

Year End Tax Planning – Mutual Funds vs. Managed Accounts

One important difference between managed accounts and mutual funds is their handling of capital gains. Mutual funds distribute gains to the people who own the fund at the end of the year. Many investors find that in years when their mutual fund holdings decline in value they still receive taxable capital-gains distributions from the fund. They lost money, but still had to pay taxes. In a managed account, however, you only get taxed on the gains you actually receive.

Most mutual funds make an annual distribution of their capital gains. This distribution usually occurs late in the year and reflects any net capital gains incurred due to the year's activity. Funds that have both long-term and short-term gains will issue two distributions, one of each. Under the accounting rules funds must follow, these gains are applied to all shareholders as of a certain date. For this reason it is possible for you to own a fund for only a few weeks and get hit with capital gains tax on transactions that occurred early in the year—before you even bought the fund.

According to one recent study, the average equity mutual fund loses more than 2½ percentage points of its return to taxes each year.¹ This means that a fund with a pre-tax return of 9 percent may return of less than 7 percent after taxes. Over time this can make a huge difference to your wealth. Because of this, the SEC now requires all funds to list after-tax returns in their prospectuses.

Because this year was so volatile, some experts fear that distributions will be particularly high. “Some fund experts predict this year's total mutual-fund distributions will be the highest ever. Despite the summer market turmoil, stocks have moved substantially higher this year, creating sizable gains in many funds. A number of funds have also exhausted their supply of losses booked during the last bear market, which they've used to offset gains in recent years.”²

Conversely, money managers buy and sell securities throughout the year and incur gains or losses on those sales, but you only get taxed on any net gains that actually occurred in your account during the tax year. Also, near the end of the year you may be able to instruct your manager to take tax losses on positions that have an unrealized loss to offset gains in the account. This strategy is called tax loss harvesting. It involves temporarily moving out of a position in

¹ KPMG Peat Marwick LLP, An Educational Analysis of Tax-Managed Mutual Funds and the Taxable Investor.

² Taxable Payouts On Many Funds Are Set to Surge, Wall Street Journal, October 24, 2007

order to satisfy the requirements for deducting the loss. Then the position is repurchased. This can be a useful strategy, but it must be done correctly and is not without its own risks.

This is how tax loss harvesting works: the manager will identify positions with unrealized capital losses, sell the securities in question generating a realized loss for tax purposes, and replace the securities sold with others that offer similar characteristics. He might also simply buy back the security that was sold after thirty days have elapsed. This waiting period avoids the IRS' Wash Sale Rule, which would void the realized loss on the original sale. Different managers will employ different strategies, depending on the nature of the portfolio and how specific their belief is in the particular security being sold.

For example, suppose you own a bond that has declined in value because of rising interest rates. The manager could sell the bond and buy another that had similar, but not identical characteristics. It might be issued by a different company in the same industry, or have the same credit rating, but slightly different coupon rate or maturity. This retains the income stream you expect, but harvests a loss that can be used to offset any gains you experienced last year.

In the case of stocks, sometimes a different stock in the same industry will be substituted. The danger of this strategy is that sometimes the market or the stock you've sold will move while you are waiting to buy it back or are invested in a less attractive stock in the same industry. As I said—this strategy does have some risk. If this short term risk concerns you, you should not request tax loss harvesting.

There is one tactic that may have little potential downside. If you have a mutual fund that is in a capital loss position and it is still prior to the ex date for the annual capital gains distribution, consider redeeming the fund and moving the money in a managed account with a similar strategy. This might be an opportunity to move up to a managed account and harvest a tax loss that can offset your gains.

Please contact us at (800) 541-7774 if you have any questions about the appropriateness of tax loss harvesting for your portfolio or to find a manager that might be good to replace a mutual fund you want to liquidate.

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