Look Before You Leap
By Gary Case

It is the time of year to look before you leap if you are considering purchasing, selling or exchanging mutual fund shares outside of a qualified plan or variable annuity. Each year mutual funds must distribute nearly all gains realized through their operations to shareholders. It is conceivable that you could receive a hefty percentage of your fund's value as a taxable distribution towards year end.

This has specific implications if you wish to minimize income and capital gains taxes. Here are some strategies that you may wish to consider:

1. Considering a substantial mutual fund purchase? Check with the fund company to see if there will be a distribution between now and year end. It may pay to delay your purchase unless you are highly confident that your investment will increase enough to offset the taxes you will pay on the distribution. The upside of making a purchase now and paying taxes this year is that your cost basis will rise by the amount of the distribution, potentially lowering the tax burden on a later sale.

2. If you know that your fund is scheduled to pay a big distribution and you have little gain on your original investment, it might pay you to exchange to another fund in the same "fund family" that will have little or no distribution and wait until after distributions to exchange back into your original fund. It is important to remember that you must wait at least 30 days between exchanges to avoid IRS "wash sale" rules.

3. If, after reviewing your portfolio, you decide it is time to rebalance, it may pay to rebalance prior to year-end distributions. By doing so, you may be able to convert some undistributed ordinary income or short term gains to long-term gain simply by selling your fund prior to the distribution. Remember, this only applies to funds you have owned for longer than one year.

If you are investing in an IRA, 401(k), or other qualified retirement plan, or in a variable annuity, year end distributions will not have a direct affect on your taxes. You may notice a difference in share price since the price per share of a fund drops by the amount of distribution on the day of the distribution. So if you closely follow the price of your fund, don't panic when you see that drop! You should consult your financial planner and tax advisor prior to acting on any of the strategies mentioned above.

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