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White Paper

Tax Planning for Mutual Funds

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Tax Planning for Mutual Funds

What is investment tax planning for mutual funds?

Investment tax planning for mutual funds involves utilizing the tax rules to maximize your after-tax return on mutual fund investments. In order to maximize 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. The funds then either distribute or reinvest these earnings. You are taxed on the earnings whether they are distributed to you or reinvested, and you may also incur a taxable gain (or loss) when you sell shares in the fund.

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, under the Jobs and Growth Tax Relief Reconciliation Act of 2003 and the Tax Increase Prevention and Reconciliation Act of 2005, qualifying dividends received by an individual shareholder from a domestic corporation or qualified foreign corporation in tax years 2003 through 2010 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. In 2011, absent further legislative action, the law reverts to pre-2003 Tax Act status--all dividend income distributions from mutual funds will again be taxable as ordinary income.

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 1, 2005. ABC Mutual Fund paid a cash dividend of 10 cents per share. The ex-dividend date was July 9, 2005. 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 4, 2005. You have no qualified dividends from ABC Mutual Fund, because you did not hold the ABC Mutual Fund stock for more than 60 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. The type of securities held by the mutual fund will determine what 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 is probably 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 vital. 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.

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. This may make calculating your tax basis easier, since you do not need to identify and keep track of specific shares sold.

If you use the average cost method, you have two options. The first is referred to as the average-cost single category method. This allows you to average the basis of all of your shares in a single mutual fund regardless of how long you have owned the shares. The actual holding period of shares sold is determined under the FIFO method. Thus, when shares are increasing in value, you are likely to receive a more favorable tax basis as well as long-term capital gains tax treatment if you use the single category average-cost method. The second option is called the average-cost double category method. This requires you to calculate separate average cost bases for your long- and short-term shares. You may then choose which shares you wish to sell. To take advantage of the average cost methods, you must make an election on your tax return. Once this election is made, you are not permitted to switch to another method without approval of the IRS. In addition, if you use the double category method, you must also inform the mutual fund custodian whether the shares sold are treated as long-term or short-term.

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 when you file your federal income tax return and claim a tax refund.

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).

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?

There are a number of tax-planning considerations relating to 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. Given the differences in the top tax rates, this could save you as much as 20 percent on the distribution amounts. Further, 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 (again, with the potential for tax savings 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 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.)

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-free bonds, state tax-free investments, or even a balanced approach. Some funds have a high turnover rate and, thus, frequent short-term gain recognition. Other funds buy and hold, producing very little taxable gain or income.

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 become familiar with the different types of mutual funds.

Disclosures

This material does not constitute the rendering of investment, legal, tax or insurance advice or services. It is intended for informational use only and is not a substitute for investment, legal, tax, and insurance advice.

State, national and international laws vary, as do individual circumstances; so always consult a qualified investment advisor, attorney, CPA, or insurance agent on all investment, legal, tax, or insurance matters.

The effectiveness of any of the strategies described will depend on your individual situation and on a number of other factors. After reviewing your personal situation, we may recommend that you not use any strategy in this document but instead consider various other strategies available through our practice.

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