Timely Topics

December 6, 2013

Mutual Fund Capital Gains Distributions: Frequently Asked Questions

In December of this year, many mutual funds will be making end-of-year capital gains distributions for the first time in several years. Since investors have grown less accustomed to capital gains distributions, the distributions differ from the dividend or interest income investors usually receive, and capital gains distributions are specific to the special legal structure of mutual funds, investors may have questions about the distributions and their tax implications. To help answer these questions, LPL Financial Research has put together this guide to some frequently asked questions. **Keep in mind that the tax circumstances for every individual are unique. Please consult a tax expert for the implications of capital gains distributions for any individual investor.**

Q: What are capital gains distributions?
A: Mutual funds are required by law to distribute nearly all net capital gains realized from the sale of securities. Investors are then responsible for the tax implications. Note that investors bear the tax consequences of the distribution if they are the shareholder of record at the time of distribution; it does not matter when the fund actually realized the capital gain.

Q: Does LPL Financial make capital gains distributions? Did LPL Financial have any role in the decisions that generated the capital gains?
A: No, capital gains distributions are made by mutual funds as a consequence of their legal structure. LPL Financial had no role in the decisions that caused the gains nor does it issue the distributions.

Q: What triggers capital gains distributions?
A: Any sale that is not offset by capital losses will trigger a distribution. There are two primary events that trigger gains: 1) A fund sells an asset to take profit, believing the proceeds can be put to work more effectively elsewhere. These are sales that occur due to normal turnover. 2) A fund sells an asset to generate the cash needed for shareholder redemptions, a particular concern when there are large outflows from a fund. Because of this trigger, a fund can have distributions even when it loses value, especially if the loss of value itself causes additional outflows.

Q: Why are we suddenly seeing capital gains distributions again?
A: Realized capital losses from the financial crisis years (2007–09) that were carried forward had provided an offset to capital gains for many funds over the last several years.

Q: How do we know if there will be a capital gains distribution?
A: Individual fund companies will usually provide information about the estimated year-end capital gains distributions on the fund's website. For the convenience of our advisors, LPL Financial Research has created a spreadsheet of announced distribution estimates for recommended funds, updated weekly, which can be found on the Resource Center at Research I Funds and Managers I Estimated Capital Gains I Recommended Mutual Fund Estimated Capital Gains Distributions.

LPL Financial

Q: When do funds generally make distributions?
A: Year-end distributions are made in November and, more typically, December. Consult individual fund companies for the exact timing of their distributions.

Q: Are capital gains distributions taxed like dividends?
A: No, they are taxed like capital gains, including the distinction between short-term and long-term gains. However, the difference between a short-term and long-term gain for a distribution depends on the fund's holding period, not the investor's. Therefore, investors may have short-term gains even if they have been holding the fund for more than a year.

Q: What happens to a fund's value when it makes a distribution?
A: Similar to dividends, the distribution lowers the net asset value (NAV) of the fund by the amount of the distribution.

Q: I pay the tax but never see the distribution. Are capital gains distributions an extra tax?
A: Many people who own mutual funds choose to have capital gains distributions automatically reinvested, so they never actually see the cash distribution itself. This can make it seem like a distribution is a tax without an actual gain. In addition, since the distribution lowers the fund's NAV, it correspondingly lowers any remaining unrealized capital gain. As a result, in most cases, capital gains distributions change the timing of the tax but they are not an additional tax. However, for many investors, the timing of taxes can have important implications.

Q: Do qualified accounts pay taxes on capital gains distributions?
A: No, the distribution in itself is not a taxable event for a qualified account.

Q: Is there any way to avoid a capital gains distribution?
A: Every individual's tax situation is different, but generally there is no effective strategy for avoiding a capital gains distribution. Investors who consider selling a fund to avoid a capital gains distribution should pay attention to the tax bill they might face due to any personal capital gains from the sale. Other factors to consider include the added commission for entering a new position, the potential opportunity cost of being out of the market, and the possibility of receiving a capital gains distribution from the new investment.

Q: Can I avoid both the capital gains distribution and personal capital gains by selling the fund, repurchasing it later, and using the "wash sale" rule?
A: No. The wash sale rule, selling a security and purchasing a substantially identical security in the period thirty days before or after the sale, only applies to capital losses. If you sell a security at a capital loss and repurchase it as described, the loss cannot be claimed as a deduction. However, you are responsible for capital gains on a sale even if you repurchase the security.

Q: Should I delay putting money into a fund until after the distribution is made to avoid receiving a capital gains distribution right after buying?

A: Every situation is unique and there are many things to take into account, including the potential opportunity costs from being out of the market. However, in many circumstances it could be prudent to avoid purchasing a fund that is about to make a distribution.

Q: If I want to make sure I sell a fund before a distribution (or purchase a fund after a distribution), what is the key date to keep in mind?

A: Funds that announce distributions provide a "record date." If you are the shareholder of record at end of business on the record date, you will receive the distribution and be responsible for the tax implications.

Q: Do municipal bond funds make capital gains distributions, and do the distributions receive any special tax treatment?

A: Yes, bond funds, including municipal bond funds, can make capital gains distributions and these distributions do not receive any special tax treatment. Only the income distributions (coupon payments) from municipal bonds receive special tax treatment. Capital gains distributions, both short term and long term, are subject to capital gains taxes. ■

RES 4425 1213
Tracking #1-227503 (Exp. 12/14)