Financial Planning Tax Considerations: Business and Investment Part 3

Course #30903B

Taxes

2 Credit Hours

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FINANCIAL PLANNING TAX CONSIDERATIONS: BUSINESS AND INVESTMENT PART 3

This course explains how mutual fund distributions are taxed, compares tax impacts across different business entity types, and reviews how marriage or divorce can affect income tax. It also covers key factors that influence the alternative minimum tax (AMT) calculation.

LEARNING ASSIGNMENTS AND OBJECTIVES

As a result of studying each assignment, you should be able to meet the objectives listed below each individual assignment.

SUBJECTS

Mutual Fund Distributions
Taxation of Business Entities
Alternative Minimum Tax
Tax Implications of Marriage and Divorce

Study the course materials

Complete the review questions at the end of each chapter

Answer the exam questions 1 to 10

Objectives:

- Recall the rules that govern the taxation of distributions from mutual funds.
- Recall various tax implications on an individual business owner that result from different forms of business entities.
- Recognize items that affect the AMT calculation.
- Recognize the rules affecting the classification of marital property and how marriage or divorce can affect income tax liabilities.

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EXAM OUTLINE

- **TEST FORMAT:** The final exam for this course consists of 10 multiple-choice questions and is based specifically on the information covered in the course materials.

- **ACCESS FINAL EXAM:** Log in to your account and click Take Exam. A copy of the final exam is provided at the end of these course materials for your convenience, however you must submit your answers online to receive credit for the course.

- **LICENSE RENEWAL INFORMATION:** This course qualifies for **2** CPE hours.

- **PROCESSING:** You will receive the score for your final exam immediately after it is submitted. A score of 70% or better is required to pass.

- **CERTIFICATE OF COMPLETION:** Will be available in your account to view online or print. If you do not pass an exam, it can be retaken free of charge.

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CHAPTER 1: MUTUAL FUND DISTRIBUTIONS

Chapter Objective

After completing this chapter, you should be able to:

- Recall the rules that govern the taxation of distributions from mutual funds.

For most Americans, the most common type of equity investment is the mutual fund. Whether it is through a 401(k), a pension plan or a direct investment outside the scope of a retirement plan, mutual funds remain a very popular form of investment. Given the widespread popularity of mutual funds, this chapter provides a look at these investment vehicles and the rules that govern the taxation of their distributions. As with other investment vehicles, income tax treatment is a key factor in determining whether it is an appropriate investment.

I. AN OVERVIEW OF MUTUAL FUNDS

American investors increasingly have turned to mutual funds to save for retirement and other financial goals. Mutual funds can offer the advantages of diversification and professional management. But, as with other investment choices, investing in mutual funds involves risk. Also, fees and taxes will diminish a fund's returns.

A. WHAT ARE THEY

A mutual fund is a regulated investment company that pools money from many investors and invests the money in stocks, bonds, and short-term debt. The combined holdings the mutual fund owns are known as its portfolio. Each share represents an investor's proportionate ownership of the fund's holdings and the income those holdings generate. Legally known as an "open-end company," a mutual fund is one type of regulated investment company.

B. MUTUAL FUNDS

Some of the traditional, distinguishing characteristics of mutual funds include the following:

- Investors purchase mutual fund shares from the fund itself (or through a broker for the fund) instead of from other investors on a secondary market, such as the New York Stock Exchange or Nasdaq Stock Market;
- The price that investors pay for mutual fund shares is the fund's per share net asset value (NAV) plus any shareholder fees that the fund imposes at the time of purchase (such as sales loads);
- Mutual fund shares are "redeemable," meaning investors can sell their shares back to the fund (or to a broker acting for the fund);

- Mutual funds generally create and sell new shares to accommodate new investors. In other words, they sell their shares on a continuous basis, although some funds stop selling when, for example, they become too large; and
- The investment portfolios of mutual funds typically are managed by separate entities known as “investment advisers” that are registered with the SEC.

C. OTHER TYPES OF INVESTMENT COMPANIES

The other basic types of investment companies are described below.

1. <u>Closed-End Funds</u>

Unlike mutual funds, this fund sells a fixed number of shares at one time (in an initial public offering) that later trade on a secondary market.

2. <u>Unit Investment Trusts (UITs)</u>

These make a one-time public offering of only a specific, fixed number of redeemable securities called “units” and which will terminate and dissolve on a date specified at the creation of the UIT.

3. <u>Exchange-Traded Funds (ETFs)</u>

These are a type of investment company that aims to achieve the same return as a particular market index. They can be either open-end companies or UITs. But ETFs are not considered to be, and are not permitted to call themselves, mutual funds.

D. HEDGE FUNDS

“Hedge fund” is a general, non-legal term used to describe private, unregistered investment pools that traditionally have been limited to sophisticated, wealthy investors. Hedge funds are not mutual funds and, as such, are not subject to the numerous regulations that apply to mutual funds for the protection of investors – including regulations requiring a certain degree of liquidity, regulations requiring that mutual fund shares be redeemable at any time, regulations protecting against conflicts of interest, regulations to assure fairness in the pricing of fund shares, disclosure regulations, regulations limiting the use of leverage, and more.

“Funds of hedge funds” are investment companies that invest in hedge funds. Some, but not all, register with the SEC and file semi-annual reports. They often have lower minimum investment thresholds than traditional, unregistered hedge funds and can sell their shares to a larger number of investors. Like hedge funds, funds of hedge funds are not mutual funds. Unlike open-end mutual funds, funds of hedge funds offer very limited rights of redemption. And, unlike ETFs, their shares are not typically listed on an exchange.

E. DERIVATIVES

Derivatives are financial instruments whose performance is derived, at least in part, from the performance of an underlying asset, security, or index. Even small market movements can dramatically affect their value, sometimes in unpredictable ways.

There are many types of derivatives with many different uses. A fund's prospectus will disclose whether and how it may use derivatives. Investors may also want to call a fund and ask how it uses these instruments.

F. INDEX FUNDS

"Index fund" describes a type of mutual fund or Unit Investment Trust (UIT) whose investment objective typically is to achieve the same return as a particular market index, such as the S&P 500 Composite Stock Price Index, the Russell 2000 Index, or the Wilshire 5000 Total Market Index.

An index fund will attempt to achieve its investment objective primarily by investing in the securities (stocks or bonds) of companies that are included in a selected index. Some index funds may also use derivatives (such as options or futures) to help achieve their investment objective. Some index funds invest in all of the companies included in an index; other index funds invest in a representative sample of the companies included in an index.

The management of index funds is more "passive" than the management of non-index funds, because an index fund manager only needs to track a relatively fixed index of securities. This usually translates into less trading of the fund's portfolio, more favorable income tax consequences (lower realized capital gains), and lower fees and expenses than more actively managed funds.

Because the investment objectives, policies, and strategies of an index fund require it to purchase primarily the securities contained in an index, the fund will be subject to the same general risks as the securities that are contained in the index. Those general risks are discussed in the descriptions of stock funds and bond funds. In addition, because an index fund tracks the securities on a particular index, it may have less flexibility than a non-index fund to react to price declines in the securities contained in the index.

Another type of investment company that attempts to track the performance of a market index is an exchange-traded fund (ETF). ETFs are legally classified as either UITs or open-end companies, but they differ from traditional UITs and open-end companies in a number of respects. For example, pursuant to SEC exemptive orders, shares issued by ETFs trade on a secondary market and are only redeemable in very large blocks (blocks of 50,000 shares, for example). ETFs are not considered to be, and may not call themselves, mutual funds.

G. ADVANTAGES AND DISADVANTAGES

Every investment has advantages and disadvantages. But it is important to remember that features that matter to one client may not be important to another. Whether any particular feature is an advantage for a particular client will depend on his or her unique circumstances. For some investors, mutual funds provide an attractive investment choice because they generally offer the following features.

1. Professional Management

Professional money managers research, select, and monitor the performance of the securities the fund purchases.