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Mutual Fund Distributions

For use in preparing

2002 Returns

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Contents

Important Change

Reporting interest and dividends. Interest or ordinary dividend income that exceeds a certain amount must be reported on a separate schedule. For 2002, this amount has increased. If you file Form 1040A, you must now attach Schedule 1 to your return if your interest or dividend income is more than $1,500; if you file Form 1040, you must now attach Schedule B to your return if your interest or dividend income is more than $1,500. Before 2002, you had to attach Schedule 1 or Schedule B if your interest or dividend income was more than $400.

Important Reminders

8% capital gain rate. The 10% capital gain rate is lowered to 8% for qualified 5-year gain. See *Capital Gain Tax Rates,* later.

10% capital gain rate. Beginning in 2006, the 20% capital gain rate will be lowered to 18% for qualified 5-year gain. The holding period for the property sold must have begun after 2000.

Photographs of missing children. The Internal Revenue Service is a proud partner with the National Center for Missing and Exploited Children. Photographs of missing children selected by the Center may appear in this publication on pages that would otherwise be blank. You can help bring these children home by looking at the photographs and calling **1–800–THE–LOST (1–800–843– 5678)** if you recognize a child.

Introduction

This publication provides federal income tax information for individual shareholders of ***mutual funds***, including ***money market funds***. It explains how to report distributions paid to you by a mutual fund and any expenses connected with your investment. In addition, it explains how to report undistributed long-term capital gains. It also explains how to figure and report your gain or loss when you sell, exchange, or redeem your mutual fund shares. A comprehensive example, with filled-in forms, appears at the end of the publication.

Mutual fund. A mutual fund is a regulated investment company generally created by "pooling" funds of investors to allow them to take advantage of a diversity of investments and professional management.

Money market fund. A money market fund is a mutual fund that tries to increase current income available to shareholders by buying short-term market investments.

Money market funds pay dividends and should not be confused with bank money market accounts that pay interest.

Qualified retirement plans and IRAs. The rules in this publication do not apply to mutual fund shares held in individual retirement arrangements (IRAs), H.R. 10 (Keogh) plans, section 401(k) plans, and other qualified retirement plans. The value of the mutual fund shares and earnings allocated to you are included in your retirement plan assets and stay tax free generally until the plan distributes them to you. The tax rules that apply to retirement plan distributions are explained in the following publications.

- Publication 560, *Retirement Plans for Small Business (SEP, SIMPLE, and Qualified Plans).*
- Publication 571, *Tax-Sheltered Annuity Plans (403(b) Plans).*
- Publication 575, *Pension and Annuity Income.*
- Publication 590, *Individual Retirement Arrangements (IRAs).*
- Publication 721, *Tax Guide to U.S. Civil Service Retirement Benefits.*

Comments and suggestions. We welcome your comments about this publication and your suggestions for future editions.

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Useful Items

You may want to see:

Publication

- ❏ **550** Investment Income and Expenses

Form (and Instructions)

- ❏ **Schedule B (Form 1040)** Interest and Ordinary Dividends
- ❏ **Schedule D (Form 1040)** Capital Gains and Losses
- ❏ **Schedule 1 (Form 1040A)** Interest and Ordinary Dividends for Form 1040A Filers
- ❏ **1099–B** Proceeds from Broker and Barter Exchange Transactions
- ❏ **1099–DIV** Dividends and Distributions
- ❏ **2439** Notice to Shareholder of Undistributed Long-Term Capital Gains
- ❏ **4952** Investment Interest Expense Deduction

See *How To Get Tax Help* near the end of this publication for information about getting these publications and forms.

Tax Treatment of Distributions

A distribution you receive from a mutual fund may be an ordinary dividend, a capital gain distribution, an exempt-interest dividend, or a nontaxable return of capital. The fund will send you a Form 1099–DIV or similar statement telling you the kind of distribution you received. This section discusses the tax treatment of each kind of distribution, describes how to treat reinvested distributions, and explains how to report distributions on your return.

CAUTION

You may be treated as having received a distribution of capital gains even if the fund does not distribute them to you. See Undistributed capital gains *under* Capital Gain Distributions.

Community property states. If you are married and receive a distribution that is community income, one-half of the distribution is generally considered to be received by each spouse. If you file separate returns, you must each report one-half of any taxable distribution. Get Publication 555, *Community Property,* for more information on community income.

If the distribution is not considered community income under state law and you and your spouse file separate returns, each of you must report your separate taxable distributions.

Share certificate in two or more names. If two or more persons, such as you and your spouse, hold shares as joint tenants, tenants by the entirety, or tenants in common, distributions on those shares are considered received by each of you to the extent provided by local law.

Certain year-end dividends received in January. Dividends declared and made payable by mutual funds in October, November, or December are considered received by shareholders on December 31 of the same year even if the dividends are actually paid during January of the following year.

Tax-exempt mutual fund. Distributions from a tax-exempt mutual fund (one that invests primarily in tax-exempt securities) may consist of ordinary dividends, capital gain distributions, undistributed capital gains, or return of capital like any other mutual fund. These distributions generally are treated the same as distributions from a regular mutual fund.

Distributions designated as exempt-interest dividends are not taxable. (See *Exempt-Interest Dividends,* later.)

Ordinary Dividends

An ordinary dividend is a distribution by a mutual fund out of its earnings and profits. Include ordinary dividends that you receive from a mutual fund as dividend income on your individual income tax return.

Ordinary dividends are the most common type of dividends. They will be reported in box 1 of the Form 1099–DIV or on a similar statement you receive from the mutual fund.

Capital Gain Distributions

These distributions are paid by mutual funds from their net realized long-term capital gains. The Form 1099–DIV (box 2a) or the fund's statement will tell you the amount you are to report as a capital gain distribution. Capital gain distributions are taxed as long-term capital gains regardless of how long you have owned the shares in the mutual fund.

Undistributed capital gains. Mutual funds may keep some of their long-term capital gains and pay taxes on those undistributed amounts. You must report your share of these amounts as long-term capital gains, even though you did not actually receive a distribution. You can take a credit for any tax paid because you are considered to have paid it.

Form 2439. The fund will send you Form 2439, instead of Form 1099–DIV, showing your share of the undistributed long-term capital gains in box 1a and any tax paid by the mutual fund in box 2. Attach Copy B of Form 2439 to your return.

Increase to basis. When you report undistributed capital gains from a mutual fund, you must increase your basis in the shares. You must keep Copy C of Form 2439 to show this increase. See *Adjusted Basis,* later.

Exempt-Interest Dividends

A mutual fund may pay exempt-interest dividends to its shareholders if it meets certain requirements. These dividends are paid from tax-exempt interest earned by the fund. Since the exempt-interest dividends keep their tax-exempt character, do not include them in income. However, you may need to report them on your return. See *Information reporting requirement,* next. The mutual fund will send you a statement within 60 days after the close of its tax year showing your exempt-interest dividends.

Exempt-interest dividends are not shown on Form 1099–DIV.

Information reporting requirement. Although exempt-interest dividends are not taxable, you must report them on your tax return if you are required to file. This is an information reporting requirement and does ***not*** convert tax-exempt interest to taxable interest. Also, this income is generally a "tax preference item" and may be subject to the alternative minimum tax. If you receive exempt-interest dividends, you should get Form 6251, *Alternative Minimum Tax—Individuals,* for more information.

Return of Capital (Nontaxable) Distributions

A distribution that is not out of earnings and profits is a return of your investment, or capital, in the mutual fund and is shown in box 3 of Form 1099–DIV. These return of capital distributions are generally not taxed and are sometimes called tax-free dividends or nontaxable distributions.

A return of capital distribution reduces your basis in the shares. Basis is explained under *Keeping Track of Your Basis,* later. Your basis cannot be reduced below zero. If your basis is zero, you must report the return of capital distribution on your tax return as a capital gain. Report this capital gain on Schedule D (Form 1040). Whether it is a long-term or short-term capital gain depends on how long you held the shares.

Example. You bought shares in a mutual fund in 1998 for $12 a share. In 1999, you received a return of capital distribution of $5 a share. You reduced your basis in each share by $5 to an adjusted basis of $7. In 2000, you received a return of capital distribution of $1 per share and further reduced your basis in each share to $6. In 2001, you received a return of capital distribution of $2 per share. Your basis was reduced to $4. In 2002, the return of capital distribution from the mutual fund was $5 a share. You reduce your basis in each share to zero and report the excess ($1 per share) as a long-term capital gain on Schedule D.

Reinvestment of Distributions

Most mutual funds permit shareholders to automatically reinvest distributions in more shares in the fund, instead of receiving cash. You must report the reinvested amounts the same way as you would report them if you received them in cash. This means that reinvested ordinary dividends and capital gain distributions generally must be reported as income. Reinvested exempt-interest dividends generally are not reported as income. Reinvested return of capital distributions are reported as explained under *Return of Capital (Nontaxable) Distributions,* earlier. See *Keeping Track of Your Basis,* later, to determine the basis of the additional shares.

How To Report

You must report mutual fund distributions on Form 1040 or Form 1040A. You cannot report mutual fund distributions on Form 1040EZ.

You ***cannot*** use Form 1040A and ***must*** use Form 1040 in either of the following situations.

- You received a return of capital distribution that must be reported as a capital gain because it is more than your basis in your mutual fund shares.
- You must report an undistributed capital gain.

Form 1040A. If you file Form 1040A, report your ordinary dividend distributions on line 9 and your exempt-interest dividends on line 8b. If the total of the ordinary dividends you received is more than $1,500 or you received ordinary dividends as a nominee, first report the ordinary dividends in Part II of Schedule 1, on line 5. Report the total from line 6 of that schedule on line 9 of Form 1040A. Attach Schedule 1 to your return.

Capital gain distributions. If you received capital gain distributions, you may have to file Form 1040. But you can report capital gain distributions on line 10 of Form 1040A, instead of on Form 1040, if both of the following are true.

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

Form 1040. If you file Form 1040, report your ordinary dividend distributions on line 9 and your exempt-interest dividends on line 8b. If the total of the ordinary dividends you received is more than $1,500 or you received ordinary dividends as a nominee, first report the ordinary dividends in Part II of Schedule B, on line 5. Report the total from line 6 of that schedule on line 9 of Form 1040. Attach Schedule B to your return.

CAUTION *Do not include capital gain distributions as dividend income on Form 1040 or Schedule B.*

Capital gain distributions. If you received capital gain distributions, you report them either directly on Form 1040, line 13, or on Schedule D, line 13, depending on your situation. Report them on Schedule D, line 13, unless all of the following are true.

1) The only amounts you would have to report on Schedule D are capital gain distributions from box 2a of Form 1099–DIV (or similar statement).
2) You do not have an amount in box 2b, 2c, 2d, or 2e of any Form 1099–DIV (or similar statement).
3) You are not filing Form 4952 or, if you are, the amount on line 4e of that form is not more than zero.

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

Undistributed capital gains. To report undistributed capital gains, you must complete Schedule D and attach it to your return. Report these gains on Schedule D, line 11, and attach Copy B of Form 2439 to your return. Report the tax paid by the mutual fund on these gains on Form 1040, line 68, and check box a on that line.

Tables 1A and 1B. See *Tables 1A* and *1B* for more information on where to report your mutual fund distributions on Form 1040 or Form 1040A.

Nominees. If you received a Form 1099–DIV or Form 2439 as a nominee (that is, it includes amounts that actually belong to someone else, other than your spouse), you must file a Form 1099–DIV or Form 2439 with the Internal Revenue Service and give the actual owner a copy. See the instructions for Forms 1099 or Form 2439 for details.

If you received an ordinary dividend distribution as a nominee, report it on line 5 of Schedule B (Form 1040) or Schedule 1 (Form 1040A). Under your last entry on line 5, put a subtotal of all ordinary dividends listed. Below this subtotal, enter "Nominee Distribution" and show the total ordinary dividends you received as a nominee. Subtract this amount from the subtotal and enter the result on 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 line 10 of Form 1040A, line 13 of Form 1040, or Schedule D (Form 1040), 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.

Foreign tax deduction or credit. Some mutual funds invest in foreign securities or other instruments. Your mutual fund may choose to allow you to claim a deduction or credit for the taxes it paid to a foreign country or U.S. possession. The fund will notify you if this applies to you. The notice will include your share of the foreign taxes paid to each country or possession and the part of the dividend derived from sources in each country or possession.

You may be able to claim a credit for income tax paid to a foreign country. However, it may be to your benefit to treat the tax as an itemized deduction on Schedule A (Form 1040). For more information on claiming a foreign tax deduction or credit, get Publication 514, *Foreign Tax Credit for Individuals.*

Keeping Track of Your Basis

You should keep track of your basis in mutual fund shares because you need the basis to figure any gain or loss on the shares when you sell, exchange, or redeem them.

Original basis. As explained in the following paragraphs, original basis depends on how you acquired your shares.

Adjusted basis. As described later, under *Adjusted Basis,* your original basis is adjusted (increased or decreased) by certain events. You must keep accurate records of all events that affect basis so you can figure the proper amount of gain or loss.

Table 1A. **Reporting Mutual Fund Distributions on Form 1040**

IF you receive...	AND...	THEN report the distribution on...
ordinary dividends (Form 1099-DIV, box 1)	your total ordinary dividends received are $1,500 or less	Form 1040, line 9
	• your total ordinary dividends received are more than $1,500, or • you received ordinary dividends as a nominee	Schedule B, line 5
capital gain distributions (Form 1099-DIV, boxes 2a–2e)	you have to file Schedule D	Schedule D, line 13, column (f)
	you do not have to file Schedule D	Form 1040, line 13, and Capital Gain Tax Worksheet, line 2
	you have qualified 5-year gain (box 2c)	Schedule D, line 29 (See Schedule D instructions)
	you have unrecaptured section 1250 gain (box 2d)	Schedule D, line 19 (See Schedule D instructions)
	you have Section 1202 gain (box 2e)	see Schedule D instructions
return of capital (nontaxable) distributions (Form 1099-DIV, box 3)		generally, not reported[1]
exempt-interest dividends (Not shown on Form 1099-DIV)		Form 1040, line 8b
undistributed capital gains (Form 2439, boxes 1a–1e)	you have total undistributed capital gains (box 1a)	Schedule D, line 11, column (f)
	you have qualified 5-year gain (box 1c)	Schedule D, line 29 (See Schedule D instructions)
	you have unrecaptured section 1250 gain (box 1d)	Schedule D, line 19 (See Schedule D instructions)
	you have Section 1202 gain (box 1e)	see Schedule D instructions

[1]Report any amount in excess of your basis in your mutual fund shares on Schedule D, line 8, column (f) (or on Schedule D, line 1, if you held your mutual fund shares one year or less).

Table 1B. **Reporting Mutual Fund Distributions on Form 1040A**

IF you receive...	AND...	THEN report the distribution on...
ordinary dividends (Form 1099-DIV, box 1)	your total ordinary dividends received are $1,500 or less	Form 1040A, line 9
	• your total ordinary dividends received are more than $1,500, or • you received ordinary dividends as a nominee	Schedule 1, line 5
capital gain distributions (Form 1099-DIV, boxes 2a–2e)	you have to file Form 1040	Form 1040; see Table 1A
	you do not have to file Form 1040	Form 1040A, line 10, and Capital Gain Tax Worksheet, line 2
	any Form 1099-DIV has an amount in box 2b, 2c, 2d, or 2e	Form 1040; see Table 1A
return of capital (nontaxable) distributions (Form 1099-DIV, box 3)		generally, not reported; see Table 1A
exempt-interest dividends (Not shown on Form 1099-DIV)		Form 1040A, line 8b
undistributed capital gains (Form 2439, boxes 1a–1e)		Form 1040; see Table 1A

Shares Acquired by Purchase

The original basis of mutual fund shares you bought is usually their cost or purchase price. The purchase price usually includes any commissions or load charges paid for the purchase.

Example. You bought 100 shares of Fund A for $10 a share. You paid a $50 commission to the broker for the purchase. Your cost basis for each share is $10.50 ($1,050 ÷ 100).

RECORDS When you buy or sell shares in a fund, keep the confirmation statements you receive. The statements show the price you paid for the shares when you bought them and the price you received for the shares when you disposed of them. The information from the confirmation statement when you purchased the shares will help you figure your basis in the fund.

Commissions and load charges. The fees and charges you pay to acquire or redeem shares of a mutual fund are not deductible. You can usually add acquisition fees and charges to your cost of the shares and thereby increase your basis. A fee paid to redeem the shares is usually a reduction in the redemption price (sales price).

You cannot add your entire acquisition fee or load charge to the cost of the mutual fund shares acquired if ***all*** of the following conditions apply.

1) You get a reinvestment right because of the purchase of the shares or the payment of the fee or charge.
2) You dispose of the shares within 90 days of the purchase date.
3) You acquire new shares in the same mutual fund or another mutual fund, for which the fee or charge is reduced or waived because of the reinvestment right you got when you acquired the shares.

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 apply to the purchase of the new shares).

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.

Shares Acquired by Reinvestment

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.

RECORDS When you acquire shares through reinvestment, keep the statements that show each date, amount, and number of full or fractional shares purchased. Keep track of any adjustments to basis of the shares as they occur.

TIP *Generally, you must know the basis* ***per share*** *to compute gain or loss when you dispose of the shares. This is explained under* Identifying the Shares Sold, *later.*

Shares Acquired by Gift

To determine your original basis of mutual fund shares you acquired by gift, you must know:

- The donor's adjusted basis,
- The date of the gift,
- The fair market value (the last quoted public redemption price) of the shares at the time of the gift, and
- Any gift tax paid on the gift of the shares.

Fair market value less than donor's adjusted basis. If the fair market value (FMV) of the shares at the time of the gift was less than the adjusted basis to the donor at the time of the gift, your basis for ***gain*** on their disposition is the donor's adjusted basis. Your basis for ***loss*** is the FMV of the shares at the time of the gift. In this situation, it is possible to sell the shares at neither a gain nor a loss because of the basis you have to use.

Example. You are given mutual fund shares with an adjusted basis of $10,000 at the time of the gift. The FMV of the shares at the time of the gift is $9,000. You later sell the shares for $9,500. The basis for figuring a gain is $10,000, so there is no gain. There also is no loss, since the basis for figuring a loss is $9,000. In this situation, you have neither a gain nor a loss.

Fair market value equal to or more than donor's adjusted basis. If the FMV of the shares at the time of the gift was equal to or more than the donor's adjusted basis at the time of the gift, your basis is the donor's adjusted basis at the time of the gift, plus all or part of any gift tax paid on the gift, depending on the date of the gift.

For information on figuring the amount of gift tax to add to your basis, see *Property Received as a Gift* in Publication 551, *Basis of Assets.*

Shares Acquired by Inheritance

If you inherited shares in a mutual fund, your original basis is generally the fair market value (FMV) (the last quoted public redemption price) on the date of the decedent's death, or the alternate valuation date if chosen for estate tax purposes.

Community property states. In community property states, you and your spouse generally are considered to each own half the estate (excluding separate property). If one spouse dies and at least half of the community interest is includible in the decedent's gross estate (whether or not the estate is required to file a return), the FMV of the community property at the date of death becomes the basis of both halves of the property.

For example, if the FMV of the entire community interest in a mutual fund is $100,000, the basis of the surviving spouse's half of the shares is $50,000. The basis of the heirs' half of the shares also is $50,000.

In determining the basis of assets acquired from a decedent, property held in joint tenancy is community property if its status was community property under state law.

Shares you gave the decedent. A different basis rule applies to inherited shares that you or your spouse gave the decedent within the one-year period ending on the date of the decedent's death if, on the date of the gift, the shares were ***appreciated property***. In this situation, the basis of the inherited shares is the decedent's adjusted basis in them immediately before his or her death, rather than their FMV.

This basis rule also applies if the decedent's estate (or a trust of which the decedent was the grantor) sells the shares instead of distributing them to you, and you are entitled to the proceeds.

Appreciated property. Appreciated property is any property (including mutual fund shares) whose FMV is more than its adjusted basis.

Exceptions. This basis rule does not apply if the decedent died before 1982 or you gave the shares to the decedent before August 14, 1981.

Adjusted Basis

After you acquire mutual fund shares, you may need to make adjustments to your basis. The adjusted basis of your shares is your original basis (defined earlier), increased or reduced as described here.

Addition to basis. Increase the basis in your shares by the difference between the amount of undistributed capital gain you include in income and the tax considered paid by you on that income.

The mutual fund reports the amount of your undistributed capital gain in box 1a of Form 2439. You should keep Copy C of all Forms 2439 to show increases in the basis of your shares.

Reduction of basis. You must reduce your basis in your shares by any return of capital distributions that you receive from the fund.

The mutual fund reports the amount of any return of capital distributions in box 3 of Form 1099–DIV. You should keep the form to show the decrease in the basis of your shares.

No reduction of basis. You do not reduce your basis for distributions from the fund that are exempt-interest dividends.

Table 2. **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.

Table 2. 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.

Sales, Exchanges, and Redemptions

When you sell or exchange your mutual fund shares, or if they are redeemed (a redemption), you will generally have a taxable gain or a deductible loss. This also applies to shares of a tax-exempt mutual fund. Sales, exchanges, and redemptions are all treated as sales of capital assets. The amount of the gain or loss is the difference between your adjusted basis (defined earlier) in the shares and the amount you realize from the sale, exchange, or redemption. This is explained further under *Gains and Losses,* later.

Sale. In general, a sale is a transfer of shares for money only.

Exchange. An exchange is a transfer of shares in return for other shares.

Redemption. A redemption occurs when a fund reacquires its shares from you in exchange for money or other property.

Recordkeeping. When there is a sale, exchange, or redemption of your shares in a fund, keep the confirmation statement you receive. The statement shows the price you received for the shares and other information you need to report gain or loss on your return.

Exchange of shares in one mutual fund for shares in another mutual fund. Any exchange of shares in one fund for shares in another fund is a taxable exchange. This is true even if you exchange shares in one fund for shares in another fund within the same family of funds. Report any gain or loss on the shares you gave up as a capital gain or loss in the year in which the exchange occurs. Usually, you can add any service charge or fee paid in connection with an exchange to the cost of the shares acquired. For an exception, see *Commissions and load charges* under *Shares Acquired by Purchase,* earlier.

Information returns. Mutual funds and brokers must report proceeds from sales, exchanges, or redemptions to the Internal Revenue Service. They must give each customer a written statement with that information by January 31 of the year following the calendar year the transaction occurred. Form 1099–B, or a substitute, may be used for this purpose.

Report your sales shown on Form(s) 1099–B (or substitute) on Schedule D (Form 1040) along with your other gains and losses. If the total of the sales price amounts reported on Form(s) 1099–B in box 2 is ***more*** than the total you report on lines 3 and 10 of Schedule D, attach a statement to your return explaining the difference.

Taxpayer identification number. You must give the broker your correct taxpayer identification number (TIN). Generally, an individual will use his or her social security number as the TIN.

If you do not provide your TIN, your broker is required to withhold tax on the gross proceeds of a transaction. For 2003, the withholding rate is 30%. In addition, you may be penalized.

Identifying the Shares Sold

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.

Cost Basis

You can figure your gain or loss using a cost basis only if you did not previously use an average basis for a sale, exchange, or redemption of other shares in the same mutual fund.

To figure cost basis, you can choose one of the following methods.

- Specific share identification.
- First-in first-out (FIFO).

Specific share identification. If you adequately identify the shares you sold, you can use the adjusted basis of those particular shares to figure your gain or loss.

You will adequately identify your mutual fund shares, even if you bought the shares in different lots at various prices and times, if you:

1) Specify to your broker or other agent the particular shares to be sold or transferred ***at the time of the sale or transfer,*** and
2) Receive confirmation of your specification from your broker ***in writing*** within a reasonable time.

The confirmation by the mutual fund must confirm that you instructed your broker to sell particular shares. You continue to have the burden of proving your basis in the specified shares at the time of sale or transfer.

First-in first-out (FIFO). If your shares were acquired at different times or at different prices and you cannot identify which shares you sold, use the basis of the shares you acquired first as the basis of the shares sold. In other words, the oldest shares you own are considered sold first. You should keep a separate record of each purchase and any dispositions of the shares until ***all*** shares purchased at the same time have been disposed of completely.

Table 3 illustrates the use of the FIFO method to figure the cost basis of shares sold, compared with the use of the single-category method to figure average basis (discussed next).

Average Basis

You can figure your gain or loss using an average basis only if you acquired the shares at various times and prices, and you left the shares on deposit in an account handled by a custodian or agent who acquires or redeems those shares.

To figure average basis, you can use one of the following methods.

- Single-category method.
- Double-category method.

Once you elect to use an average basis, you must continue to use it for all accounts in the same fund. (You must also continue to use the same method.) However, you may use the cost basis (or a different method of figuring the average basis) for shares in other funds, even those within the same family of funds.

Example. You own two accounts that hold shares of the income fund issued by Company A. You also own 100 shares of the growth fund issued by Company A. If you elect to use average basis for the first account of the income fund, you must use average basis for the second account. However, you may use cost basis for the growth fund.

TIP *You may be able to find the average basis of your shares from information provided by the fund.*

Single-category method. Under the single-category method, you find the average basis of ***all*** shares owned at the time of each disposition, regardless of how long you owned them. Include shares acquired with reinvested dividends or capital gain distributions.

Table 3 illustrates the use of the single-category method to figure the average basis of shares sold, compared with the use of the FIFO method to figure cost basis (discussed earlier).

Even though you include all unsold shares of a fund in a single category to compute average basis, you may have both short-term and long-term gains or losses when you sell these shares. To determine your holding period, the shares disposed of are considered to be those acquired first.

Example. You bought 400 shares in the LJO Mutual Fund: 200 shares on May 15, 2001, and 200 shares on May 15, 2002. On November 11, 2002, you sold 300 shares. The basis of all the shares sold is the same, but the holding period of 200 shares is long-term and the holding period of 100 shares is short-term.

How to figure the basis of shares sold. To figure the basis of shares you sell, use the steps in the following worksheet.

1) Enter the total adjusted basis of all the shares you owned in the fund just before the sale. (If you made an earlier sale of shares in this fund, add the adjusted basis of any shares you still owned after the last sale and the adjusted basis of any shares you acquired after that sale.)	$ ____
2) Enter the total number of shares you owned in the fund just before the sale.	____
3) Divide the amount on line 1 by the amount on line 2. This is your ***average basis per share.***	$ ____
4) Enter the number of shares you sold.	____
5) Multiply the amount on line 3 by the amount on line 4. This is the ***basis of the shares you sold.***	$ ____

Example 1. You bought 300 shares in the LJP Mutual Fund: 100 shares in 1999 for $1,000 ($10 per share); 100 shares in 2000 for $1,200 ($12 per share); and 100 shares in 2001 for $2,600 ($26 per share). Thus, the total cost of your shares was $4,800 ($1,000 + $1,200 + $2,600). On May 16, 2002, you sold 150 shares. The basis of shares you sold is $2,400 ($16 per share), figured as follows.

1) Enter the total adjusted basis of all the shares you owned in the fund just before the sale. (If you made an earlier sale of shares in this fund, add the adjusted basis of any shares you still owned after the last sale and the adjusted basis of any shares you acquired after that sale.)	$4,800
2) Enter the total number of shares you owned in the fund just before the sale.	300
3) Divide the amount on line 1 by the amount on line 2. This is your ***average basis per share.***	$ 16
4) Enter the number of shares you sold.	150
5) Multiply the amount on line 3 by the amount on line 4. This is the ***basis of the shares you sold.***	$2,400

Remaining shares. The average basis of the shares you still hold after a sale of some of your shares is the same as the average basis of the shares sold. The next time you make a sale, your average basis will still be the same, unless you have acquired additional shares (or have made a subsequent adjustment to basis).

Example 2. Using the same facts as in *Example 1,* assume you sold an additional 50 shares on December 15, 2002. You would not recompute the average basis of the 150 shares you owned at that time because no shares were acquired or sold since the last sale; rather, your basis is the $16 per share figured earlier.

Example 3. Using the same facts as in *Example 1,* assume you bought an additional 150 shares at $14 a share on September 19, 2002, and then sold 50 shares on December 16, 2002. The total adjusted basis of all the shares you owned just before the sale is $4,500, figured as follows.

1) Basis of remaining shares ($16 x 150)	$2,400
2) Cost of shares acquired 9/19/02 ($14 x 150)	$2,100
3) Total adjusted basis of all shares owned ($2,400 + $2,100)	$4,500

The basis of the shares sold is $750 ($15 a share), figured as follows.

1) Enter the total adjusted basis of all the shares you owned in the fund just before the sale. (If you made an earlier sale of shares in this fund, add the adjusted basis of any shares you still owned after the last sale and the adjusted basis of any shares you acquired after that sale.)	$4,500
2) Enter the total number of shares you owned in the fund just before the sale.	300
3) Divide the amount on line 1 by the amount on line 2. This is your ***average basis per share.***	$ 15
4) Enter the number of shares you sold.	50
5) Multiply the amount on line 3 by the amount on line 4. This is the ***basis of the shares you sold.*** . . .	$ 750

Table 3. **How To Figure Basis of Shares Sold**

This is an example showing two different ways to figure basis. It compares the cost basis using the FIFO method with the average basis using the single-category method.

Date	Action	Share Price	No. of Shares	Total Shares Owned
02/05/01	Invest $4,000	$25	160	160
08/06/01	Invest $4,800	$20	240	400
12/17/01	Reinvest $300 dividend	$30	10	410
09/30/02	Sell $6,720	$32	210	200

COST BASIS (FIFO)

To figure the basis of the 210 shares sold on 9/30/02, use the share price of the first 210 shares you bought, namely the 160 shares you purchased on 2/5/01 and 50 of those purchased on 8/6/01.

$4,000 (cost of 160 shares on 2/5/01)
+ $1,000 (cost of 50 shares on 8/6/01)
Basis= $5,000

AVERAGE BASIS (single-category)

To figure the basis of the 210 shares sold on 09/30/02, use the average basis of all 410 shares owned on 9/30/02.

$9,100 (cost of 410 shares)
÷ 410 (number of shares)
$22.20 (average basis per share)

$22.20
× 210
Basis= $4,662

Double-category method. In the double-category method, all shares in an account at the time of each disposition are divided into two categories: short-term and long-term. Shares held one year or less are short-term. Shares held longer than one year are long-term.

The basis of each share in a category is the average basis for that category. This is the total remaining basis of all shares in that category at the time of disposition divided by the total shares in the category at that time. To use this method, you specify, to the custodian or agent handling your account, from which category the shares are to be sold or transferred. The custodian or agent must confirm ***in writing*** your specification. If you do not specify or receive confirmation, you must first charge the shares sold against the long-term category and then charge any remaining shares sold against the short-term category.

Changing categories. After you have held a mutual fund share for more than one year, you must transfer that share from the short-term category to the long-term category. The basis of a transferred share is its actual cost or other basis to you unless some of the shares in the short-term category have been disposed of. In that case, the basis of a transferred share is the average basis of the undisposed shares at the time of the most recent disposition from this category.

Making the choice. You choose to use the average basis of mutual fund shares by clearly showing on your income tax return, for each year the choice applies, that you used an average basis in reporting gain or loss from the sale or transfer of the shares. You must specify whether you used the single-category method or the double-category method in determining average basis. This choice is effective until you get permission from the IRS to revoke it.

Shares received as gift. If your account includes shares that you received by gift, and the fair market value of the shares at the time of the gift was not more than the donor's basis, special rules apply. You cannot choose to use the average basis for the account unless you submit a statement with your initial choice. It must state that the basis used in figuring the average basis of the gift shares will be the FMV at the time of the gift. This statement applies to gift shares received before and after making the choice, as long as the choice to use the average basis is in effect.

Gains and Losses

You figure gain or loss on the disposition of your shares by comparing the ***amount you realize*** with the ***adjusted basis*** of your shares. If the amount you realize is more than the adjusted basis of the shares, you have a gain. If the amount you realize is less than the adjusted basis of the shares, you have a loss.

Amount you realize. The amount you realize from a disposition of your shares is the money and value of any property you receive for the shares disposed of, minus your expenses of sale (such as redemption fees, sales commissions, sales charges, or exit fees).

Adjusted basis. Adjusted basis is explained under *Keeping Track of Your Basis,* earlier. Also see the explanations of cost basis and average basis under *Identifying the Shares Sold,* earlier.

Wash sales. If you sell mutual fund shares at a loss and within ***30 days before or after*** the sale you buy, acquire in a taxable exchange, or acquire a contract or option to buy ***substantially identical*** shares, you have a wash sale. You cannot deduct losses from wash sales.

Substantially identical. In determining whether the shares are substantially identical, you must consider all the facts and circumstances. Ordinarily, shares issued by one mutual fund are not considered to be substantially identical to shares issued by another mutual fund.

For more information on wash sales, get Publication 550.

Reporting information from Form 1099–B. Mutual funds and brokers report dispositions of mutual fund shares on Form 1099–B, or a substitute form containing substantially the same language. The form shows the amount of the sales price and indicates whether the amount reported is the gross amount or the net amount (gross amount minus commissions).

If your Form 1099–B or similar statement from the payer shows the gross sales price, do not subtract the expenses of sale from it when reporting your sales price in column (d) on Schedule D. Instead, report the gross amount in column (d) and increase your cost or other basis, column (e), by any expense of the sale. If your Form 1099–B shows that the gross sales price less commissions was reported to IRS, enter the net amount in column (d) of Schedule D and ***do not*** increase your basis in column (e) by the sales commission.

Example 1. You sold 100 shares of Fund HIJ for $2,500. You paid a $75 commission to the broker for handling the sale. Your Form 1099–B shows that the net sales proceeds, $2,425 ($2,500 – $75), were reported to the IRS. Report $2,425 in column (d) of Schedule D.

Example 2. You sold 200 shares of Fund KLM for $10,000. You paid a $100 commission at the time of the sale. You bought the shares for $5,000. The broker reported the gross proceeds to IRS on Form 1099–B, so you enter $10,000 in column (d) of Schedule D and increase your basis in column (e) to $5,100.

Note. Whether you use Schedule D's line 1 (for a short-term gain or loss) or line 8 (for a long-term gain or loss) depends on how long you held the shares, discussed next.

Holding Period

When you dispose of your mutual fund shares, you must determine your holding period. Your holding period determines whether the gain or loss is a short-term capital gain or loss or a long-term capital gain or loss.

Short-term gain or loss. If you hold the shares for one year or less, your gain or loss will be a short-term gain or loss.

Long-term gain or loss. If you hold the shares for more than one year, your gain or loss will be a long-term gain or loss.

Determining period held. Determine your holding period by using the trade dates of your purchases and your sales. The ***trade date*** is the date on which you contract to buy or sell shares. Most mutual funds will show the trade dates on confirmation statements showing your purchases and sales.

CAUTION *Do not confuse the trade date with the* **settlement date**, *which is the date by which the mutual fund shares must be delivered and payment must be made.*

To find out how long you have held your shares, begin counting on the day after the trade date on which you bought the shares. (Do not count the trade date itself.) The trade date on which you dispose of the shares is counted as part of your holding period.

Example. If you bought shares on January 11, 2001 (trade date), and sold them on January 11, 2002 (trade date), your holding period would not be more than one year. If you sold them on January 12, 2002, your holding period would be more than one year (12 months plus 1 day).

Mutual fund shares received as a gift. If you receive a gift of mutual fund shares and your basis is determined by the donor's basis, your holding period is considered to have started on the same day that the donor's holding period started.

Inherited mutual fund shares. If you inherit mutual fund shares, you are considered to have held the shares for more than one year, regardless of how long you actually held them. Report the sale of inherited mutual fund shares on line 8 of Schedule D and enter **"INHERITED"** in column (b) instead of the date you acquired the shares.

Reinvested distributions. If your dividends and capital gain distributions are reinvested in new shares, the holding period of each new share begins the day after that share was purchased. Therefore, if you sell both the new shares and the original shares, you might have both short-term and long-term gains and losses.

Certain short-term losses. Special rules may apply if you have a short-term loss on the sale of shares on which you received an exempt-interest dividend or a capital gain distribution.

Exempt-interest dividends before short-term loss. If you received exempt-interest dividends on mutual fund shares that you held for 6 months or less and sold at a loss, you may claim only the part of the loss that is more than the exempt-interest dividends. On Schedule D, column (d), increase the sales price by the amount of exempt-interest dividends. Report the loss as a short-term capital loss.

Example. On January 8, 2002, you bought a mutual fund share for $40. On February 4, 2002, the mutual fund paid a $5 dividend from tax-exempt interest, which is not taxable to you. On February 12, 2002, you sold the share for $34. If it were not for the tax-exempt dividend, your loss would be $6 ($40 – $34). However, you must increase the sales price from $34 to $39 (to account for the $5 portion of the loss that is not deductible). You can deduct only $1 as a short-term capital loss.

Capital gain distribution before short-term loss. Generally, if you received capital gain distributions (or had to report undistributed capital gains) on mutual fund shares that you held for 6 months or less and sold at a loss, report only the part of the loss that is more than the capital gain distribution (or undistributed capital gain) as a short-term capital loss. The rest of the loss is reported as a long-term capital loss.

Example. On April 8, 2002, you bought a mutual fund share for $20. On June 25, 2002, the mutual fund paid a capital gain distribution of $2 a share, which is taxed as a long-term capital gain. On July 11, 2002, you sold the share for $17.50. If it were not for the capital gain distribution, your loss would be a short-term loss of $2.50 ($20 – $17.50). However, the part of the loss that is not more than the capital gain distribution ($2) must be reported as a long-term capital loss. The remaining $0.50 of the loss can be reported as a short-term capital loss.

How To Figure Net Gain or Loss

Separate your short-term gains and losses from your long-term gains and losses on all the mutual fund shares and other capital assets you disposed of during the year. Then determine your net short-term gain or loss and your net long-term gain or loss.

Net short-term capital gain or loss. Net short-term capital gain or loss is determined by adding the gains and losses from lines 1 through 6 in column (f) of Part I, Schedule D (Form 1040), *Capital Gains and Losses.* Line 7 is the net short-term capital gain or loss.

Net long-term capital gain or loss. Net long-term capital gain or loss is determined by adding the gains and losses from lines 8 through 14 in column (f) of Part II, Schedule D (Form 1040). Line 16 is the net long-term capital gain or loss.

In figuring the net long-term capital gain or loss, you should include any undistributed capital gain you reported on line 11 of Schedule D and any capital gain distributions you reported on line 13 of Schedule D.

Total net gain or loss. The total net gain or loss is determined by combining the net short-term capital gain or loss on line 7 with the net long-term capital gain or loss on line 16. Enter the result on line 17 of Part III, Schedule D (Form 1040). If line 17 shows a gain, enter the amount on line 13 of Form 1040. If line 17 shows a loss, see *Limit on Capital Loss Deduction,* later.

Figuring Your Tax

If you are reporting capital gain distributions on Form 1040A, use the *Capital Gain Tax Worksheet* in the Form 1040A instructions to figure your tax. See *How To Report,* earlier, to see whether you can report your capital gain distributions on Form 1040A.

If you are reporting capital gain distributions on Form 1040, but are not required to file Schedule D, use the *Capital Gain Tax Worksheet* in the Form 1040 instructions to figure your tax. See *How To Report,* earlier, to see whether you must file Schedule D.

If you are required to file Schedule D, you will need to use Part IV of Schedule D (Form 1040) to figure your tax if both of the following are true.

1) You have a net capital gain. You have a net capital gain if both lines 16 and 17 of Schedule D are gains.
2) Your taxable income on Form 1040, line 41, is more than zero.

If you have any collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain, you may also have to use the *Schedule D Tax Worksheet* in the Schedule D instructions to figure your tax. See the directions below line 19 of Schedule D.

Capital Gain Tax Rates

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

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

The maximum capital gain rate can be 8%, 10%, 20%, 25%, or 28%. See *Table 4.*

The maximum capital gain rate does not apply if it is higher than your regular tax rate.

Table 4. **What Is Your Maximum Capital Gain Rate?**

IF your net capital gain is from. . .	THEN your maximum capital gain rate is. . .
collectibles gain	**28%**
gain on qualified small business stock equal to the section 1202 exclusion	**28%**
unrecaptured section 1250 gain	**25%**
other gain[1] and the regular tax rate that would apply is 27% or higher	**20%**
other gain[1] and the regular tax rate that would apply is lower than 27%	**8%[2] or 10%**

[1] "Other gain" means any gain that is not collectibles gain, gain on qualified small business stock, or unrecaptured section 1250 gain.
[2] The rate is 8% only for qualified 5-year gain.

Example. You have a capital gain distribution that is a section 1202 gain, so the maximum capital gain rate on the distribution would be 28%. Because you are single and your taxable income is $25,000, none of your taxable income will be taxed above the 15% rate. The 28% rate does not apply.

8% rate. The 10% maximum capital gain rate is lowered to 8% for "qualified 5-year gain."

Qualified 5-year gain. Qualified 5-year gain is capital gain from the sale of property that was held for more than 5 years.

Note. Your mutual fund may issue Form 1099–DIV or Form 2439 showing qualified 5-year gain. Enter these amounts and any other qualified 5-year gain on the *Qualified 5-Year Gain Worksheet,* in the instructions for Schedule D (Form 1040).

18% capital gain rate. Beginning in 2006, the 20% maximum capital gain rate will be lowered to 18% for qualified 5-year gain. The holding period for the property sold must have begun after 2000.

Limit on Capital Loss Deduction

If line 17 of Part III, Schedule D (Form 1040) shows a loss, your allowable capital loss deduction is the smaller of:

1) $3,000 ($1,500 if you are married and filing a separate return), or
2) Your total net loss shown on line 17 of Schedule D.

Enter your allowable loss on line 13 of Form 1040.

Example. Bob and Gloria sold all of their shares in a mutual fund. The sale resulted in a capital loss of $7,000. They had no other sales of capital assets during the year. On their joint return, they can deduct $3,000, which is the smaller of their loss or the net capital loss limit.

If Bob and Gloria's capital loss had been $2,000, their capital loss deduction would have been $2,000, because it is less than the $3,000 limit.

Capital loss carryover. If your total net loss is more than your allowable capital loss deduction, you may carry over the excess to later years until it is completely used up. To determine your capital loss carryover, subtract from your total net loss the lesser of:

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

If your deductions exceed your gross income, you start the computation in (2) above with a negative number.

Use the *Capital Loss Carryover Worksheet* in the Schedule D instructions to figure your capital loss carryover.

When carried over, the loss will keep its original character as long-term or short-term. Therefore, a long-term capital loss carried over from a previous year will offset long-term gains of the current year before it offsets short-term gains of the current year. For more information on figuring capital loss carryovers, get Publication 550.

Separate returns. Capital loss carryovers from separate returns are combined if you now file a joint return. However, if you once filed jointly and are now filing separately, a capital loss carryover from the joint return can be deducted only on the separate return of the spouse who actually had the loss.

Investment Expenses

You can generally deduct the expenses of producing taxable investment income. These include expenses for investment counseling and advice, legal and accounting fees, and investment newsletters. These expenses are deductible as miscellaneous itemized deductions to the extent that they exceed 2% of your adjusted gross income. See chapter 3 in Publication 550 for more information.

Interest paid on money to buy or carry investment property is also deductible, but the deduction may be limited. See *Limit on Investment Interest Expense,* later.

Publicly offered mutual funds. Most mutual funds are publicly offered. Expenses of publicly offered mutual funds are not treated as miscellaneous itemized deductions. This is because these mutual funds report only the net amount of investment income after your share of the investment expenses has been deducted.

Nonpublicly offered mutual funds. If you own shares in a nonpublicly offered mutual fund during the year, you can deduct your share of the investment expenses on your Schedule A (Form 1040). Claim them as a miscellaneous itemized deduction to the extent your miscellaneous itemized deductions exceed 2% of your adjusted gross income. Your share of the expenses will be shown in box 5 of Form 1099–DIV. A nonpublicly offered mutual fund is one that:

1) Is not continuously offered pursuant to a public offering,
2) Is not regularly traded on an established securities market, and
3) Is held by fewer than 500 persons at any time during the tax year.

Contact your mutual fund if you are not sure whether it is nonpublicly offered.

Expenses allocable to exempt-interest dividends. You cannot deduct expenses that are for the collection or production of exempt-interest dividends. Expenses must be allocated if they were for both taxable and tax-exempt income. One accepted method for allocating expenses is to divide them in the same proportion that each type of income from the mutual fund is to your total income from the fund. To find the part of the expenses that relates to the tax-exempt income, you must first divide your tax-exempt income by your total income. Then multiply your expenses by the result. You cannot deduct this part.

Example. William received $600 in dividends from his mutual fund: exempt-interest dividends of $480 and taxable dividends of $120. In earning this income, he had a $50 expense for a newsletter on mutual funds. William divides the exempt-interest dividends by the total dividends to figure the part of the expense that is not deductible. Therefore, 80% ($480 ÷ $600) of William's expense is for exempt-interest income. He cannot deduct $40 (80% of $50) of the expense. William may claim the balance of the expense, $10, as a miscellaneous itemized deduction subject to the 2%-of-adjusted-gross-income limit. That is the part of the expense allocable to the taxable dividends.

Limit on Investment Interest Expense

The amount you can deduct as investment interest expense may be limited in two different ways. First, you may not deduct the interest on money you borrow to buy or carry shares in a mutual fund that distributes only exempt-interest dividends. If the fund also distributes taxable dividends, you must allocate the interest between the taxable and nontaxable income. Allocate the interest as explained under *Expenses allocable to exempt-interest dividends* under *Investment Expenses,* earlier.

Second, your deduction for investment interest expense is limited to the amount of your net investment income.

Net investment income. This is figured by subtracting your investment expenses other than interest from your investment income. For this purpose, do not include any income or expenses taken into account to figure gain or loss from passive activities.

Investment income. Investment income generally includes gross income derived from property held for investment (such as interest, dividends, annuities, and royalties). It generally does not include net capital gain derived from disposing of investment property. Nor does it include capital gain distributions from mutual fund shares. However, you can choose to include part or all of your net capital gain in investment income. For information on this choice, see chapter 3 of Publication 550.

Investment expenses. Investment expenses include all income-producing expenses relating to the investment property, other than interest expenses, that are allowable deductions after subtracting 2% of adjusted gross income. In figuring the amount over the 2% limit, miscellaneous expenses that are not investment expenses are disallowed before any investment expenses are disallowed.

For information on the 2% limit, get Publication 529, *Miscellaneous Deductions.* For more information on passive activity losses, get Publication 925, *Passive Activity and At-Risk Rules.*

Example. Jane, a single taxpayer, has investment income for the year of $12,000. Jane's investment expenses (other than interest expense) directly connected with the production of income were $980 after subtracting the 2% limit on miscellaneous itemized deductions. Jane incurred $12,500 of investment interest expense during the year. She had no passive activity losses. Jane figures net investment income and the limit on her investment interest expense deduction as follows:

Total investment income	$12,000
Subtract: Investment expenses (other than interest)	−980
Net investment income	$11,020

For the year, Jane's investment interest expense deduction is limited to $11,020 (her net investment income). The disallowed interest expense of $1,480 ($12,500 − $11,020) can be carried forward to the following year as explained next under *Carryover.*

Carryover. You can ***carry forward*** to the next tax year the investment interest that you cannot deduct because of the limit. You can deduct the interest carried forward to the extent that your net investment income exceeds your investment interest in that later year.

Form 4952. Use Form 4952 to figure your investment interest expense deduction. For more information about investment interest expense, get Publication 550.

Comprehensive Example

Robert and Janice Martin have the following four sources of investment income to report on their 2002 tax return. Their Schedule D (Form 1040) is shown later.

1) $1,204 gain from the sale of 200 shares of Mutual Fund S on October 8, 2002. They received Form 1099–B, and they report the sale on Schedule D (Form 1040).

   Robert and Janice purchased these shares in 1988 at $10 each. They received some return of capital distributions in 1990, 1991, and 1999 that reduced their basis in the shares. In 2000 and 2001, the Martins reported undistributed capital gains that increased their basis in their shares. They received no distributions in 2002 before the sale.

2) $265 in ordinary dividends and $61 in capital gain distributions from Mutual Fund R. The capital gain distributions include $30 of qualified 5-year gain. The Martins received Form 1099–DIV showing these amounts. They report the capital gain distributions on Schedule D (Form 1040) because they have other capital transactions. They complete the *Qualified 5-Year Gain Worksheet* in the instructions for Schedule D. They report the ordinary dividends on line 9 of Form 1040. They do not report the ordinary dividends on Schedule B (Form 1040) because their total ordinary dividends were not over $1,500.

   Robert and Janice invested $3,800 in this fund in June 2002 and received 153.16 shares that cost $24.81 per share. They requested that all of their distributions be reinvested in more shares of the fund. On December 26, 2002, they acquired an additional 13.03 shares at $25.01 per share from their reinvested dividends.

3) $101 of exempt-interest dividends from Mutual Fund X. They receive a statement from the fund, and they report this nontaxable amount on line 8b of Form 1040.

   The Martins invested $2,600 in this fund in April 2000 and received 87.54 shares at $29.70 per share. They received exempt-interest dividends of $92 in 2000 and $107 in 2001.

4) $237 in ordinary dividends from 100 shares of common stock in Green Publishing Company. They received Form 1099–DIV, and they report the dividends on line 9 of Form 1040.

   Robert and Janice bought this stock in 1988 for $10.29 per share.

Mutual Fund Record. Robert and Janice keep track of all their basis adjustments on their *Mutual Fund Record,* shown later. They show the return of capital distributions and the undistributed capital gains from Mutual Fund S and the reinvested dividends from Mutual Fund R. They do not show the exempt-interest dividends from Mutual Fund X because those dividends do not reduce their basis in the shares.

The Martins keep this record with their mutual fund documents, and they use it to report their 2002 sale of Mutual Fund S.

Preparing Schedule D. The Martins use their Form 1099–B and their *Mutual Fund Record* to figure the gain from the sale of Mutual Fund S to report on Schedule D.

Robert and Janice enter the $61 capital gain distribution from Mutual Fund R (from box 2a of Form 1099–DIV) on line 13, column (f). They do not make an entry in column (g) of line 13 because Mutual Fund R did not indicate that any of the capital gain distribution was a 28% rate gain distribution (box 2b of Form 1099–DIV).

They enter the $30 qualified 5-year gain (from box 2c of Form 1099–DIV) on line 5 of the *Qualified 5-Year Gain Worksheet* in the instructions for Schedule D.

They report the sale of their shares in Mutual Fund S on line 8 because they owned the shares for more than 1 year. They use the information from their *Mutual Fund Record* to complete columns (a), (b), and (e). After adjustment for their return of capital distributions and their undistributed capital gains, their basis is $1,996 ($9.98 per share). They use their Form 1099–B to complete columns (c) and (d). Their sales price in column (d) (the gross proceeds shown in box 2 of Form 1099–B) is $3,200 ($16 per share). They enter their gain of $1,204 in column (f). They do not make an entry in column (g) because the gain was not 28% rate gain.

Because they owned their shares in mutual fund S for more than 5 years, the $1,204 gain is qualified 5-year gain. They enter $1,204 on line 1 of the *Qualified 5-Year Gain Worksheet*. They add the amounts on lines 1 and 5 of the worksheet and enter the total, $1,234, on line 6 and line 8 of the worksheet and on line 29 of Schedule D.

Robert and Janice add the amounts on lines 8 and 13 of Schedule D and enter their net long-term capital gain of $1,265 on line 16. They also enter that amount on line 17. Because lines 16 and 17 are gains, they compute their tax using Part IV of Schedule D. (Part IV is shown, but not filled in, except line 29 for reporting qualified 5-year gain.)

Table 5. **Mutual Fund Record for Robert and Janice Martin**

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
MUTUAL FUND S	7–12–88	200	10.00	12–31–90 (.05)	12–31–91 (.02)	12–31–99 (.04)	12–31–00 .03	8–31–01 .06	9.98	10–8–02	200
MUTUAL FUND X	4–19–00	87.54	29.70								
MUTUAL FUND R	6–6–02	153.16	24.81								
	12–26–02	13.03	25.01								

[1] Include share received from reinvestment of distributions.
[2] Cost plus or minus adjustments.

Qualified 5-Year Gain Worksheet—Line 29

Keep for Your Records

1. Enter the total of all gains that you reported on line 8, column (f), of Schedules D and D-1 from dispositions of property held more than 5 years. **Do not** reduce these gains by any losses . . . **1.** 1,204.00
2. Enter the total of all gains from dispositions of property held more than 5 years from Form 4797, Part I, but **only** if Form 4797, line 7, is more than zero. **Do not** reduce these gains by any losses . . **2.** ______
3. Enter the total of all capital gains from dispositions of property held more than 5 years from Form 4684, line 4, but **only** if Form 4684, line 15, is more than zero. **Do not** reduce these gains by any losses **3.** ______
4. Enter the total of all capital gains from dispositions of property held more than 5 years from Form 6252; Form 6781, Part II; and Form 8824. **Do not** reduce these gains by any losses . . . . . . **4.** ______
5. Enter the total of any qualified 5-year gain reported to you on:
   - Form 1099-DIV, box 2c;
   - Form 2439, box 1c; and
   - Schedule K-1 from a partnership, S corporation, estate, or trust (**do not** include gains from section 1231 property; take them into account on line 2 above, but **only** if Form 4797, line 7, is more than zero). **5.** 30.00
6. Add lines 1 through 5 . . . . **6.** 1,234.00
7. Enter the part, if any, of the gain on line 6 that is:
   - Attributable to 28% rate gain **or**
   - Included on line 6, 10, 11, or 12 of the **Unrecaptured Section 1250 Gain Worksheet** on page D-7. . . . . **7.** ______
8. **Qualified 5-year gain.** Subtract line 7 from line 6. Enter the result here and on Schedule D, line 29 **8.** 1,234.00

SCHEDULE D (Form 1040)

Department of the Treasury
Internal Revenue Service

Capital Gains and Losses

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

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

OMB No. 1545-0074

2002

Attachment Sequence No. **12**

Name(s) shown on Form 1040: ROBERT A. and JANICE P. MARTIN

Your social security number: 123 00 4567

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)
1						
2	Enter your short-term totals, if any, from Schedule D-1, line 2		2			
3	**Total short-term sales price amounts.** Add lines 1 and 2 in column (d)		3			
4	Short-term gain from Form 6252 and short-term gain or (loss) from Forms 4684, 6781, and 8824				4	
5	Net short-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				5	
6	Short-term capital loss carryover. Enter the amount, if any, from line 8 of your 2001 Capital Loss Carryover Worksheet				6	( )
7	**Net short-term capital gain or (loss).** Combine lines 1 through 6 in column (f).				7	

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

	(a) Description of property (Example: 100 sh. XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price (see page D-5 of the instructions)	(e) Cost or other basis (see page D-5 of the instructions)	(f) Gain or (loss) Subtract (e) from (d)	(g) 28% rate gain or (loss) * (see instr. below)
8	200 Shares MUTUAL FUND S	7-12-88	10-8-02	3,200	1,996	1,204	
9	Enter your long-term totals, if any, from Schedule D-1, line 9		9				
10	**Total long-term sales price amounts.** Add lines 8 and 9 in column (d)		10	3,200			
11	Gain from Form 4797, Part I; long-term gain from Forms 2439 and 6252; and long-term gain or (loss) from Forms 4684, 6781, and 8824				11		
12	Net long-term gain or (loss) from partnerships, S corporations, estates, and trusts from Schedule(s) K-1				12		
13	Capital gain distributions. See page D-1 of the instructions				13	61	
14	Long-term capital loss carryover. Enter in both columns (f) and (g) the amount, if any, from line 13 of your 2001 Capital Loss Carryover Worksheet				14	( )	( )
15	Combine lines 8 through 14 in column (g)				15		
16	**Net long-term capital gain or (loss).** Combine lines 8 through 14 in column (f) **Next:** Go to Part III on the back.				16	1,265	

***28% rate gain or loss** includes **all** "collectibles gains and losses" (as defined on page D-6 of the instructions) and up to 50% of the eligible gain on qualified small business stock (see page D-4 of the instructions).

Part III Taxable Gain or Deductible Loss

17	Combine lines 7 and 16 and enter the result. If a loss, go to line 18. If a gain, enter the gain on Form 1040, line 13, and complete Form 1040 through line 41	17	1,265
	Next: • If both lines 16 and 17 are gains **and** Form 1040, line 41, is more than zero, complete Part IV below. • Otherwise, skip the rest of Schedule D and complete Form 1040.		
18	If line 17 is a loss, enter here and on Form 1040, line 13, the **smaller** of **(a)** that loss or **(b)** ($3,000) (or, if married filing separately, ($1,500)). Then complete Form 1040 through line 39	18	( )
	Next: • If the loss on line 17 is more than the loss on line 18 **or** if Form 1040, line 39, is less than zero, skip **Part IV** below and complete the **Capital Loss Carryover Worksheet** on page D-6 of the instructions before completing the rest of Form 1040. • Otherwise, skip **Part IV** below and complete the rest of Form 1040.		

Part IV Tax Computation Using Maximum Capital Gains Rates

19	Enter your unrecaptured section 1250 gain, if any, from line 17 of the worksheet on page D-7 of the instructions					19	
	If line 15 or line 19 is more than zero, complete the worksheet on page D-9 of the instructions to figure the amount to enter on lines 22, 29, and 40 below, and skip all other lines below. Otherwise, go to line 20.						
20	Enter your taxable income from Form 1040, line 41			20			
21	Enter the **smaller** of line 16 or line 17 of Schedule D	21					
22	If you are deducting investment interest expense on Form 4952, enter the amount from Form 4952, line 4e. Otherwise, enter -0-	22					
23	Subtract line 22 from line 21. If zero or less, enter -0-			23			
24	Subtract line 23 from line 20. If zero or less, enter -0-			24			
25	Figure the tax on the amount on line 24. Use the Tax Table or Tax Rate Schedules, whichever applies					25	
26	Enter the **smaller** of: • The amount on line 20 **or** • $46,700 if married filing jointly or qualifying widow(er); $27,950 if single; $37,450 if head of household; or $23,350 if married filing separately			26			
	If line 26 is greater than line 24, go to line 27. Otherwise, skip lines 27 through 33 and go to line 34.						
27	Enter the amount from line 24			27			
28	Subtract line 27 from line 26. If zero or less, enter -0- and go to line 34			28			
29	Enter your qualified 5-year gain, if any, from line 8 of the worksheet on page D-8	29	1,234				
30	Enter the **smaller** of line 28 or line 29			30			
31	Multiply line 30 by 8% (.08)					31	
32	Subtract line 30 from line 28			32			
33	Multiply line 32 by 10% (.10)					33	
	If the amounts on lines 23 and 28 are the same, skip lines 34 through 37 and go to line 38.						
34	Enter the **smaller** of line 20 or line 23			34			
35	Enter the amount from line 28 (if line 28 is blank, enter -0-)			35			
36	Subtract line 35 from line 34			36			
37	Multiply line 36 by 20% (.20)					37	
38	Add lines 25, 31, 33, and 37					38	
39	Figure the tax on the amount on line 20. Use the Tax Table or Tax Rate Schedules, whichever applies					39	
40	**Tax on all taxable income (including capital gains).** Enter the **smaller** of line 38 or line 39 here and on Form 1040, line 42					40	

Schedule D (Form 1040) 2002

How To Get Tax Help

You can get help with unresolved tax issues, order free publications and forms, ask tax questions, and get more information from the IRS in several ways. By selecting the method that is best for you, you will have quick and easy access to tax help.

Contacting your Taxpayer Advocate. If you have attempted to deal with an IRS problem unsuccessfully, you should contact your Taxpayer Advocate.

The Taxpayer Advocate represents your interests and concerns within the IRS by protecting your rights and resolving problems that have not been fixed through normal channels. While Taxpayer Advocates cannot change the tax law or make a technical tax decision, they can clear up problems that resulted from previous contacts and ensure that your case is given a complete and impartial review.

To contact your Taxpayer Advocate:

- Call the Taxpayer Advocate at **1–877–777–4778.**
- Call, write, or fax the Taxpayer Advocate office in your area.
- Call **1–800–829–4059** if you are a TTY/TDD user.

For more information, see Publication 1546, *The Taxpayer Advocate Service of the IRS.*

Free tax services. To find out what services are available, get Publication 910, *Guide to Free Tax Services.* It contains a list of free tax publications and an index of tax topics. It also describes other free tax information services, including tax education and assistance programs and a list of TeleTax topics.

Personal computer. With your personal computer and modem, you can access the IRS on the Internet at **www.irs.gov**. While visiting our web site, you can:

- See answers to frequently asked tax questions or request help by e-mail.
- Download forms and publications or search for forms and publications by topic or keyword.
- Order IRS products on-line.
- View forms that may be filled in electronically, print the completed form, and then save the form for recordkeeping.
- View Internal Revenue Bulletins published in the last few years.
- Search regulations and the Internal Revenue Code.
- Receive our electronic newsletters on hot tax issues and news.
- Learn about the benefits of filing electronically (IRS e-file).
- Get information on starting and operating a small business.

You can also reach us with your computer using File Transfer Protocol at **ftp.irs.gov.**

TaxFax Service. Using the phone attached to your fax machine, you can receive forms and instructions by calling **703–368–9694.** Follow the directions from the prompts. When you order forms, enter the catalog number for the form you need. The items you request will be faxed to you.

For help with transmission problems, call the FedWorld Help Desk at **703–487–4608.**

Phone. Many services are available by phone.

- *Ordering forms, instructions, and publications.* Call **1–800–829–3676** to order current and prior year forms, instructions, and publications.
- *Asking tax questions.* Call the IRS with your tax questions at **1–800–829–1040.**
- *Solving problems.* Take advantage of Everyday Tax Solutions service by calling your local IRS office to set up an in-person appointment at your convenience. Check your local directory assistance or **www.irs.gov** for the numbers.
- *TTY/TDD equipment.* If you have access to TTY/TDD equipment, call **1–800–829–4059** to ask tax questions or to order forms and publications.
- *TeleTax topics.* Call **1–800–829–4477** to listen to pre-recorded messages covering various tax topics.

Evaluating the quality of our telephone services. To ensure that IRS representatives give accurate, courteous, and professional answers, we use several methods to evaluate the quality of our telephone services. One method is for a second IRS representative to sometimes listen in on or record telephone calls. Another is to ask some callers to complete a short survey at the end of the call.

Walk-in. Many products and services are available on a walk-in basis.

- *Products.* You can walk in to many post offices, libraries, and IRS offices to pick up certain forms, instructions, and publications. Some IRS offices, libraries, grocery stores, copy centers, city and county governments, credit unions, and office supply stores have an extensive collection of products available to print from a CD-ROM or photocopy from reproducible proofs. Also, some IRS offices and libraries have the Internal Revenue Code, regulations, Internal Revenue Bulletins, and Cumulative Bulletins available for research purposes.
- *Services.* You can walk in to your local IRS office to ask tax questions or get help with a tax problem. Now you can set up an appointment by calling your local IRS office number and, at the prompt, leaving a message requesting Everyday Tax Solutions help. A representative will call you back within 2 business days to schedule an in-person appointment at your convenience.

Mail. You can send your order for forms, instructions, and publications to the Distribution Center nearest to you and receive a response within 10 workdays after your request is received. Find the address that applies to your part of the country.

- **Western part of U.S.:**
  Western Area Distribution Center
  Rancho Cordova, CA 95743–0001
- **Central part of U.S.:**
  Central Area Distribution Center
  P.O. Box 8903
  Bloomington, IL 61702–8903
- **Eastern part of U.S. and foreign addresses:**
  Eastern Area Distribution Center
  P.O. Box 85074
  Richmond, VA 23261–5074

CD-ROM for tax products. You can order IRS Publication 1796, *Federal Tax Products on CD-ROM,* and obtain:

- Current tax forms, instructions, and publications.
- Prior-year tax forms and instructions.
- Popular tax forms that may be filled in electronically, printed out for submission, and saved for recordkeeping.
- Internal Revenue Bulletins.

The CD-ROM can be purchased from National Technical Information Service (NTIS) by calling **1–877–233–6767** or on the Internet at **http://www.irs.gov/cdorders.** The first release is available in early January and the final release is available in late February.

CD-ROM for small businesses. IRS Publication 3207, *Small Business Resource Guide,* is a must for every small business owner or any taxpayer about to start a business. This handy, interactive CD contains all the business tax forms, instructions and publications needed to successfully manage a business. In addition, the CD provides an abundance of other helpful information, such as how to prepare a business plan, finding financing for your business, and much more. The design of the CD makes finding information easy and quick and incorporates file formats and browsers that can be run on virtually any desktop or laptop computer.

It is available in March. You can get a free copy by calling **1–800–829–3676** or by visiting the website at **www.irs.gov/smallbiz.**

Index

To help us develop a more useful index, please let us know if you have ideas for index entries. See “Comments and Suggestions” in the “Introduction” for the ways you can reach us.

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