Should You Sell Mutual Funds to Avoid Capital Gain Distributions?

By Patti S. Spencer, Esq.
Published in the *Lancaster Intelligencer Journal* October 20, 2008

Spencer Law Firm
320 Race Avenue
Lancaster, PA 17603
Phone 717.394.1131
Fax 717.509.2018
patti@spencerlafirm.com
www.spencerlawfirm.com

It has been a lousy year for equity mutual fund investors. According to ***Morningstar***, the average U.S. diversified stock fund is down 33% year-to-date. Adding insult to injury, some mutual fund owners are going to have to pay hefty income tax bills on their mutual funds that lost value. Why? Because of year-end capital gain distributions. Yes, even funds that are way down may be throwing off substantial amounts of income because of sales inside the fund earlier in the year.

Some fund holders may wonder how it is possible for capital gains to be possible in a declining market. The realized gains are from stocks that were in the mutual fund portfolio, perhaps for several years, and when liquidated this year, even in a down market, still had significant gains.

In general, a mutual fund itself is not taxed if it distributes substantially all of its income (at least 98%) to its shareholders. The shareholders must report mutual fund distributions as income. Dividends and interest from holdings inside the fund, as well as any capital gains from the sales inside the fund, are taxed to the shareholders.

There are two types of mutual fund distributions: (1) ordinary dividends and (2) capital gain distributions. Ordinary dividends are taken from the dividends and interest earned inside the mutual fund and are paid out to shareholders, often quarterly. Capital gain distributions are distributions made to fund shareholders when the gains from the fund's sales of securities exceed losses. Capital gain distributions are always treated as long term capital gain, no matter how long you owned the mutual fund shares.

Since mutual funds are required to distribute at least 98% of their income annually, and since net gains and losses cannot be determined with any accuracy until near year-end, many mutual funds make their largest distributions in December. Don’t buy mutual fund shares right before a December capital gain distribution. Buying mututal fund shares at this time will result in you paying tax on the distribution, which represents earnings over the course of a year in which you did not participate.

Tom Herman, writing for the *Wall Street Journal*, points out that despite the stock market's nose dive, many funds are likely to make year-end capital-gains distributions this year. Herman says: "That means it may be a good time to consider selling some underperforming funds before they make a taxable distribution. It also means that bargain-hunters looking to get back into the market now need to be careful. Otherwise they could be saddled with a stiff tax bill that could easily have been avoided."

If you sell fewer than all of your mutual fund shares, you need to determine what is the best way to allocate your basis among the shares. There are three approaches: 1) first-in, first-out (FIFO), 2) average cost, and 3) specific identification.

First-in, first-out assumes that the first shares you bought are the first shares you sold.

Average cost is determined by adding up the total cost of all the shares you own and dividing by the number of shares. It can be done on all shares, or in two categories, the average cost of long-term shares and the average cost of short-term shares.

If you have a record of all the purchase dates and prices of all shares you own, including shares purchased with reinvested dividends, you can pick individual shares to be sold. If you use this method you can pick out the shares that have the highest basis to be the ones you sell, thus, keeping your gain to a minium. To use this method you must indicate to the fund or your broker which shares you are selling - you can't designate them after the fact.

Your mutual fund statement may calculate gain or loss for you. The mutual fund broker usually uses the average cost method. You are not required to calculate your gain or loss using the method shown on the statement. However, once you start reporting using average cost, you have to report all future sales using that method.

Capital gains and losses can offset each other dollar-for-dollar. If your losses exceed your gains, you can deduct $3,000 of capital losses from other ordinary income. Unused losses are carried over into future years.

If you decide to sell a mutual fund to avoid the capital gain distribution and then buy it back because you like it as an investment, beware of the wash sale rules. You can't deduct losses from sales of stock in a wash sale, which occurs when you sell a stock at a loss and buy the same stock within 30 days before or after a sale.