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Mutual Funds and Taxes





Mutual Funds: Tax Planning

What is investment tax planning for mutual funds?

Investment tax planning for mutual funds involves utilizing the tax rules that may help enhance your after-tax return on mutual fund investments. In order to help enhance the return on your investment in mutual funds, it is important for you to know how to determine income or gain from mutual funds, how to calculate your capital gains tax liability, and when to buy or sell mutual funds.

How does a mutual fund generate earnings for investors?

Mutual funds can generate income and gain on their investment portfolios. Any earnings are then distributed to individual investors based on the number of shares they hold; an investor can use the earnings, reinvest them into the fund, or invest them elsewhere. Regardless of what you do with those earnings, they are considered taxable (unless they represent interest from tax-exempt investments such as municipal bonds or are held in a tax-deferred account), and you may also incur a taxable gain (or loss) when you sell shares in the fund.

Caution: *Mutual funds are not guaranteed or insured by the FDIC or any government agency, and your shares may be worth more or less than you paid when you sell them. Bond funds are subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance. Before investing in a mutual fund, carefully consider the investment objectives, risks, charges, and expenses of the fund. This information can be found in the prospectus, which can be obtained from the fund. Read it carefully before investing.*

How do you determine income or gain from mutual funds?

Understanding how you are taxed is the first step to investment tax planning for mutual funds. To get a handle on this, you need to know how you can realize money or value from your investment. Basically, there are six ways that you can receive investment returns from a mutual fund:

1. Ordinary income (dividend) distributions
2. Dividends that qualify for taxation at capital gains tax rates ("qualifying dividends")
3. Tax-exempt interest distributions
4. Capital gains distributions
5. Capital gains (or losses) when you sell your shares in the mutual fund
6. Return of capital distributions

In general, your investment income and capital gains distributions are subject to federal taxation. (State laws vary, so you should check to see how your state taxes investment income.) Note that "distributions" refers to actual cash distributions or to reinvested earnings. You may not actually receive any money. You may, for instance, get additional shares of the mutual fund instead. The earnings of the mutual fund generally pass through to the shareholders.

Dividend income distributions

Up until 2003, all dividend income distributions from mutual funds were classified as ordinary income, subject to ordinary income tax rates. Now, qualifying dividends received by an individual shareholder from a domestic corporation or qualified foreign corporation are taxable at long-term capital gains tax rates. Mutual fund distributions that represent such dividends will, subject to an additional holding period requirement described below, also qualify for capital gains tax treatment. All other dividend distributions will be taxed at ordinary income tax rates.

Taxpayers may receive both types of dividends in a given year. The mutual fund company should indicate the amount of ordinary dividends and the amount of qualified dividends on Form 1099-DIV.

Caution: *Special holding period requirements apply to mutual fund shareholders. For stock dividends to qualify for taxation at the long-term capital gains tax rates, the stock must generally be held for at least 61 days during the 121-day period beginning 60 days before the ex-dividend date. Mutual funds that hold dividend-paying stock and meet this requirement may pass through qualifying dividends to mutual fund shareholders. However, mutual fund shareholders must themselves hold their mutual fund*



shares for at least 61 days during the 121-day period beginning 60 days before the ex-dividend date to be able to take advantage of the lower capital gains rates on the dividends that are passed through.

Example(s): (From IRS Publication 550) You bought 10,000 shares of ABC Mutual Fund common stock on July 9, 2014. ABC Mutual Fund paid a cash dividend of 10 cents per share. The ex-dividend date was July 16, 2014. The ABC Mutual Fund advises you that the portion of the dividend eligible to be treated as qualified dividends equals 2 cents per share. Your Form 1099-DIV from ABC Mutual Fund shows total ordinary dividends of \$1,000 and qualified dividends of \$200. However, you sold the 10,000 shares on August 12, 2014. You have no qualified dividends from ABC Mutual Fund, because you held the ABC Mutual Fund stock for less than 61 days.

Tax-exempt interest distributions

A mutual fund can earn tax-exempt income (exempt from federal and possibly state income tax) if the interest is generated by municipal bonds. If the income is generated from U.S. Treasury securities, it will be exempt from state income taxes only. U.S. Treasury securities are guaranteed by the federal government as to the timely payment of principal and interest. The type of securities held by the mutual fund will determine the type of tax (state or federal) from which you may be exempt.

Caution: *The receipt of tax-exempt interest dividends may affect the alternative minimum tax liability of certain taxpayers.*

Caution: *Bear in mind, also, that some states may tax interest from municipal bonds issued by other states and their municipalities. While the state tax-exempt character of Treasury securities passes through to shareholders, the interest from U.S. government agency obligations usually will not. Check your state laws to determine if your tax-exempt interest distributions are subject to state income tax.*

Capital gains distributions

A mutual fund makes a capital gains distribution when it makes a distribution out of its net realized long-term capital gains (for instance, when it distributes profits from the sale of its investments held longer than one year). You must pay tax on these distributions at the applicable long-term capital gains tax rates (discussed later). You may also be required to pay tax at long-term capital gains tax rates on the fund's realized but undistributed long-term capital gains.

Caution: *What happens if the mutual fund suffers long-term capital losses? These are offset against capital gains within the fund, so only the net gain is passed on to you. If capital losses exceed capital gains, the losses are not passed on to you. The mutual fund simply carries these losses forward to offset future capital gains.*

Capital gains when you sell your shares in the mutual fund

A share of a mutual fund is considered a capital asset. When you realize net gains on the sale of capital assets held for over one year, you are subject to tax at long-term capital gains tax rates. Generally, the gain or loss is the difference between what you paid for the shares of the mutual fund and the amount you received when you sold such shares. Note that there are some special tax basis rules relating to mutual funds. You need to know these rules to calculate your gain (discussed later).

Return of capital distributions

Cash distributions are usually paid from a fund's earnings and profits. However, certain mutual funds may, on occasion, distribute cash when they have no undistributed earnings and profits. Such a distribution is usually called a "return of capital" because the fund returns some of the investment to the shareholders, rather than some of the profit. Return of capital distributions is fairly uncommon and the mutual fund manager will inform you when a return of capital has occurred. The important point is that these distributions are not taxed as long as they do not exceed your tax basis (which is the amount you invested, plus any subsequent adjustments). A return of capital distribution reduces your basis in the mutual fund shares (but not below zero). If you receive a return of capital distribution that exceeds your adjusted tax basis in your mutual fund shares, the excess is reported as capital gain. (Whether the capital gain is treated as long-term or short-term depends on how long you held your mutual fund shares.)

How do you calculate your capital gains tax liability?

This may be the most complex area of mutual funds taxation. Essentially, however, you should understand the following areas:

Calculating the tax on distributions that include a return of capital



First of all, bear in mind that when a distribution occurs, your mutual fund company will classify the distribution for you, informing you of which portion represents ordinary dividends, qualified dividends, capital gains distributions, or a return of capital. If a distribution includes both a return of capital portion and an income portion (such as dividends or capital gains), the income portion will be taxable in accordance with the rules previously discussed. You should maintain accurate records of your tax basis in order to handle any return of capital portion of the distribution.

Calculating the tax on capital gains distributions

In reporting capital gains distributions, remember that the source of capital gains distributions is the net long-term capital gain realized by the fund from the sale of investments in its portfolio. As a shareholder, you are entitled to treat distributions from these gains as long-term capital gains.

Calculating the tax on the sale of mutual fund shares

Essentially, your capital gain (or loss) on the sale of mutual fund shares equals the profit (or loss) you make from the sale of your investment in the fund (i.e., the sales price or amount realized from the sale minus your adjusted tax basis). However, tracking the tax basis of your mutual fund shares can get a bit involved, so accurate record keeping is important. In order to track your adjusted tax basis in your mutual fund shares, you will need to know: (1) when your mutual fund tax basis must be adjusted, and (2) how to calculate tax basis when you sell only some of your mutual fund shares.

Tip: *As of January 1, 2011, brokers are required to track the adjusted cost basis (your cost basis adjusted for a variety of factors such as stock splits, corporate acquisitions or spinoffs, and reinvested dividends) of stocks acquired in taxable accounts. They must report that cost basis to both the IRS and to clients on their 1099 forms. As of January 1, 2012, the new tracking and reporting requirements also apply to mutual funds. However, you must still track the cost basis for fund shares acquired before then.*

When you purchase mutual fund shares, your initial tax basis will be your cost for the shares (including any commissions or load charges). However, if you receive mutual funds via an inheritance or gift, the usual tax basis rules for inheritances and gifts apply--your starting basis for funds received as an inheritance is the date of death fair market value, and your starting basis for funds received as a gift is the tax basis of the donor.

As a holder of mutual fund shares, there are certain instances when your tax basis in your shares must be adjusted. In particular, dividends and capital gains distributions that are reinvested may warrant basis adjustments. Reinvestment plans allow you to reinvest dividends and capital gains distributions in new mutual funds shares instead of receiving cash; the distributions are reported as if you had received them in cash. However, the basis of your mutual fund account is adjusted upward for the amount reinvested. The reinvested distributions are considered your cost basis for the newly acquired shares. So, if you reinvest distributions, your basis in the new shares will equal your taxable distribution divided by the number of new shares received. The basis of your mutual fund shares will increase by the reinvested distribution amount.

Example(s): *Assume that your mutual fund generates \$10 worth of taxable earnings that has been reinvested; two additional mutual fund shares have been issued to you. Your basis in the new shares is \$5 each, while your basis in the old shares remains the same. (Your basis for all of your mutual fund shares is increased by the \$10 worth of reinvested earnings.)*

What about a return of capital distribution--how is basis affected? As mentioned earlier, return of capital distributions are fairly uncommon. Nevertheless, it is possible that you might receive a cash distribution from a mutual fund that represents a return of your investment (return of capital). A distribution in excess of earnings and profits is generally viewed as a nontaxable return of capital. When a return of capital occurs, your basis is reduced accordingly. The amount of the distribution that is a return of capital first reduces the basis of your investment. However, the basis for your mutual fund investment can never go below zero. Any return of capital distribution in excess of your adjusted basis will be treated as capital gain income.

Example(s): *Assume you have a \$12 basis in your mutual fund shares. The fund distributes \$10 as a return of capital. The distribution is not taxable, but your basis is reduced to \$2. Assume, instead, that your predistribution basis was \$8 and that the fund distributes \$10 as a return of capital. Your new basis is zero and you have \$2 of capital gain. (This gain will be treated as a long-term capital gain if you have held your shares for more than one year.)*

When you sell less than all of your shares in a mutual fund, it may be necessary to determine which shares were sold if all of your shares don't have the same holding period and/or adjusted tax basis.

The general capital gains rules require that you use the specific identification method, the first in, first out (FIFO) rule, or the average cost method to determine basis in partial sales. Basically, the specific identification method lets you pick and choose



which securities to sell (assuming you can identify them and use their specific bases). If you use the specific identification method, you must be able to (1) specify to your broker or other agent the particular shares to be sold or transferred at the time of the sale or transfer, and (2) receive confirmation of your specification from your broker in writing within a reasonable time. The FIFO method requires you to treat the first share purchased as the first sold. This may be beneficial from a long-term capital gains perspective, but it may have negative consequences in terms of tax basis if the market value of your shares has risen over time. The average cost method allows you to average your total cost basis among the number of shares you own.

Note: *You can use the specific identification method or the first-in first-out method only if you did not previously use the average cost method for a sale, exchange, or redemption of other shares in the same mutual fund.*

Are there any special issues related to mutual funds?

There are some special issues related to mutual funds. These include the following:

Withholding of taxes from mutual fund distributions

If you decide to invest in a mutual fund, the fund manager or broker will require you to furnish certain tax information up front. Mutual funds are required to withhold 28 percent ("back-up withholding") of a distribution if you:

- Ignored IRS notices stating that you have underreported interest and dividends
- Did not report your correct Social Security number to the fund, or
- Failed to certify that you are not subject to back-up withholding

However, you may be able to recover these withholding amounts as a credit when you file your federal income tax return.

Timing of gain recognition

You generally include mutual fund distributions for tax purposes in the year received. However, distributions declared in the last quarter of the year but not paid until January of the following year will generally be included in your income in the year declared (even if not distributed).

Timing of sales

If you receive a capital gains distribution and sell the shares at a loss after holding them for six months or less, you must treat this loss as a long-term capital loss.

If you received tax-exempt interest on mutual fund shares that you held for six months or less and sold at a loss, you may claim only the portion of the loss that exceeds the amount of the tax-exempt interest.

Foreign taxes

Some mutual funds invest in foreign securities or other instruments. Your mutual fund may choose to allow you to claim a deduction or credit for the taxes it paid to a foreign country or U.S. possession. The fund will notify you if this applies to you. The notice will include your share of the foreign taxes paid to each country or possession and the part of the distribution derived from sources in each country or possession.

You may be able to claim a credit for income taxes paid to a foreign country. However, it may be to your benefit to treat the tax as an itemized deduction on Schedule A (Form 1040). Investing internationally carries additional risks such as differences in financial reporting, currency exchange risk, as well as economic and political risk unique to the specific country. This may result in greater share price volatility.

Mutual fund and other investment expenses

Commissions, fees, and load charges paid to acquire or redeem mutual fund shares are not deductible against your ordinary income. Rather, these costs, when incurred in connection with the purchase of mutual fund shares, are added to tax basis. This decreases your capital gain or increases your capital loss when the shares are eventually sold.

What are your options?



Though tax considerations alone shouldn't be the sole factor in your investment decisions, there are a number of tax-planning strategies you can employ with mutual funds. These include the following:

Timing the purchase and sale of mutual funds

A mutual fund may have realized capital gains but not yet distributed these amounts to the shareholders. Prior to the record date of the distribution, the share prices should reflect this added value. Likewise, once these amounts are paid, the share value should decrease. If you purchase shares prior to the record date, you will receive a taxable distribution and your share price should decline accordingly. You have effectively accelerated your tax liability. From a tax standpoint (but not necessarily an investment standpoint), it may be more prudent to wait to purchase until after the record date.

Of course, if you can sell just prior to the record date, you may have the opportunity to convert a short-term capital gain (treated as an ordinary income distribution) into a long-term capital gain: Since the fund's basis and holding period in its investments are used to determine whether distributions from the fund are treated as capital gains distributions, but your own basis and holding period in your mutual fund shares are used to determine the tax treatment of any gain on the sale of your mutual fund shares, you may have the opportunity to convert short-term gain into long-term gain (with the potential for tax savings of up to 20 percent of the distribution).

Anticipating the gain and loss potential of your funds is essential to investment tax planning. After taking into account your tax situation and the market price of a mutual fund, think about timing your mutual fund transactions based on some or all of the following:

- Expected distributions
- Unrealized capital appreciation
- Unrealized income potential
- Unrealized losses
- Existing loss carryforward
- Turnover rates

Year-end tax planning

Year-end strategies, in part, take timing factors into consideration. You may want to recognize or avoid recognizing certain gains or income at the end of the year in light of your personal situation (i.e., the availability of capital or ordinary losses, or your tax bracket). There may be a good reason to increase your receipt of taxable income and gain.

Of course, most year-end strategies focus on deferring taxation until the next year. This is generally accomplished by selling depreciated or declining investments in the earlier year, while deferring the sale of appreciated or rising investments. Given the diversity of mutual fund investments that are available, the proceeds from the earlier sales can be immediately reinvested in similar investments. (However, if you reinvest the sales proceeds within 30 days before or after the sale in substantially identical mutual fund shares, any loss on the sale may be disallowed under the wash sale rules.)

If you have realized capital gains from selling securities at a profit and you have no tax losses carried forward from previous years, you can sell losing positions to avoid being taxed on some or all of those gains. Any losses over and above the amount of your gains can be used to offset up to \$3,000 of ordinary income (\$1,500 for a married person filing separately) or carried forward to reduce your taxes in future years. Selling losing positions for the tax benefit they could provide is a common financial practice known as "harvesting your losses."

Example(s): Harry sold shares of ABC Mutual Fund this year for \$2,500 more than he paid when he bought the shares four years ago. He now decides to sell the XYZ Mutual Fund that he bought six years ago because it seems unlikely to regain the \$20,000 he paid for it. He sold his XYZ shares at a \$7,000 loss. He offset his \$2,500 capital gain in the ABC fund, as well as \$3,000 of ordinary income tax this year. He also can carry forward the remaining \$1,500 to be applied in future tax years.

The type of mutual fund

Keep in mind that mutual funds specialize in specific types of investments. Many funds are dedicated to a single or predominant investment goal, whether it be stock with high-growth potential, income producing bonds, federal tax-exempt bonds, state tax-exempt investments, or even a balanced approach. The type of investments a fund holds could have a major impact on the tax liability you incur.



Also, a fund's investment strategy can affect the taxes you may owe on it. Some funds have a high turnover rate and, thus, frequent short-term gain recognition. Other funds buy and hold, producing relatively little taxable gain or income from year to year; these are often referred to as tax-efficient funds. The higher your tax bracket, the more consideration you should give to the tax efficiency of a fund held in a taxable account.

To engage in proper investment tax planning, you must have a clear understanding of your own tax situation--your tax bracket, the holding periods and bases of your investments, and the availability of ordinary and capital losses. One of the first decisions you must make when engaging in tax planning is whether you prefer ordinary income or capital gain income (generally, capital gain is preferable, but not always).

Once you've determined the type of income you prefer, you need to consider the various investment vehicles available. And if you decide to invest in mutual funds, it is important to include your tax situation as a factor when evaluating the various types of funds.

Matching a fund to an appropriate account

When evaluating the tax consequences of owning a particular fund, consider the type of account in which you plan to hold it. Some funds may make more sense to hold in a taxable account; others might be better in a tax-advantaged account. For example, it's generally not a good idea to hold tax-exempt investments, such as municipal bond funds, in a tax-deferred account, such as a 401(k) or IRA. Doing so provides no additional tax advantage to compensate you for tax-exempt investments' typically lower returns. Similarly, if you have mutual funds that trade actively and therefore generate a lot of short-term capital gains, it may make sense to hold them in a tax-advantaged account to defer taxes on those gains, which can occur even if the fund itself has a loss. Finally, keep in mind that distributions from a tax-deferred retirement plan don't qualify for the lower tax rate on capital gains and qualifying dividends. Before taking any specific action, be sure to consult a tax professional.

To schedule an appointment with Faye Sykes, click [here](#) .

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