 7; or on Schedule D (Form 1040), line 13, depending on your situation. If you received capital gain distributions from a mutual fund or real estate investment trust (REIT), the distributions of net realized short-term capital gains are not treated as capital gains.

Instead, they are included on Form 1099-DIV as ordinary dividends. Report them on your tax return as ordinary dividends.

**Exceptions to filing Form 8949 and Schedule D (Form 1040).** There are certain situations where you may not have to file Form 8949 and/or Schedule D (Form 1040). See Instructions for Form 1040, Line 7, for those exceptions.

***Undistributed capital gains.*** Follow the Instructions for the Shareholder on Form 2439 to report undistributed capital gains and the tax paid by the mutual fund on those gains.

**Nondividend distributions.** Report nondividend distributions (Form 1099-DIV, box 3) only after your basis in the stock has been reduced to zero. After the basis of your stock has been reduced to zero, you must show this excess amount on Form 8949, Part I, if you held the stock 1 year or less.

Show it on Form 8949, Part II, if you held the stock for more than 1 year. See Form 8949 and instructions.



*Report these transactions on Form 8949 with the correct box checked.*

For more information on Form 8949 and Schedule D (Form 1040), see Reporting Capital Gains and Losses in chapter 4. Also, see the Instructions for Form 8949 and the Instructions for Schedule D (Form 1040).

**Nominees.** If you received ordinary dividends as a nominee (that is, the dividends are in your name but actually belong to someone else), include them on Schedule B (Form 1040), Part II, line 5. Several rows above Schedule B (Form 1040), Part II, line 6, put a subtotal of all dividend income listed on Schedule B (Form 1040), Part II, line 5. Below this subtotal, enter “Nominee Distribution” and show the amount received as a nominee. Subtract the total of your nominee distributions from the subtotal.

Enter the result on Schedule B (Form 1040), Part II, line 6.

If you received a capital gain distribution or were allocated an undistributed capital gain as a nominee, report only the amount that belongs to you on Form 1040 or 1040-SR, line 7; or Schedule D (Form 1040), line 13, whichever is appropriate. Attach a statement to your return showing the full amount you received or were allocated and the amount you received or were allocated as a nominee.

***File Form 1099-DIV with the IRS.*** If you received dividends as a nominee in 2024, you must file a Form 1099-DIV (or Form 2439) for those dividends with the IRS. Send the Form 1099-DIV with a Form 1096 to your Internal Revenue Service Center by February 28, 2025 (March 31, 2025, if you file Form 1099-DIV electronically). Give the actual owner of the dividends Copy B of the Form 1099-DIV by January 31, 2025. On Form 1099-DIV, you should be listed as the "Payer."



The other owner should be listed as the "Recipient." You do not, however, have to file a Form 1099-DIV to show payments 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 Certain Information Returns and the Instructions for Form 2439.

## **Stripped Preferred Stock**

If the dividend rights are stripped from certain preferred stock, the holder of the stripped preferred stock may have to include amounts in income equal to the amounts that would have been included if the stock were a bond with OID.

**Stripped preferred stock defined.** Stripped preferred stock is any stock that meets both of the following tests.

1. There has been a separation in ownership between the stock and any

dividend on the stock that has not become payable.

2. The stock:
  - a. Is limited and preferred as to dividends,
  - b. Does not participate in corporate growth to any significant extent, and
  - c. Has a fixed redemption price.

**Treatment of buyer.** If you buy stripped preferred stock after April 30, 1993, you must include certain amounts in your gross income while you hold the stock. These amounts are ordinary income. They are equal to the amounts you would have included in gross income if the stock were a bond that:

1. Was issued on the purchase date of the stock, and
2. Has OID equal to:

- a. The redemption price for the stock, minus
- b. The price at which you bought the stock.

Include these amounts on Schedule 1 (Form 1040), line 8z.

This treatment also applies to you if you acquire the stock in such a way (for example, by gift) that your basis in the stock is determined by using a buyer's basis.

**Treatment of person stripping stock.** If you strip the rights to one or more dividends from preferred stock, you are treated as having purchased the stock. You are treated as making the purchase on the date you disposed of the dividend rights. Your adjusted basis in the preferred stock is treated as your purchase price. The rules described in *Treatment of buyer*, earlier, apply to you.

# **REMICs, FASITs, and Other CDOs**

Holders of interests in real estate mortgage investment conduits (REMICs), financial asset securitization investment trusts (FASITs), and other collateralized debt obligations (CDOs) must follow special rules for reporting income and any expenses from these investment products.

## **REMICs**

A REMIC is an entity formed for the purpose of holding a fixed pool of mortgages secured by interests in real property. A REMIC issues regular and residual interests to investors. A REMIC generally is not treated as a corporation, partnership, or trust. For purposes of subtitle F of the Internal Revenue Code (Procedure and Administration), a REMIC generally is treated as a partnership with the residual interest holders treated as the partners. The regular interests are treated as debt instruments.

REMIC income or loss is not income or loss from a passive activity.

For more information about the qualifications and tax treatment that apply to a REMIC and the interests of investors in a REMIC, see sections 860A through 860G of the Internal Revenue Code, and the regulations under those sections.

## **Regular Interest**

A REMIC can have several classes (also known as “tranches”) of regular interests. A regular interest unconditionally entitles the holder to receive a specified principal amount (or other similar amount).

A REMIC regular interest is treated as a debt instrument for income tax purposes.

Accordingly, the OID, market discount, and income reporting rules that apply to bonds and other debt instruments as described

earlier in this publication under *Discount on Debt Instruments* apply, with certain modifications discussed below.

Generally, you report your income from a regular interest on Form 1040 or 1040-SR, line 2b. For more information on how to report interest and OID, see *How To Report Interest Income*, earlier.

**Holders must use accrual method.**

Holders of regular interests must use an accrual method of accounting to report OID and interest income. Because income under an accrual method is not determined by the receipt of cash, you may have to include OID or interest income in your taxable income even if you have not received any cash payments.

**Forms 1099-INT and 1099-OID.** You should receive a copy of Form 1099-INT or Form 1099-OID from the REMIC. See the General Instructions for Certain Information Returns for information on

when you should receive your copy of Form 1099-INT or Form 1099-OID and a written statement providing additional information. The statement should contain enough information to enable you to figure your accrual of market discount or amortizable bond premium.

Form 1099-INT shows interest income that accrued to you for the period you held the regular interest.

Form 1099-OID shows OID and interest, if any, that accrued to you for the period you held the regular interest. You will not need to make any adjustments to the amounts reported even if you held the regular interest for only a part of the calendar year. However, if you bought the regular interest at a premium or acquisition premium, see Refiguring OID shown on Form 1099-OID, earlier.

### ***You may not get a Form 1099.***

Corporations and other persons specified in Regulations section 1.6049-7(c) will not receive Forms 1099. These persons and fiscal year taxpayers may obtain tax information by contacting the REMIC or the issuer of the CDO, if they hold their interest directly from the REMIC or issuer of the CDO. Pub 938 explains how to request this information.



Pub. 938 is available at  
[IRS.gov/pub938.](https://www.irs.gov/pub938)

If you hold a regular interest or CDO through a nominee (rather than directly), you can request the information from the nominee.

**Allocated investment expenses.** A single-class REMIC will report your share of its investment expenses in Form 1099-INT, box 5 or Form 1099-OID, box 9. This amount is not deductible.



A single-class REMIC is one that generally would be classified as a trust for tax purposes if it had not elected REMIC status.

**Redemption of regular interests at maturity.** Redemption of debt instruments at their maturity is treated as a sale or exchange. You must report redemptions on your tax return whether or not you realize gain or loss on the transaction. Your basis is your adjusted issue price, which includes any OID you previously reported in income.

Any amount you receive on the retirement of a debt instrument is treated as if you had sold or exchanged that instrument. A debt instrument is retired when it is reacquired or redeemed by the issuer and canceled.

***Sale or exchange of a regular interest.***

Some of your gain on the sale or exchange of a REMIC regular interest may be ordinary income.

The ordinary income part, if any, is:

- The amount that would have been included in your income if the yield to maturity on the regular interest had been 110% of the applicable federal rate at the beginning of your holding period, minus
- The amount you included in your income.

## **Residual Interest**

A residual interest is an interest in a REMIC that is not a regular interest. It is designated as a residual interest by the REMIC.

If you acquire a residual interest in a REMIC, you must take into account on a quarterly basis your daily portion of the taxable income or net loss of the REMIC for each day during the tax year you hold the residual interest. You must report these amounts as ordinary income or loss.

**Basis in the residual interest.** Your basis in the residual interest is increased by taxable income you take into account. Your basis is decreased (but not below zero) by the cash or the fair market value of any property distributed to you, and by any net loss you have taken into account. If you sell or transfer your residual interest, you must adjust your basis to reflect your share of the REMIC's taxable income or net loss immediately before the sale or transfer. See Wash Sales, in chapter 4, for more information about selling a residual interest.

**Treatment of distributions.** You must include in your gross income the part of any distribution that is more than your adjusted basis. Treat the distribution as a gain from the sale or exchange of your residual interest.

**Schedule Q (Form 1066).** If you hold a REMIC residual interest, you should receive Schedule Q (Form 1066) and instructions from the REMIC each quarter.

Schedule Q (Form 1066) will indicate your share of the REMIC's quarterly taxable income (or loss).

Use Schedule E (Form 1040), Part IV, to report your total share of the REMIC's taxable income (or loss) for each quarter included in your tax year.

For more information about reporting your income (or loss) from a residual interest in a REMIC, follow the Instructions for Schedule Q (Form 1066) and Schedule E (Form 1040).

## **Collateralized Debt Obligations (CDOs)**

A CDO is a debt instrument, other than a REMIC regular interest, that is secured by a pool of mortgages or other evidence of debt and that has principal payments subject to acceleration. (**Note:** While REMIC regular interests are collateralized debt obligations, they have unique rules that do not apply to CDOs issued before 1987.) CDOs,

also known as “pay-through bonds,” are commonly divided into different classes (also called “tranches”).

CDOs can be secured by a pool of mortgages, automobile loans, equipment leases, or credit card receivables.

For more information about the qualifications and the tax treatment that apply to an issuer of a CDO, see section 1272(a)(6) of the Internal Revenue Code and the regulations under that section.

The OID, market discount, and income-reporting rules that apply to bonds and other debt instruments, as described earlier in this chapter under *Discount on Debt Instruments*, also apply to a CDO.

You must include interest income from your CDO in your gross income under your regular method of accounting. Also, include any OID accrued on your CDO during the tax year.

Generally, you report your income from a CDO on Form 1040 or 1040-SR, line 2b. For more information about reporting these amounts on your return, see *How To Report Interest Income*, earlier.

**Forms 1099-INT and 1099-OID.** You should receive a copy of Form 1099-INT or Form 1099-OID generally by January 31, 2025. See the General Instructions for Certain Information Returns for information on when you should receive your copy of Form 1099-INT or Form 1099-OID and a written statement providing additional information. The statement should contain enough information about the CDO to enable you to figure your accrual of market discount or amortizable bond premium.

Form 1099-INT shows the interest income paid to you for the period you held the CDO.

Form 1099-OID shows the OID accrued to you and the interest, if any, paid to you for the period you held the CDO.

You should not need to make any adjustments to the amounts reported even if you held the CDO for only a part of the calendar year. However, if you bought the CDO at a premium or acquisition premium, see Refiguring OID shown on Form 1099-OID, earlier.

If you did not receive a Form 1099, see You may not get a Form 1099, earlier.

## **FASITs**

A financial asset securitization investment trust (FASIT) is an entity that securitizes debt obligations such as credit card receivables, home equity loans, and automobile loans.

A regular interest in a FASIT is treated as a debt instrument. The rules described under Collateralized Debt Obligations (CDOs), earlier, apply to a regular interest in a FASIT, except that a holder of a regular interest in a FASIT must use an accrual method of accounting to report OID and interest income.

See Internal Revenue Code sections 860H, 860I, 860J, 860K, 860L, before repeal by PL 108-357, October 22, 2004, for more information on FASITs.



*Beginning January 1, 2005, the special rules for FASITs are repealed.*

*However, the special rules still apply to any FASIT in existence on October 22, 2004, to the extent that regular interests issued by the FASIT before that date continue to remain outstanding in accordance with the original terms of issuance.*

## **S Corporations**

In general, an S corporation does not pay a tax on its income. Instead, its income and expenses are passed through to the shareholders, who then report these items on their own income tax returns.

If you are an S corporation shareholder, your share of the corporation's current year income or loss and other tax items are taxed



to you whether or not you receive any amount. Generally, those items increase or decrease the basis of your S corporation stock, as appropriate.

Generally, S corporation distributions, except dividend distributions, are considered a return of capital and reduce your basis in the stock of the corporation. The part of any distribution that is more than your basis is treated as a gain from the sale or exchange of property. The corporation's distributions may be in the form of cash or property.

S corporation distributions are not treated as dividends except in certain cases in which the corporation has accumulated earnings and profits from years before it became an S corporation.

**Reporting S corporation income, deductions, and credits.** The S corporation should send you a copy of Schedule K-1 (Form 1120-S) showing your share of the S corporation's income, credits,

and deductions for the tax year. You must report your distributive share of the S corporation's income, gain, loss, deductions, or credits on the appropriate lines and schedules of your Form 1040 or 1040-SR.

For more information about your treatment of S corporation tax items, see Shareholder's Instructions for Schedule K-1 (Form 1120-S).

***Limit on losses and deductions.*** The deduction for your share of losses and deductions shown on Schedule K-1 (Form 1120-S) is limited to the adjusted basis of your stock and any debt the corporation owes you. Any loss or deduction not allowed because of this limit is carried over and treated as a loss or deduction in the next tax year.

***Passive activity losses.*** Rules apply that limit losses from passive activities. Your copy of Schedule K-1 (Form 1120-S) and its

instructions will explain the limits and tell you where on your return to report your share of S corporation items from passive activities.

**Form 8582.** If you have a passive activity loss from an S corporation, you must complete Form 8582 to figure the allowable loss to enter on your return. See Pub. 925 for more information.

## **Investment Clubs**

An investment club is formed when a group of friends, neighbors, business associates, or others pool their money to invest in stock or other securities. The club may or may not have a written agreement, a charter, or bylaws.

Usually, the group operates informally with members pledging to pay a monthly regular amount into the club. Some clubs have a committee that gathers information on securities, selects the most promising securities, and recommends that the club

invest in them. Other clubs rotate these responsibilities among all their members. Most clubs require all members to vote for or against all investments, sales, trades, and other transactions.

**Identifying number.** Each club must have an EIN to use when filing its return. The club's EIN also may have to be given to the payer of dividends or other income from investments recorded in the club's name. To obtain an EIN, apply online at [IRS.gov/Businesses/Small-Businesses-&Self-Employed/Apply-for-an-Employer-IdentificationNumber-\(EIN\)-Online](https://www.irs.gov/Businesses/Small-Businesses-&Self-Employed/Apply-for-an-Employer-IdentificationNumber-(EIN)-Online) or file Form SS-4. See chapter 5, *How To Get Tax Help*, for more information about how to get this form.

**Investments in name of member.** When an investment is recorded in the name of one club member, this member must give its SSN to the payer of investment income. (When an investment is held in the names of two or

more club members, the SSN of only one member must be given to the payer.) This member is considered the record owner for the actual owner, the investment club. This member is a “nominee” and must file an information return with the IRS. For example, the nominee member must file Form 1099-DIV for dividend income, showing the club as the owner of the dividend, its SSN, and the EIN of the club.

## **Tax Treatment of the Club**

Generally, an investment club is treated as a partnership for federal tax purposes unless it chooses otherwise. In some situations, however, it is taxed as a corporation or a trust.

**Clubs formed before 1997.** Before 1997, the rules for determining how an investment club is treated were different from those explained in the following discussions. An investment club that existed before 1997 is treated for later years the same way it was

treated before 1997, unless it chooses to be treated a different way under the new rules. To make that choice, the club must file Form 8832.

## **Club as a Partnership**

If your club is not taxed as a corporation or a trust, it will be treated as a partnership.

**Filing requirement.** If your investment club is treated as a partnership, it must file Form 1065. However, as a partner in the club, you must report on your individual return your share of the club's income, gains, losses, deductions, and credits for the club's tax year. (Its tax year generally must be the same tax year as that of the partners owning a majority interest.) You must report these items whether or not you actually receive any distribution from the partnership.

**Schedule K-1 (Form 1065).** You should receive a copy of Schedule K-1 (Form 1065) from the partnership.

The amounts shown on Schedule K-1 (Form 1065) are your share of the partnership's income, deductions, and credits. Report each amount on the appropriate lines and schedules of your income tax return.

The club's expenses for producing or collecting income, for managing investment property, or for determining any tax are listed separately on Schedule K-1 (Form 1065).

For more information about reporting your income from a partnership, see the Schedule K-1 (Form 1065) instructions. Also, see Pub. 541.

***Passive activity losses.*** Rules apply that limit losses from passive activities. Your copy of Schedule K-1 (Form 1065) and its instructions will tell you where on your return to report your share of partnership items from passive activities. If you have a passive activity loss from a partnership, you must complete Form 8582 to figure the amount of the allowable loss to enter on your tax return.

**No social security coverage for investment club earnings.** If an investment club partnership's activities are limited to investing in savings certificates, stock, or securities, and collecting interest or dividends for its members' accounts, a member's share of income is not earnings from self-employment. You cannot voluntarily pay the self-employment tax to increase your social security coverage and ultimate benefits.

### **Club as a Corporation**

An investment club formed after 1996 is taxed as a corporation if:

- It is formed under a federal or state law that refers to it as incorporated or as a corporation, body corporate, or body politic;
- It is formed under a state law that refers to it as a joint-stock company or joint-stock association; or
- It chooses to be taxed as a corporation.



## **Choosing to be taxed as a corporation.**

To choose to be taxed as a corporation, the club cannot be a trust (see *Club as a Trust*, later) or otherwise subject to special treatment under the tax law. The club must file Form 8832 to make the choice.

**Filing requirement.** If your club is taxed as a corporation, it must file Form 1120. In that case, you do not report any of its income or expenses on your individual return. All ordinary income and expenses and capital gains and losses must be reported on the Form 1120. Any distribution the club makes that qualifies as a dividend must be reported on Form 1099-DIV if total distributions to the shareholder are \$10 or more for the year.

You must report any distributions you receive from the club on your individual return.

You should receive a copy of Form 1099-DIV from the club showing the distributions you received.

Some corporations can choose not to be taxed and have earnings taxed to the shareholders. See *S Corporations*, earlier.

For more information about corporations, see Pub. 542.

## **Club as a Trust**

In a few cases, an investment club is taxed as a trust. In general, a trust is an arrangement through which trustees take title to property for the purpose of protecting or conserving it for the beneficiaries under the ordinary rules applied in chancery or probate courts. An arrangement is treated as a trust for tax purposes if its purpose is to vest in trustees responsibility for protecting and conserving property for beneficiaries who cannot share in that responsibility and so are not associates in a joint enterprise for the conduct of business for profit. If you need more information about trusts, see Regulations section 301.7701-4.

**Filing requirement.** If your club is taxed as a trust, it must file Form 1041. You should receive a copy of Schedule K-1 (Form 1041) from the trust. Report the amounts shown on Schedule K-1 (Form 1041) on the appropriate lines and schedules of your income tax return.

## **2.**

# **Tax Shelters and Other Reportable Transactions**

## **Introduction**

Investments that yield tax benefits are sometimes called “tax shelters.” In some cases, Congress has concluded that the loss of revenue is an acceptable side effect of special tax provisions designed to encourage taxpayers to make certain types of investments. In many cases, however, losses from tax shelters produce little or no benefit to society, or the tax benefits are

exaggerated beyond those intended. Those cases are called “abusive tax shelters.” An investment that is considered a tax shelter is subject to restrictions, including the requirement that it be disclosed. See *Disclosure of reportable transactions*, later.

## Topics

This chapter discusses:

- *Abusive Tax Shelters*,
- *Rules To Curb Abusive Tax Shelters*,
- *Investor Reporting*,
- *Penalties, and*
- *Whether To Invest*.

## Useful Items

You may want to see:

## Publication

- **538** Accounting Periods and Methods

- ☐ **561** Determining the Value of Donated Property
- ☐ **925** Passive Activity and At-Risk Rules

## **Form (and Instructions)**

- ☐ **8275** Disclosure Statement
- ☐ **8275-R** Regulation Disclosure Statement
- ☐ **8283** Noncash Charitable Contributions
- ☐ **8865** Return of U.S. Persons With Respect to Certain Foreign Partnerships
- ☐ **8886** Reportable Transaction Disclosure Statement
- ☐ **8918** Material Advisor Disclosure Statement
- ☐ **8938** Statement of Specified Foreign Financial Assets

See chapter 5, *How To Get Tax Help*, for information about getting these publications and forms.

## **Abusive Tax Shelters**

Abusive tax shelters are marketing schemes involving artificial transactions with little or no economic reality. They often make use of unrealistic allocations, inflated appraisals, losses in connection with nonrecourse loans, mismatching of income and deductions, financing techniques that do not conform to standard commercial business practices, or mischaracterization of the substance of the transaction. Despite appearances to the contrary, the taxpayer generally takes little risk.

Abusive tax shelters commonly involve package deals designed from the start to generate losses, deductions, or credits that will be far more than the present or future investment.

For example, abusive tax shelters may promise investors from the start that future inflated appraisals will enable them to deduct charitable contribution deductions based on those appraisals. (But see the appraisal requirements discussed under *Rules To Curb Abusive Tax Shelters*, later.) They are commonly marketed in terms of the ratio of tax deductions allegedly available to each dollar invested. This ratio (or “write-off”) is frequently said to be several times greater than one-to-one.

Because there are many types of abusive tax shelters, it is not possible to list all the factors you should consider in determining whether an offering is an abusive tax shelter.

However, you should ask the following questions, which might provide a clue to the abusive nature of the plan.

- Do the tax benefits far outweigh the economic benefits? Are the tax benefits the primary reason for the transaction?

- Is this a transaction you would seriously consider if you hoped to make a profit?
- Do shelter assets really exist and, if so, are they insured for less than their purchase price?
- Is there a nontax justification for the way profits and losses are allocated to partners?
- Do the facts and supporting documents make economic sense? For example, are there sales and resales of the tax shelter property at ever increasing prices?
- Does the investment plan involve a gimmick, device, or sham to hide the economic reality of the transaction?
- Does the promoter offer to backdate documents? Are you instructed to backdate checks covering your investment?



- Is your debt a real debt or are you assured by the promoter that you will never have to pay it?
- Does this transaction involve laundering U.S. source income through foreign corporations incorporated in a tax haven and owned by U.S. shareholders?

## **Rules To Curb Abusive Tax Shelters**

Congress has enacted a series of income tax laws designed to halt the growth of abusive tax shelters. These provisions include the following.

### ***Disclosure of reportable transactions.***

You must disclose information for each reportable transaction in which you participate. See Reportable Transaction Disclosure Statement, later.

Material advisors with respect to any reportable transaction must disclose information about the transaction on Form 8918, Material Advisor Disclosure Statement.

To determine whether you are a material advisor to a transaction, see the Instructions for Form 8918.

Material advisors will receive a reportable transaction number for the disclosed reportable transaction. They must provide this number to all persons to whom they acted as a material advisor. They must provide the number at the time the transaction is entered into. If they do not have the number at that time, they must provide it within 60 calendar days from the date the number is mailed to them. For information on penalties for failure to disclose and failure to maintain lists, see sections 6707, 6707A, and 6708.

***Requirement to maintain list.*** Material advisors must maintain a list of persons to whom they provide material aid, assistance, or advice on any reportable transaction.

The list must be available for inspection by the IRS, and the information required to be included on the list must generally be kept for 7 years. See Regulations section 301.6112-1 for more information (including what information is required to be included on the list).

***Confidentiality privilege.*** The confidentiality privilege between you and a federally authorized tax practitioner does not apply to written communications made after October 21, 2004, regarding the promotion of your direct or indirect participation in any tax shelter.

***Appraisal requirement for donated property.*** If you claim a deduction of more than \$5,000 for an item or group of similar items of donated property, you must generally get a qualified appraisal. See section 170 and Form 8283 for more information.

If you claim a deduction of more than \$500,000 for the donated property, you must generally attach the qualified appraisal to your return. If you file electronically, see Form 8453, U.S. Individual Income Tax Transmittal for an IRS *e-file* Return, and its instructions. See Pub. 561 for information about appraisals.

**Conservation easements.** The IRS issued final Regulations section 1.6011-9 to identify certain syndicated conservation easement transactions and substantially similar transactions as listed transactions. These transactions require additional disclosures by advisors and certain participants as a reportable transaction. The definition of the term “conservation easement” is modified to include a restriction (granted in perpetuity) on the use that may be made of the real property, within the meaning of section 170(h)(2)(C), exclusively for conservation purposes, within the meaning of section

170(h)(1)(C) and (h)(4). The preservation of a certified historic structure is included in the definition of real property for purposes of identifying a transaction as a listed transaction. See Regulations section 1.6011-9, effective October 8, 2024, for details and examples.

***Limits on deductions for donations of conservation contributions by pass-through entities.*** A deduction for a donation of a qualified conservation contribution by a partnership or S corporation is limited to 2.5 times the sum of each partner's relevant basis. Any contribution in excess of that amount is disallowed and not treated as a qualified conservation contribution. For more information, see section 170(h).

***Passive activity loss and credit limits.*** The passive activity loss and credit rules limit the amount of losses and credits that can be claimed from passive activities and limit the amount that can offset nonpassive income,

such as certain portfolio income from investments. See Pub. 925 for information about income, losses, and credits from passive activities.

***Interest on penalties.*** If you are assessed an accuracy-related or civil fraud penalty (as discussed under *Penalties*, later), interest will be imposed on the amount of the penalty from the due date of the return (including any extensions) to the date you pay the penalty.

***Accounting method restriction.*** Tax shelters generally cannot use the cash method of accounting.

***Uniform capitalization rules.*** The uniform capitalization rules generally apply to producing property or acquiring it for resale. Under those rules, the direct cost and part of the indirect cost of the property must be capitalized or included in inventory. See Pub. 538 for uniform capitalization rules.

***Denial of deduction for interest on an underpayment due to a reportable transaction.*** You cannot deduct any interest you paid or accrued on any part of an underpayment of tax due to an understatement arising from a reportable transaction if the relevant facts affecting the tax treatment of the item are not adequately disclosed. See *Reportable transaction*, later. This rule applies to reportable transactions entered into in tax years beginning after October 22, 2004.

## **Authority for Disallowance of Tax Benefits**

The IRS has published guidance concluding that the claimed tax benefits of various abusive tax shelters should be disallowed. The guidance is the IRS's conclusion on how the law is applied to a particular set of facts. Guidance is published in the Internal Revenue Bulletin for taxpayers' information and also for use by IRS officials.

So, if your return is examined and an abusive tax shelter is identified and challenged, published guidance dealing with that type of shelter, which disallows certain claimed tax shelter benefits, could serve as the basis for the examining official's challenge of the tax benefits you claimed. In such a case, the examiner will not compromise even if you or your representative believe you have authority for the positions taken on your tax return. In addition, the examiner can also assess penalties based on the facts and circumstances.



*The courts are generally unsympathetic to taxpayers involved in abusive tax shelter schemes and have ruled in favor of the IRS in the majority of the cases in which these shelters have been challenged.*

## **Investor Reporting**

You may be required to file a reportable transaction disclosure statement.



## **Reportable Transaction Disclosure Statement**

Use Form 8886 to disclose information for each reportable transaction in which you participated. See Reportable transaction, later. Generally, you must attach Form 8886 to your return for each tax year in which you participated in the transaction. Under certain circumstances, a transaction must be disclosed within 90 days of the transaction being identified as a listed transaction or a transaction of interest. See Listed transaction, later. In addition, for the first year Form 8886 is attached to your return, you must send a copy of the form to:

Internal Revenue Service  
OTSA Mail Stop 4915  
1973 Rulon White Blvd.  
Ogden, UT 84201

If you file your return electronically, the copy sent to The Office of Tax Shelter Analysis (OTSA) must show exactly the same

information, word for word, provided with the electronically filed return and it must be provided on the official IRS Form 8886 or an exact copy of the form. If you use a computer-generated or substitute Form 8886, it must be an exact copy of the official IRS form.

If you fail to file Form 8886 as required or fail to include any required information on the form, you may have to pay a penalty. See *Penalty for failure to disclose a reportable transaction*, later.

The following discussion briefly describes reportable transactions. For more details, see the Instructions for Form 8886.

**Reportable transaction.** A reportable transaction is any of the following.

- A listed transaction.
- A confidential transaction.
- A transaction with contractual protection.

- A loss transaction.
- A transaction of interest entered into after November 1, 2006.

**Note.** Transactions with a brief asset holding period were removed from the definition of reportable transaction for transactions entered into after August 2, 2007.

**Listed transaction.** A listed transaction is the same as, or substantially similar to, one of the types of transactions the IRS has determined to be a tax-avoidance transaction. These transactions have been identified in notices, regulations, and other published guidance issued by the IRS.

For more information, go to [Abusive Tax Shelters and Transactions](#), where you will find a link to a list of listed transactions.

**Confidential transaction.** A confidential transaction is offered to you under conditions of confidentiality and for which you have paid an advisor a minimum fee.

A transaction is offered under conditions of confidentiality if the advisor who is paid the fee places a limit on your disclosure of the tax treatment or tax structure of the transaction and the limit protects the confidentiality of the advisor's tax strategies. The transaction is treated as confidential even if the conditions of confidentiality are not legally binding on you.

***Transaction with contractual protection.***

Generally, a transaction with contractual protection is one in which you or a related party has the right to a full or partial refund of fees if all or part of the intended tax consequences of the transaction are not sustained, or a transaction for which the fees are contingent on realizing the tax benefits from the transaction. For information on exceptions, see Revenue Procedure 2007-20, 2007-7 I.R.B. 517, available at

[IRS.gov/irb/2007-07\\_IRB#RP-2007-20](http://IRS.gov/irb/2007-07_IRB#RP-2007-20).

***Loss transaction.*** For individuals, a loss transaction is one that results in a deductible loss if the gross amount of the loss is at least \$2 million in a single tax year or \$4 million in any combination of tax years. A loss from a foreign currency transaction under section 988 is a loss transaction if the gross amount of the loss is at least \$50,000 in a single tax year, whether or not the loss flows through from an S corporation or partnership.

Certain losses (such as losses from casualties, thefts, and condemnations) are excepted from this category and do not have to be reported on Form 8886. For information on other exceptions, see Revenue Procedure 2013-11, 2013-2 I.R.B. 269, available at [IRS.gov/irb/ 2013-02 IRB#RP-2013-11](https://www.irs.gov/irb/2013-02_IRB#RP-2013-11). See Updates on reportable transactions, later, for updates on loss transactions.

***Transaction of interest.*** A transaction of interest is a transaction entered into after November 1, 2006, that is the same as,

or substantially similar to, one of the types of transactions that the IRS has identified by notice, regulation, or other published guidance as a transaction of interest. For more information, go to [Abusive Tax Shelters and Transactions](#), where you will find a link to a list of transactions of interest.

***Updates on reportable transactions.*** For updates on all reportable transactions, go to [Abusive Tax Shelters and Transactions](#).

## **Penalties**

Investing in an abusive tax shelter may lead to substantial expenses. First, the promoter generally charges a substantial fee. If your return is examined by the IRS and a tax deficiency is determined, you will have to pay more taxes and interest on the underpayment, possibly a 20%, 30%, or even 40% accuracy-related penalty, or a 75% civil fraud penalty.

You may also be subject to the penalty for failure to pay tax. These penalties are explained in the following paragraphs.

**Accuracy-related penalties.** An accuracy-related penalty of 20% can be imposed for underpayments of tax due to:

- Negligence or disregard of rules or regulations,
- Substantial understatement of tax,
- Substantial valuation misstatements (increased to 40% for gross valuation misstatements),
- Transactions lacking economic substance. Economic substance means that the transaction makes business sense, without the tax benefits. (Penalty increased to 40% for nondisclosed noneconomic substance transactions),
- Undisclosed foreign financial asset understatements

- (40% for tax years beginning after March 18, 2010), or
- Disallowance of a deduction for a qualified conservation contribution by a pass-through entity under section 170(h)(7).

If you are charged an accuracy-related penalty, interest will be imposed on the amount of the penalty from the due date of the return (including extensions) to the date you pay the penalty.

The 20% penalties do not apply to any underpayment attributable to a reportable transaction understatement subject to an accuracy-related penalty (discussed later).

***Negligence or disregard of rules or regulations.*** The penalty for negligence or disregard of rules or regulations is imposed only on the part of the underpayment due to negligence or disregard of rules or regulations.



Generally, the penalty will not be charged if you can show you had reasonable cause for understating your tax and that you acted in good faith.

Negligence includes any failure to make a reasonable attempt to comply with the provisions of the Internal Revenue Code. It also includes any failure to keep adequate books and records. A return position that has a reasonable basis is not negligence. See Regulations section 1.6662-3(b)(1).

Disregard includes any careless, reckless, or intentional disregard of rules or regulations.

The penalty for disregard of rules and regulations can be avoided if all the following are true.

- You keep adequate books and records.
- You have a reasonable basis for your position on the tax issue.

- You make an adequate disclosure of your position.

Use Form 8275 to make your disclosure and attach it to your return. To disclose a position contrary to a regulation, use Form 8275-R. Use Form 8886 to disclose a reportable transaction. See Reportable transaction, earlier.

***Substantial understatement of tax.*** An understatement is considered to be substantial if it is more than the greater of:

- 10% of the tax required to be shown on the return, or
- \$5,000.

For tax years 2018 through 2025, if you claim any deduction allowed under section 199A, an understatement is considered to be substantial if it is more than the greater of:

- 5% of the tax required to be shown on the return, or

- \$5,000.

In general, “understatement” means the excess of:

1. The amount of the tax required to be shown on the return for the tax year; over
2. The amount of the tax imposed which is shown on the return, reduced by any rebate (within the meaning of section 6211(b)(2)).

For items other than tax shelters, you can file Form 8275 or Form 8275-R to disclose items that could cause a substantial understatement of income tax. In that way, you can avoid the substantial understatement penalty if you have a reasonable basis for your position on the tax issue.

Disclosure of the tax shelter item on a tax return does not reduce the amount of the understatement.

Also, the understatement penalty will not be imposed if you can show there was reasonable cause for the underpayment caused by the understatement and that you acted in good faith. An important factor in establishing reasonable cause and good faith will be the extent of your effort to determine your proper tax liability under the law.

***Substantial valuation misstatement.*** In general, you are liable for a 20% penalty for a substantial valuation misstatement if any the following are true.

- The value or adjusted basis of any property claimed on the return is 150% or more of the correct amount.
- You underpaid your tax by more than \$5,000 because of the misstatement.
- You cannot establish that you had reasonable cause for the underpayment and that you acted in good faith.

You may be assessed a penalty of 40% for a gross valuation misstatement. If you misstate the value or the adjusted basis of property by 200% or more of the amount determined to be correct, you will be assessed a penalty of 40%, instead of 20%, of the amount you underpaid because of the gross valuation misstatement. The penalty rate is also 40% if the property's correct value or adjusted basis is zero.

***Transaction lacking economic substance.***

The economic substance doctrine only applies to an individual that entered into a transaction in connection with a trade or business or an activity engaged in for the production of income. A transaction has economic substance for you as an individual taxpayer only if:

- The transaction changes your economic position in a meaningful way (apart from federal income tax effects), and

- You have a substantial purpose (apart from federal income tax effects) for entering into the transaction.

For purposes of determining whether economic substance exists, a transaction's profit potential will only be taken into account if the present value of the reasonably expected pre-tax profit from the transaction is substantial compared to the present value of the expected net tax benefits that would be allowed if the transaction were respected.

If any part of your underpayment is due to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance or failing to meet the requirements of any similar rule of law, that part of your underpayment will be subject to the 20% accuracy-related penalty even if you had a reasonable cause and acted in good faith concerning that part.

Additionally, the penalty increases to 40% if you do not adequately disclose, on your return or in a statement attached to your return, the relevant facts affecting the tax treatment of a transaction that lacks economic substance. Relevant facts include any facts affecting the tax treatment of the transaction.

For the understatement of tax related to reportable transactions, no penalty is imposed to any portion of an understatement if you can demonstrate the understatement was due to reasonable cause. The reasonable cause exception does not apply if the underpayment is due to a transaction that lacks economic substance.

For underpayments, no penalty will be assessed if a reasonable cause exception applies. A reasonable cause exception is generally not available for an underpayment attributable to a transaction lacking economic

substance, or for an underpayment associated with a disallowed deduction for a conservation easement.



*You may be subject to a 20% penalty based on the excessive amount of an erroneous claim for an income tax refund or credit. If that excessive amount results from a transaction found to be lacking economic substance, it will **NOT** be treated as due to reasonable cause.*

***Undisclosed foreign financial asset understatement.*** For tax years beginning after March 18, 2010, you may be liable for a 40% penalty for an understatement of your tax liability due to an undisclosed foreign financial asset. An undisclosed foreign financial asset is any asset for which an information return, required to be provided under sections 6038, 6038B, 6038D, 6046A, or 6048 for any tax year, is not provided.



The penalty applies to any part of an underpayment related to the following undisclosed foreign financial assets.

- Any foreign business you control, reportable on Form 5471, Information Return of U.S. Persons With Respect To Certain Foreign Corporations, or Form 8865, Return of U.S. Persons With Respect to Certain Foreign Partnerships.
- Certain transfers of property to a foreign corporation or partnership, reportable on Form 926, Return by a U.S. Transferor of Property to a Foreign Corporation, or certain distributions to a foreign person, reportable on Form 8865.
- Your ownership interest in an otherwise undisclosed foreign financial asset, reportable on Form 8275 or 8275-R. See the Instructions for Form 8275 or Form 8275-R.



*Instead of, or in addition to, Form 8275 or 8275-R, you may have to file Form 8938, Statement of Specified Foreign Financial Assets, with your tax return. See the Instructions for Form 8938 for details.*

- Your acquisition, disposition, or substantial change in ownership interest in a foreign partnership, reportable on Form 8865.
- Creation or transfer of money or property to certain foreign trusts, reportable on Form 3520, Annual Return To Report Transactions With Foreign Trusts and Receipt of Certain Foreign Gifts.

**Penalty for incorrect appraisals.** The person who prepares an appraisal of the value of property may have to pay a penalty if:

- He or she knows, or reasonably should have known, that the appraisal would be

used in connection with a return or claim for refund; and

- The claimed value of the property on a return or claim for refund based on that appraisal results in a substantial valuation misstatement or a gross valuation misstatement. See Substantial valuation misstatement, earlier.

For details on the penalty amount and exceptions, see Pub. 561.

**Penalty for failure to disclose a reportable transaction.** If you fail to include any required information regarding a reportable transaction on a return or statement, you may have to pay a penalty of 75% of the decrease in tax shown on your return as a result of such transaction (or that would have resulted if the transaction were respected for federal tax purposes). See Reportable transaction, earlier.

For an individual, the minimum penalty is \$5,000 and the maximum is \$10,000 (or \$100,000 for a listed transaction). This penalty is in addition to any other penalty that may be imposed.

The IRS may rescind or abate the penalty for failing to disclose a reportable transaction under certain limited circumstances but cannot rescind the penalty for failing to disclose a listed transaction. See Revenue Procedure 2007-21, as updated by Treasury Decision 9686 and Announcement 2016-1, for information on rescission.

**Accuracy-related penalty for a reportable transaction understatement.** If you have a reportable transaction understatement, you may have to pay a penalty equal to 20% of the amount of that understatement. This applies to any item due to a listed transaction or other reportable transaction with a significant purpose of avoiding or evading federal income tax.

The penalty is 30% rather than 20% for the part of any reportable transaction understatement if the transaction was not properly disclosed.

This penalty does not apply to the part of an understatement on which the fraud penalty, gross valuation misstatement penalty, or penalty for nondisclosure of noneconomic substance transactions is imposed.

**Civil fraud penalty.** If any underpayment of tax on your return is due to fraud, a penalty of 75% of the underpayment will be added to your tax.

***Joint return.*** The fraud penalty on a joint return applies to a spouse only if some part of the underpayment is due to the fraud of that spouse.

**Failure to pay tax.** If a deficiency is assessed and is not paid within 10 days of the demand for payment,

you may be penalized with up to a 25% addition to tax if the failure to pay continues.

## **Whether To Invest**

Take into account the risks, benefits, and the source of every financial transaction before investing. You may wish to consider professional legal and financial advice for help in evaluating the transaction.