

Taxes—Mutual Fund Taxation

We all know that mutual fund distributions have tax consequences associated with them. The tax law generally treats mutual fund shareholders as if they directly owned a proportionate share of the fund's portfolio of securities. Thus, all dividends and interest from securities in the portfolio, as well as any capital gains from the sales of securities, are taxed to the shareholders. The fund itself is not taxed, provided certain tests are met.

Those are the basics, but how well do you know the details?

Questions

Here's a little quiz to test your knowledge. Answers are at the end.

1. Distributions from mutual funds include which of the following categories on Form 1099-DIV?
 - a. Interest, capital gains, and ordinary dividends
 - b. Ordinary dividends, qualified dividends, and capital gains
 - c. Interest and capital gains
 - d. Special dividends and capital gains
2. The portion of a mutual fund distribution attributable to a "qualified dividend" is, generally, taxed at 15 percent (affluent and high-net worth clients).
 - a. True
 - b. False
3. How is a mutual fund capital gains distribution appearing on Form 1099-DIV taxed?
 - a. As long-term or short-term capital gain, depending on how long the client has been invested in the fund
 - b. At ordinary income tax rates
 - c. At long-term capital gains tax rates

- d. At a rate determined by multiplying the taxpayer's regular income tax rate by a fraction equal to the proportion of capital gains distributions to all distributions from the mutual fund.
4. Ordinary dividend distributions from mutual funds include interest.
- a. True
 - b. False
5. Which of the following is accurate concerning the taxation of re-invested dividends from mutual funds?
- I. Taxable to clients in the year of re-investment
 - II. Added to client's basis in his or her mutual fund shares
 - III. Taxable to clients in the year his or her mutual fund shares are sold
- a. I and II only
 - b. II and III only
 - c. I only
 - d. III only
6. An exchange of mutual fund shares for shares of another mutual fund is tax-free, so long as both funds are part of the same "family" of funds.
- a. True
 - b. False
7. Taxpayer C purchased 1,000 shares of Mutual Fund XYZ for \$10 per share a few days before the ex-dividend date. Taxpayer C receives a \$1 per share distribution. What are the likely tax consequences?
- a. The distribution is taxable at ordinary income tax rates because it was made after the ex-dividend rate.
 - b. The distribution is tax-free because the taxpayer purchased shares before the ex-dividend rate.
 - c. The distribution reduces the fund's net asset value (NAV) on a per share basis because the distribution reduced the fund's overall value.

- d. The distribution results in a “wash” to the taxpayer because he or she is required to re-invest it.
8. How is the sale of mutual fund shares taxed?
- a. As long-term or short-term capital gain, depending on how long the client has been invested in the fund
 - b. At ordinary income tax rates
 - c. At long-term capital gains tax rates
 - d. It depends on whether the fund is characterized as Aggressive, Balanced, or Conservative.
9. A “return of capital” distribution from a mutual fund has the effect of reducing the taxpayer’s basis in fund shares.
- a. True
 - b. False
10. Which of the following accounting methods may be used to determine gain or loss on the sale of mutual fund shares?
- I. FIFO
 - II. Average cost (single category and double category)
 - III. Specific identification
- a. I and II only
 - b. II and III only
 - c. I and III only
 - d. I, II, and III

Answers

Question 1—b. Ordinary dividends, qualified dividends, and capital gains

There are several types of taxable distributions: (1) ordinary dividends and (2) qualified dividends, and capital gain distributions.

Ordinary Dividends. Distributions of ordinary dividends, which come from the interest and dividends earned by securities in the fund's portfolio, represent the net earnings of the fund. They are paid out periodically to shareholders. Like the return on any other investment, mutual fund dividend payments decline or rise from year to year, depending on the income earned by the fund in accordance with its investment policy. Because these payments are considered dividends, they must be reported as such, and are taxed up to the top marginal tax rate.

Qualified Dividends. Many ordinary dividends are also classified as qualified dividends. The amount of qualified dividends will be shown in box 1b of Form 1099-DIV. They are taxed at 15 percent if the regular tax rate that would apply is 25 percent or higher. The dividend must have been paid by a U.S. corporation or a qualified foreign corporation. The dividend must not be of a type excluded by law from the definition of a qualified dividend. Finally, the taxpayer must meet the holding period requirements

Capital gain distributions. When gains from the fund's sales of securities exceed losses, they are distributed to shareholders. As with ordinary and qualified dividends, these capital gain distributions vary in amount from year to year.

Question 2 —a. True

Dividend distributions from mutual fund attributable to “qualified dividends” are taxed at capital gains rates (currently 15 percent), if the regular tax rate that would apply exceeds 25 percent.

Question 3—c. At long-term capital gains tax rates

Currently, capital gain distributions reported on Form 1099-DIV are treated as long-term capital gains (and taxed at 15 percent), regardless of how long the taxpayer has owned fund shares.

Question 4 —a. True

Ordinary dividends from mutual funds include dividends and interest.

Question 5—a. I and II

Re-invested dividends are taxable to clients in the year of re-investment. In addition, they are added to the client's basis in his or her mutual fund shares.

Question 6—b. False

The “exchange privilege,” or the ability to exchange shares of one fund for shares of another, is a popular feature of many mutual fund “families,” i.e., fund organizations that offer a variety of

funds. For tax purposes, exchanges are treated as if the taxpayer sold shares in one fund and used the cash to purchase shares in another fund.

Question 7—c. The distribution reduces the fund's net asset value (NAV) on a per share basis because the distribution reduced the fund's overall value.

The date on which a fund's shareholders become entitled to future payment of a distribution is referred to as the ex-dividend date. On that date the fund's net asset value (NAV) is reduced on a per share basis by the exact amount of the distribution.

Question 8—a. As long-term or short-term capital gain, depending on how long the client has been invested in the fund

When the taxpayer sells mutual fund shares, he or she realizes a capital gain or loss in the year the shares are sold. The taxpayer must pay tax on any capital gain arising from the sale, just as he or she would from a sale of individual securities. (Losses may be used to offset other gains in the current year and deducted up to an additional \$3,000 of ordinary income. Remaining loss may be carried for comparable treatment in later years.)

The amount of the gain or loss is determined by the difference between the cost basis of the shares (generally the original purchase price) and the sale price. Thus, in order to figure the gain or loss on a sale of shares, it is essential to know the cost basis. Whether the gain is considered short or long depends on the holding period of the taxpayer's shares.

Question 9—a. True

Sometimes mutual funds make distributions to shareholders that are not attributable to the fund's earnings. These are nontaxable distributions, also known as returns of capital. Because a return of capital is a return of part of the taxpayer's investment, it is not taxable, but it reduces basis in the taxpayer's shares.

Question 10—d. I, II, and III

Calculating the capital gain or loss on shares the taxpayer sells is somewhat more complicated if, as is usually the case, only some shares are sold. The taxpayer must use some accounting method to identify which shares were sold to determine capital gain or loss. The IRS recognizes several methods of identifying the shares sold:

- First-in, first-out (FIFO);
- Average cost (single category and double category); and
- Specific identification.

Bottom Line

Although Advisors should not hold themselves out as tax experts, it's important to know the basics.

Taxes and similar topics are covered in great detail in many of Cannon's professional development solutions. To find out more visit: www.cannonfinancial.com.

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