Investing in Mutual Funds

Despite recent concerns with regulatory compliance by some mutual funds, many of our clients remain investors in mutual funds while others have expressed an interest in putting some of their investment money into mutual funds. A complex set of tax rules need to be considered when making decisions about when to invest, what type of fund to invest in, dividend options, switching between funds within a mutual fund family, and selling shares.

What type of fund. There are literally thousands of mutual funds that you can choose from to invest in. The choice of fund generally narrows based on one's investment preferences and goals, e.g., high current yield income, long-term appreciation, or tax-free income. These considerations are generally the same as would be applied in making a direct investment in corporate stock, bonds, etc.

As among the choice of funds, if you have unused capital losses carried over from an earlier year, you might prefer to invest in a fund whose objective is capital appreciation rather than current income. Capital gain distributions by the fund can be offset by the loss carryover so that in effect the distribution is tax-free. If your income puts you in a high tax bracket, you might want to select a fund seeking capital appreciation (to take advantage of the favorable rates on long-term capital gains), a fund that invests in dividend paying stocks and that distributes dividends taxable at capital gains rates, or a tax-free bond fund. However, it's important to remember that regardless of the type of fund selected, distributions from any fund, even a so-called tax-free bond fund (see below), can have unanticipated tax consequences to the investor.

When to invest. A purchaser of mutual fund shares owns a proportionate share of all of the fund's investment holdings, including, in addition to the stock and bonds that comprise the fund's portfolio, any accrued but undistributed interest or dividend income and capital gains earned by the fund. If you buy mutual fund shares shortly before a dividend distribution, you may be buying a tax liability. The share price you pay reflects this income right. Say for example that you buy 1,000 mutual fund shares for $10 a share shortly before the fund declares and pays a dividend of $2 per share.

As a result of the dividend, the per share price will drop to $8. More important, you will have to include the $2,000 ($2 × 1,000) dividend in your income (regardless of whether you receive the dividend in cash or reinvest it in additional fund shares) even though there has been no increase in the overall value of your investment. If the investment had been delayed until after the dividend. the same $10,000 investment would have purchased 1,250 shares (at $8 per share) and this problem of phantom income would have been avoided.

Nature of fund distributions. A mutual fund or regulated investment company (the more formal name for these investment vehicles) is generally taxed as a conduit. They distribute all or most of their income to shareholders. These distributions can take the form of dividends that are taxed at capital gains rates, capital gain distributions, tax-exempt-interest dividends, and distributions that represent return of capital. A mutual fund shareholder will receive a Form 1099-DIV from the fund showing the total amount distributed and providing the information necessary to properly report those distributions on the shareholder's income tax return. It's worth noting that a fund that invests solely in tax-exempt municipal bonds may nonetheless generate taxable income.

If the fund has realized a profit on the sale or disposition of such bonds, the resulting capital gain will be distributed and taxed to the shareholders. Note also that a mutual fund does not pass its losses through to its shareholders, it just uses them to net against gains, with excess losses carried to other years.

The fact that the investor may choose to receive his distribution in additional shares in the fund (rather than in cash) does not affect the immediate tax consequences. A dividend reinvestment option is treated as if the investor had received the distribution in cash and then used the cash to acquire additional shares. These new shares have a basis equal to their cost, i.e., the amount of the dividend that was used to purchase them.

An investor who makes specific direct investments in stocks or bonds can generally control when and to what extent to realize capital gains. This is not true to the same extent with mutual fund investments. If a fund's investment portfolio has done well in a given year, the fund may make a large distribution near the end of the year because of gains that it has realized. These will be taxed to the investor as ordinary dividend to the extent of short-term gains, and capital gain distribution to the extent it represents long-term gains of the fund. Because the fund may wait until late in Dec. before announcing the amount that it is distributing, year-end tax planning can be more difficult for individuals with substantial mutual fund holdings.

So-called 'index funds' offer a way to avoid most of the problems associated with capital gain distributions. Index funds generally invest in the stocks or bonds that make up some market index, e.g., the Standard and Poor's 500. They remain fully invested in the component elements of the underlying index so that the price of the fund tracks the movement of the index. These funds generally do not sell any of their holdings unless necessary to provide funds for shareholder redemptions or to adjust for changes in the components of the index. As a result, these funds generally do not realize significant capital gains and their capital gain distributions are correspondingly low. Instead, appreciation in value is reflected in the price of the fund's shares and is only translated into capital gain when the investor chooses to sell.

Even if you do not invest in index funds, you should be able to minimize tax costs by checking several factors in the financial information made available by the fund in which you are

considering investing. First, check the fund's portfolio turnover rate (the reciprocal of its average holding period for its stocks). The longer the fund tends to hold its investments the lower its turnover rate and the less likely it is for the fund to be distributing taxable gains to its shareholders.

Next, check the fund's net realized gain. This is the amount of gain the fund has realized since its last distribution. Finally, check the unrealized appreciation in the fund's holdings. This represents the gains the fund will realize as it sells its investments. By investing in funds with low portfolio turnover and comparatively lower realized and unrealized gains, you should be able to minimize the tax cost of your mutual fund investments.
In order to properly determine basis, discussed below, proper recordkeeping with respect to reinvestment of fund distributions is very important.

Sale of fund shares. When an investor in a mutual fund sells some or all of his shares, gain or loss is recognized. The gain or loss is measured by the difference between the amount realized from the sale of the fund shares and the basis for those shares. One difficulty with mutual fund investments is that certain transactions are treated as sales even though they might not normally be thought of as such. Another problem can arise in determining your basis for shares sold, particularly if you are selling only a portion of your fund holdings and the shares were acquired at different times and at different prices.

What is a sale. No one is likely to dispute the fact that a sale occurs when an investor has all of his shares in a mutual fund redeemed and receives a check for the proceeds. Similarly, there is a sale if the investor directs the fund to redeem the number of shares necessary for a specific dollar payout, e.g., sufficient shares to produce a payout of $5,000.
It may be less obvious that a sale occurs if you are merely swapping funds within a fund family, for example the surrender of shares of the X Income Fund for an equal value of shares of the X Growth Fund received in exchange. Even though no money passes hands, this is treated as a sale of the X Income Fund shares.

Many mutual funds provide check writing privileges to their investors. This is often a convenient and speedy way to pay large bills (as compared to directing the fund to redeem shares and send you a check, which then must be deposited in your regular checking account and clear before you can draw against it). However, each time you write a check on your fund account you are making a sale of shares in the fund. Do this 20 or 30 times a year and you are going to have a fairly complex capital gains schedule attached to your income tax return.

Determining basis of shares sold. If an investor disposes of all of his shares in a particular mutual fund in a single transaction, determining basis is relatively easy. Simply add the basis of

all the shares, i.e., the amount of actual cash investments (including any commissions or sales charges) plus distributions by the fund which were reinvested to acquire additional shares less any distributions that represented a return of capital.

The calculation becomes more complex if the investor is disposing of only a portion of his interest in the fund and the shares were acquired at different times and at different prices. Taxpayers can use one of several methods to identify the shares sold and determine their basis.

• First-in first-out method. The basis of the earliest acquired shares is used as the basis for the shares sold. If the share price has been increasing over the period of ownership, the older shares are likely to have a lower basis and thus result in more gain.
• Specific identification method. You can specify to the fund at the time of the sale the particular shares to be disposed of, e.g., 'sell 200 of the 300 shares I purchased on July 1, Year 1'. You must receive written confirmation of your specification from the fund. This method often can be used to lower the resulting tax liability by directing the sale of the shares with the highest basis.
• Average basis. IRS permits you to use the average basis for shares that were acquired at various times and that were left on deposit with the fund or a custodian agent. Under the single category method, you find the average cost of all of your shares regardless of how long you owned them. In applying the long-term and short-term rules, shares are considered to be sold in the order in which they were acquired. This method gives the investor less flexibility in choosing which shares to dispose of, but is relatively simple to apply. An investor can also use a somewhat more complex double category method which determines the average basis for two separate groups of shares, those held long-term and short-term holdings. As with the specific identification method, above, the investor specifies from which category the shares are to be sold.