2021 Fund Distribution Estimates

November 24, 2021

Q&A: 2021 Income and Capital Gain Distributions

This information is intended to help you understand capital gain distributions and how they are calculated.

Q: Why are income and capital gain distributions made to shareholders?

A: As long as certain conditions imposed by the Internal Revenue Service (IRS) are met, a mutual fund is not subject to income taxes on income, such as interest and dividends, that it earns from portfolio holdings or on the capital gains that are realized when a portfolio manager sells securities in the portfolio. The reason for this is that a mutual fund is a conduit through which its income and capital gains flow to its shareholders in the form of distributions. The distributions are then subject to tax when they are paid to the shareholders. These distributions are included in a shareholder's income tax return. According to IRS rules, a mutual fund must distribute 98% of its calendar-year income and 98.2% of its capital gains realized from November 1 of the previous year to October 31 of the current year. If it fails to meet these minimum distribution requirements, the fund is subject to a 4% excise tax on any undistributed amounts.

Q: What determines the amount of the capital gains to be distributed?

A: The capital gain distribution is generally based on the capital gains the fund realizes from November 1 of the previous year to October 31 of the current year. This period may not correspond with the fund's fiscal year. If it does not, a comparison will be made of the capital gains realized during the fiscal year with those realized during the excise tax measurement period. Generally, the higher of the two amounts will be distributed.

Q: What other factors could affect the estimated capital gains?

A: Additional trading or shareholder activity through October 31, 2021, and tax adjustments could affect the estimates.

Q: How do a fund's realized capital gains relate to current market conditions?

A: Just because securities markets may be up or down does not mean that a fund will have more or less in realized capital gains. A fund may distribute a capital gain during a bear market and, conversely, it may not distribute a large capital gain during a bull market. A fund must pay a capital gain distribution if at the end of its fiscal year it has a net gain from the sales of securities. Capital gain/loss is the difference between the price at which each security is purchased and the price at which it is subsequently sold. If it is sold for more than its cost, there is a gain. If it is sold for less than its cost, there is a loss. Losses from the sales of securities may be used to offset gains realized from the sale of other securities. However, if at the end of its fiscal year the fund is in a net gain position, the amount of net capital gains must be distributed to shareholders. Although a capital gain is a taxable event, it is important to remember that it occurs because the fund makes a profit on an investment. That profit is included in the price per share and in the value of the account until it is distributed in additional shares or as a cash distribution. This is why you often see a fund's price per share drop when it distributes capital gains. Unless a shareholder receives a capital gain distribution in cash, the value of the shareholder's account is not affected by a capital gain distribution.

Q: What is equalization and how does it impact the distribution of registered investment companies?

A: Equalization is an accounting practice that is permitted for registered investment companies (RIC) whereby the net asset value of each share sold or repurchased comprises the par value of the share, undistributed income, and paid-in and other surplus.

When shares are sold or repurchased, the RIC calculates the amount of undistributed income available for distribution to its shareholders and, based on the number of shares outstanding, determines the amount associated with each share.

The per share amount so determined is credited to the equalization account when shares are sold and is charged to the equalization account when shares are repurchased.

The equalization account when added to undistributed net investment income and divided by shares outstanding, provides an amount that effectively equals income earned and income purchased. The purchased portion equalizes equity allocations among shareholders. A portion of the distribution made as a result of a stock redemption to a surrendering shareholder that represents its proportionate share of earnings and profits allocable to such surrendered shares can be included in determining the equalization amount.

Q: Why might the portfolio manager not try to reduce gains by realizing losses?

A: Although losses realized as a result of trading do offset gains, decisions about buying and selling securities are made on the basis of whether or not we believe the security remains a good investment for the fund. We will not sell a security simply to realize a loss. When we decide to sell a security, we try to do so in the most tax-advantageous manner. The decision to sell, however, is based on the portfolio manager's analysis of that security's prospects as an investment, not on how its sale will affect the fund's overall gains or losses. Our focus is on the long-term performance of the fund for our shareholders.