

Capital Ideas

LEARNING FROM THE PAST TAX SEASON

| BY HOWARD MCEWEN, CFA

After closing his last spreadsheet and filing his last tax return, Scott Malof, CPA/PFS of SS&G Financial Services, decided it was time his clients, most taxpayers in fact, relearned an old lesson: with mutual funds, it's after tax returns that matter.

"The market went up and we had a tremendous second half last year," said Malof. "It was an opportunity for mutual fund managers to cash in and that results in capital gains."

Mutual fund investors haven't worried about large capital gains recently, but not too long ago, many were surprised by them. In 1999, at the height of the tech bubble, funds started throwing off large capital gains as they bought and sold stocks at high prices. Investors were happy about the high returns, but not the tax bill that came along with it.

Mutual funds are required to pass along cash to shareholders, cash they make from selling stock at a gain, dividends or interest from investments held. If the mutual funds are in retirement plans such as IRAs or 401(k)s there's no tax implications – the money is usually just reinvested in the fund. But for funds held outside retirement plans – individual accounts, joint accounts, college funds – the distributions mean a higher tax bill for the investor.

Capital gains and dividends are taxed at 15% while interest payments are taxed at ordinary income tax rates, which can be as high as 35%.

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One fund that surprised its shareholders was the American Century International Opportunities Fund (symbol: AIOIX). In 2003, 2004, and 2005, the fund paid out \$.01, .27, and .29 respectively per share. In 2006, that distribution jumped to \$3. The fund returned 25.37% but that \$3 distribution represented 25% of its value. An investor with \$50,000 in the fund would had to have reported an additional \$13,000 in gains.

"We had this occurrence back in the 90s where a lot of these mutual funds throw off a lot of capital gains distributions," said Malof. "This year, my clients weren't too upset about it. I tell them, 'Let's not look past the fact that we made a bunch of money'."

Malof said the surprise of large dividends could be minimized with proper tax planning (before the end of the year) such as using losses elsewhere to lower total gains and investing in funds that are tax-efficient. Tax-efficient funds attempt to minimize distributions by anticipating the after-tax return of each of their investments.

