

What your clients might ask about year-end tax planning

As you prepare for client conversations about year-end tax planning, consider these frequently asked questions and the advantages of a tax swap strategy.

Frequently asked questions about distributions

What are the record date and payable date?

Record date (also considered the ex-date for open-end mutual funds). This date determines who is entitled to receive a mutual fund's dividend. Anyone who is a fund shareholder on the record date will receive the fund's capital gains distribution. These shareholders are liable for taxes on this distribution, whether they receive it in cash or reinvest it. This is also the day the fund records the capital gains distribution payable to shareholders of record, deducting it from the fund's net asset value (NAV) — that is, the value of one share of the fund.

Payable date. This is when proceeds of the capital gains distribution are paid to shareholders of record. It is generally 2–4 business days after the record date/ex-date.

Why does the net asset value drop when a fund has a capital gain?

When the amount of a fund distribution is significant, the NAV may drop considerably on the ex-date. It is important for shareholders to realize that the lower NAV does not indicate lower performance. The drop in NAV does not reflect a loss in the overall investment value, but instead indicates that a portion of that value has been given to the shareholder as a capital gain. Shareholders who automatically reinvest distributions will see that their account value does not change. Instead, they will see an increase in the number of shares. Shareholders who take the distribution in cash will receive a check for the capital gain. All shareholders must pay taxes on the amount of the capital gains distribution, whether they take the dividend in cash or reinvest it.

What is net investment income?

Net investment income consists of interest and dividends earned by the fund, minus fund expenses. Some funds pay out net investment income once a year. Others pay regular monthly or quarterly distributions. When these funds pay out an additional net investment income distribution, it is sometimes called “extra taxable dividend income.” This income receives the same tax treatment as ordinary dividend income. Foreign currency gains/losses and swap income/losses are treated as ordinary income (or loss) for tax purposes and can increase or reduce a fund's distribution of net investment income or its extra taxable dividend income.

Why do funds have net investment income dividends?

Dividends are paid from the earnings in a fund's portfolio. According to IRS rules, a mutual fund must distribute what it earns during the year to maintain its tax status. If additional earnings remain at year-end, they must be distributed to shareholders in a special one-time lump sum.

What is a capital loss carryforward?

Capital gains realized by a mutual fund are passed on to the shareholder; conversely, capital losses are not. Historically, when a fund realized a capital loss, it was retained by the fund for up to eight years as a capital loss carryforward, available to offset future gains. Effective for funds with fiscal year-ends beginning after December 22, 2010, capital losses will no longer expire. However, they will no longer be carried over as short-term, but rather will be carried over to the subsequent tax year in the character realized (short-term or long-term). Capital losses incurred prior to this effective date will be grandfathered in and will retain their 8-year expiration schedule. Any capital gains realized after this effective date must first be used to offset the capital losses without expirations, prior to offsetting those with expirations.

Why would a municipal bond fund pay extra taxable income?

In most cases, the extra taxable income is the result of a market discount on the sale of bonds, which is required to be distributed as taxable ordinary income. It is common for tax-exempt funds to pay taxable income at the end of the year due to the market discount. Investments in tax-exempt partnerships can also generate taxable income.

What is return of capital?

If the taxable income and gains earned through the fiscal year-end of a fund are lower than the distributions the fund has paid out, that difference is characterized as a return of capital for tax purposes. The return of capital is non-taxable. Shareholders will need to reduce the cost basis of their fund holdings by the amount of the non-taxable return of capital reported on their 1099 in January.

The tax swap: Use investment losses to your advantage

When selling low may be helpful

While investment losses aren't pleasant, they only exist on paper until you sell your shares. That is why many financial advisors counsel investors to hold on to mutual fund shares rather than sell at a low point and realize a loss.

However, there can be an advantage to selling low. It is known as tax swapping — when you apply a capital loss against a capital gain in another investment or apply up to \$3,000 of a capital loss against net ordinary income on your tax return.

Tax-swap strategy example for mutual funds

- Investor owns ABC Equity Fund, which has declined substantially
- Investor sells ABC Equity Fund, realizing a capital loss

- Investor buys XYZ Equity Fund, a different fund with a similar strategy as a replacement
- Investor realizes a loss, but remains exposed to the same types of investments

Tax-swap benefits

- Capital losses, from one or multiple funds, can be used to offset capital gains from other investments
- A capital loss may also create a carryforward that can be used in subsequent years to offset income and capital gains
- Up to \$3,000 in net capital losses can be used to reduce current taxable income

Consider the wash sale rule

- Under the wash sale rule, investors cannot deduct losses if they reinvest the proceeds of a sale into “substantially identical” securities within 30 days
- In most cases, the wash sale rule does not apply to actively managed mutual funds because portfolio holdings differ enough that two funds would not be “substantially identical”
- Wash sale rules typically apply to swaps between index funds or exchange-traded funds (ETFs) that are managed against the same index

Watch for year-end capital gains

- Investors making a tax swap late in the year should pay attention to year-end capital gains distributions for mutual funds
- It is best to avoid investing in a fund shortly before it makes its year-end distribution. If you do, you could be taxed on gains that the fund made before you owned your shares — essentially “buying a tax liability”

To learn more about year-end distributions and other tax information for Putnam funds, visit putnam.com/advisor/tax-center/

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