

Mutual Fund Distributions

Mutual funds can be very effective investment tools. They provide investors with access to a wide range of investment options, they offer much broader diversification than most investors can achieve by investing in stocks, and they allow investors to create broadly diversified portfolio with small investments.

Most investors understand these advantages, and they have embraced mutual funds. One aspect of mutual funds that tends to confuse many investors, however, is how they are treated for tax purposes.

HOW MUTUAL FUND INVESTORS ARE TAXED

Mutual fund investors are taxed for three things:

Sale. When an investor sells a mutual fund in an account that is not tax-advantaged (IRA, 401k, etc...), she is responsible for paying taxes on the fund's appreciation, or the gain that she has experienced while holding the mutual fund.

The gain will be taxed as long-term capital gains if the asset has been held for more than 12 months, or short-term capital gains if the asset was held for 12 months or less. The investor generally has control over this decision, and this is no different than the way an investor in individual stocks is taxed when he/she sells the individual stock.

Dividend distribution. Dividends paid by the stocks that a fund owns are generally taxable income for the fund's shareholders – *whether or not the distribution is paid to the investor or reinvested in the fund.*

This taxation is not unlike that of an investor who receives a dividend from an individual stock. Dividend distributions are reported annually on a Form 1099.

Capital gains distributions. Mutual funds are “pass through entities” for tax purposes, and they are required to pass their realized gains along to their shareholders. Consequently, if a mutual fund's transactions throughout the year result in net capital gains, the shareholders receive a capital gains distribution.

Unless the fund is held in a tax-advantaged account, this distribution is taxable *whether or not it is paid to the investor or reinvested in the fund.* Capital gains distributions are reported annually on a Form 1099.

TAX BASIS, AND ADJUSTMENTS FOR DISTRIBUTIONS

When a mutual fund is sold, the investor reports capital gains or losses (unless the fund is held in a tax-advantaged account). In order to calculate the gain or loss, it is necessary to know the fund's “tax basis,” or the net cost of the fund. The tax basis is essentially calculated as follows: *tax basis = total contributions - total withdrawals.*

Investors often reinvest their dividend and capital gains distributions back into the mutual fund that generated the distribution. These reinvested distributions are still considered taxable income to the investor, which makes logical sense...the investor had the opportunity to either take the distribution in cash, or to reinvest it. Choosing to reinvest the distribution is no different than taking the cash and using it to purchase more shares of the mutual fund.

Since the investor made an additional purchase in the mutual fund with his distribution, reinvested mutual fund distributions are added to the fund's tax basis in order to more accurately reflect the cost an investor incurred for purchasing the fund. This reduces the taxable gain when the fund is eventually sold.

STRATEGIES TO MANAGED MUTUAL FUND TAXES

Use tax-efficient funds in taxable accounts. Certain mutual funds are inherently more tax-efficient than others. The managers of these funds may minimize trading, “harvest” losses to offset gains, or extend the average holding period in order to take advantage of lower long-term capital gains tax rates.

Passively managed asset class funds, which are predominately used in our portfolios, are generally more tax-efficient because they sell shares relatively infrequently.

Be aware of fund distribution dates. Most funds distribute their earnings in the fourth quarter of the year, and they will generally provide information on the timing and amount of expected distributions. If you are planning to invest in December, understanding when a fund plans to distribute earnings may be important, since waiting a short period of time may avoid an unnecessary tax liability.

Avoid funds high turnover rates. A fund's turnover rate is a measure of how frequently the funds assets are sold. The higher the turnover rate, the more likely the fund is to generate taxable distributions.

SUMMARY

Mutual funds are very effective tools for most investors, but they need to be understood in order to be used effectively. The taxes associated with mutual funds may be significant, and unexpected. If you're investing in a taxable account, take the appropriate steps to manage your taxes.

It is impossible to avoid all taxes, however, and even the most tax-efficient funds will have to pass along taxes at some point. The only way to avoid any taxable distributions is to invest in funds that generate no gains, and this is classic “tail wagging the dog” strategy.

Taxes are an important factor in investment analysis, but they should not be allowed to dictate policy. It is after-tax return this is the primary goal, not tax minimization by itself.

If you have questions about this article, or the tax-efficiency of the funds held in your portfolio, please do not hesitate to contact me.

Sincerely,

Bill Moeckel, CFA, CFP