



Save Your Clients Money with Capital Gain Distribution Avoidance

By Josh R. Meyer, CFP®

Advisors utilize many strategies to help their clients generate higher after-tax investment returns, including location optimization, short-term gain avoidance, and tax-managed mutual funds.

Though less well-known than those other strategies, capital gain distribution avoidance (CGDA) might be another strategy. CGDA is the act of selling a mutual fund with a high estimated year-end distribution and buying a similar fund that has a smaller estimated distribution. The mechanics are similar to tax-loss harvesting, but the fund is not being sold to generate a tax loss. The fund is being sold to avoid taxes on the capital gain distributions.

Mutual funds usually distribute dividend income every month or quarter. However, capital gains accumulate throughout the year and are generally distributed to shareholders at the end of the year. Fund companies typically announce estimated capital gain distributions in late October. Since these distributions can include qualified and non-qualified dividends, as well as short-term and long-term capital gains, the tax consequences can be substantial.

Advisors and their clients have few options for handling capital gain distributions. They can:

- Take the distributions and pay the taxes;
- Sell the fund prior to the distribution date, and then wait until after distributions are paid to buy it back; or
- Use CGDA to reduce taxable income, while still maintaining the preferred market position.

To determine if CGDA will be beneficial for your clients, you must first find the distributing fund's estimated distribution. If the distribution will be material, the next step is to locate a similar fund with a lower estimated distribution. If there is a substantial

difference between the two distributions, CGDA might be appropriate.

There are a couple of complexities. Most importantly, for each client owning the distributing fund, the advisor must make sure that the tax lots to be sold do not generate a taxable gain in excess of the CGDA benefit. Most portfolio accounting software allows advisors to see cost basis by tax lot, along with short-term and long-term unrealized gains. This will help the advisor compare the tax cost of selling shares of the distributing fund vs. the taxes that will be avoided by reducing capital gain distributions. When calculating taxes, be sure to use each individual client's respective tax rates. With the pieces of the puzzle in place, number crunching is all that remains.

Let's look at an example, shown in the table:

		Long-term capital gain distribution per share	Short-term capital gain	Cost basis per share	Market value per share
Distributing fund (100 shares, long-term capital gain)	ABC	\$5	\$2	\$11.50	\$12
Distributing fund (100 shares, short-term capital gain)	ABC	\$5	\$2	\$11.60	\$12
Replacement fund (200 shares)	XYZ	\$2	\$1		
Assumed federal and state long-term capital gain tax rate			20%		
Assumed federal and state ordinary tax rate			40%		

In the example in the table, the tax savings from CGDA will be the (Difference in Long-Term Distributions x Long-Term Capital Gain rate) plus (Difference in Short-Term Distributions x Ordinary Tax Rate) minus (Tax on Gains Recognized).

Let's calculate. Assume that the client sells 200 shares of ABC, thus avoiding \$200

x (\$5 - \$2) = \$600 in long-term distributions and 200 x (\$2 - \$1) = \$200 in short-term distributions. The savings from this is (\$600 x 20%) + (\$200 x 40%) = \$200. From this, subtract the tax costs of recognizing the gains on the shares of the distributing fund that was sold, which is 100 x (\$12 - \$11.50) = \$50 long-term capital gain and 100 x (\$12 - \$11.60) = \$40 short-term capital gain. The tax on the gains will be (\$50 x 20%) + (\$40 x 40%) = \$26. Thus, the savings is: \$200 - \$26 = \$174.

That's a substantial benefit. Admittedly, CGDA can be labor intensive, but whether you choose to do CGDA by hand, spreadsheet, or program, your clients will thank you when it comes time for paying taxes, if this analysis is included in your current fee structure. NA

Josh R. Meyer, CFP®, is financial technology advisor for Total Rebalance Expert, developer of Total Rebalance Expert®, a patent-pending software program for rebalancing, cash management, tax-loss harvesting, and more. He can be contacted at josh@TRXpert.com or 619.294.4TRX, ext. 222.