Bigelow & Company, CPA, PLLC

500 Commercial Street
Manchester, NH 03101
Tel: 603-627-7659
Fax: 603-626-0617

500 Market Street
Portsmouth, NH 03801
Tel: 603-433-7383
Fax: 603-433-7298

Tax & Business Alert

NOVEMBER 2017

HANDLE WITH CARE: MUTUAL FUNDS AND TAXES

Many people overlook taxes when planning their mutual fund investments. But you've got to handle these valuable assets with care. Here are some tips to consider.

AVOID YEAR-END INVESTMENTS

Typically, mutual funds distribute accumulated dividends and capital gains toward the end of the year. But 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. Also make a note of the "record date" — investors who own fund shares on that date will participate in the distribution.

INVEST IN TAX-EFFICIENT FUNDS

Actively managed funds tend to be less tax efficient. 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 rather than the lower, long-term capital gains rates.

Consider investing in tax-efficient funds instead. For example, index funds generally have lower turnover rates. And "passively managed" funds (sometimes described as "tax managed" funds) 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.

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.

WATCH OUT FOR REINVESTED DISTRIBUTIONS

Many investors elect to have their distributions automatically reinvested in their funds. Be aware that those distributions are taxable regardless of whether they're reinvested or paid out in cash.

DIRECTING TAX-INEFFICIENT FUNDS INTO NONTAXABLE ACCOUNTS

If you invest in actively managed or other tax-inefficient funds, ideally you should put these holdings in nontaxable accounts, such as a traditional IRA or 401(k). 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.

Reinvested distributions increase your tax basis in a fund, so track your basis carefully. 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, or if you purchased units in the fund outside of the current broker holding your units.

DO YOUR DUE

Tax considerations should never be the primary driver of your investment decisions. Yet it's important to do your due diligence on the potential tax consequences of funds you're considering — particularly for your taxable accounts. ■

BAD DEBTS AREN'T ALWAYS BAD NEWS

The IRS defines a business bad debt as "a loss from the worthlessness of a debt that was either created or acquired in a trade or business or closely related to your trade or business when it became partly to totally worthless." Although no business owner goes out of his or her way to acquire a bad debt, they're not always bad news.

THE SILVER LINING

Indeed, there's a potential silver lining to bad debts. In certain situations, you can deduct uncollected debts from your business income, which may reduce your tax liability.

One requirement for a deduction generally is that the amount of the bad debt was previously included in your income. This effectively means that only businesses that use accrual-basis accounting can deduct bad debts.

Cash-basis businesses generally can't deduct bad debts because they haven't previously reported the debt as income. So they can't claim a bad debt deduction simply because someone failed to pay a bill. But they may be able to claim a bad debt deduction if they've made a business-related loan that became uncollectible.

WHAT MAY BE DEDUCTIBLE

The IRS lists the following examples of potentially deductible bad debts:

- Credit sales to customers,
- Loans to clients and suppliers, and
- Business loan guarantees.

Bankruptcy is a common reason a business might determine that a debt is uncollectible and should be written off. For example, suppose a customer files for bankruptcy and states that the liquidation value of its assets is less than the amount owed to its primary lien holder. Once this customer informs you that your receivable won't be paid, you can generally write off the amount as a bad debt.

There's no standard test or formula for determining whether a debt is a bad debt; it depends on the specific facts and circumstances. To qualify for the deduction, you simply must show that you've taken reasonable steps to collect the debt and there's little likelihood it will be paid. If you have outstanding debts that you don't think will be paid and could be deductible on your 2017 tax return, be sure, if you haven't already, to take steps to try to collect the debt.

WHOLLY VS. PARTIALLY WORTHLESS DEBT

The IRC doesn't define "worthlessness." Courts, however, have defined wholly worthless debts as those lacking both current and potential value. The U.S. Tax Court says that partial worthlessness is evidenced by "some event or some change in the financial condition of the debtor . . . which adversely affects the debtor's ability to make repayment."

In general, you may recover a portion of a partially worthless debt in the future. You never recover any part of a wholly worthless debt.

IMPORTANT TOPIC

The right tax strategy for your company's bad debts is an important topic to consider every year end. Our firm can help you ensure you're taking all the bad debt deductions you're entitled to. ■

PONDERING THE PURCHASE OF A LIFE INSURANCE POLICY

What, if any, role life insurance should play in your financial plan depends on a variety of factors. These include whether you're single or married, if you have minor children or other dependents, and your net worth and estate planning goals. There's also the tax impact to consider. Let's look a little more closely at some of the issues behind whether you should buy a policy.

LOOKING AT YOUR SITUATION

Life insurance is appealing because relatively small payments now can produce a proportionately much larger payout at death. But the fact that the return on the investment generally isn't realized until death can also be a downside, depending on your financial situation and goals.

If you have others depending on you financially, your No. 1 priority is likely ensuring that they will continue to be provided for after you're gone. Life insurance can be a useful tool for achieving this goal.

If you're single and have no dependents, life insurance may be less important or even unnecessary. Perhaps you'll want just enough coverage so that your mortgage can be paid off and your home can pass unencumbered to the designated heir(s) — or just enough to pay your funeral expenses.

ASSESSING YOUR FINANCES

Some people of high net worth may not need life insurance for any of the aforementioned purposes. Nonetheless, it might serve other purposes in their estate plans. For example, a policy can provide liquidity to pay estate taxes without having to sell assets that you want to keep in the family. Or it can be used to equalize inheritances for children who aren't involved

in a family business so that family business interests can go only to those active in the business.

While proceeds are generally income-tax-free to the beneficiary, they'll be included in your taxable estate as long as you're the owner. If your estate might exceed your estate tax applicable exemption amount ($5.49 million for 2017), some or all of the life insurance proceeds could be subject to estate taxes. To avoid this result, consider having someone else own the policy. This can create other tax complications, however, so it's important to consult your tax advisor.

FIGURING OUT YOUR NEEDS

For many people, life insurance is critical to creating financial security for their family or achieving other financial goals. Please contact our firm for specific insight into this important matter. ■

ARE FREQUENT FLYER MILES EVER TAXABLE?

If you recently redeemed frequent flyer miles to treat the family to a fun summer vacation or to take your spouse on a romantic getaway, you might assume that there are no tax implications involved. And you're probably right — but there is a chance your miles could be taxable.

Generally, miles awarded by airlines for flying with them are considered nontaxable rebates, as are miles awarded for using a credit or debit card. The IRS even addressed the issue in Announcement 2002-18, where it said:

> Consistent with prior practice, the IRS will not assert that any taxpayer has understated his federal tax liability by reason of the receipt or personal use of frequent flyer miles or other in-kind promotional benefits attributable to the taxpayer's business or official travel.

There are, however, some types of miles awards the IRS might view as taxable. Examples include miles awarded as a prize in a sweepstakes and miles awarded as a promotion.

For instance, in the 2014 case of *Shankar v. Commissioner*, the U.S. Tax Court sided with the IRS in finding that airline miles awarded in conjunction with opening a bank account were indeed taxable. Part of the evidence of taxability was the fact that the bank had issued Forms 1099 MISC to customers who'd redeemed rewards points to buy airline tickets.

The value of the miles for tax purposes generally is their estimated retail value. If you're concerned you've received miles awards that could be taxable, please contact us. ■