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Tax & Business Alert

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HOW TO BE TAX-SMART WHEN IT COMES TO MUTUAL FUNDS

Mutual funds are so common these days that many people overlook the tax considerations involved. Here are some tips on how to be tax-smart with these investment vehicles.

AVOID YEAR-END INVESTMENTS

Typically, mutual funds distribute accumulated dividends and capital gains toward the end of the year. It's generally 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 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 participate in the distribution.

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 gains, much of it short-term gains 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.

BUT DON'T IGNORE TAX-INEFFICIENT FUNDS

Tax-inefficient funds may have a place in your portfolio. In some cases, actively managed funds may offer

REINVESTED DISTRIBUTIONS CAN LEAD TO DOUBLE TAXATION

Many investors elect to have their distributions automatically reinvested in their mutual 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 could end up paying tax on them twice — once when they're paid and again when you sell your shares in the fund.

benefits, such as above-market returns, that outweigh their tax costs.

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, qualifying distributions will escape taxation altogether.

MAKE NO ASSUMPTIONS

It's important to do your due diligence on mutual funds. Don't assume that a fund that historically has been tax efficient will stay that way in the future. Feel free to contact our firm for help. ■

DEDUCTING HOME EQUITY INTEREST UNDER THE TAX CUTS AND JOBS ACT

Passage of the Tax Cuts and Jobs Act (TCJA) in December 2017 has led to confusion over some longstanding deductions. In response, the IRS recently issued a statement clarifying that the interest on home equity loans, home equity lines of credit and second mortgages will, in many cases, remain deductible.

HOW IT USED TO BE

Under prior tax law, a taxpayer could deduct "qualified residence interest" on a loan of up to $1 million secured by a qualified residence, plus interest on a home equity loan (other than debt used to acquire a home) up to $100,000. The home equity debt couldn't exceed the fair market value of the home reduced by the debt used to acquire the home.

For tax purposes, a qualified residence is the taxpayer's principal residence and a second residence, which can be a house, condominium, cooperative, mobile home, house trailer or boat. The principal residence is where the taxpayer resides most of the time; the second residence is any other residence the taxpayer owns and treats as a second home. Taxpayers aren't required to use the second home during the year to claim the deduction. If the second home is rented to others, though, the taxpayer also must use it as a home during the year for the greater of 14 days or 10% of the number of days it's rented.

In the past, interest on qualifying home equity debt was deductible regardless of how the loan proceeds were used. A taxpayer could, for example, use the proceeds to pay for medical bills, tuition, vacations, vehicles and other personal expenses and still claim the itemized interest deduction.

WHAT'S DEDUCTIBLE NOW

The TCJA limits the amount of the mortgage interest deduction for taxpayers who itemize through 2025.

Beginning in 2018, for new home purchases, a taxpayer can deduct interest only on acquisition mortgage debt of $750,000.

On February 21, the IRS issued a release (IR 2018-32) explaining that the law suspends the deduction only for interest on home equity loans and lines of credit that aren't used to buy, build or substantially improve the taxpayer's home that secures the loan. In other words, the interest isn't deductible if the loan proceeds are used for certain personal expenses, but it is deductible if the proceeds go toward, for example, a new roof on the home that secures the loan. The IRS further stated that the deduction limits apply to the combined amount of mortgage and home equity acquisition loans — home equity debt is no longer capped at $100,000 for purposes of the deduction.

FURTHER CLARIFICATIONS

As a relatively comprehensive new tax law, the TCJA will likely be subject to a variety of clarifications before it settles in. Please contact our firm for help better understanding this provision or any other. ■

3 COMMON TYPES OF IRS TAX PENALTIES

Around this time of year, many people have filed and forgotten about their 2017 tax returns. But you could get an abrupt reminder in the form of an IRS penalty. Here are three common types and how you might seek relief:

1. Failure-to-file and failure-to-pay. The IRS will consider any reason that establishes that you were unable to meet your federal tax obligations despite using "all ordinary business care and prudence" to do so. Frequently cited reasons include fire, casualty, natural disaster or other disturbances. The agency may also accept death, serious illness, incapacitation or unavoidable absence of the taxpayer or an immediate family member.

If you don't have a good reason for filing or paying late, you may be able to apply for a first-time penalty abatement (FTA) waiver. To qualify for relief, you must have: 1) received no penalties (other than estimated tax penalties) for the three tax years preceding the tax year in which you received a penalty, 2) filed all required returns or filed a valid extension of time to file, and 3) paid, or arranged to pay, any tax due. Despite the expression "first-time," you can receive FTA relief more than once, so long as at least three years have elapsed.

2. Estimated tax miscalculation. It's possible, but unlikely, to obtain relief from estimated tax penalties on grounds of casualty, disaster or other unusual circumstances. You're more likely to get these penalties abated if you can prove that the IRS made an error, such as crediting a payment to the wrong tax period, or that calculating the penalty using a different method (such as the annualized income installment method) would reduce or eliminate the penalty.

3. Tax-filing inaccuracy. These penalties may be imposed, for example, if the IRS finds that your return was prepared negligently or that there's a substantial understatement of tax. You can obtain relief from these penalties if you can demonstrate that you properly disclosed your tax position in your return and that you had a reasonable basis for taking that position.

Generally, you have a reasonable basis if your chances of withstanding an IRS challenge are greater than 50%. Reliance on a competent tax advisor greatly improves your odds of obtaining penalty relief. Other possible grounds for relief include computational errors and reliance on an inaccurate W-2, 1099 or other information statement. ■

BEWARE OF TAX TRAPS WHEN MAKING AN EMPLOYEE A PARTNER

In today's competitive employment market, offering an employee an equity interest in your business can be a powerful tool for attracting and retaining top talent. If your company is organized as a partnership, however, beware of the tax traps of doing so.

Employees pay half of the Social Security and Medicare taxes on their wages, through withholdings from their paychecks. The employer pays the other half. Partners, on the other hand, are treated as being self-employed — they pay the full amount of "self-employment" taxes through quarterly estimates.

Often, when employees receive partnership interests, the partnership incorrectly continues to treat them as employees for tax purposes, withholding employment taxes from their wages and paying the employer's share. The problem with this practice is that, because a partner is responsible for the full amount of employment taxes, the partnership's payment of a portion of those taxes could be treated as a guaranteed payment to the partner.

That payment would then be included in income and trigger additional employment taxes. Any employment taxes not paid by the partnership on a partner's behalf are the partner's responsibility.

Treating a partner as an employee can also result in overpayment of employment taxes. Suppose your partnership pays half of a partner's employment taxes and the partner also has other self-employment activities — for example, interests in other partnerships or sole proprietorships. If those activities generate losses, the losses will offset the partner's earnings from your partnership, reducing or even eliminating self-employment taxes.

As you can see, there's much to consider. Please contact our firm before making this move. ■