Mutual Funds: Frequently Asked Questions

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How are mutual fund distributions taxed?

You must generally report as income any mutual fund distribution, whether or not it is reinvested. The tax law generally treats mutual fund shareholders as if they directly owned a proportionate share of the fund's portfolio of securities. The fund itself is not taxed on its income if certain tests are met and substantially all of its income is distributed to its shareholders. 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.

There are two types of taxable distributions: ordinary dividends and capital gain distributions.

Ordinary dividends are the most common type of distribution from a corporation and are paid out of the earnings and profits of the corporation. For mutual funds, this is the interest and dividends earned by securities held in the fund's portfolio that represent the net earnings of the fund. Ordinary dividends are periodically paid out to shareholders and are taxable as ordinary income unless they are qualified dividends. Qualified dividends are ordinary dividends that meet the requirements to be taxed as net capital gains and are included with your capital gain distributions as long-term capital gain, regardless of how long you have owned your fund shares.

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. You should receive a Form 1099-DIV, Dividends and Distributions, from each payer for distributions of $10.00 or more; however, even if you do not receive a Form 1099–DIV or Schedule K-1 (dividends received through a partnership, an estate, a trust, or a subchapter S corporation), you must still report all taxable dividends.

Ordinary dividends are taxed at ordinary tax rates for whatever tax bracket you fall under. Qualified dividends are taxed at a 15 percent rate.

Capital gain distributions are the net gains, if any, from the sale of securities in the fund's portfolio. When gains from the fund's sales of securities exceed losses, they are distributed to shareholders. As with ordinary dividends, capital gain distributions vary in amount from year to year and are reported of Form 1099-DIV, Dividends and

Distributions. Capital gain distributions are always reported as long-term capital gains for tax purposes. The tax rate is 15 percent for higher tax brackets (25-35 percent), but if your tax bracket is 10 or 15 percent, the tax rate for long-term capital gains is 20 percent starting in 2013.

Are reinvested dividends from a mutual fund taxable?

Most mutual funds offer you the option of having dividend and capital gain distributions automatically reinvested in the fund-a good way to buy new shares and expand your holdings. Most shareholders take advantage of this service, but you should be aware that you do not avoid paying tax by doing this. Reinvested ordinary dividends are taxed as ordinary income, just as if you had received them in cash and reinvested capital gain distributions are taxed as long-term capital gain.

Tip: If you reinvest, add the amount reinvested to the "cost basis" of your account. "Cost basis" is the amount you paid for your shares. The cost basis of your new shares purchased through automatic reinvesting is easily seen from your fund account statements. This information is important later on when you sell shares.

Make sure that you don't pay any unnecessary capital gain taxes on the sale of mutual fund shares because you forgot about reinvested amounts. When you reinvest dividends and capital gain distributions to buy more shares, you should add the cost of those shares (that is, the amount invested) to the cost basis of the shares in that account because you have already paid tax on those shares.

Example: You bought 500 shares in Fund PQR in 1990 for $10,000. Over the years you reinvested dividends and capital gain distributions in the amount of $10,000, for which you received 100 additional shares. This year, you sold all 600 of those shares for $40,000.

If you forget to include the price paid for your 100 shares purchased through reinvestment (even though the fund sent you a statement recording the shares you received in each transaction), you will unwittingly report on this year's tax return a capital gain of $30,000 ($40,000 - $ 10,000) on your redemption of 600 shares, rather than the correct capital gain of $20,000 ($40,000 [$10,000 + $10,000]).

Failure to include reinvested dividends and capital gain distributions in your cost basis is a costly mistake.

Am I subject to tax if I switch from one fund to another in the same mutual fund family?

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." Families are fund organizations offering a variety of funds.

For tax purposes, exchanges are treated as if you had sold your shares in one fund and used the cash to purchase shares in another fund. This means you must report any capital gain from the exchange on your return. The same tax rules used for calculating gains and losses when you redeem shares apply when you exchange them.

Note: Gains on these redemptions and exchanges are taxable whether the fund invests in taxable or tax-exempt securities.

Am I subject to tax on return-of-capital distributions?

Sometimes mutual funds make distributions to shareholders that are not attributable to the fund's earnings. These are called **nontaxable distributions**, also known as returns of capital. Note that nontaxable distributions are not the same as the tax-exempt dividends. Because a return of capital is a return of part of your investment, it is not taxable. Your mutual fund will show any return of capital on Form 1099-DIV in the box for nontaxable distributions.

If you receive a return of capital distribution, your basis in the shares is reduced by the amount of the return.

Example: Two years ago you purchased 100 shares of Fund ABC at $10 a share. Last year, you received a $1-per-share return of capital distribution, which reduced your basis in those shares by $1, to give you an adjusted basis of $9 per share. This year, you sell your 100 shares for $15 a share. Assuming no other transactions during this period, you would have a capital gain this year of $6 a share ($15 - $9) for a total reported capital gain of $600.

Non-taxable distributions cannot reduce your basis below zero. If you receive returns of capital that, taken together, exceed your original basis, you must report the excess as a long-term capital gain.

Should I invest in tax-exempt funds to cut my income taxes?

If you're in the higher tax brackets and are seeing your investment profits taxed away, you might want to consider tax-exempt mutual funds as an alternative.

The distributions of municipal bond funds that are attributable to interest from state and municipal bonds are exempt from federal income tax, although they may be subject to state tax.

The same is true of distributions from tax-exempt money market funds. These funds also invest in municipal bonds, but only in those that are short-term or close to maturity, the aim being to reduce the fluctuation in NAV that occurs in long-term funds.

Many taxpayers can ease their tax bite by investing in municipal bond funds. The catch with municipal bond funds is that they offer lower yields than comparable taxable bonds. For example, if a U.S. Treasury bond yields 4.8 percent, then a quality municipal bonds of the same maturity might yield 4 percent. The tax advantage makes it worthwhile to invest in the lower-yielding tax-exempt fund, and the tax advantage to a particular investor hinges on that investor's tax bracket.

To figure out how much you'd have to earn on a taxable investment to equal the yield on a tax-exempt investment, use this formula:

The tax-exempt yield divided by (1 minus your tax bracket) = equivalent yield of a taxable investment.

Example: You are in the 28 percent bracket, and the yield of a tax-exempt investment is 4 percent. Applying the formula, we get 0.04 divided by (1.00 minus 0.28) = 0.055. Therefore, 5.55 percent is the yield you would have to receive from a taxable investment to match the tax-exempt yield of 4 percent.

Note: For some taxpayers, portions of income earned by tax-exempt funds may be subject to the federal alternative minimum tax.

Although income from tax-exempt funds is federally tax-exempt, you must still report on your tax return the amount of tax-exempt income you received during the year. This is an information-reporting requirement only and does not convert tax-exempt earnings into taxable income.

Your tax-exempt mutual fund will send you a statement summarizing its distributions for the past year and explaining how to handle tax-exempt dividends on a state-by-state basis.

Note: Capital gain distributions paid by municipal bond funds (unlike distributions of interest) are not free from federal tax. Most states also tax these capital gain distributions.

How do states generally tax mutual fund distributions?

Generally, states treat mutual fund distributions as taxable income, just as the federal government does. However, states may not provide favored tax rates for dividends or long-term capital gains. Further, if your mutual fund invests in U.S. government obligations, states generally exempt dividends attributable to federal obligation interest from state taxation.

Mutual funds that invest in state obligations are another special situation. Most states do not tax income from their own obligations, whether held directly or through mutual funds. On the other hand, the majority of states do tax income from the obligations of other states. Thus, in most states, you will not pay state tax to the extent you receive, through the fund, income from obligations issued by your state or its municipalities.

What are the tax benefits and drawbacks of investing in a foreign mutual fund?

Dividends from funds investing in foreign stocks may qualify for the 15/5/0 percent rate on dividends. If your fund invests in foreign stocks or bonds, part of the income it distributes may have been subject to foreign tax withholding. If so, you may be entitled to a tax deduction or credit for your pro-rata share of taxes paid. Your fund will provide you with the necessary information.

Tip: A tax credit provides a dollar-for-dollar offset against your tax bill, while a deduction reduces the amount of income on which you must pay tax, so it is generally advantageous to claim the foreign tax credit. If you decide to take the credit, you may need to attach a special form to your Form 1040, depending on the amount of credit involved.

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