

Investment Clubs and Taxes

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

Usually the group operates informally with members pledging to pay a regular amount into the club monthly. Some clubs have a committee that gathers information on securities, selects the most promising securities, and recommends that the club invest in them. Other clubs rotate these responsibilities among all their members. Most clubs require all members to vote for or against all investments, sales, exchanges, and other transactions.

IDENTIFYING NUMBER. Each club must have an employer identification number (EIN) to use when filing its return. The club's EIN also may have to be given to the payer of dividends or other income from investments recorded in the club's name. If your club does not have an EIN, get Form SS-4, Application for Employer Identification Number, from your nearest Social Security Administration office or by calling 1-800-TAX-FORM (1-800-829-3676). Mail the completed Form SS-4 to the Internal Revenue Service Center where you file the club's tax return.

INVESTMENTS IN NAME OF MEMBER. When an investment is recorded in the name of one club member, this member must give his or her social security number to the payer of investment income. (When an investment is held in the names of two or more club members, the social security number of only one member must be given to the payer.) This member is considered as the record owner for the actual owner, the investment club. This member is a "nominee" and must file an information return with the IRS. For example, the nominee member must file Form 1099-DIV for dividend income, showing the club to be the owner of the dividend, his or her social security number, and the EIN of the club.

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

Clubs formed before 1997. Before 1997, the rules for determining how an investment club is treated were different from those explained in the following discussions. An investment club that existed before 1997 is treated for 1997 and later years the same way it was treated before 1997, unless it chooses to be treated a different way under the new rules. To make that choice, the club must file Form 8832, Entity Classification Election.

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

CLUB FILES FORM 1065. If your investment club is treated as a partnership, it must file Form 1065. However, as a partner in the club, you must report on your individual return your share of the club's income, gains, losses, deductions, and credits for the club's tax year. (Its tax year generally must be the same tax year as that of the partners owning a majority interest.) You must report these items whether or not you actually receive any distribution from the partnership. You should receive a copy of Schedule K-1 (Form 1065), Partner's Share of Income, Credits, Deductions, Etc., from the partnership. The amounts shown on Schedule K-1 are your share of

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the partnership's income, deductions, and credits. Report each amount on the appropriate lines and schedules of your income tax return.

The club's expenses for producing or collecting income, for managing investment property, or for determining any tax are listed separately on Schedule K-1 and can be deducted by the individual partners if the partners itemize their deductions on Schedule A (Form 1040). These expenses are listed on line 22 of Schedule A along with other miscellaneous deductions subject to the 2% limit. See chapter 3 for more information.

If you are treating partnership items on your tax return differently from the way the partnership reported the items on its return, you must complete Form 8082, Notice of Inconsistent Treatment or Administrative Adjustment Request (AAR), and attach it to your tax return. For more information about reporting your income from a partnership, see the Schedule K-1 instructions. For more information about the tax treatment of partnership items and a partner's tax return, see Publication 541, Partnerships.

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

NO SOCIAL SECURITY COVERAGE FOR INVESTMENT CLUB EARNINGS. If an investment club partnership's activities are limited to investing in savings certificates, stock, or securities, and collecting interest or dividends for its members' accounts, a member's share of income is not earnings from self employment. You cannot voluntarily pay the self employment tax to increase your social security coverage and ultimate benefits. For more information on self employment tax, see Publication 533, Self Employment Tax.

CHOOSING NOT TO BE TREATED AS A PARTNERSHIP. An unincorporated club used only for investment purposes, and not for the active conduct of a business, can choose not to be treated as a partnership if all the partners agree. It can choose either:

1. To be taxed as a corporation, as explained later, or
2. Not to be treated as a separate entity.

To make the choice in (2), above, the club must file a partnership return, Form 1065, for the first year for which it does not want to be treated as a partnership. The return must be filed by the due date, including extensions, for filing the return. This return should show only the name or other identification and the address of the club. A separate statement must be attached to the return showing the following information:

1. The names, addresses, and identification numbers of all the members of the club,
2. A statement that the club is used for investment purposes only and that its members can figure their income without figuring partnership taxable income,
3. A statement that the club is an investing partnership,

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4. Information about where to obtain the terms of the agreement, written or oral, under which the club operates, and
5. A statement that all the members of the club have chosen the exclusion from partnership treatment.

If the investment club makes this choice, Form 1065 need not be filed for later years, but the members must report their share of income, deductions, and credits on their individual returns. The members can deduct their share of investment expenses, as miscellaneous deductions subject to the 2% limit, on Schedule A (Form 1040) if they itemize their deductions. The choice remains in effect as long as the club qualifies, or until the IRS approves the club's application to change the choice.