

OAKLAND BUSINESS & Finance

Calculate taxability on mutual fund gains



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During a typical year, as a mutual fund investor you receive money from mutual funds in the form of dividends and capital gains distributions. Both types are reported on Form 1099-DIV. All distributions must be reported as income, even if they are reinvested. Capital gains or losses are incurred not only when fund shares are sold, but also when they are switched between different funds. Also, capital gains apply even when tax-free municipal bond funds are traded.

Taxable gains or losses

To calculate the taxable gain or loss on mutual fund shares sold, you have to determine the sale price and the true cost of those shares, known as the cost basis. The former is easy to determine; the latter can cause some problems.

There are three basic ways to determine the cost basis:

Specific Identification Method. When a capital gain is reported on a mutual fund sale, the IRS allows you to identify the sale of those shares for which originally the highest price was paid. Frequently, this constitutes the best strategy, since in most instances that would automatically minimize the gain and hence the tax liability for that year.

First-in, First-out Method. If you do not, or cannot, use the first approach, by default the IRS as-

sumes that shares sold were those that were acquired first, known as the First-in, First-out, or FIFO, approach. Although not always, this method may maximize the current tax bill, since as a general rule, the shares bought first are likely to have the lowest cost.

Average Cost Method. A better alternative might be to use the average cost approach, which requires calculating the average per-share price for all the shares of the fund. This may generate a lower current tax liability than with the First-in, First-out, or FIFO, approach.

The tax consequences of using the three approaches described in the accompanying table are interesting. The Specific Identification Method resulted in a short-term gain of \$400, while the Average Cost Method generated a long-term gain of \$658. Finally, as expected, the FIFO method resulted in a long-term gain of \$1,000.

At this point, it is appropriate to add an important caveat. In determining the tax liability of mutual fund gain it is extremely important to properly calculate the tax basis of that investment. The following example clarifies the point.

Assume you placed \$5,000 in a mutual fund 10 years ago and reinvested \$4,000 received as fund distributions during the next 10 years. Now if you sell all the shares for, say \$10,000, what would be the taxable gain? If you figured that the taxable gain is \$5,000 (\$10,000 minus \$5,000), then you would be wrong. The cost basis is \$9,000 (\$5,000 plus \$4,000 reinvested distribution) and the taxable gain is only \$1,000 (\$10,000 minus \$9,000).

| Mutual fund tax calculation | | | |
|--|-------------------------------|-----------|--|
| DATE | BUY BASIS SALE | NET GAIN | |
| April 1993 | Purchase 1,000 shares at \$20 | \$20,000 | |
| September 1993 | Purchase 100 shares at \$22 | \$2,200 | |
| December 1993 | Purchase 100 shares at \$22 | \$2,200 | |
| June 1994 | Purchase 100 shares at \$22 | \$2,200 | |
| December 1994 | Purchase 100 shares at \$24 | \$2,400 | |
| December 1994 | Sell 200 shares at \$25 | \$5,000 | |
| SHORT-TERM GAIN (VS. LONG-TERM GAIN) | | | |
| Total funds received (200 x \$25 per share) | | \$5,000 | |
| Less highest cost shares (100 shares at \$22/share purchased June 1994 and 100 shares at \$24/share purchased Dec. 1994) | | (\$4,600) | |
| Short-term gain | | \$400 | |
| LONG-TERM GAIN (VS. SHORT-TERM GAIN) | | | |
| Total funds received (200 x \$25 per share) | | \$5,000 | |
| Less cost of first 100 shares acquired (shares purchased in April 1993 at \$20/share) | | (\$4,000) | |
| Long-term gain | | \$1,000 | |
| AVERAGE COST METHOD (VS. FIFO METHOD) | | | |
| Total funds received (200 x \$25 per share) | | \$5,000 | |
| Less average cost of \$20.71/share (Divide total purchase price of \$20,000 by 1,000 shares. That equals \$20.71/share) | | (\$4,121) | |
| Long-term gain* | | \$879 | |

* Assumes that the shares were held for more than 12 months. Also, in this example, it is assumed that there were no distributions.

Sid Mittre, Ph.D., CFP, is Professor of Finance, Oakland University, Rochester Hills, and owner, Mittre & Associates, a

Troy financial consulting firm. Oakland University Professor Jerrold Grossman critically reviewed this column.

BUSINESS MILESTONES

This column highlights promotions, transfers, hirings, openings and other key business news with Farmington-area connections. Send a brief biographical summary — including the towns of residency and employment and a photo, if possible, to: Business Editor, Farmington Observer, 3311 Grand River, Farmington 48335. The Observer's fax number is (313) 477-9722.

Lori Anderson has been promoted to account executive at Hermanoff & Associates, a full-time service public relations firm based in Farmington Hills.

In her new position, she will continue to service the McDonald's Restaurants of Southeastern Michigan and Prism Performance Systems accounts.

Linda Woolwine of Farmington Hills, a regional director with AAA Michigan has been selected as a member of Leadership Detroit XVII.

Leadership Detroit provides a foundation for lifelong commitment to effective leadership through education. The 10-month series of seminars challenges emerging and existing community leaders on key issues affecting political, business, human service, criminal justice and cultural activities in Detroit.

Dean Babb, assessor for the city of Farmington Hills, has been elected president of the Michigan Assessors Association for 1996. He has been the assessor in Farmington Hills since October 1984. He has also worked for West Bloomfield Township and the Oakland County Equalization Department.

Babb has a bachelor's degree from Oakland University and is certified by the state of Michigan as a Level IV assessing officer.

Nancy Van Zant has been named vice president for Corporate Development Services with Mercy Health Services headquartered in Farmington Hills.

Mary Banks was promoted from account supervisor to vice president, account supervisor at Hermanoff & Associates Inc., a public relations firm in Farmington Hills.

Jack C. Rosely of Farmington Hills has taken on the role of taxable fixed income coordinator in addition to his responsibilities as tax advantaged investment coordinator at the PaineWebber offices in Farmington Hills.

Rosely is a certified financial planner and a graduate of the PaineWebber Equity Institute, allowing him to teach stock investing to other investment professionals as well as clients.

Gerald Fuller of Farmington has been named one of the top guns in the MAACO Auto Painting & Bodyworks chain. The award recognizes excellent quality, leadership and productivity. He is the production manager at MAACO.

The Association for Worksite Health Promotion has announced that Dr. Don R. Powell, the president and founder of the American

Institute for Preventive Medicine in Farmington Hills, is the recipient of its 1995 Distinguished Leadership and Service Award. The award is given to an individual who has shown outstanding leadership and contributed significant services in employee health promotion profession.

Pat Murphy, a Livonia/Farmington Hills area Realtor, has been awarded the Certified Residential Specialist Designation by the Residential Sales Council of the Realtors National Marketing Institute, an affiliate of the National Association of Realtors.

Murphy is a sales associate broker with Realty Professionals in Farmington Hills. He is a member of the Western Wayne and Oakland County Association of Realtors, where he serves as director. He has also served as the chairman of the Multiple Listing Service Committee.

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