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TIP 123 TAX STRATEGIES FOR MUTUAL FUNDS

Q. How can I reduce taxes on my mutual fund investments?

A. Mutual funds must distribute their capital gains and dividend income to investors at least once per year. These distributions are subject to income taxes, whether taken in cash or reinvested into the fund. Even in a down market, do not assume that your fund will not have capital gains to distribute. Capital gains result from stocks (or bonds) being sold at a profit, which means that, even if your mutual fund posted a loss, you still could be hit with a capital gains distribution.

Here are some strategies to reduce the tax liability from your mutual fund investments.

Invest in Tax-Efficient Mutual Funds

Depending on how they are managed, some mutual funds generate a larger tax bill than others, so it pays to consider tax efficiency when choosing funds. To reduce tax liability, consider investing in a tax-managed fund or an index fund.

Tax-managed funds are those in which the fund manager takes steps to reduce capital gains distributions throughout the year by reducing the number of trades in the fund and/or by offsetting gains with losses before the end of the year.

Index funds are inherently tax-efficient, because they are designed to track a benchmark (like the S&P 500). Benchmarks are baskets of selected stocks pooled together to represent the broad stock market or a specific segment of the market. Because the makeup of the baskets does not change regularly, the stocks therefore aren't traded frequently, and the fund doesn't realize capital gains on the sale of appreciated stocks in the portfolio.

Invest in Tax-Exempt Municipal Bond Funds

As with individual state and local municipal bonds, the interest earned on municipal bond funds is exempt from both federal and state income tax in the state in which the bonds originated. Thus, investors in high income tax brackets reap the tax benefits of municipal bonds, while also benefiting from the diversity, lower investment minimums, and professional management of mutual funds.

Time Your Investments Carefully

If you invest in a mutual fund late in the year and that fund has realized significant capital gains that year, you may be purchasing a tax liability. To avoid this, review funds for the estimated dates and amounts of capital gains distributions before you invest, and purchase after the capital gains distributions have taken place. You can usually get information about expected capital gains distributions by calling the mutual fund company or visiting them online.

Harvest Tax Losses

Before the end of each year, inventory capital gains distributions that you have or expect to receive. If you have significant capital gains, consider selling an investment at a loss to offset some of those gains. You may even wish to consider this strategy in a down market where you do not have capital gains. This strategy is called *harvesting tax losses*. You may repurchase the same positions that you sold after 31 days, or you may purchase similar investments right away.

Identify Which Shares You Are Selling

The IRS allows you to determine which shares you are selling when you sell a portion of your stock or mutual fund holdings. The shares you specify will determine your tax liability. You may choose from the following methods when determining which shares to sell: first in, first out; average cost; and specific identification. If you do not choose a method, the IRS assumes that the shares sold were the first shares you purchased. A note of caution, however: This method usually results in realizing the greatest tax liability in the near term. The average cost method is the simplest to use, and it may help balance your tax liability by averaging the purchase cost over all of your shares. The specific identification method gives you the greatest control over matching your shares sold; however, it is also the most time-consuming method, and good record keeping is a must. Whichever method you choose, you must continue to use.

Keep Good Records

To correctly identify which shares to sell takes good records. Each time you make a mutual fund purchase, keep track of the date of purchase, number of shares, and price paid for all original and subsequent shares purchased. Also, keep track of all shares that were reinvested (dividend and capital gains distributions should be automatically reinvested in most cases). These distributions are taxed in the year received. If reinvested to buy more shares, these distributions, should be added to the cost basis of your investment. This will avoid double taxation when the shares are eventually sold.

If you own individual stocks, keep records of stock splits, spin-offs, and mergers so that later you have the historical information to accurately assess the capital gains/loss implications of selling. The easiest way to do this is with a software program like Quicken or Money and by using financial Web sites like Yahoo and your brokerage firm’s.

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