Forbes http://onforb.es/1iW6tnp

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TAXES 3/17/2014 @ 12:15PM | 14,395 views

Mutual Fund Tax Guide

You need to know 11 things

This simple guidebook is aimed at investors with mutual funds and ETFs in their taxable accounts. None of it applies to tax-sheltered accounts like IRAs.

1. *Funds are pass-throughs*. If they profit from capital gains, interest or dividends, they are compelled to pass those profits through to you as distributions. You must pay tax on the distributions. You owe the same tax whether you do or don't reinvest in more fund shares.

If the fund has long-term gains (profits on securities held for more than a year), they get passed through as long-term gains taxable at low rates. If the dividends collected by the fund are "qualified" (eligible for the favorable rate), then they get passed through to you as qualified dividends. If the fund collects interest from tax-exempt municipal bonds, then your income distribution is treated like tax-exempt interest.

Note: Income distributions from bond funds appear on your tax return as "dividends." But they get taxed as if they were interest.

2. *The distributions go down a one-way street*. Gains and net income are distributed. Losses are not distributed.

If the fund has a net loss from its trading, this can't be passed through to you for you to use on your tax return. The fund just sits on it, carrying the loss forward to later years when it can be used to offset a gain.

3. *The distributions cause pain to innocent victims*. You owe tax on a distribution even if you didn't benefit from it.

Say a fund starts out worth $10 a share, and doubles in value as its stocks climb. You buy in at $20. Soon after, the fund distributes $5 a share of realized gains. When that happens, you have $5 of cash plus a fund share now worth only $15. You become an innocent victim. You have to pay tax on the $5, even though at this point you are just breaking even.

There's an antidote in this situation. Sell the fund share for $15. Your $5 loss on the fund share offsets the $5 capital gain. Your net gain is $0, so there's no tax to pay.

All of this buying and selling is a nuisance. Instead of curing the problem, prevent it by not buying funds that are about to make distributions. The big ones often come at the end of the year. If you are looking at a fund that has been performing well and does a lot of trading, avoid buying it late in the year. Wait until January.

4. *Reinvesting is a bad idea*. You put $100,000 in a fund, it makes a $5,000 distribution, and you use that to buy more fund shares. That sounds nice, except that it messes up your cost basis. You now have two lots of shares with two purchase prices and two holding periods. Keep this up for a decade and you could wind up with 10 or 40 or even 120 purchases. Now what happens when you want to take some money out? That means selling shares. Which shares are you selling? Bought at what prices?

The only way to cope with this mess is to use the fund company's "average cost" calculation when you sell shares. That's suboptimal. It would be better to identify the high-cost shares as the ones you're selling.

A better idea is to check "No" when asked about whether to reinvest. Send distributions (both income and capital gain distributions) into your money market account. When that account gets fat, use it to make a lump-sum purchase of the same or a different fund. When you want to need to raise cash, you can pick a high-cost position to minimize your tax burden.

5. *Stock index funds cause little tax pain*. These are funds that buy a fixed collection of stocks, such as all the ones in the S&P 500 index, and sit on them. Since they don't trade in and out, they don't realize very many gains. So there's not much except the dividend income that has to be thrown out on the fund investors.

An index fund does occasionally have to sell, such as when it gets a lot of redemption orders. But if it selectively sells the high-cost share lots first, it may wind up with no capital gain.

The Vanguard 500 Index fund is one of these well-behaved funds. It was recently worth $168 a share, of which $69 represented paper gains. But it has no realized gains to dish out. In fact, it was sitting on $4 a share of realized losses.

6. *Index funds organized as ETFs are even more tax efficient*. Using some fast footwork of which the taxing authorities are surprisingly tolerant, exchange-traded funds hive off their low-cost shares to arbitragers. Here are

four ETFs that have gone two years without paying out any capital gains: **iShares Russell 2000 Growth (IWO)**, **Schwab U.S. Broad Market (SCHB)**, **SPDR S&P 500 (SPY)** and **Vanguard Total Stock Market (VTI)**.

7. *Short-term gains turn poisonous inside a fund*. If a fund has a gain from short-term trading, it's passed through to you not as a short-term capital gain but as ordinary income. That's unfortunate, because short-term capital gains are more desirable than ordinary income. It's also kind of unfair. It violates the pass-through principle (see Rule #1).

Why are short gains more desirable than ordinary income? Because, depending on what is happening with the rest of your portfolio, a short gain can wind up effectively being taxed at either a low rate or a 0% rate.

Example I: You already are sitting on $6,000 of short-term losses and $10,000 of long-term gains. If nothing else happens, you've got a net $4,000 long gain that will be taxed at a favorable rate.

Now let's say an extra $6,000 in short gains comes your way. The two short items net out and you wind up with $10,000 of long gain. In effect, the last $6,000 got taxed at the low rate.

Example II: You've got a $200,000 capital loss carryforward that you will probably never get the chance to use up. Now you make a quick $6,000 flipping a stock. You can use $6,000 of your loss carryforward to erase the gain.

In neither of these cases could an extra $6,000 of ordinary income be married to any capital losses. Any ordinary income distribution from a fund is simply going to get whacked by the tax collector.

8. *Funds that shuffle their portfolios run up tax bills for their investors*. TFS Small Cap is a hot fund, with performance that rates it five Morningstar stars. But look at the 600% turnover, suggesting that it's reluctant to hold onto a stock for much more than two months. In December 2013 it paid out a fearsome $3.10 short-term capital gain, inflicting ordinary income and therefore tax pain on helpless investors.

9. *Funds make great vehicles for loss harvesting*. The game here is to capture a loss on an investment that is depressed without running afoul of the rule against wash sales. Sell the loser, replace it with something similar but not identical. After 31 days you can restore the original position.

It wouldn't do to replace one S&P 500 fund with another one. But you could substitute a total stock market for a 500 fund, or a mix of short-term and long-term muni funds for an intermediate-term one, or a diversified small-company fund with a mix of small growth and small value funds.

There's more guidance in this article on the wash sale rule.

10. *You can't turn a quick sale into a tax benefit*. Mischievous investors might see a tax dodge in the antidote described in rule #3. You deliberately buy a fund that is pregnant with a $5 long-term capital gain distribution, collect the distribution, then sell the fund share for a $5 short-term loss.

Why would you do that? Depending on what else you have going on that year (other gains and losses), the combination of a short-term loss with an identical long-term gain could be quite valuable.

No dice. A short-term loss from a mutual fund automatically becomes treated as a long-term loss, to the extent of your long-term gain distribution.

11. *Commodity funds have weird tax rules*. If you own a bullion fund, like **SPDR Gold Shares (GLD)**, you get taxed as if you were buying "collectibles," with a 28% federal rate on long-term gains. Own **Powershares DB Commodity Index Tracking Fund (DBC)** and you'll be taxed as if you were buying commodity futures. The **Pimco Real Return Strategy Fund (PCRDX)** has yet a different set of rules. For more, see Tax Wise Commodity Investing.