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Special Concerns

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Which special concerns impact investment tax planning?

Congress has created a variety of rules to limit your ability to manipulate the tax laws to your favor. Although many rules attack abusive tax situations, some rules provide tax benefits for particular investments. Special concerns (regarding investment tax planning) typically involve income timing rules, income characterization concerns, and small business issues.

Timing rules

To a certain extent, investors can control the timing of taxation on their investments. Indeed, many investment devices allow you to defer taxation. Special rules apply to some timing-driven vehicles.

Wash sale rule

A wash sale occurs when you sell (or otherwise dispose of) a security, or a contract or option to acquire or sell such security, at a loss and then reacquire the same or a substantially similar security within a period beginning (with some exceptions) 30 days before the date of the sale or exchange and ending 30 days after the date of the sale or exchange. Generally, if you repurchase the same or similar security shortly after the loss sale, the loss is disallowed and added to the basis of the newly purchased securities.

Short sales

When you engage in a short sale, you borrow shares from your broker and sell them on the market. If the price goes down, you make a profit by buying shares to cover or replace the borrowed shares. If you own shares of a certain stock and sell an equal amount of the same shares short, you are said to be "short against the box." The short sale rules attempt to prohibit use of this transaction for abusive tax purposes. Short sale gains are generally treated as short-term capital gains.

Tax shelters

Tax shelters seek to avoid the taxation of income by generating tax losses sufficient to offset the income. The IRS aggressively polices tax shelter programs. In addition to a variety of tax rules that disallow particular tax shelter losses, significant reporting requirements exist. In a very general sense, you might think of an investment vehicle as (primarily) a tax shelter if it is tax-driven and not investment-driven.

Income characterization concerns

Because capital gain tax rates are favorable, investors often try to convert ordinary income into capital gain income. Investors sometimes design transactions to disguise or convert ordinary income improperly; therefore, Congress has created rules to curtail improper transactions.

Market discount rule

The market discount rule recharacterizes certain gains on bonds as ordinary income. The market discount is the spread or difference between market purchase price and redemption price.

Anti-conversion rule

The anti-conversion rule prohibits recasting a loan transaction as a sale. Generally, this involves the sale of an asset and a simultaneous agreement to repurchase the asset at a predetermined price.

Small business concerns

Qualifying small business stock rules

If a five-year holding period is met, qualified investors can exclude 50 percent (75 percent for stock issued after February 17, 2009 and before September 28, 2010; 100 percent for stock issued after September 27, 2010) of gain on the sale of stock in a qualified small business. A qualified small business must be a C corporation that is engaged in an active trade or business and not devoted to professional services, such as banking, or agriculture.

Specialized small business investment companies (SSBIC)

Subject to certain limitations, individual investors may defer taxation on investment gains reinvested in SSBICs. The reinvestment must occur within 60 days of the gain transaction. The deferral occurs by adjusting downward the basis of the SSBIC stock. In addition, gain on stock in an SSBIC may also qualify for the 50 percent (75 percent for stock issued after February 17, 2009 and before September 28, 2010; 100 percent for stock issued after September 27, 2010) exclusion of gain available to qualified small businesses.

Other

Other special concerns include installment sales and like-kind exchanges.

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