Tax Impact

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Tax Tips

4 tax-smart techniques for mutual fund investors

Many people overlook tax considerations when planning their mutual fund investments. Here are four tips that can help you improve tax efficiency and avoid costly tax traps:

1. Avoid year-end investments. Typically, mutual funds distribute accumulated dividends and capital gains toward the end of the year. It's wise to avoid investing in a fund shortly before such a distribution. Why? Because you'll end up paying taxes on gains you didn't share in.

Don't fall for the common misconception that investing in a fund just before a distribution date is like getting "free money." True, you'll receive a year's worth of income right after you invest, but the value of your shares will immediately drop by the same amount, so you won't be any better off. Plus, you'll be liable for taxes on the distribution as if you had owned your shares all year.

You can get a general idea of when a particular fund anticipates making a distribution by checking its website periodically. It's also important to make a note of the "record date" — because investors who own shares of the fund on that date will participate in the distribution.

When it comes to tax efficiency, not all funds are created equal.

2. Invest in tax-efficient funds. When it comes to tax efficiency, not all funds are created equal. Actively managed funds tend to be less tax efficient — that is, they buy and sell securities more frequently, generating a greater amount of capital gain, much of it short-term gain taxable at ordinary income rates. To reduce your tax liability, consider investing in tax-efficient funds, such as index funds, which generally have lower turnover rates, and "passively managed" funds (sometimes described as "tax managed" funds), which are designed to minimize taxable distributions.

Another option is exchange-traded funds (ETFs). Unlike mutual funds, which generally redeem shares by selling securities, ETFs are often able to redeem securities "in kind" — that is, to swap them for other securities. This limits an ETF's recognition of capital gains, making it more tax efficient.

Accounting for cost basis

If, like most people, you buy mutual fund shares at different times for different prices, the method you select to account for your cost basis can have a big impact on your tax bill. There are three methods to choose from:

First-in, first-out (FIFO). Under this method, it's assumed that the first shares purchased are the first shares sold, but, if the value of your shares increases over time, this method will increase your taxes because older shares have a lower basis.

Specific identification. This method provides more control over the tax consequences of your transactions. Each time you sell mutual fund shares, you specify which shares are to be sold. It's more work, but it enables you to select the shares that will provide the greatest tax benefits. Some mutual fund companies offer plans under which they select the shares that minimize your tax liability.

Average cost. This method typically generates taxes falling somewhere between FIFO and specific identification. On the plus side, it's simple to use and has the advantage of distributing your tax liability evenly over time.

This isn't to say that tax-*inefficient* funds don't have a place in your portfolio. In some cases, actively managed funds may offer benefits, such as above-market returns, that outweigh their tax costs.

3. Hold tax-inefficient funds in nontaxable accounts. If you invest in actively managed or other tax-inefficient funds, ideally you should hold them in nontaxable accounts, such as traditional IRAs or 401(k) plan accounts. Because earnings in these accounts are tax-deferred, distributions from funds they hold won't have any tax consequences until you withdraw them. And if the funds are held in a Roth account, those distributions will escape taxation altogether.

4. Watch out for reinvested distributions. Many investors elect to have their distributions automatically reinvested in their funds. But it's important to remember that those distributions are taxable regardless of whether they're reinvested or paid out in cash.

Reinvested distributions increase your cost basis in a fund, so it's critical to track your basis carefully to avoid double taxation. If you fail to account for these distributions, you'll end up paying tax on them twice — once when they're paid and again when you sell your shares in the fund.

Fortunately, under current rules, mutual fund companies are required to track your basis for you. But you still may need to track your basis in funds you owned before 2012, when this requirement took effect. Also, even if a fund is tracking your basis, there are several accounting methods available, and it's important to elect the one that's most effective for you. (See "Accounting for cost basis" above.)

Do your homework

It's important to do your due diligence on the funds you're considering, particularly for your taxable accounts. Examine a fund's history of making taxable distributions, its tax-cost ratio and other data that reflect the fund's tax efficiency. And don't assume that a fund that historically has been tax efficient will stay that way in the future. Monitor your funds for changing circumstances that may lead to larger taxable distributions in the future. ■

Educate your children on wealth management

If you've worked a lifetime to build a large estate, you undoubtedly would like to leave a lasting legacy to your children and future generations. Educating your children about saving, investing and other money management skills can help keep your legacy alive.

Teaching techniques

There's no one right way to teach your children about money. The best way depends on your circumstances, their personalities and your comfort level.

If your kids are old enough, consider sending them to a money management class. For younger children, you might start by simply giving them an allowance in exchange for doing household chores. This helps teach them the value of work. And, after they spend the money all in one place a few times and don't have anything left for something they *really* want, it teaches them the value of saving. Opening a savings account or a CD, or buying bonds, can help teach kids about investing and the power of compounding.

For families that are charitably inclined, a private foundation can be a great vehicle for teaching children about the joys of giving and the impact wealth can make beyond one's family. For this strategy to be effective, children should have some input into the foundation's activities. When the time comes, this can also be a great way to get your grandchildren involved at a very young age.

Timing and amount of distributions

Many parents take an all-or-nothing approach when it comes to the timing and amounts of distributions to their children — either transferring substantial amounts of wealth all at once or making gifts that are too small to provide meaningful lessons.

Consider making distributions large enough so that your kids have something significant to lose, but not so large that their entire inheritance is at risk. For example, if your child's trust is worth $2 million, consider having the trust distribute $200,000 when your son or daughter reaches age 21. This amount

is large enough to provide a meaningful test run of your child's financial responsibility while safeguarding the bulk of the nest egg.

Or maybe you want to encourage financial success by making matching gifts equal to the amount of income your children earn each year. Be careful, though, not to accidentally dissuade your beneficiaries from pursuing other worthwhile though less financially rewarding endeavors.

Introduce incentives, but remain flexible

An incentive trust is a trust that rewards children for doing things that they might not otherwise do. Such a trust can be an effective estate planning tool, but there's a fine line between encouraging positive behavior and controlling your children's life choices. A trust that's too restrictive may incite rebellion or invite lawsuits.

Incentives can be valuable, however, if the trust is flexible enough to allow a child to chart his or her own course. A so-called "principle trust," for example, gives the trustee discretion to make distributions based on certain guiding principles or values without limiting beneficiaries to narrowly defined goals. But no matter how carefully designed, an incentive trust won't teach your children critical money skills.

Communication is key

To maintain family harmony when leaving a large portion of your estate to your children, clearly communicate the reason for your decisions. Contact your estate planning advisor for more information. ■

New rules limit tax benefits of leveraged partnerships

In October 2016, the IRS issued a suite of final, temporary and proposed regulations that tighten the disguised sale rules for contributions of appreciated property to partnerships.

One of the most significant changes made by the new rules effectively eliminates the ability of partners to defer gain on contributed property by taking advantage of leveraged partnership transactions. These rules apply to partnerships as well as to limited liability companies (LLCs), which are taxed as partnerships.

Disguised sales unmasked

Ordinarily, a partner doesn't recognize gain when he or she contributes property to a partnership. In addition, distributions from a partnership to a partner are generally tax-free to the extent of the partner's basis in his or her partnership interest. The disguised sale rules are designed to prevent partners from avoiding current taxation of what essentially is a sale of appreciated property by characterizing it as a contribution followed by an unrelated distribution.

The rules are complex. But in a nutshell, they treat a contribution and distribution as a single, taxable sale if 1) the partnership wouldn't have made the distribution but for the contribution, and 2) the transfers aren't simultaneous. In this case, the subsequent transfer isn't subject to the "entrepreneurial risks" of partnership operations.

Generally, absent evidence to the contrary, contributions and distributions within two years of each other are presumed to be disguised sales.

Exception for leveraged partnerships

There are several exceptions to the disguised sale rules, most notably the debt-financed distribution exception. Under this exception, if the partnership distributes borrowed funds to a partner who contributes property, the transaction is treated as a disguised sale only to the extent the distribution exceeds the partner's allocable share of that debt.

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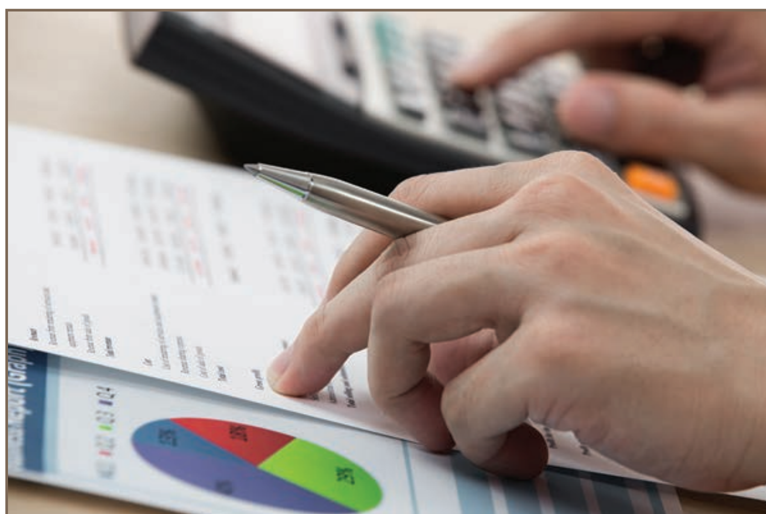
Prior to the new rules, a partner could use a leveraged partnership transaction to tap his or her equity in contributed property without triggering current taxation. To accomplish this, the partner would guarantee the partnership's debt, rendering it recourse debt as to the partner, which is fully allocable to him or her. The new rules essentially eliminate the benefits of leveraged partnership transactions by providing that, for disguised sale purposes, such debt must be treated as *nonrecourse*, which is generally allocable among the partners according to their respective shares of the partnership's profits.

Here's an example that illustrates the impact of the new rules. Ron forms a partnership with several other partners, contributing property with a fair market value of $2 million and an adjusted basis of $400,000. The contribution doesn't trigger taxable gain, and Ron's adjusted basis in his partnership interest is $400,000. Two months later, the partnership borrows $1.6 million and distributes the funds to Ron, who has personally guaranteed the loan. Because the debt is recourse with respect to Ron, the entire amount is allocable to him, increasing his adjusted basis to $2 million. Ordinarily, this transaction would be treated as a disguised sale, resulting in a $1.6 million gain to Ron. Under the old rules, however, the debt-financed distribution exception would apply, allowing Ron to avoid current taxation. (Keep in mind, however, that the distribution reduces Ron's basis to $400,000, so the tax is deferred rather than eliminated.)

Under the new rules, Ron's guarantee is disregarded for disguised sale purposes, so the debt is treated as nonrecourse. Thus, Ron's $1.6 million distribution is taxable to the extent it exceeds his $400,000 adjusted basis plus his allocable share (based on his percentage of partnership profits) of the debt.

Assess the impact

Partnerships should evaluate the impact of the new rules on their tax planning strategies. In addition to limiting the value of leveraged partnerships, the rules make several other changes to the disguised sale rules and modify the way partnership liabilities are allocated outside the disguised sale context. ■



Watch out for tax scams

With tax season in full swing, criminals posing as IRS officials are stepping up their efforts to steal taxpayers' money or personal information. To protect yourself, keep in mind that IRS officials will never contact you by email or text seeking personal or financial information. Nor will they use aggressive collection tactics, such as threatening legal action or demanding immediate payment by credit card over the phone. Generally, when launching collection procedures or an audit, the IRS will initiate contact by mail, not telephone.

Here are a few common scams to look out for:

- Aggressive IRS impersonators call taxpayers, claiming that they owe money to the government that must be paid promptly through a preloaded debit card or wire transfer. Those who refuse to cooperate are threatened with arrest and other legal actions. Callers sound convincing, use fake names and IRS ID badge numbers, and alter the caller ID to make it appear that the IRS is calling.
- Thieves send phishing emails that appear to be from the IRS that contain links to a fake IRS website and instruct recipients to update their IRS e-files immediately.
- Scammers posing as the Taxpayer Advocacy Panel (TAP) send emails that purport to be about a tax refund in an effort to trick victims into providing personal and financial information.

If you receive suspicious emails, don't respond to them or click on any of the links. Instead, forward them to phishing@irs.gov. Contact your tax advisor if you have questions about suspicious IRS claims. ■

Check your IRS account online

Recently, the IRS launched an online tool that lets you check your account balance, including taxes due, penalties and interest. To use this service, you'll need to complete a registration process that takes about 15 minutes and requires an email address, a text-enabled mobile phone in your name and certain taxpayer account information. Each time you log in, the site will verify your identity by requiring a code sent via text or email.

For more information, visit irs.gov. (Under the "Payments" tab, click on the link under "Check Your Balance Due.") ■

Using a charitable trust for college expenses

If you're charitably inclined, a charitable remainder trust (CRT) can be a surprisingly effective tool for financing college expenses. To use this strategy, you set up an irrevocable trust that provides an annual income stream to your child or other beneficiary during college. (The income stream must be no less than 5% and no more than 50%, and is subject to other limitations.) The payout percentage is a function of the value of the trust, calculated either as of the time the trust is created or recalculated each year, depending on the type of CRT. At the end of the trust term, the remaining assets are transferred to a qualified charity. You enjoy a charitable deduction based on the value of the charity's interest, and your beneficiary receives money for college, taxed at his or her tax rate. And if you donate appreciated stock or other property to the CRT, the trustee can sell it and reinvest the proceeds without immediately triggering capital gains taxes. The capital gains, however, may eventually be passed through to the beneficiary. ■

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