

Floating NAVs could prove taxing

Money market fund reform would likely result in accounting headaches for investors

By Robert N. Gordon

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As much as I hate to admit it, the forces that advocate keeping a stable net asset value for money market funds have found a potent argument.

In "Say Goodbye to Money Funds" (Feb 15, 2009), I argued for the idea of money market funds' reflecting their true NAV. A stable NAV can give investors a false sense of security.

We now are told that there have been more than 300 instances where sponsors have dug into their own pockets so as not to "break the buck." Are we to depend on the kindness of sponsors to dig deep to support a money-losing business and the notion that a money fund can't break the buck?

So it is ironic that I use this space to observe the tax headache that might come with floating-NAV money funds. Quite simply, investors would be flooded with buy and sell tickets.

Every time money is charged to the account from a check clearing, it would be considered a sale. Every time money is swept into the account, it would be considered a new purchase.

Any analysis of new legislation is supposed to contain a discussion of the costs and benefits of enacting the legislation. I don't see in that analysis the costs to investors of keeping track of and reporting these trades.

Nor do I see the costs of the burdens put on brokers who have a responsibility not only to report sales but also to calculate and report cost bases for those sales.

A bigger headache could come from the interaction of the wash sale rules. A wash sale is when a taxpayer sells assets at a loss and then repurchases substantially identical assets within 30 days of the sale.

If the wash sale rules are triggered, investors who sell shares at a loss cannot take the loss. Instead, any loss is added to the cost basis of the offending purchase.

If a money fund is sold for a profit, a gain will be recognized. If a money fund is sold for a loss, the loss can only be taken if there were no corresponding purchases either 30 days before or after the sale. One can only imagine the nightmare as hundreds of purchases and sales are made between \$99.99 and \$100.01 as money is swept in and out of the account.

A taxpayer can mitigate somewhat the damage caused by electing to deliver the highest cost basis shares, but if no election is made, then the method will default to first in, first out.

Let's assume you buy one share at \$99.99 on Jan. 1 and then buy another on Jan. 2 at \$100.01. A week later you sell one share at \$100.

If you were taxed by the default first-in, first-out basis you would have a 1 cent gain. If instead, you elected to always deliver your highest basis shares, a 1 cent loss will be triggered, married to your purchase at \$100.01.

In this scenario, though, the wash sale rules will defer the recognition of the loss. But that is better than paying tax on a phantom gain.

The only way to avoid being whipsawed by the wash sale rules directly would be for the taxpayer to get out of the money fund completely.

If a taxpayer terminates all his or her holdings in a money fund and doesn't re-enter that fund for at least 31 days, the wash sale rule's deferred losses should all be recognized. Doing this at the end of the year would be operationally efficient and make bookkeeping simple.

One can trigger the wash sale rule inadvertently by purchasing a "substantially identical" asset within 30 days of a loss-producing sale. Although the government has expanded the interpretation of "substantially identical," buying another manager's money fund shouldn't run afoul of the wash sale rule, though this isn't certain.

Buying a different money fund run by the same sponsor and managed by the same team within the same parameters might not pass muster.

It is obvious to conclude that stable-value money market funds are more operationally efficient. Floating-NAV money funds will be both cumbersome and tax inefficient.

Investment Company Institute surveys show that investors will leave money funds if NAVs float. I wonder how much those numbers would increase once the tax headaches of floating NAVs become more evident.

Robert N. Gordon (bobg@twenty-first.com) is chief executive of Twenty-First Securities and an adjunct professor at New York University's Leonard N. Stern School of Business.