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Passive Investing Is Moving Up

Broadly speaking, investors have two types of strategies to pursue: active and passive. Recently, passive investing has gained popularity. In 2013, for example, net investments into passive equity funds topped $60 billion, versus $3.4 billion for active funds.

Should you be an active or a passive investor, or should you use both methods? To make an informed decision, you should know the background.

Sitting on a benchmark

Historically, investing was an active endeavor, in today's terms. (This discussion will focus on stocks, but the principles apply to all investment securities.)

Example 1: In the early 20th century, young John Smith could pick his own stocks, perhaps based on the proverbial hot tip, or he could buy stocks suggested by his securities broker. In the middle of the century, John's choices expanded. He could hire a professional money manager to pick stocks for him (assuming John had a sizable amount to invest), or he could put his money into a publicly offered fund and let the fund manager select the fund for him.

In all of these modes, John hoped that the stocks he owned, directly or through a fund, performed well. He was following an active investment strategy.

When the 20th century moved toward its end, investors had another option: They could invest in an index fund. Such funds do not rely on stock picking; they allow individuals and institutions to invest in a broad segment of the stock market.

Example 2: John's granddaughter Sue Jones decided to invest in a fund that tracks the S&P 500 Index, a benchmark for large company U.S. stocks. This fund (and Sue, as a shareholder) holds the stocks in the index. As the broad stock market goes up or down, the value of Sue's investment flows and ebbs.

As mentioned, index funds, such as the one in which Sue invests, have become widespread. You can find funds tracking indexes of bonds, small company stocks, foreign stocks and other asset classes.

Assessing their appeal

With an index fund, you are assured of participating in market moves. When large company U.S. stocks move up by 30%, as they did in 2013, you'll get that return with an index fund tracking the S&P 500. You won't fall short, as you would with an active manager who picked the wrong stocks. Index funds tend to have low expenses because they don't have to support research staffs. In addition, index funds often hold onto the same stocks, so they may not generate unwelcome tax bills from taking gains.

Perhaps most important, many active managers have lagged index returns over long time periods. Although investors have tried, there apparently is no certain way to predict which active managers will beat their benchmarks in the future.

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Old News
According to the Social Security Administration, about one out of every 4 people age 65 today will live past age 90, and one out of 10 will live past 95.

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Trusted Advice

Weight Watching

An example can illustrate capitalization weighting of index funds.

- Vanguard 500 Index Fund, a market cap mutual fund, has over 3% of its assets invested in Apple stock (its largest holding), as of this writing.
- This indicates that the value of all Apple shares is roughly 3% of the value of all the shares in the benchmark S&P 500 Index.
- The 10 largest holdings of this fund (including Apple, ExxonMobil, Google, and Microsoft) make up more than 18% of the fund's assets, even though they are only 2% of the approximately 500 companies in the index.

Weighty woes

With all of the advantages of passive investing, why go active? For one reason, there will be some active managers who deliver returns greater than their benchmark indexes over the next 10 or 20 years or longer. Even modest outperformance can make a huge difference in long-term wealth building. In an index fund, you have no chance of profiting from a wise manager selection.

In addition, major market indexes are primarily “cap weighted,” that is, the stocks in such indexes are held in proportion to the total market value of their shares. (See the “Weight Watching” Trusted Advice box.) At times, cap weighted indexes become heavily tilted towards tech stocks, oil companies, banks, or whichever market sector is in favor. Rising prices boost market capitalization for such companies. When these companies lose some appeal, as inevitably happens, the index may drop sharply, pulling down index funds.

Seeking a better blend

Some investment companies have attempted to improve the performance of traditional cap weighted index funds by devising “enhanced” indexes, then offering funds to track those indexes. These include equal weighted indexes: each stock in an S&P 500 index fund might be represented by 1/500 of the fund’s assets, for instance. Alternatively, major indexes might be tweaked to give more weight to stocks that pay dividends or to stocks that historically have been less volatile than the broad market.

These enhanced index funds have an active component: They’re designed to accentuate some attribute the fund sponsor believes will improve results. Many enhanced index funds are relatively new, so it may be too soon to judge the success of these efforts. However, the basic rule applies to all funds, whether they’re active or passive or somewhere in between. Before investing, you should know how the fund will operate and be comfortable with its approach.

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Inherited IRAs in Bankruptcy

Under federal law (and under the laws of most states), retirement plans such as IRAs enjoy some protection in bankruptcy proceedings. Does that same protection apply to inherited IRAs? The issue has been disputed in many court cases in recent years with mixed verdicts. Finally, in June 2014, the U.S. Supreme Court unanimously decided that bankruptcy creditors may have access to these accounts (Clark v. Rameker, No. 13–299 (U.S. 6/12/14)).

This ruling has implications for IRA owners as well as for the beneficiaries of such accounts.

In this case, Ruth Heffron held over $450,000 in her IRA. If Ruth had declared bankruptcy, she probably could have kept certain IRA assets. “Allowing debtors to protect funds in traditional and Roth IRAs ensures that debtors will be able to meet their basic needs during their retirement years,” the Supreme Court noted. Keeping some assets from bankruptcy creditors helps debtors “obtain a fresh start,” reducing the chance that these debtors will be “left destitute and a public charge.”

Beneficiary battle

Many IRAs still hold assets when the owner dies. Then, the IRA may pass to the designated beneficiary.

Here, after Ruth died, her daughter Heidi Heffron-Clark inherited the account. Nine years later, Heidi and her husband filed for bankruptcy. The couple asserted that the funds in Heidi’s inherited IRA, which now amounted to almost $300,000, should be exempt from creditors’ claims.

In such cases, debtors have prevailed some of the time. Retirement funds held in tax-exempt retirement accounts are protected in bankruptcy, some courts have ruled, and the funds in an Individual Retirement Account remain retirement funds even after they pass to a beneficiary and are held in an inherited IRA.

Other courts, including the one ruling on Heidi’s case, found that funds in an inherited IRA are no longer retirement funds because the funds are not specifically set aside for use by the beneficiary in retirement. Thus, they are not protected in bankruptcy. Heidi and her husband appealed to the Supreme Court, which upheld the ruling against them.

In favoring the creditors in this case, the Supreme Court gave several reasons why funds held in an inherited IRA are not funds set aside for retirement purposes. First, a beneficiary can’t contribute to an inherited IRA. An individual can put money into a Roth or traditional IRA via annual contributions or direct transfers or rollovers from other retirement accounts. Indeed, various tax incentives encourage such contributions.

As its second reason, the Court noted that beneficiaries are required to take minimum distributions from inherited IRAs, even if they are many years from retirement. Traditional IRA owners face required distributions only after age 70½, when they are likely to be retired, and Roth IRA owners never have to withdraw funds. Finally, the Court noted that “the holder of an inherited IRA may withdraw the entire balance of the account at any time— and use it for any purpose—without penalty.” Traditional and Roth IRA owners, on the other hand, generally are

subject to penalties for early withdrawals before age 59½.

Points to consider

After this decision, people who declare bankruptcy can't expect to protect inherited IRAs from creditors. Therefore, IRA owners should review their choice of IRA beneficiaries. If a future bankruptcy filing by a beneficiary is a concern, you might designate an irrevocable trust as the beneficiary of your IRA and name your human heir as the trust beneficiary. Such a procedure may increase the chance that the IRA will enjoy protection in bankruptcy.

Moreover, surviving spouses who inherit an IRA from the other spouse might be affected by this decision. A spousal beneficiary "may roll over the IRA funds into his or her own IRA, or he or she may keep the IRA as an inherited IRA," the Supreme Court observed. Once the IRA has been rolled over into the surviving spouse's own IRA, it probably will be protected in bankruptcy.

Still, some spousal beneficiaries choose to keep the account as an inherited IRA. That's often the case if the survivor intends to take withdrawals before age 59½ and wants to avoid a 10% early withdrawal penalty. The Supreme Court's decision does not indicate whether an inherited IRA held by a surviving spouse would get bankruptcy protection, but all of the reasons cited to disallow such protections—no future contributions, required minimum distributions at any age, no penalties for early distributions—apply to inherited IRAs held by a surviving spouse. Therefore, any widow or widower who is considering leaving a deceased spouse's IRA as an inherited IRA might discuss creditor protection issues with a knowledgeable attorney.

Finally, you should keep in mind that the Supreme Court's decision applies to bankruptcy cases, not other types of creditors' claims. In non-bankruptcy litigation, state law usually will determine whether inherited IRAs are protected from creditors. Some states specifically protect inherited IRAs, but most states have not passed relevant legislation. Again, you should consult with counsel if this is a concern. ■

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Deducting Foreign Business Travel

As the world shrinks, business owners may find themselves traveling to foreign destinations. Often, such trips are vital, leading to personal visits with suppliers and potential customers. Ideally, you'll be able to deduct all your travel costs, but that may not be the case if you venture beyond the 50 states and Washington, D.C.

The seven-day rule

If you travel outside the U.S. for a week or less, your trip will be considered entirely for business, even if you combine business and nonbusiness activities. Then, you can deduct all of your travel costs. A week, for this purpose, is seven consecutive days, not counting the day you leave the U.S.

Example 1: Denise Edwards has a clothing import business in Chicago. She travels to San Francisco on Tuesday, then flies to Hong Kong on Wednesday. After spending Thursday andFriday in business discussions, Denise spends Saturday through Tuesday sightseeing. She flies back to San Francisco on Wednesday and returns to Chicago on Thursday.

Here, Denise was not outside the U.S. for more than a week. (The day she departed from San Francisco does not count as a day outside the U. S.) Therefore, she can deduct all of her travel costs. She also can deduct the cost of her stay in Hong Kong for the days she worked there but not her costs for her sightseeing days.

More than one week

Business trips longer than one week trigger another set of rules. As long as 75% or more of the trip's total days are business days, you can deduct all your travel costs. Days traveling to and from your destination count as business days, for the purpose of reaching the 75% mark. Again, your costs for nonbusiness days are not tax deductible.

If your trip is primarily for business, but you fail both the one week and the 75% tests for the travel, calculating your deduction becomes more complicated. You can only deduct the business portion of your cost of getting to and from your destination and must allocate your travel time on a day-to-day basis between business days and nonbusiness days.

Example 2: Henry Jackson owns a restaurant supply business in Boston. He flies to Berlin onMarch 7 for a conference and spends time there on business until March 17. That day, Henry flies to Brussels to see friends and tour the local museums. On March 24, he returns to Boston from Brussels.

As the IRS looks at Henry's itinerary, it appears that Henry could have returned to Boston onMarch 17, after completing his business. Thus, 11 days of the trip (March 7–17) count as business days while the other seven days (March 18–24) are nonbusiness days.

With this reasoning, 7 out of 18 days of the trip were nonbusiness days, so 7/18 of what it would have cost him to travel roundtrip between Boston and Brussels is not tax deductible.

Assume Henry's total airfare costs were $2,000, whereas roundtrip airfare between Boston and Brussels would have been $1,500. Henry must subtract 7/18 of this roundtrip fare ($1,500 x 7/18 = $583) from his actual travel expenses. Because Henry spent $2,000, subtracting $583 gives him a $1,417 deduction for his airfare. He can deduct his costs while in Berlin on business but not his costs while in Brussels for other purposes.

As you can see, calculating foreign business travel deductions can be complex. If you will be outside the United States for business, our office can help you set up a schedule for optimal tax benefits. ■

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TAX CALENDAR

SEPTEMBER 2014

September 15

Individuals. If you are not paying your 2014 income tax through withholding (or will not pay in enough tax during the year that way), pay the third installment of your 2014 estimated tax. Use Form 1040-ES.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in August if the monthly rule applies.

Corporations. If you are a calendar year filer, file a 2013 income tax return (Form 1120) and pay any tax, interest, and penalties due. This due date applies only if you timely requested an automatic six-month extension.

Deposit the third installment of estimated income tax for 2014. Use the worksheet Form 1120-W to help estimate tax for the year.

S corporations. If you are a calendar year filer, file a 2013 income tax return (Form 1120S) and pay any tax due. This due date applies only if you timely requested an automatic six-month extension. Provide each shareholder with a copy of Schedule K-1 (Form 1120S) or a substitute Schedule K-1.

OCTOBER 2014

October 15

Individuals. If you are a calendar year filer and have an automatic six-month extension to file your income tax return for 2013, file Form 1040, 1040A, or 1040EZ and pay any tax, interest, or penalties due.

Employers. For Social Security, Medicare, withheld income tax, and nonpayroll withholding, deposit the tax for payments in September if the monthly rule applies.

Electing large partnerships. If you are a calendar year filer and were given an additional six-month extension, file a 2013 tax return (Form 1065-B).

October 31

Employers. For Social Security, Medicare, and withheld income tax, file Form 941 for the third quarter of 2014. Deposit any undeposited tax. (If your tax liability is less than $2,500, you can pay it in full with a timely filed return.) If you deposited the tax for the quarter in full and on time, you have until November 10 to file the return.

For federal unemployment tax, deposit the tax owed through September if more than $500.

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