



## Big Cap Gains Taxes Expected on Funds This Year

By Rob Wherry  
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**INVESTORS ENDURED** a volatile ride in November, so they would probably like to sit back and relax this holiday season. After all, why should they waste time trying to make sense of a market that even the pros are having a hard time navigating? But investors shouldn't take it easy quite yet. They're about to be blindsided once again — this time with a hefty tax bill from Uncle Sam.

Fund industry experts are predicting a double whammy this year that we haven't seen since the tech bubble burst. Not only will investors be staring at flat or dismal returns, but they'll also be faced with paying taxes on big capital gains distributions from the well-performing funds they held before the recent turmoil began. Lipper senior research analyst Tom Roseen estimates that investors may pay 20% to 30% more to the federal government than the \$24 billion they shelled out last year. That means the typical investor, depending on how much they've saved in certain funds and what type of an account that money is in, could face a tax bill of thousands of dollars. "We could easily hit the highest tab investors have ever seen," says Roseen.

Taxes are an important factor that investors often overlook. Keep in mind that what we are talking about here only applies to the half of the \$12 trillion invested in mutual funds that sit in brokerage-type accounts (the other half is in 401(k)s and IRAs, which defer taxes). Over the past 10 years, these taxes have eaten 1.4 to 2.3 percentage points in annual returns, according to Lipper. There are ways to help negate that impact, however. And while it may be too late to curb your tax bill for 2007, it's not too late to start planning for 2008 and beyond.

"It's hard to predict what mutual-fund companies will pay out," says Kathy Harrison-Suits, a tax specialist with Summit Capital Advisors in Tacoma, Wash. "But you can plan for what might happen."

First, it's helpful to know why you're getting whacked in the first place. Mutual funds typically distribute the dividend income they generated from investments and any profits they made from selling securities to shareholders at the end of the year. The Internal Revenue Service allows fund managers to reduce their overall tax bill by offsetting those gains with any losses they incur. So ideally, a manager who records \$1 million in capital gains would find an equal dollar amount in poorly-performing stocks. That way, shareholders won't owe anything. Earlier this decade, that was an easy feat because many funds had stockpiled losses during the bear market. As allowed by the IRS, they then could spread those losses out over eight years. But now the well of losses has run dry.

Particularly vulnerable are small-cap, energy and foreign offerings. These fund categories had double-digit annual returns over the last five years. Large-cap growth funds, which have lagged for some time before they showed signs of success this year, are less susceptible to this phenomenon — at least, for the moment. In fact, no fund category is entirely immune from this problem. At T. Rowe Price, the average capital gains hit will jump more than 69% in 2007, to \$1.77 from \$1.05 per share for retail equity funds that are paying out distributions. That's an increase in the portion of a fund's net asset value being paid out from 3.7% to 5.7%.

"That level is still below the 6.1% distribution in 2000, but it's getting darn close," said Sam Beardsley, director of investment tax for T. Rowe Price funds, through a spokesperson.

In order to get a handle on your potential capital gains, you'll need to dig out some of your account statements. Look for long-term capital gains and losses vs. short-term gains and losses. Qualified dividends and long-term gains — defined as profits from stocks held more than a year — are typically taxed at 15%; short-term gains top out at 35%. (If you can't find this information, good fund companies will post it on their web sites starting in early November.) Obviously, you want to avoid short-term gains. You can do that by steering clear of funds with high portfolio turnover, big outflows or a manager change. Typically, when a fund experiences one of those things it means it has to sell some stocks. Any time there is a trade, that move triggers a potential taxable event.

Just like a fund manager, you want to be able to harvest some losses in your portfolio to counter any gains. Financial advisors, though, warn against selling a stock simply for tax purposes, especially if you still believe in what drove you to the stock in the first place. Of course, you could always sell and buy it back later. But you risk triggering what's called a "wash sale." If you sell a stock at a loss and buy it back within 30 days, the IRS won't allow you to deduct the loss from your taxes that year.

One option that's becoming popular is to use an exchange-traded fund as a placeholder. Here's an extreme example to illustrate the point: Say you think **Toll Brothers** (TOL<sup>1</sup>), the home builder that has seen its stock drop to \$19 a share from \$35 earlier this year, is poised for a comeback in 2008 and you want to hold onto the stock. You could sell the shares and use the proceeds to buy the **iShares Dow Jones Home Construction ETF** (ITB<sup>2</sup>). This ETF has 7% of its assets in the company. So if the stock recovers while you record the losses and wait 30 days, you would still get a piece of that gain. Once a month has passed, you can sell the ETF and get back into the shares.

Another alternative is to seek out tax-efficient mutual funds. Lipper assigns a "1" score to funds that are in the top 20% of their peer group when it comes to keeping as much of its profits as possible. Click here<sup>3</sup> to see our take on tax-efficient offerings or use our fund screening tool to find them. Index funds and ones with low turnover also typically avoid paying out big distributions. And ETFs are widely acknowledged as being more tax-friendly since their underlying structure allows them to avoid dealing with outflows that could trigger capital gains. (Of course, there is a trade-off: You'd have to pay a commission to buy and sell the ETFs.)

But perhaps the smartest tactic is to max out your tax-advantaged accounts, like your 401(k) or IRA. You don't have to worry about capital gains, making these accounts a perfect place to invest in aggressive funds that might kick off payouts if they were in a brokerage account. "[Investors] need to really think about which is the best place to put their funds," says Mary McGrath, a portfolio manager with Cozad Asset Management in Champaign, Ill. "For a lot of people IRAs are the way to go."

One more tip: Be on the lookout for bargains during this time of the year. Many stocks see a decline in their stock price because investors are selling for tax purposes. You just might be able to find a deal or two.

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<sup>1</sup><http://www.smartmoney.com/cfscripts/Director.cfm?searchString=TOL>

<sup>2</sup><http://www.smartmoney.com/cfscripts/Director.cfm?searchString=ITB>

<sup>3</sup><http://www.smartmoney.com/fundscreen/index.cfm?story=20070316>