



# STAAR<sup>SM</sup> Strategies Report



## TAX EFFICIENT INVESTING AND MUTUAL FUNDS

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Tax efficiency is a term used to describe the relative level of taxation caused by trading within a mutual fund. Sales of securities made (realized) during a tax year cause two basic types of tax "events", which are reported to shareholders and the IRS on 1099 forms:

**Ordinary Income:** Interest, dividends and capital gains resulting from the sale of securities held less than a year are generally taxed at "ordinary" tax rates. In other words, the regular income tax brackets apply with the highest being 39.5%.

**Long Term Capital Gains:** Securities sold after being held more than one year are taxed at more favorable capital gain rates. The maximum rate is 20%. If the taxpayer is in the 15% tax bracket, the tax is only 10%.

Gains on securities held but not sold are not taxed until they are sold. As long as the mutual fund manager does not sell a security, any tax on gains (appreciation) is deferred.

Obviously, a fund that has low turnover (sales) will produce less current taxes. If tax efficiency is measured by how much tax is caused by a fund's activity, a fund that has low dividends and keeps securities longer without selling them is going to be more tax efficient. Some people are attempting to rank funds on the basis of tax efficiency, but there are some fallacies in their analysis that could cost investors dearly.

**Fallacy #1: High tax-efficiency will produce higher net returns.**

This is true only if the returns between two compared funds are similar. However, many funds with higher turnover ratios also produce higher returns because of intelligent selling by the fund managers. This is especially noteworthy as long as most of the selling produces long-term gains.

**Fallacy #2: It is better to buy a fund which has a good tax-efficiency history.**

If a fund has produced fewer taxes in the past, you may actually be buying already appreciated securities which could create "phantom taxes". For example, a fund's holdings currently consist of securities, which are appreciated 50% (unrealized appreciation). Because it has sold few of its securities in recent years, its shareholders have paid less taxes and the fund has a high tax efficiency rating. That's great for those who have been in the fund the entire time and that is why the fund gets a good tax efficiency rating.

But someone buying the fund now is buying a tax risk. If the manager decides to sell a lot of his positions, the new investor would receive the same proportional taxable gains as the old investor. The fund could actually go down in value while the new investor would have to pay tax on the "old" gains now. That's not very efficient.

**A "Tax Balanced" Approach Is Best**

In my view, the most tax "balanced" approach is found in a fund that generally sells a reasonable portion of securities every year and spreads out the tax "events" more evenly. It is also a fund that avoids short-term capital gains as much as possible. This pay-as-you go approach serves both old investors and new investors more evenly.

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**Like Rome, a good investment**



portfolio wasn't built in a day.