PacificCPE

COURSE
30901C

Financial Planning: Tax Treatment of Investment Income and Expenses

Understanding how investment income is taxed—and how to deduct related expenses—is essential for advising clients with portfolios of any size. This course covers interest income, dividends, discount on debt instruments, and stripped preferred stock, then moves into deduction limits, investment interest expenses, and reporting requirements. It also addresses passive activity limitations, at-risk rules, basis of investment property, and wash sale rules. CPAs and tax professionals who work with individual investors will find this a practical, well-rounded review of the rules that affect investment-related returns.

CREDIT HOURS 2 | FIELD OF STUDY TAXES | EXAM QUESTIONS 10

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LEARNING ASSIGNMENTS AND OBJECTIVES

Assignment

- Study the full course materials included here.
- Complete the review questions after each chapter.
- Answer 10 final exam questions.
- Final exam is scored immediately, 70% or better passes.
- Certificate of completion is available in your account.
- Failed exams can be retaken free of charge.

Course Objectives

- Recognize the proper tax treatment for various types of investment income.
- Identify limitations on the deductibility of investment expenses.
- Identify how the passive activity and at-risk rules affect the deductibility of investment losses.
- Recall what constitutes the basis of an investment.

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Chapter 1: TAX TREATMENT OF INVESTMENT INCOME

Chapter Objective

After completing this chapter, you should be able to:

- Recognize the proper tax treatment for various types of investment income.

No investment advisor or financial professional can properly recommend any particular investment or investment strategy without a thorough understanding of its tax consequences. This chapter provides information on the tax treatment of investment income. Investment income generally includes interest, dividends, capital gains, and other types of distributions.

I. INTEREST INCOME

In general, any interest that an individual receives or that is credited to an individual's account and can be withdrawn is taxable income.

A. EXCEPTIONS

1. Exempt-Interest Dividends

Form 1099-DIV, box 12, shows exempt-interest dividends from a mutual fund or other regulated investment company paid during the calendar year. Form 1099-DIV, box 13, shows exempt-interest dividends subject to the alternative minimum tax. This amount is included in box 12.

2. Interest on VA Dividends

Interest on insurance dividends that are left on deposit with the Department of Veterans Affairs (VA) is not taxable. This includes interest paid on dividends on converted United States Government Life Insurance policies and on National Service Life Insurance policies.

3. Individual Retirement Arrangements (IRAs)

Interest on a Roth IRA generally is not taxable. Interest on a traditional IRA is tax deferred. Individuals generally do not include it in their income until they make withdrawals from the IRA.

B. TAXABLE INTEREST – GENERAL

Taxable interest includes interest individuals receive from bank accounts, loans they make to others, and other sources. The following are some sources of taxable interest.

1. Dividends That Are Actually Interest

Certain distributions commonly called dividends are actually interest.

Persons must report as interest so- called “dividends” on deposits or on share accounts in:

- Cooperative banks;
- Credit unions;
- Domestic building and loan associations;
- Domestic savings and loan associations;
- Federal savings and loan associations, and
- Mutual savings banks.

The “dividends” will be shown as interest income on Form 1099-INT.

2. Money Market Funds

Money market funds are offered by nonbank financial institutions, such as mutual funds and stock brokerage houses, and pay dividends. Generally, amounts received from money market funds should be reported as dividends, not as interest.

3. Certificates of Deposit and Other Deferred Interest Accounts

When one of these accounts is opened, interest may be paid at fixed intervals of 1 year or less during the term of the account. This generally must be included as interest income when it is actually received or when the individual is entitled to receive it without paying a substantial penalty. The same is true for accounts that mature in 1 year or less and pay interest in a single payment at maturity.

a. Interest Subject to Penalty for Early Withdrawal

If funds are withdrawn from a deferred interest account before maturity, the owner may have to pay a penalty.

Individuals must report the total amount of interest paid or credited to their account during the year, without subtracting the penalty.

b. Money Borrowed to Invest in Certificate of Deposit

The interest paid on money borrowed from a bank or savings institution to meet the minimum deposit required for a certificate of deposit from the institution and the interest earned on the certificate are two separate items.

Individuals must report the total interest earned on the certificate as income. If the individual itemizes deductions, he or she can deduct the interest paid as investment interest, up to the amount of his or her net investment income.

Example

Jane deposited $5,000 with a bank and borrowed $5,000 from the bank to make up the $10,000 minimum deposit required to buy a 6-month certificate of deposit. The certificate earned $575 at maturity in 2026, but Jane received only $265, which represented the $575 Jane earned minus $310 interest charged on her $5,000 loan. The bank gives Jane a Form 1099-INT for 2026 showing the $575 interest earned. The bank also gives Jane a statement showing that she paid $310 interest for 2026. Jane must include the $575 in income. If she itemizes her deductions on Schedule A (Form 1040), she can deduct $310, subject to the net investment income limit.

4. Interest on Insurance Dividends

Interest on insurance dividends left on deposit with an insurance company that can be withdrawn annually is taxable to the individual in the year it is credited to his or her account.

However, if the individual can withdraw it only on the anniversary date of the policy (or other specified date), the interest is taxable in the year that date occurs.

5. Prepaid Insurance Premiums

Any increase in the value of prepaid insurance premiums, advance premiums, or premium deposit funds is interest if it is applied to the payment of premiums due on insurance policies or made available for an individual to withdraw.

6. U.S. Obligations

Interest on U.S. obligations, such as U.S. Treasury bills, notes, bonds, and obligations, issued by any agency or instrumentality of the United States, is taxable for federal income tax purposes.

7. Interest on Tax Refunds

Interest received on tax refunds is taxable income.

8. Installment Sale Payments

If a contract for the sale or exchange of property provides for deferred payments, it also usually provides for interest payable with the deferred payments. Generally, that interest is taxable when it is received. If little or no interest is provided for in a deferred payment contract, part of each payment may be treated as interest.

9. Interest on Annuity Contract

Accumulated interest on an annuity contract sold before its maturity date is taxable.

10. Bonds Traded Flat

If an individual buys a bond at a discount when interest has been defaulted or when the interest has accrued but has not been paid, the transaction is described as trading a bond flat. The defaulted or unpaid interest is not income and is not taxable as interest if paid later. When the individual receives a payment of that interest, it is a return of capital that reduces the remaining cost basis. Interest that accrues after the date of purchase, however, is taxable interest income for the year received or accrued.

C. BELOW-MARKET LOANS

If someone makes a below-market gift or demand loan, he or she must report as interest income any forgone interest from that loan. If an individual receives a below-market loan, he or she may be able to deduct the forgone interest as an expense if the loan proceeds are used for business or investment, but not if it is personal interest. The rules for below-market loans apply to:

- Gift loans;
- Compensation-related loans;
- Corporation-shareholder loans;
- Tax-avoidance loans, and
- Certain loans to qualified continuing care facilities under a continuing care contract

A compensation-related loan is any below-market loan between an employer and an employee or between an independent contractor and a person for whom the contractor provides services.

A tax-avoidance loan is any below-market loan where the avoidance of federal tax is one of the main purposes of the interest arrangement.

The rules that apply to a below-market loan depend on whether the loan is a gift loan, demand loan, or term loan.

A gift loan is any below-market loan where the forgone interest is in the nature of a gift.

A demand loan is a loan payable in full at any time upon demand by the lender. A demand loan is a below-market loan if no interest is charged or if interest is charged at a rate below the applicable federal rate. Ademand loan or gift loan that is a below-market loan is generally treated as an arm's-length transaction in which the lender is treated as having made:

- A loan to the borrower in exchange for a note that requires the payment of interest at the applicable federal rate; and
- An additional payment to the borrower in an amount equal to the forgone interest.

The borrower is generally treated as transferring the additional payment back to the lender as interest. The lender must report that amount as interest income. The lender's additional payment to the borrower is treated as a gift, dividend, contribution to capital, pay for services, or other payment, depending on the substance of the transaction. The borrower may have to report this payment as taxable income, depending on its classification. These transfers are considered to occur annually, generally on December 31. A term loan is any loan that is not a demand loan. A term loan is a below-market loan if the amount of the loan is more than the present value of all payments due under the loan. Alender who makes a below-market term loan other than a gift loan is treated as transferring an additional lump-sum cash payment to the borrower (as a dividend, contribution to capital, etc.) on the date the loan is made. The amount of this payment is the amount of the loan minus the present value, at the applicable federal rate, of all payments due under the loan. An equal amount is treated as original issue discount (OID). The lender must report the annual part of the OID as interest income. The borrower may be able to deduct the OID as interest expense. The following are exceptions to the below-market loan rule:

- The rules for below-market loans do not apply to any day on which the total outstanding amount of loans between the borrower and lender is $10,000 or less. This exception applies only to:
  - Gift loans between individuals if the gift loan is not directly used to buy or carry income-producing assets, and