

# Is there a mutual fund tax bomb in your future?

Capital losses can be used to offset gains, with proper planning

By Howard McEwen  
B2B Contributor

The fuse of a tax bomb was lit on March 9, 2009, when the S&P 500 reached bottom at 676.53. Since that day, the market has been on a historic climb and the fuse kept burning — until this month when mutual funds announce their capital-gains distributions. The result may be an explosion that causes unexpected damage to client portfolios.

“Shareholders in mutual funds are often surprised when they receive a 1099-DIV form from their fund reflecting capital gain distributions,” said Jeff Jackson, CPA/PFS, CFP, a director with Brady Ware in Dayton. “This can happen whether or not the fund actually appreciates in value from year to year. What some mutual fund investors do not realize is that mutual funds are required to distribute their net capital gains to investors each year.”

Investors who hold all their mutual funds in tax-qualified accounts such as IRAs are protected from the tax bomb.

Even in the face of the steep market climb, Jackson thinks that damages from tax bombs may be limited this year.

“Capital-gain dividends are only required to the extent that the fund’s realized capital-gain transactions exceed its realized capital-loss transactions for the year,” Jackson said.

“This year, many funds will be able to manage to a net-capital loss on realized transactions. So, even though the value of the fund may appreciate substantially, there may be no net realized capital gains. If there are no net capital gains,



no year-end capital gain distributions will be required.”

Jackson said that, while there have been gains, this year’s stock market recovery is offset by the losses racked up from 2008 until the March rebound.

“There have indeed been gains, but there are significant loss positions in many mutual fund portfolios that can be liquidated to offset current-year realized gains,” Jackson said. “Mutual-fund portfolios may be able to manage their gains and losses this year to their investors’ benefit.”

Fund companies announce estimates of their tax distributions in November and December of each year. If a tax bomb is in your future, Jackson sug-

gested a few strategies to help minimize damage.

“Once the investor knows if there will be capital-gain dividends, he or she may be able to harvest capital losses by selling other investments which will produce capital losses,” he said. “Remember, capital losses can be used to offset capital gains, including those mutual-fund capital-gain dividends, plus up to \$3,000 of ordinary income. Many investors are also carrying capital losses over from prior years. Those losses can be combined with current-year losses to shelter capital gains from tax.”

The only way to minimize damage from a tax bomb is planning.