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Long term Gain Distributions and Tax Arbitrage

When one reads about massive long term gain distributions being paid you wonder about the tax traps (or opportunities) that are created.

One cannot be worse off tax wise if an investor sells in the same calendar year as when they receive the distribution. Below we show the math on that and also explore the possible tax arbitrage that might be employed because of large long term gain distributions.

The Trap

Last year, FPA Perennial Fund paid 81% of its value to its shareholders. In round numbers, the $50 fund paid a $40 long term gain distribution. If a holder owned the fund on the record date and received the $40 long term gain distribution last year, that income was included in the investor's taxable income calculation this April no matter what the investor did with the fund after that. The trick is to also realize any corresponding unrealized capital loss in the same year in order to offset the gain. A 2017 loss will not help lower the tax bill caused by the receipt of a gain distribution received in 2016.

Example:

Investor bought at $50

Sell this year at $10

Realize $40 capital loss

Receive $40 long term gain distribution

Net result- no taxable gain or loss this year or next. The same result is achieved if they sold before the record date for the distribution. If sold in the same year, the investor will only pay tax on any unrealized gain they had before the distribution was paid.

The Opportunity

One would think the $40 loss would be a short term loss. But if the $40 loss were short term, a tax arbitrage opportunity would be created. Before you get too excited, the IRS is aware of this possibility. IRC Section 852(b)(4) makes the capital loss long term in order to eliminate the mismatch of short term losses and long term gains. Indeed, in the FPA Perennial Fund example, if Section 852 didn't exist there would be more than $8 of after tax benefit to holding the fund over its record date from a $40 short term loss and a $40 long term gain.

Section 852 (b)(4),when first put in place, converted any losses from short term to long term if you did not hold the fund for at least one month. If you held for more than a month you could, and some did, exploit the distribution as a tax arbitrage. The government then lengthened the minimum holding period to 6 months thinking no one would want to take that much market risk in order to do a tax arbitrage. Also, due to the six month holding period requirement, any loss would be recognized in 2017 and must be used against 2017 short term gains for the arbitrage to be successful.

It is possible that someone confident in having 2017 short term gains would be willing to hold a $10 fund for 6 months knowing there is at least $8 of after tax benefit at the end of the trade. I don't think Section 852 ever contemplated such a large gain.

Since the season for gain distributions is upon us, we thought it might be useful to alert investors to the traps (or opportunities) created when funds pay giant long term gain distributions.