

TAX LETTER

Mutual Funds and Form 1099

Dear Clients and Friends:

Recently I received a letter which highlighted a mutual fund investment dilemma. It referred to this as “paying taxes on 40% losses”. Yes, if it is the case, it certainly as “double jeopardy” as it can be. How can it be?

Ordinarily, an investment in a mutual fund, income or equity, will not receive any real distribution of income in the form of money, but will receive a Form 1099 for the income allocated to each and every investor of the mutual fund. This Form 1099 usually reports to the IRS the taxable income, such as interest, dividend and capital gain distribution, which an investor must recognize in his or her income tax return and pay whatever required amount of income taxes, Federal and State. The problem of “double jeopardy” can be understood readily in the area of “capital gain distribution” by the mutual fund.

If you have to pay income taxes for the “capital gain distribution” figure indicated on Form 1099 and you have a satisfactory, overall appreciation of the value of your mutual fund through out the year, the appreciation of value may be substantially out-weight the income taxes you have to pay, therefore it is acceptable.

What happened, if the mutual fund you invested did not appreciate or only appreciated slightly? Will you continue to think that it is OK to pay the income taxes on the “capital gain distribution” given to you from the mutual fund on Form 1099? This could happen, because through out the year, in order to maintain a certain value and/or appreciation for the fund, your mutual fund managers have to execute numerous transactions and trades. These transactions and trades will generate capital gains or losses. By the end of the year, these capital gains or losses usually will net to certain level of gain and will be 100% distributed to all the investors in proportion to their individual holdings, regardless of the level of market appreciation experienced by the individual investors.

The recent financial and market melt down made the “double jeopardy” real. Even conservative value funds lost their value by 20%, 30%, 40% or greater. If the year end net asset value of your investment in a certain mutual fund plummeted by, say 40%, and you received a Form 1099 in January mandating that you recognize and pay income taxes on a sizeable “capital gain distribution”, what will you think?

How to get out of this dilemma? If your investment included mutual fund or funds, we suggest you to have a thorough analysis of your investment and mutual fund(s) and have a talk with your investment advisor before it is too close to the record date of the year. In general, you may do one of these two things:

(A) If you are the owner of a mutual fund which will be making large distribution of “capital gain” and if the fund is trading at a loss, you may want to discuss with your investment advisor

about selling or redeeming the fund for its net asset value before the record date. This way, you may avoid the 1099 dilemma and deduct the capital loss.

(B) If you are the owner of a mutual fund which will be making large distribution of “capital gain” and if the market loss of the fund is relatively small, you may want to consider the option of selling or redeeming the fund before the record date and buy it back sometime early next year. As long as the date of reacquiring the fund is more than 30 days after the sale, you may avoid the 1099 dilemma, re-own the fund and at the same time deduct the capital loss, if any.

If unfortunately, your combined net capital loss is greater than your combined net capital gain, you could only deduct an additional \$3,000 each year. The balance unused net capital loss will be carried over to the future years.

Finally, before you proceed any further or making any decision concerning your 1099 dilemma, please have a good discussion with your investment advisor.

If you need any further information, please give us a call at 415-381-0681, or visit our web site “**www.chochan.com**”.

Sincerely,

Cho F. Chan CPA, Inc.