

BETTER INVESTING

MAGAZINE

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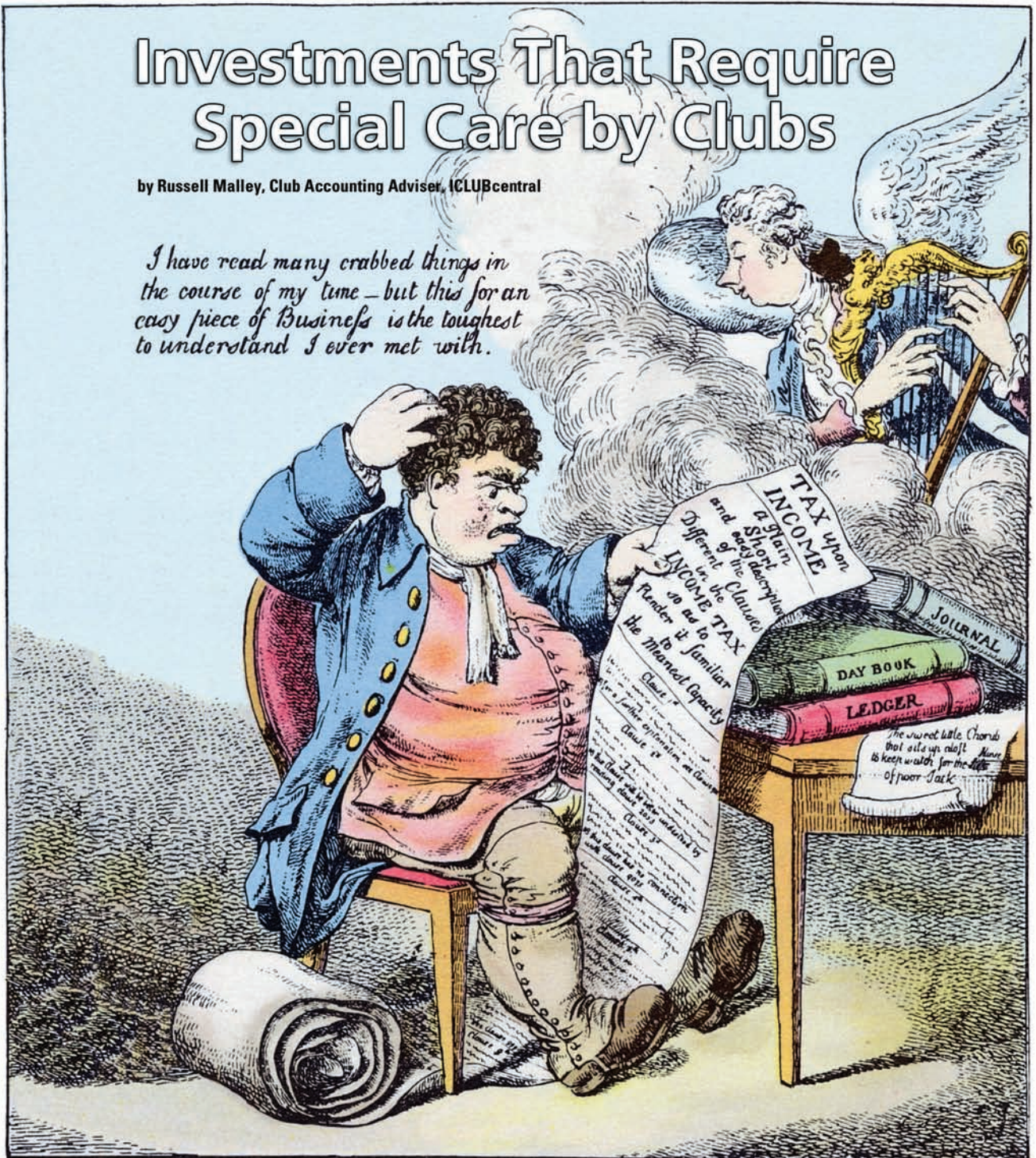
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Taxing Issues

Investments That Require Special Care by Clubs

by Russell Malley, Club Accounting Adviser, ICLUBcentral

I have read many crabbed things in the course of my time—but this for an easy piece of Business is the toughest to understand I ever met with.



As we head into the end of 2011, investment clubs are preparing to close their books for the year and to distribute the tax forms early next year. Although the process for preparing club taxes for standard stocks is fairly well-established, a notable number of clubs have been exploring investments that might require some extra work at tax time. Club treasurers should make sure they're handling these holdings properly. This month Russell Malley, a club accounting adviser for ICLUBcentral, discusses how to account for some of the main alternative investments. At the end of this article are some additional resources. We would particularly encourage club treasurers to sign up for BetterInvesting's discussion list for treasurers, an excellent resource for any questions, as well as participate in the quarterly webinars for treasurers.

We've warned investment clubs about accounting headaches concerning holdings in real estate investment trusts, certain exchange-traded funds and publicly traded partnerships. So your club didn't heed these warnings and now tax time is coming? Well, it isn't impossible to work around the accounting issues in the club accounting. Just be prepared for extra work.

It's fairly easy to make the entries for real estate investment trusts or REITs. Companies managing the properties comprising publicly traded REITs are required to distribute 90 percent of their taxable income; REITs will make these distributions throughout the year.

Although these payments are usually entered as dividends when received, they actually are composed of multiple parts including long-term capital gains, short-term capital gains and dividends. The company will itemize the components at year end.

When the club treasurer receives this information, the dividend entries need to be deleted and re-entered as the appropriate category. In ICLUBcentral's club accounting programs (the myICLUB.com website or Club Accounting 3 desktop software), treasurers will use the drop-down menu in the cash distribution entry screen to find the appropriate type.

REITs have two other entries that may cause concerns: unqualified dividends and Section 1250 gains. Section 1250 is the Internal Revenue Service's section dealing with real estate that has accelerated depreciation claimed — applying to relatively few properties these days. These entries are managed with the allocation-of-income process. If the treasurer has properly identified a security as a REIT, the allocation process will show fields to enter the unqualified dividends and Section 1250 gains for the club's REITs. These will

then be allocated to all the members when the allocation is completed. The tax software also will ask for the same information.

Commodity Exchange-Traded Funds

Many ETFs that hold commodities, such as gold, are treated as investments in collectibles rather than securities for tax purposes. The maximum tax rate on gains from these investments is 28 percent. The accounting and tax software will treat these as security investments. A work-around for this is to delete the sale of these securities and run the allocation process. The treasurer then prints the allocation report, re-enters the sale of these investments, redoes the allocation process and compares the two reports.

The difference in the capital gain allocations will be the allocation for the 28 percent collectibles gain. With this information the treasurer can manually enter the correct amount for the 28 percent gain on Form 1065 and the Schedule K-1s of each member. Treasurers need to remember to enter this on all member K-1s!

Another issue with these commodity ETFs is that when the fund sells some of the commodity to pay expenses, it's assumed the shareholders are selling a pro-rata share of the fund's holdings. This doesn't change the club's number of shares owned.

To account for these tax-related sales, the treasurer will need to calculate the gain or loss from these tax sales. After the gain is calculated, a capital gain distribution will be entered. This will cause the cash account to be unbalanced. A negative return of capital will balance a gain from the sale and bring the cash account back into balance.

The fund should provide per-share data of how much of the commodity was sold. If it doesn't send the club this information, the treasurer can check the

fund's website. I've found itemized data on websites for each sale. The treasurer will also need to find the commodity's price on the sale date and on the purchase date. Use the purchase date of the club's shares as the commodity's purchase date.

The club may also be able to use the price of fund shares as a proxy for the commodity's price if historical data on the commodity price is difficult to find. For example, say gold on the sale date sold at a price equal to 25 times the value of one fund share. For the club's purchase price, the treasurer multiplies the fund share price on the sale date by 25, remembering to make these entries for sales and return of capital for each expense sale of the fund. If the club sold all fund shares before entering these expense tax sales, the sale should be deleted, the expense sales entered to adjust the club's cost basis in the fund and then the final sale re-entered.

Publicly Traded Partnerships

Partnerships have multiple accounting issues for clubs. For taxes a big one is when the K-1 is received. Although publicly traded partnerships probably will send K-1s earlier, they aren't required to do so until April 15. Keep this in mind and be prepared to request an extension to file the club's 1065.

On the K-1 will be itemized information on the distributions from the partnership as well as the total of all distributions. When entering these distributions, the treasurer needs to match the type listed on the K-1 with the type in the club accounting program. For

example, K-1 dividends should be entered as dividends in the program. If the club's K-1 lists operating income, the treasurer enters this as "other income" in the program.

The total entered should match the total distributions on the K-1. These entries increase the amount in the club's cash account. The treasurer will need to make a return-of-capital entry to balance the partnership distributions.

A negative return of capital will balance a positive distribution amount. For example, if the club's total distributions amounted to \$345, a return-of-capital entry for negative \$345 will decrease the club's cash account by \$345 and increase the cost basis in the partnership by \$345.

The final issue with partnerships is checking the allocation of operating income among the states where the partnership does business. The partnership should provide this information. The treasurer can check the partnership website if this information isn't sent to the club. The club allocates the partnership operating income from the K-1 among all the states. Treasurers should also check the filing requirements for these states; the club may be required to file in multiple states.

The club members should also look at their share of the operating income's allocation from this publicly traded partnership to each state. It's possible individual club members may be required to file multiple state tax returns, also.

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Other Resources

Articles

"Tax Planning for Carry-Over Losses," "Between the Lines," *BetterInvesting Magazine*, September 2011
 "Year-End Tax Tips," "Financial Planner," *BetterInvesting Magazine*, October 2011

Webpages

General Investment Club Tax Principles
www.iclub.com/support/general_tax_principles.asp
Understanding Investment Club Tax Season
www.iclub.com/support/tax_season.asp

Webinar

"Closing the Investment Club's Books at Year-End"
www.iclub.com/webinars/webinar_iclub.asp

E-mail Discussion List

Members may subscribe to the Club Treasurers discussion list by going to the Tools & Resources menu of the member website, selecting Online Community, clicking Click Here in the E-mail List section and filling out the form at the bottom of the page that follows. Make sure to select the Club Treasurers list. Once you've subscribed you'll receive a message asking you to confirm your subscription.

Club Treasurer Workshop

BetterInvesting offers periodic live webinars for club treasurers. The December event will focus on club taxes; see the BetterInvesting Online section of the table of contents for more information.