*Chapter 6*

# Mutual Funds and Taxes

Mutual funds make two basic types of taxable distributions to shareholders every year: ordinary dividends and capital gains.

**Dividend distributions** come primarily from the interest and dividends earned by the securities in a fund's portfolio, after expenses. These payments must be reported as dividends on an investor's tax return.

**Capital gain distributions** represent a fund's net gains, if any, from the sale of securities held in its portfolio for more than one year. When gains from these sales exceed losses, they are distributed to shareholders.

At tax time, mutual funds send investors Form 1099-DIV (see page 53), which tells them what earnings, if any, to report on their income tax return. Ordinary dividends are reported as dividend income; capital gain distributions are reported as long-term capital gains—regardless of how long the taxpayer has owned the fund shares.

## HOW DIVIDEND AND CAPITAL GAIN DISTRIBUTIONS AFFECT A FUND'S SHARE PRICE

Whenever funds distribute dividends and capital gains to shareholders, the share price or net asset value (NAV) drops by the amount distributed. For example, an

### The Chief Federal Statute Governing Mutual Fund Taxation

Unlike most corporations, a mutual fund generally distributes all of its earnings each year and is taxed only on amounts it retains. Thus, the fund's earnings typically are taxed only once—when received by the fund's shareholders.

This specialized "pass-through" tax treatment of mutual fund income and capital gains was established under the Revenue Act of 1936 and endures today under Subchapter M of the Internal Revenue Code of 1986. To qualify for this favorable tax treatment under the Code, mutual funds must meet, among other conditions, various investment diversification standards and pass a test regarding the source of their income.

## Capital Gain and Dividend Distributions to Shareholders All Types of Mutual Funds

(billions of dollars)

| Year | Capital Gain Distributions | Dividend Distributions | | |
|---|---|---|---|---|
| | Equity and Bond & Income Funds | Equity and Bond & Income Funds | Taxable Money Market Funds | Tax-exempt Money Market Funds |
| 1978 | $0.7 | $2.1 | $0.4 | - |
| 1979 | 0.9 | 2.5 | 2.7 | - |
| 1980 | 1.8 | 2.7 | 7.7 | $0.1 |
| 1981 | 2.7 | 3.1 | 18.5 | 0.1 |
| 1982 | 2.4 | 3.8 | 21.7 | 0.3 |
| 1983 | 4.4 | 5.0 | 13.2 | 0.6 |
| 1984 | 6.0 | 7.2 | 15.4 | 1.0 |
| 1985 | 5.0 | 12.9 | 14.4 | 1.6 |
| 1986 | 17.5 | 22.3 | 11.1 | 2.4 |
| 1987 | 23.0 | 31.8 | 12.8 | 2.8 |
| 1988 | 6.3 | 32.0 | 17.3 | 3.5 |
| 1989 | 14.8 | 34.1 | 24.7 | 3.9 |
| 1990 | 8.1 | 32.9 | 26.3 | 3.8 |
| 1991 | 14.1 | 35.3 | 25.2 | 3.5 |
| 1992 | 22.3 | 59.2 | 17.2 | 3.1 |
| 1993 | 36.1 | 73.3 | 15.9 | 3.3 |
| 1994 | 30.0 | 61.5 | 20.5 | 3.2 |
| 1995 | 54.6 | 67.5 | 32.8 | 4.2 |
| 1996 | 101.1 | 73.7 | 38.3 | 4.2 |
| 1997 | 184.1 | 80.0 | 44.0 | 4.7 |

investor buys 10 shares of a fund for $100 at an NAV of $10. Later, the fund distributes a capital gain of 50 cents per share and ordinary income of 50 cents per share ($1 per share). At this point, the shareholder receives a $10 dividend, the NAV drops to $9 a share, and the total value of the shareholder's 10 shares declines to $90.

Despite the lower post-distribution price, the total value of the shareholder's investment remains unchanged. If the shareholder reinvested the dividend, 1.1 additional shares (with an NAV of $9) are

## How to Read Form 1099-DIV

Once a year a fund sends a Form 1099-DIV to any shareholder receiving $10 or more of taxable income. This form contains much of the tax reporting information a shareholder needs. Any taxpayer who receives a capital gain distribution from a mutual fund is required to complete Schedule D (for capital gains and losses) as part of year-end tax filing.

**Ordinary dividends**—the amount to report on Form 1040 as dividend income. These include any short-term capital gain distributions (assets held less than 12 months).

**Total capital gain distributions**—the amount to report as capital gain distributions. Amounts reported in box 2a include amounts reported in boxes 2b, 2c and 2d.

**28% rate gain**—capital gain distributions subject to the 28% maximum tax rate. These include assets held by the fund between 12 and 18 months.

**Unrecaptured sec. 1250 gain**—the portion, if any, of capital gain distributions attributable to certain real estate investments.

**Nontaxable distributions**—distributions that represent a return of capital; these are not taxable, but do reduce the basis of fund shares.

**Foreign tax paid and foreign country or U.S. possession**—an amount entered here represents a shareholder's proportionate share of foreign income tax paid by the fund. An investor may be able to take a deduction or credit for this amount. An investor taking a foreign tax credit may be required to attach Form 1116 to Form 1040.

| | | | |
|---|---|---|---|
| PAYER'S name, street address, city, state, ZIP code, and telephone no.<br>Mutual Fund XYZ<br>555 Investment Street<br>San Francisco, CA 94104 | 1 Ordinary dividends<br>$ 986.10<br>2a Total capital gain distr.<br>$ 1,691.03 | OMB No. 1545-0110<br>1998<br>Form 1099-DIV | Dividends and Distributions |
| PAYER'S Federal identification number 12-3456789 / RECIPIENT'S identification number 234-56-7890 | 2b 28% rate gain<br>$ 947.66 | 2c Unrecap. sec. 1250 gain<br>$ 0.00 | Copy B<br>For Recipient |
| RECIPIENT'S name<br>Jane D. Investor | 2d Section 1202 gain<br>$ | 3 Nontaxable distributions<br>$ 0.00 | This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported. |
| Street address (including apt. no.)<br>345 Capitol Street | 4 Federal income tax withheld<br>$ | 5 Investment expenses<br>$ | |
| City, state, and ZIP code<br>Washington, DC 20002 | 6 Foreign tax paid<br>$ 0.00 | 7 Foreign country or U.S. possession | |
| Account number (optional) | 8 Cash liquidation distr.<br>$ | 9 Noncash liquidation distr.<br>$ | |

Form 1099-DIV (Keep for your records.) Department of the Treasury - Internal Revenue Service

*Note: Funds often send "substitute" forms that contain the required information shown above, but in a different layout.*

purchased for $10 and the total value of the 11.1 shares returns to $100. If the $10 is retained, the investor has 10 shares worth $90 and $10 in cash.

## SHARE SALES AND EXCHANGES

An investor who sells mutual fund shares usually incurs a capital gain or loss in the year the shares are sold; an exchange of shares between funds in the same fund family also results in either a capital gain or loss (see page 56, *Tax-deferred Retirement Accounts,* for exceptions to these rules).

Investors are liable for tax on any capital gain arising from the sale of fund shares, just as they would be if they sold any other security such as a stock or bond. Capital losses from mutual fund share sales and exchanges, like capital losses from other investments, may be used to offset other gains in the current year and thereafter.

The amount of a fund's gain or loss is determined by the difference between the "cost basis" of the shares (generally, the purchase price for shares, including those acquired with reinvested dividends) and the sale price. To figure the gain or loss on a sale of shares, it is essential to know the cost basis. Many funds provide cost basis information to shareholders or compute gains and losses for shares sold.

Gains and losses on the sale or exchange of fund shares are reported on Part I of Schedule D (*Short-term Capital Gains and Losses*) if the shares were held for one year or less, and on Part II (*Long-term Capital Gains and Losses*) if held for more than one year. The amount of any redemption gain or loss on a "28 percent rate gain" transaction is reported in the 28 percent rate column (column [g]) of Schedule D.

## TAX-EXEMPT FUNDS

Tax-exempt bond funds pay dividends earned from municipal bond interest. This income is exempt from federal income tax and, in some cases, state and local taxes as well. Tax-exempt money market funds invest in short-term municipal securities, and also pay exempt-interest dividends.

Even though income from these two types of funds is generally tax-exempt, investors must still report it on their income tax returns. Tax-exempt mutual funds provide investors with this information in a year-end statement, and typically explain how to handle tax-exempt dividends on a state-by-state basis. For some taxpayers, portions of

## How to Read Form 1099-B

A mutual fund sends Form 1099-B, typically after year-end, to each shareholder who sells fund shares during the year. Any taxpayer who sells or exchanges during the year must complete Schedule D (for capital gains and losses) as part of their year-end tax filing, based on information found on Form 1099-B and fund account statements.

**Date of Sale**—the date on which the fund transaction occurred.

**CUSIP No.**—the fund's identification number.

**Stocks, bonds, etc.**—the proceeds in dollars delivered to the shareholder.

**Federal income tax withheld**—shareholders not furnishing a taxpayer identification number are subject to backup withholding at a 31% rate on certain payments.

**Description**—a brief description of the transaction or the fund.

PAYER'S name, street address, city, state, ZIP code, and telephone no.
Mutual Fund XYZ
555 Investment Street
San Francisco, CA 94104

1a Date of sale
4/29/97

1b CUSIP No.
74148110

OMB No. 1545-0715
1998
Form 1099-B

**Proceeds From Broker and Barter Exchange Transactions**

2 Stocks, bonds, etc.
$ 2,756.94

Reported to IRS } ☐ Gross proceeds ☐ Gross proceeds less commissions and option premiums

PAYER'S Federal identification number
12-3456789

RECIPIENT'S identification number
234-56-7890

3 Bartering
$

4 Federal income tax withheld
$0.00

**Copy B**
**For Recipient**

RECIPIENT'S name
Jane D. Investor

5 Description
Exchange to International Fund

**Regulated Futures Contracts**

Street address (including apt. no.)
345 Capitol Street

6 Profit or (loss) realized in 1998
$

7 Unrealized profit or (loss) on open contractsÐ12/31/97
$

City, state, and ZIP code
Washington, DC 20002

8 Unrealized profit or (loss) on open contractsÐ12/31/98
$

9 Aggregate profit or (loss)
$

Account number (optional)

This is important tax information and is being furnished to the Internal Revenue Service. If you are required to file a return, a negligence penalty or other sanction may be imposed on you if this income is taxable and the IRS determines that it has not been reported.

Form **1099-B** (Keep for your records.) Department of the Treasury - Internal Revenue Service

*Note: Funds often send "substitute" forms that contain the required information shown above, but in a different layout.*

income earned by tax-exempt funds may also be subject to the federal alternative minimum tax, which can raise the need for an investor to consult a tax adviser.

Even though municipal bond dividends and interest may be tax-free, an investor who redeems tax-exempt fund shares may realize a taxable capital gain. An investor may also realize a taxable gain from a tax-exempt fund if the fund manager sells securities during the year for a net gain.

## TAX-DEFERRED RETIREMENT ACCOUNTS

Mutual fund investments in certain retirement accounts are tax-deductible and, generally, dividend and capital gain distributions remaining in the accounts accrue tax-deferred until distributed to the investor.

In employer-sponsored 401(k) plans, for example, individuals typically contribute pre-tax dollars from their salary to an account in the plan. Similarly, IRA contributions may be tax-deductible depending upon a person's eligibility to participate in an employer-

### Year-end Distributions from Mutual Funds

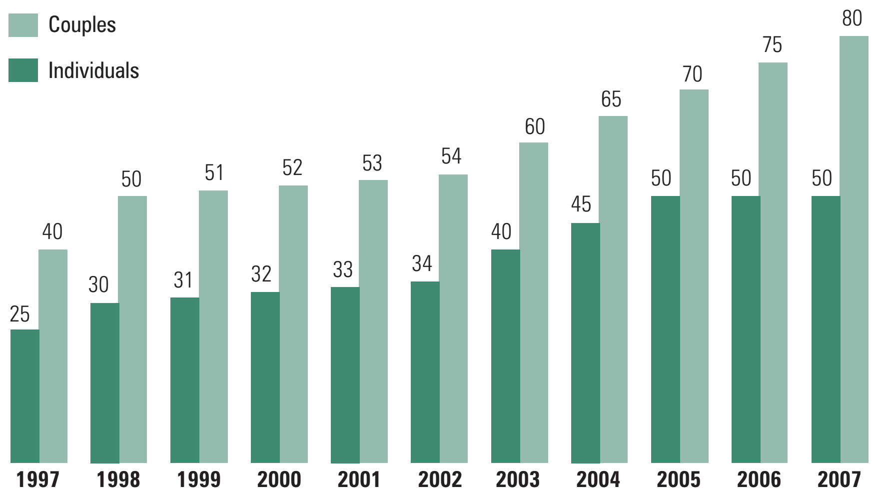
Investors often hear suggestions, around November and December, to postpone large, lump-sum mutual fund share purchases until January. Mutual funds sometimes make large taxable distributions around this time, the argument goes, and an investor can avoid taxes by waiting the few weeks until the new tax year begins on January 1.

A "timing" strategy can ignore other important considerations. Before employing a timing strategy, investors should consider the type of fund and the amount of any expected distribution. The timing of investments in money market funds, for example, is irrelevant. These funds declare dividends daily, maintain a $1 share price, and investors incur a tax liability on the dividends declared each day. Even with long-term funds—stock, bond and hybrid (which invest in both stocks and bonds)—the value of a timing strategy may prove less than clear-cut. For example, bond funds usually offer periodic (e.g., monthly) distributions, making year-end payouts typically small.

Generally, for investors considering funds that make relatively small dividend and capital gain distributions, the benefits of timed transactions may be outweighed by the market risks they entail. An increase in a share price while waiting to buy, for example, could cost more than the tax an investor is trying to avoid.

## Increased Eligibility for Deductible IRAs in Tax-year 1998 and Beyond

(thousands of dollars)




sponsored retirement plan and their adjusted gross income.

Taxes on mutual fund earnings are deferred when they remain in 401(k) plans, IRAs and other tax-deferred accounts, such as 403(b) accounts. Thus, no tax is incurred as a result of dividend and capital gain distributions, or from the sale of fund shares, until the investor takes distributions from the tax-deferred account. Distributions are treated as income, which is subject to the investor's federal income tax rate at the time of distribution. (Non-deductible or after-tax contributions to these retirement accounts are not subject to taxation at distribution, and distributions from the newly created Roth IRA also may not be subject to taxation at distribution.)

For most investors, distributions from tax-deferred accounts typically begin at or near retirement age, at which time the individual may be in a lower income tax bracket. Investors who receive proceeds from tax-deferred accounts prior to age 59½ may incur a tax penalty in addition to federal, state and local income taxes.