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## Save Taxes On Your Mutual Funds

There are two ways to save taxes on mutual funds. One is to choose funds that are tax efficient—that is, where the fund manager employs such tax-saving strategies as holding shares long term and harvesting losses to offset gains. The other is to pay close attention to mutual fund purchases and sales and carefully manage the tax impact of each transaction. Here's how you do it.

**If you pay attention to certain tax rules *at the time you place the order*, you could save a considerable amount of dollars at tax-time.**

Here are the rules.

First, let's start with the basics: mutual fund shares are considered a security for tax purposes. In the case of a gain, the tax is assessed on the difference between the cost basis and the sales proceeds. These taxes are assessed at either ordinary income tax rates ( your rate on earnings, interest or dividends) or long-term capital gains rates (20% at the most), depending on how long you've held the shares. If there's a loss, it can be used to offset other gains or carried forward to future years. Very straightforward.

You have four choices in determining your cost basis:

- **First-in, first-out (FIFO).** This is the default method. If you do not specify otherwise, the IRS will assume the shares being sold are the ones that were acquired first. This usually results in the highest tax bill, assuming the share price has been steadily increasing.

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- **Specific identification method.** A more complicated, but less taxing, method is to identify the exact shares you are selling. This allows you to sell the highest-cost shares to reduce the gain or even produce a loss. However, *you must specify at the time you place the order* which shares you are selling. You should write a memo to your broker or to the mutual fund company instructing them to sell shares acquired on such-and-such a date at such-and-such a cost. You should keep this paperwork with your tax records in case of audit.
  - **Single-category average cost method.** This method calculates the average cost of all shares owned. This figure is often reported on your mutual fund statement. Any shares sold are considered to be those held the longest; this is fine if you're establishing a gain, but not so good if you're selling for a loss (short-term losses are better than long-term losses). Once you start using this method for a particular fund, you may not switch to another method (however, other funds are not affected).
  - **Double-category average cost method.** With this method, you separate shares into two pools, long term and short term, and calculate the average cost for each. You can sell from either pool or both pools as you see fit.

### Bottom line

FIFO is clearly the worst method because it will usually result in the highest tax. The specific identification method gives you the greatest control over taxes, because it allows you to sell high-basis shares regardless of when they were purchased.

**Here's a good example:** If the market drops right after a recent purchase, you can sell those shares for a short-term loss. However, do be aware of a rule designed to prevent mutual fund shareholders from capturing a long-term capital gain distribution and then selling for a short-term loss after the price drops. If an investor realizes a loss on shares held less than six months and during that time receives a long-term capital gain distribution, only the portion of the loss that



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exceeds the amount of the distribution can be reported as a short-term loss. The portion that is equal to or less than the distribution is long term.

Finally, now is the time to look for mutual funds with “loss carryforwards” embedded into the portfolio due to the market’s recent decline. Check with your broker, Morningstar or another mutual fund publication for more details.

*Steve*

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