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# Taxability of Mutual Fund Distributions

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Most investors view mutual funds as being invested exclusively in company stock. In reality, most funds are made up of various types of investments, from company stock to cash and bonds, and even to more exotic instruments, like derivatives. The exact makeup of a fund's investment portfolio is generally related to the management objective of the particular fund. This variety of investments, however, means that the taxpayer can't treat all distributions of investment income from a single fund in the same manner.

Income from mutual funds can be broadly described as coming from the realization of three different sources: interest income, dividend income, and net capital gains. Interest income is received from investment in bonds and other debt instruments, and dividend income comes from investments in company stock. Net capital gains are realized when the fund buys and sells investments during the year.

A fund's income from these sources, distributed to the fund holder, falls into five different groups:

1. Ordinary dividends
2. Qualified dividends
3. Exempt-interest dividends
4. Capital gains distributions
5. Nondividend distributions

*Ordinary dividends:* In general, distributions from mutual funds, whether derived from dividend or interest income, are treated as ordinary dividends to the fund holder, per Reg. §1.852-4(a).

*Qualified dividends:* This category was created by the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRR). Under the JGTRR, dividends received from domestic and "qualified foreign corporations" are taxed generally at the same rates as capital gains tax. A qualified foreign corporation is an entity that is incorporated in a U.S. possession or is eligible for the benefits of a U.S. tax treaty. Dividends from other types of foreign corporations are also eligible for the lower rates if the company's stock is traded on an established U.S. equities market, such as the New York Stock Exchange. Several IRS notices have been issued to provide guidance addressing the treatment as qualified dividend income of distributions to 1099-DIV issuers (for example, Notice 2003-79, 2003-50 IRB 1219; Notice 2004-70, 2004-44 IRB, 724; Notice 2004-71, 2004-45 IRB, 783).

This provision applies to both the regular and alternative minimum tax. As a result, dividends are taxed at 5% (0% in 2008) for taxpayers in the 10% and 15% tax brackets and at 15% for those in the 25% bracket and above. This provision is retroactive and applies to dividends received from the 2003 taxable year onward. This special tax treatment is only temporary and is scheduled to terminate after 2008. Beginning on January 1, 2009, dividend tax rates will revert to the ordinary income tax rate unless Congress extends the provision or makes it permanent.

Except for the dividends specified in Sec. 301(a) of the Act, the JGTRR generally applies to all dividends, including dividend distributions by a mutual fund of income derived from such qualified dividends. One important point to bear in mind is that this provision does not apply to dividends received in tax-deferred retirement accounts, such as IRAs and 401(k) plans. Income earned in those accounts is recognized at the time the funds are withdrawn and is taxed at the ordinary income tax rate at that time.

*Exempt-interest dividends:* Another exception to the ordinary dividend rule applies to dividends paid by a mutual fund that has at least 50% of the value of its total assets (as defined in IRC §851(c)(4)) invested in state or local bonds (as defined in IRC §103(a)) at the close of each quarter of the taxable year. The dividends from such funds qualify as exempt-interest dividends to the fund holders.

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It should be noted that these dividends are only exempt from federal income tax; the dividends still may be fully or partially subject to state income tax. For example, a Pennsylvania taxpayer would pay state income tax on the portion of exempt interest from non-Pennsylvania bonds whereas a Texas taxpayer wouldn't be subject to any state income tax at all (Texas is one of seven states without a state income tax). Although a taxpayer is required to properly apportion the dividend income as taxable and nontaxable, mutual funds generally provide the approximate percentage of state holdings within a fund.

*Capital gains distributions:* Pursuant to IRC §851(a), regulated investment companies are required to distribute over 90% of their earnings for the tax year to fund holders. This includes net capital gains and losses that result from the buying and selling of investments by the fund manager throughout the year, resulting in net realizable gains. Fund holders generally treat all such distributions as long-term capital gains (IRC §852(b)(3)).

In the case where a fund doesn't distribute all capital gains and instead pays the tax on the undistributed amount, the taxpayer treats the undistributed gain as if it were received under IRC §852(b)(3)(D). The taxpayer, however, is able to take credit for the tax paid on the undistributed gain by the fund (35% of the gain) and increase his/her basis in the fund by 65% of the gain, as required by IRC §1201(a).

Investors of tax-exempt mutual funds invested in state and local bonds must remember that the tax exemption only applies to ordinary dividend distributions from the fund; capital gains distributions from such municipal bond funds aren't exempt from capital gains tax. Likewise, sales of these funds by an investor can result in a capital gain or loss that must be recognized by the taxpayer.

*Nondividend distributions:* Nondividend distributions aren't paid out of earnings or profits of the fund and are effectively return of capital. Ordinarily, this merely reduces the taxable basis of the investment in the mutual investment and, therefore, isn't taxable. The investment basis can never be reduced to less than zero, however, so if the nondividend distributions exceed the current basis, the excess is treated as a capital gain. The capital gain may be long- or short-term, depending on the taxpayer's holding period of the fund.

A feature of mutual funds that has become quite popular among mutual fund investors is the automatic reinvestment option, which allows investors to increase their holdings in the fund. Although there are no actual distributions of cash, the reinvested amount is deemed to be distributed and then reinvested. As a result, the reinvested dividend amount is included in gross income tax and as an increase in the investment basis of the fund. Failure to properly account for the basis increase results in a financial loss for the taxpayer at the time of sale of the fund, as it will overstate capital gains and understate capital losses.

Recent legislation resulted in a reduction in tax from funds and stocks distributing qualifying dividends to shareholders and a renewed interest in dividend-paying investments among the investors. If the legislation isn't renewed in a few years, another result will occur: What happens to the market's interest in these investments, and, more importantly, their stock value? ■

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