MAXIMIZING RETURNS, PART 2: TAX CONSIDERATIONS FOR INVESTING

By Clark M.Blackman II and Ellen J. Boling

Intelligent investing requires some knowledge of those tax rules that will have an impact on your returns. Part 2 in a series on fundamental tax rules.

Taxes shouldn't be your only concern when making investment decisions. But they do have a big impact on your bottom line, and in the end it is what's left over that really counts. All investors need to keep in mind a few basic tax rules in order to maximize what they keep.

This column is the second part of a two-part series on fundamental tax rules every investor should know.

PUTS AND CALLS

A put is an option that gives the put owner the right to **sell** a set number of shares within a certain time frame at a specified price. A call, on the other hand, is an option that gives the call owner the right to **buy** a set number of shares within a certain time frame at a specified price.

Let's look at the tax consequences if you are the owner of either a put or a call.

If you exercise the put, you are selling stock at a pre-determined price to the investor who sold you the put. You exercise the put when the stock price has declined and you realize a gain on the spread between the put's exercise price and the stock's lower fair market value. The cost of the put option is subtracted from the proceeds of selling the related stock, which reduces your total profit.

If you exercise a call option, you are buying stock at a pre-determined price from the investor who sold you the call. You exercise the call when the stock price has increased and you realize a gain between the call's exercise price and the stock's higher fair market value. The cost of the call option is added to your cost basis of the stock acquired. This, too, will ultimately reduce your taxable gain when the stock is later sold.

If you do not exercise the options you have purchased and they expire, the loss is treated as a short-term capital loss.

Alternatively, let's consider the result if you are the seller (writer) of either a put or a call option. Let's also assume that you own the shares of stock on which you are selling the call options (a "covered" call).

If the call option you sold is exercised, you are required to sell shares to the holder of the option. The income you received from selling the option increases the amount of proceeds you realize from the stock sale; it is short- or long-term gain or loss depending on the holding period of the underlying stock sold.

If the put option is exercised, you are required to buy shares from the option holder at the specified price. The income you received from selling the option is added to your cost basis of the shares you have to buy. Whether this income is taxed as short-term or long-term gain depends on how long you own the stocks before you ultimately sell.

If the options you have sold expire without being exercised by the buyer, the gain is treated as a short-term capital gain upon expiration, regardless of the holding period.

Clark M. Blackman II, CPA/PFS, CFA, CFP, is managing director of Post Oak Capital Advisors, Inc., in Houston. Ellen J. Boling, CFP, is director of Financial Counseling Services for Deloitte & Touche LLP in Cincinnati.

Further complications may arise if "straddle" rules apply. These rules are beyond the scope of this article and will be addressed in a future article on "equity collars."

SMALL BUSINESS INVESTMENT

If you invest in qualified small business stock (QSBS), there are special tax rules regarding capital gains upon sale. To qualify as a qualified small business stock, the stock must have been purchased at its original issue date (either directly or through an underwriter), and the issuance must have occurred after August 10, 1993. Qualified small business stock is C Corporation stock of a domestic company whose assets do not exceed $50 million as of the date of issuance.

The special tax rules state that if you realize a capital gain upon sale or exchange of qualified small business stock, and you held the stock for more than five years, you can exclude 50% of the gain. This exclusion is limited to the greater of $10 million of gain or 10 times your basis in the stock. The remaining gain is taxed at a rate of 28%.

Alternatively, if you have owned the original small business stock for more than six months, you can elect to roll over any capital gain. A rollover is allowed if within 60 days from the sale of qualified small business stock, other qualified small business stock is purchased.

To the extent that sale proceeds exceed the cost of the replacement stock, a gain is recognized on the rollover. The basis of the acquired qualified small business stock is reduced by any gain deferred and the holding period includes the holding period of the qualified small business stock sold.

PASSIVE LOSSES

A passive activity is one that involves a pass-through entity that conducts a trade or business in which you do not materially participate. Therefore, this does not include situations where you own stock in a C Corporation. Any rental activity is a passive activity regardless of your level of participation. The rules regarding passive losses are applied on a year-by-year basis. Therefore, whether an activity is considered passive or non-passive can change year-to-year as a result of the changes in your level of participation. These rules apply to individuals, estates, and trusts, as well as personal service corporations.

There are several tests to determine whether you have materially participated in an activity. Four of the most often used are:

- You participated more than 500 hours in the activity during the year;
- You participated more than 100 hours and no other individual participated more than you;
- Your participation constitutes substantially all of the participation in the activity; or
- You materially participated in any five of the last 10 preceding tax years.

The tax rules regarding passive losses allow that passive losses can only be used to offset passive income. They cannot be used to offset non-passive income, which includes items such as wages, interest, and dividends.

An activity is considered a rental activity if tangible property that is associated with the activity is used by customers, or held for use by customers, and the income received by the activity is income received as a result of the property being used. The most common example of this is rental real estate.

For rental activities, there is a special rule allowing the use of passive losses. If you actively participate in the activity, up to $25,000 of losses is allowed as an offset to your non-passive income. The active participation requirement may be satisfied if you participate in making management decisions (such as deciding rental terms) or arrange for others to provide services (such as repairs). Note the significant difference between "active" participation and "material" participation. A phase-out of this allowance begins when your adjusted gross income reaches $100,000. The allowance is completely phased out at $150,000 of adjusted gross income.

Any disallowed loss is "suspended" and carried forward to a future tax year. These suspended losses become fully deductible in the year that there is a complete disposition of the activity (through sale of the investment or dissolution of the activity). However, suspended losses can be fully deductible in a partial disposition, if substantially all of the activity is disposed of. If there is not a complete disposition of substantially all the interest, depending on the level of participation, the loss will be considered either passive or non-passive. Passive losses first offset passive income, and any remaining passive losses can offset non-passive income.

Losses are further limited by the at-risk rules. These rules state that the deductibility of a loss is limited to the amount that the taxpayer is personally "at-risk" with respect to that activity. The at-risk rules generally limit the deduction of a loss to the amount of contributed cash or the adjusted basis of property contributed by the investor, in addition to any debt for which the investor is personally liable. In a partnership investment if the partnership has a liability for which the partner is not liable, the partner is not at-risk to the extent of that debt.

You need to be alert to the tax consequences when your basis in an activity is negative. Negative basis reflects deductions and losses that were previously allowed for income tax purposes but which exceed your contributions to the investment (cash, property). So, if upon dissolution a partner receives a distribution and has negative basis, taxable income must be recognized equal to the sum of the distribution received

plus the amount of the negative basis account. For example, assume you received $10,000 from the sale of a passive activity and had a negative capital account of $30,000. You would have taxable income of $40,000 to report on your tax return for the year of disposition.

From a planning perspective, it is possible to get a double tax benefit based on the timing of disposition of a passive activity. If you have capital losses, or a capital loss carryover, they can be used to offset the capital gain that is generated from the sale of the activity. In addition, any suspended losses that have arisen from the activity are released that year and may be used to offset *other income*.

INVESTMENT INTEREST

Interest paid on debt to acquire investments yielding certain investment income is known as investment interest expense. The following types of income generally constitute investment income for this purpose:

- Interest;
- Ordinary dividends;
- Annuities;
- Royalties not derived from the ordinary course of business; and
- Net income from certain passive activities.

Investment interest is deductible for federal income tax purposes as an itemized deduction, but only to the extent of net investment income. The disallowed investment interest expense is carried forward to future tax years.

Net investment income is the excess of investment income over investment expenses. Net capital gains are excluded from this computation. However, a taxpayer could elect to include capital gains for purposes of claiming a larger investment interest expense deduction, but the gains would no longer be eligible for the favorable capital gain income tax rates. In essence, the benefit of your deduction could fall from a top rate of 39.6% (if that is your marginal tax bracket) to the long-term capital gain rate of 20%. This may occur because the deductible interest expense would be offsetting long-term capital gain income rather than other ordinary income in a future year.

Any interest expense related to a rental real estate activity in which the taxpayer actively participates, or is taken into account when computing income or loss from a passive activity is not eligible for investment interest expense treatment.

The investment interest expense deduction may be reduced if your investment portfolio contains both taxable and tax-exempt securities. Merely tracing the proceeds of the debt to acquisition of taxable investments in the portfolio is not sufficient to satisfy the rules to allow a full interest deduction. The allowable deduction is calculated by multiplying the amount of investment interest expense by the ratio of the average amount of the portfolio’s tax-exempt securities (valued at their adjusted basis), to the average amount of the entire portfolio (valued at its adjusted basis). If this ratio yields a percentage less than 2%, no reduction is required.

ALTERNATIVE MINIMUM TAX

The alternative minimum tax (AMT) is a way to ensure that a minimum amount of tax is paid by all corporate and individual taxpayers. Without the alternative minimum tax, it would be possible for some taxpayers to pay little or no tax at all due to available tax breaks.

The alternative minimum tax is calculated by adding back certain adjustments and “preference” items to your adjusted gross income less itemized or standard deductions. A portion of your alternative minimum taxable income may be exempt from tax depending on your income level and filing status. The alternative minimum tax rates are 26% and 28%. Once your alternative minimum tax is calculated, you compare it to your tax liability for regular tax purposes. You then pay the higher of the alternative minimum tax or your regular tax.

Many investments can have an impact on the calculation of alternative minimum tax. Several are discussed below.

Capital Gain Property: Your tax basis in an investment may be different for regular and alternative minimum tax purposes. Consequently, the amount of gain or loss from disposition may be different. For alternative minimum tax purposes, long-term capital gain property is taxed at the same rate as for regular tax purposes. An example of this is a share of stock acquired by exercising an incentive stock option, which is explained further below. Another is rental real estate, which may have different depreciation methods used for alternative minimum tax versus regular tax.

Passive Activities: For passive activities, the same basic rules apply as for regular tax. However, one difference exists for taxpayers that are insolvent (where liabilities exceed the fair market value of assets). Generally, they are not required to add back passive activity losses to the alternative minimum taxable income. For insolvent taxpayers, the amount of passive activity loss allowed for alternative minimum tax purposes can be increased by the amount that liabilities exceed the fair market value of the assets.

Incentive Stock Options: The profit, or “bargain element,” of an incentive stock option at the time of exercise is subject to alternative minimum tax, even though that income is not subject to regular tax. The amount that is included in alternative minimum taxable income is determined when the rights to stock are not subject to substantial risk of forfeiture, as well as when the rights are freely transferable.

The amount that should be included is the excess of the fair market value at that point over the actual price paid by the taxpayer for the incentive stock option. As a result of this, the cost basis of a share of stock acquired by exercising an employer incentive stock option is the fair market value on date of exercise for alternative minimum tax purposes, while for regular tax purposes it is the exercise cost.

Small Business Stock: As previously discussed, there are special tax rules regarding the capital gain realized upon the sale or exchange of qualified small business stock (QSBS). These special rules provide a benefit for regular income tax purposes, but can have a negative impact when looking at the alternative minimum tax. For alternative minimum tax purposes, 42% of the gain that is excludable for regular income tax purposes, must be added back to compute alternative minimum taxable income.

Investment Interest Expense: For alternative minimum tax purposes, net investment income is not recomputed until all the AMT adjustments and preferences are accounted for. Also, net investment income includes interest income from "private-activity" municipal bonds issued after August 7, 1986. This allows for an increase in the allowable interest expense deduction as well. Interest expense for alternative minimum tax purposes includes home equity indebtedness used to invest in stocks or bonds, as well as interest paid to carry private-activity bonds issued after August 7, 1986.

Specified Private Activity Bonds: These bonds are municipal bonds issued after August 7, 1986, for the purpose of financing specified business activities. The interest received from these bonds is added back to the taxpayer's regular adjusted gross income to compute alternative minimum taxable income.

If you do not owe any income taxes, be sure to run through IRS Form 6251 to make sure you are not subject to this alternative tax.

Once you've run through that procedure, you will probably then be prompted to call your congressman to share your thoughts on how they might simplify your taxes. ✦