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Client Information Bulletin

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The Tax Tale of Mutual Fund Profits

How to determine taxable gain for 2004 returns

One of the easiest ways to invest in a variety of stocks and bonds is to buy mutual fund shares. However, it isn't so easy to determine the tax consequences if you realize a profit. Here's a quick guide for navigating through the maze of rules.

Reinvestment dividends and capital gains: You pay tax each year on your share of the fund's dividends and gains, even if you reinvest the proceeds in additional shares of the fund. The additional shares are treated as if you had paid for them in cash. As a result, your "basis" in the mutual fund shares includes reinvested amounts as well as your original cost for the shares (including commissions or load charges paid for the purchase).

Complete liquidation: If you sell or redeem all the shares you own in a particular mutual fund, your taxable gain is equal to your proceeds, less your original cost for the shares, less reinvested dividends and gains. If you have held all the shares (including those purchased through reinvestment) for more than one year, your entire profit is **long-term capital gain.**

The maximum tax rate on most long-term capital gains and ordinary divi-

dends realized in 2004 is 15%. However, any short-term gain on shares held for one year or less is taxed at **ordinary income rates.**

Example: You bought 1,000 shares of Giant Mutual Fund for $10,000 ($10 per share) two years ago. Suppose you have picked up 50 additional shares due to dividend reinvestment and you sell all 1,050 shares for $15,750 ($15 per share). Of the 50 additional shares acquired through reinvestment, 25 were acquired 15 months ago when Giant shares were valued at $12; the other 25 were acquired two months ago when the shares were valued at $14. Thus, the reinvestments cost you $650 [(25 shares x $12) + (25 shares x $14)].

Result: You show a $5,100 gain ($15,750 proceeds - $10,000 cost - $650 reinvestments). Of this amount, $25 is short-term gain [($15 - $14) x 25 shares]. The remaining $5,075 is long-term gain.

Partial sales: If you sell some of your mutual fund shares, the first shares you bought are generally treated as the first shares sold (the first-in-first-out rule). In other words, if you sell 50 shares of Giant today, you are considered to have sold 50 of the original shares you bought two years ago, yielding a $250 long-term capital gain [($15 - $10) x 50 shares].

There are, however, at least three other ways to handle mutual fund sales.

1. Average cost method: The first mutual fund shares you bought are considered the first sold, but the basis is averaged (divide total cost by total number of shares, then multiply by the number of shares sold to find their cost basis).

2. Double-category method: All of your mutual fund shares are divided into two categories: those you have held for more than one year and those you have held for one year or less. Each share in each category has a basis equal to the average cost of all shares in that category. When you sell shares, you must specifically tell the selling agent which category you are selling from.

3. Identification of shares: You may be able to tell the selling agent which specific mutual fund shares you want to sell. In that case, you can control whether you will have a capital gain or a loss and whether it will be a short-term or long-term gain or loss. Going back to the example, if you sold 25 shares of Giant at $15 and identified the shares sold as the last shares you bought, you would have a $25 short-term capital gain [($15 - $14) x 25]. Under the first-in-first-out rule, your long-term capital gain is $125 [($15 - $10) x 25].

Of course, you may have losses from sales of mutual fund shares, which can be used to offset capital gains realized in 2004 plus up to $3,000 of ordinary income.

Bottom line: *As you can see, the rules for mutual fund sales are exceedingly complex. Consult with a professional tax adviser for more details.*

Getting More Time to File Your Return

IRS provides extension for looming tax return deadline

The deadline for filing your personal tax return for 2004 -- April 15, 2005 -- is right around the corner. However, due to circumstances beyond your control, you may not be able to wrap things up on time.

In that case, you may decide to file for an extension. The IRS will grant you an automatic extension for four months if the request is properly made by the April 15 deadline. In other words, you have until **August 15, 2005**, to complete your 2004 return -- even if your tax liability has not been paid in full. No late-filing penalties will be imposed for a valid request.

Nevertheless, you still must provide an estimate of your tax liability based on the information available to you at the time. Furthermore, you must pay at least **90% of your tax liability**, through income tax withholding or estimated tax payments, by the original tax return due date. Otherwise, a late payment penalty will be assessed for each month dating from the original due date to the date of payment as well as interest figured on the regular interest rate for underpayments.

Note: An extension to file will not be valid if a proper estimate of tax liability is not made. If your estimate is found to be improper, the extension is invalid and you will be subject to **failure-to-file penalties**.

Special rules apply to individuals who are out of the country or serving in a combat zone. Consult with a professional tax adviser concerning these extenuating circumstances.

What happens if you can't complete your return within the four-month filing extension? You can apply for an additional extension, but the request isn't granted automatically. Generally, you must file for the automatic extension before you can apply for additional relief. The subsequent request should include the following information:

- The reason for requesting the extension;
- The tax year in which the extension applies;
- The length of time needed for filing; and
- Whether another extension for filing has already been requested for this particular tax year.

In summary: *The IRS is willing to give you some leeway as long as you comply with the rules. It is important to ensure that all the paperwork is in order.*

Survivorship Insurance: A Lifeline for Estate Planning

Insurance protection geared toward a married couple

Despite rumors of its demise, the need for survivorship life insurance -- also called "second-to-die" insurance in some circles -- remains critical in the wake of recent revisions in the estate-tax law.

Basic premise: With a survivorship policy, both spouses are insured under the policy, but no proceeds are paid when the first spouse dies. Instead, all of the proceeds become payable when the second spouse dies -- at a time when the family is likely to need additional funds to pay federal estate tax. Thus, the need for survivorship insurance has often been linked to **estate-tax planning**.

Although the cost varies among insurance companies and types of products, premiums for survivorship life insurance are generally reasonable. Since the policy is based upon the joint life expectancies of both spouses, the annual premiums are typically less than the cost of two individual policies with the same total death benefit.

Caution: In certain situations, the premiums of a second-to-die policy may increase as both spouses become older, while other policies have premium schedules that remain level year-to-year. Make sure you read all of the fine print in a particular policy.

Under the **Economic Growth and Tax Relief Reconciliation Act of 2001** (EGTRRA), the top federal estate-tax rate is being gradually reduced in conjunction with a gradual increase in the estate-tax exemption. After 2009, the federal estate tax will be repealed outright, only to be revived again in 2011 unless further legislation is enacted. Although the future is uncertain, survivorship insurance remains a viable solution to estate-tax issues.

In addition, a survivorship insurance policy may be used in a variety of other situations, including:

1. The policy may provide protection against the forced sale of a closely held business or other business assets.
2. Life insurance can provide beneficiaries with income to pay estate taxes, help protect the value of your estate, replace income and minimize the debt load of survivors, and provide beneficiaries with income tax-free proceeds.
3. The policy may help meet the insured's philanthropic inclinations without a substantial reduction of other assets.
4. A survivorship policy can fund the special needs of a family member with a disability.

In short, the proceeds of a survivorship policy become available precisely at the time when the surviving family members may be most economically or emotionally vulnerable.

Of course, survivorship life insurance is not for everyone. Be sure to discuss your personal situation with your trusted insurance advisers.

Tax Court Makes a Fashion Statement

As a general rule, you can deduct the cost of special clothing you must wear on the job such as a uniform or safety gear. The cost is deductible as a miscellaneous expense. You can deduct miscellaneous expenses to the extent the annual total exceeds 2% of your adjusted gross income (AGI).

However, you cannot take a deduction for clothing that is suitable for everyday use -- even if your employer requires you to wear a certain style or color.

New case: The district manager of a department store was required by her company to wear black or white dresses or suits, consisting of either pants or a skirt with a matching jacket, while she worked. The outfits could be purchased in any clothing store and did not include any company logo or emblem. Since she did not own any black or white apparel, the manager was forced to buy an entire new wardrobe at a cost of almost $10,000.

Although the manager purchased the wardrobe specifically for work, she never claimed that the clothes were unsuitable -- in terms of price, quality or style -- for her personal wear. **Result:** The Tax Court denied the deduction. It doesn't matter that the business wardrobe had to consist of two particular colors.

Note: If you do qualify for clothing deductions, you may also deduct the costs of cleaning the outfit as a miscellaneous expense.

New Tax Ground Rules for Signing Bonuses

New rulings impose employment tax on compensation agreements

The IRS recently issued two new Revenue Rulings that dampen the tax benefits for "signing bonuses" and similar types of compensation agreements.

Background: Without a specific exception in the law, federal employment taxes -- such as the tax under **Federal Insurance Contributions Act** (FICA), **Federal Unemployment Tax Act** (FUTA) tax and income tax withholding -- are imposed on wages. For this purpose, "employment" includes establishing, advancing, changing or canceling the employer-employee relationship unless clear and adequate consideration is received in return. The two new rulings cement this interpretation while one of them revokes another ruling dating back to the 1950s.

Ruling #1: A baseball player negotiated a signing bonus as part of his initial contract. The ballplayer is entitled to the bonus if he merely reports to spring training. Along the same lines, bonuses paid to members of a unit ratifying a collective bargaining agreement were not contingent on any past or future services.

Result: The IRS concluded that the signing bonus paid by the baseball club represents compensation to the player. Similarly, the bonuses received by the collective bargaining unit, which establishes the basis for the employer-employee relationship, must be treated as wages.

Ruling #2: An employee agreed to an employment contract covering a term of years. Under the contract, no payment is required if the parties mutually cancel the deal. However, before the contract was up, the employer agreed to make an early termination payment in exchange for the employee relinquishing all rights under the contract.

Result: The IRS determined that the payment canceling the contract in exchange for relinquishing future rights constitutes wages for employment tax purposes.

In the first new ruling, the IRS revoked a 1958 Revenue Ruling which held that signing bonuses are not wages for employment tax purposes if they are not contingent on future services being performed. However, the IRS will continue to apply an employment tax exemption for contracts established before **January 12, 2005**, if the facts and circumstances mirror the 1958 ruling. **Note:** This only affects a first-time bonus signer who is able to walk away from the deal with no strings attached.

The new rulings may have an impact on signing bonuses and other incentives that are designed to attract top talent to an organization. Consider all of the ramifications carefully when agreements are worked out.

Facts and Figures

Timely points of particular interest

- **Just Following Orders --** In a new case, a taxpayer managed an auto dealership for his former father-in-law. When the dealership faltered, the owner instructed the taxpayer to pay other creditors instead of the IRS. Nevertheless, he was held personally liable for unpaid employment tax under the **100% penalty**. According to the district court, it didn't matter that the taxpayer probably would have been fired if he didn't follow orders from the owner.

- **Cyber Crime --** Extortion is a growing concern for companies that rely heavily on Internet traffic. **Typical situation:** The modern-day version of an extortionist threatens to expose trade secrets or disrupt operations if the firm doesn't pay up. Some business managers succumb because they figure it is the least expensive route to take. This trend points out the need to implement information technology safeguards and to keep all personnel on alert.