Mutual Funds - Unforeseen Tax Consequences

Mutual funds are probably the single most popular way for investors to participate in the securities markets. Combined with the post-May 6, 1997, reduction in capital gains rates, sales of mutual funds represent a significant opportunity to cash in on the runup in stock prices of the last few years. Yet these investments are subject to a number of special tax rules that can yield unexpected tax results come April 15th, not all of them pleasant. Fortunately, these tax consequences can often be minimized with proper planning for your mutual fund investments.

First, you should be aware that you must include on your tax return mutual fund transactions that you wouldn't normally think of as taxable sales. Among these are switches among types of funds, even within one family of funds run by the same company. For example, if you switch part or all of your investment from a family's technology fund to its overseas fund, you have made a taxable exchange, even if you are not charged a fee for the switch. Thus, an investor who often realigns a portfolio this way can accumulate a large number of taxable transactions during the year and, where less than the full investment is disposed of, drastically increase recordkeeping chores until the investment is fully disposed of. Also, if a fund offers check-writing privileges, *each* check written is considered a redemption that requires reporting on Schedule D, even if there is no gain or loss.

Another consideration is that *when* you buy or sell mutual funds can affect your tax liability. For example, if you buy a fund after a dividend is declared but before it is paid, you will have to include the dividend in your ordinary income even though the price you paid reflected the upcoming dividend. Conversely, selling the same fund at this time can result in favorable capital gains treatment of the sales proceeds, even though part of the price you receive is really for the imminent dividend on your shares.

Although capital gain distributions generally are treated as long-term capital gains regardless of how long the taxpayer has owned the shares in the mutual fund, less advantageous consequences result if the taxpayer receives a capital gain distribution on mutual fund shares that he held for six months or less and sold at a loss.

These potential problems may be alleviated not only by careful attention to timing, but also by choosing the right method of determining the tax basis of the shares you sell. You can identify each block of shares you sell and specify what you paid for them. The IRS also allows you either to compute your tax basis in a first-in-first-out manner or, alternatively, to elect to use one of two averaging cost methods. Under any of these methods, however, there are specific procedures to be followed in order for you to use the one that works out best for you. Professional advice is essential to following these procedures correctly so that they are effective in minimizing your tax bill.

There may even be state income tax consequences resulting from what your mutual fund invests in. For example, New York does not tax the portion of mutual fund dividends paid from a fund's U.S. Treasury securities, even though these dividends are fully taxable for Federal purposes.

The key to correctly reporting your mutual fund transactions and optimizing their tax results is meticulous record-keeping. You should always retain all documentation supplied by your mutual funds, so that, for example, when you sell you are sure to receive full credit in your tax basis for any commissions, redemption fees, load charges and all fund earnings, whether dividends (including exempt-interest dividends) or capital gain distributions, that are reinvested on your behalf.

If you have already engaged in mutual fund transactions this year or are thinking of doing so, please do not hesitate to call us.