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Dealing With Year-end Fund Distributions

Remember that time when you or your accountant filed your tax return and you were hit with an unexpected tax bill? It's not fun seeing that extra cash you had put away to go on vacation suddenly disappear. One of the causes of these unexpected tax bills could be from making changes to your investment portfolio at the end of the year.

As 2014 comes to an end, many people use this time to make changes to their investment portfolios. This is also the time of year that many mutual funds and exchange traded funds (ETFs) distribute capital gains. Buying or selling shares of a mutual fund or ETF in taxable accounts just prior to a year end distribution means you could be stuck with an unexpected tax bill and less money in your pocket. Here are a few strategies you can use to mitigate the impact of year end distributions.

Buying After the Distribution

If a mutual fund or ETF is about to make a significant distribution, you may owe tax on that distribution if you hold the fund on the ex-dividend date. Therefore, it is often worth waiting until after the ex-dividend date to purchase new shares.

For example, you may decide to purchase 1,000 shares of Mutual Fund A. Fund A is scheduled to distribute a $3 per share short-term capital gain and a $1 per share long-term capital gain. If you invest prior to the distribution date, you will have to pay tax on the distribution which amounts to a $3,000 short-term gain (reported as an ordinary dividend) and a $1,000 long-term gain. This amounts to about $1,600 of additional tax if you are in the top tax bracket, not including the effect of state taxes.

If you decide to wait until after the distribution to purchase new shares, the fund price will drop in price by the amount of the distribution. So you'll now be able to buy more shares with the same investment and you won't have an additional tax burden.

If you want to sell a fund that you have not held for at least one year and it is distributing long-term capital gains, then it might make sense to sell after the distribution. This will essentially convert a small portion of the short-term gain you would have realized into the more favorably taxed long-term gain.

Selling Before the Distribution

This strategy is beneficial when a fund you've held for longer than one year and wish to sell is making a distribution that consists of significant short-term capital gains.

For example, you hold Mutual Fund B for more than one year. You currently have a gain of $20,000. Fund B is making a $5,000 short-term capital gain distribution. If you wait and sell this fund after the distribution, you will have the $5,000 short-term gain and a $15,000 long-term gain (the short-term gain will increase your cost basis). Thus, your gain in this fund is being taxed at less favorable rates. To circumvent this, selling the fund before the ex-dividend date would cause you to realize the same $20,000 gain but allow for more favorable long-term rates.

The examples given do not necessarily reflect a typical fund distribution. Year-end distributions can vary greatly depending on the fund. To find out if any of the mutual funds and ETFs you own, or are thinking of purchasing, are making year end distributions and to what extent, look on the fund company website, call the fund company or talk with your investment advisor.

Using any of the strategies discussed in this article may or may not make sense given your specific situation and you should never let tax consequences completely guide how you make your investment decisions. Even if you decide not to use these strategies, being on the lookout for capital gain distributions will help you and your accountant properly plan your tax situation. If you have any questions or are considering using these techniques, please consult your investment or tax advisor.

For questions about dealing with year-end fund distributions, please contact Jonathan Swartz by calling 770.396.2200.