

How to start the year off right

Also, new mutual fund tax rules and the end of a Social Security free lunch

By Robert N. Gordon

January 2, 2011

Here are four timely tax-related rules that advisers should note: **Cost basis reporting.** Brokerage firms are required to keep track of an investor's cost basis in any shares purchased after Jan. 1. When the securities are sold, the broker will report a capital gain or loss to the Internal Revenue Service. Until now, brokers have reported sales proceeds but not cost basis information. Since an investor may have multiple lots of stock bought at different prices, brokers now will match any sale with the first shares the client bought (a first-in, first-out methodology), unless notified otherwise. Most investors will be best-served if they instruct their broker always to deliver their highest-cost shares. Delivering the highest-basis shares will minimize the realized gain or maximize the realized loss. Any trades made after Jan. 1 will be reported using FIFO until the investor makes a different election for future transactions.

Incentive stock options. Employees who own appreciated ISOs are tempted to exercise their options and then hold on to their shares in order to benefit from the favorable tax rate on long-term capital gains. But unless the shares are sold in the same year that the option is exercised, the difference between the stock's market price and the exercise price becomes an alternative-minimum-tax preference item. Since an employee has only the time between exercising an option and Dec. 31 of that year to decide whether to sell, ISOs should be exercised at the very beginning of the year to maximize the time available for the employee to decide whether to continue to hold and accept the AMT consequences or to sell.

Roth conversions. If an investor did not convert to a Roth individual retirement account in 2010, the best time to convert in 2011 is at the beginning of the year. The government gives Roth converters the opportunity to re-characterize a Roth conversion until the tax return is filed. For those utilizing extensions, 2011 tax returns can be filed as late as Oct. 15, 2012. By converting in January 2011, investors give themselves 21 months in which to consider re-characterization. This is one more case in which we recommend that investors maximize the choices given to them by the government.

But if using multiple Roths to maximize flexibility when re-characterizing, investors must be careful. Each Roth must come into existence as a result of a conversion from a traditional IRA, which means it's best to convert multiple IRAs to multiple Roths. If an investor converts one big IRA into one big Roth and then splits that into multiple Roths, he or she will be able to re-characterize only the one big Roth and not be able to cherry-pick among the Roths that have declined in value.

New fund law. The Investment Company Institute was successful in promoting the passage of the Regulated Investment Company Modernization Act of 2010, which addresses a laundry list of member concerns. Previously, mutual funds were able to carry forward capital losses only for a limited number of years. Now funds can carry forward any capital losses until they can be paired off against realized capital gains.

Another change involves funds of funds. Previously, such funds had trouble passing through the tax attributes realized at the underlying-fund level, such as a fund of municipal bond funds that could not distribute to its owners the tax-free-muni income it received from its holdings. The latest legislation clears away such problems.

One disappointment: the elimination of a provision in an earlier version that would have allowed commodities-based income to be considered "good income" for purposes of the tax code. As a result, mutual funds aiming for exposure to commodities must continue

to invest in notes tied to commodities rather than commodities themselves, a less-than-optimal route. Possible detriments are greater counterparty risk, less liquidity and an increase in costs.

Ending Social Security do-overs. In recent years, an interest-free borrowing technique has become popular whereby retiring senior citizens can start receiving Social Security benefits at their earliest possible opportunity and then change their mind years later, give the government back its money without paying interest and start receiving higher benefits. The Social Security Administration, believing that the practice would be too costly if widely adopted, has decided to limit to one year the period in which a person who starts receiving benefits can withdraw his or her application and return payments received.

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