Executive Summary

In this paper, the authors attempt to give the reader a better understanding of mutual fund distributions and the tax implications of those distributions for taxable investors. The authors will also illustrate their belief that yield should not be the only measure used to make mutual fund investment decisions. They argue that a total return approach that matches an investor with the least risky portfolio suited to his or her investment goals should be used. The paper also briefly talks about yield and financial behavior.

- A mutual fund is a conduit security, which means it avoids double taxation of earnings by passing dividends, interest, and capital gains on to the shareholders who are then taxed.
- Mutual fund shares are traded at net asset value (NAV) which reflects the value of the fund’s underlying securities.
- When a mutual fund pays a distribution to shareholders, NAV drops in accordance with the amount of the distribution. Investors’ accounts will remain unchanged whether they reinvest the earnings or accept distributions; think of it as the transfer of wealth.
- Yield is a measure used in the industry to calculate the amount of income generated from an investment based on the investment’s initial cost. The authors feel that investors should focus on the total return of a fund which includes dividends and capital gains as well as the fund’s contribution to total return and overall wealth creation.
- Actual investment returns and investor wealth creation are dependent on taxation. Since tax laws change frequently, investors and financial professionals should always keep abreast with the current tax situation.
- When there is a capital loss and no capital gain in any subsequent years, $3,000 of the capital loss can be used to offset ordinary income with the balance carried forward indefinitely.
- Capital gains usually have favorable tax treatments over ordinary dividends. Yet, many investors continue to prefer dividends. The authors believe that mental accounting is the reason behind this phenomenon. Investors tend to think of dividends as “income” and capital gains as “capital.” Investors generally use these mental accounts to limit their spending — basically a form of financial self-control. Again, this self-control comes at a price — higher taxes on ordinary dividends.
Introduction

Mutual funds are a special type of corporation subject to tax rules set forth in subchapter M of the Internal Revenue Code. Unlike most corporations, mutual funds are not subject to taxation on their income and capital gains at the corporate level, given they meet certain gross income and asset requirements, and distribute at least 90 percent of their income to shareholders each year. Mutual funds are also subject to a 4 percent excise tax unless they distribute at least 98 percent of their ordinary income and net capital gains. Most funds choose to avoid the taxation of earnings by electing to distribute them to shareholders each year.

In this paper the authors attempt to give the reader a better understanding of mutual fund distributions, i.e., dividends and capital gains, and the tax implications of those distributions for taxable investors. The authors also attempt to illustrate their belief that yield should not be the sole method used to make mutual fund investment decisions, but that a total return approach should be used that matches an investor with the least risky portfolio needed to meet his or her investment goal.

Origins of Mutual Funds

Historians are uncertain of the origins of investment funds; some cite the closed-end investment companies launched in the Netherlands in 1822 by King William I as the first mutual funds, while others point to a Dutch merchant named Adriaan van Ketwich whose investment trust created in 1774 may have given the king the idea. Whether it was King William I or Ketwich, we can opine that the originator may have theorized diversification would increase the appeal of investments to investors with minimal capital.

The idea of pooling resources and spreading risk using pooled investments soon took root in Great Britain and France, making its way to the United States. Today, in the U.S. alone there are more than 10,000 mutual funds. If we account for all share classes of similar funds, fund holdings are estimated to be in trillions of dollars. Despite the launch of separate accounts, exchange-traded funds and other competing products, the mutual fund industry remains healthy and fund ownership continues to grow.

Investment Companies

According to the U.S. Securities and Exchange Commission, an “investment company” is a company that issues securities and is primarily engaged in the business of investing in securities. An investment company invests the money it receives from investors on a collective basis, and each investor shares in the profits or losses in proportion to the investor’s interest in the investment company. The performance of the investment company will be based on the performance of the underlying securities and other assets that the investment company owns.

Federal securities laws categorize investment companies into three basic types:

- Open-end companies (also known as mutual funds);
- Closed-end companies (also known as closed-end funds);
- Unit Investment Trusts (also known as UITs).

Each has its own advantages and merit as an investment vehicle. Mutual funds however, have a distinctive feature in that they issue redeemable securities, meaning investors buy and sell shares from the fund. This makes mutual funds unique in that they do not trade at a discount or premium. Instead, they trade at net asset value (NAV) calculated at the close of the stock market each day. The NAV reflects the value of the underlying securities contained within the fund. The example below illustrates how a fund’s NAV is calculated.

### Determining Share Price

Fund X owns a portfolio of stocks worth $10 million; its liabilities are $100,000; its shareholders own 500,000 shares.

\[
\text{Market value in dollars of securities minus liabilities} = \frac{10,000,000 - 100,000}{500,000} = \$19.80
\]

$19.80

Share price

or

net asset value (NAV)
How Do Funds Earn Money

Mutual fund investors can earn money in three ways:

• **Dividend Payments** — A fund may earn income in the form of dividends or interest on the securities held in its portfolio. The fund pays its shareholders nearly all of the income, minus expenses, it has earned in the form of dividends throughout the year.

• **Capital Gains Distributions** — The price of the securities a fund owns may increase. When a fund sells a security that has increased in price, the result is a capital gain. At the end of the year, most funds distribute these gains, minus any capital losses, to investors.

• **Increased Net Asset Value (NAV)** — If the market value of a fund’s portfolio increases after deduction of expenses and liabilities, then the value (NAV) of the fund and its shares increase. The higher NAV reflects the higher value of the investment.

Distributions

A mutual fund is a “conduit” security, which means that mutual funds avoid the double taxation of earnings by passing dividends, interest, and realized capital gains through to fund shareholders each year where these earnings are taxed to the shareholders. The two main types of taxable distributions paid by mutual funds to shareholders come in the form of: ordinary dividends and capital gains.

Dividend distributions come primarily from interest and dividends earned by the securities in a fund’s portfolio and net short-term gains, if any, after expenses are paid by the fund. These distributions must be reported as dividends on an investor’s tax return.

Long-term capital gain distributions represent a fund’s net gains, if any from the sale of securities held in its portfolio for more than one year. Long-term capital gain distributions received by shareholders of a mutual fund are taxed at long-term capital gain rates, regardless of how long fund shares have been held.

With respect to dividend and capital gain distributions, investors can choose to receive payment in cash, or they can reinvest the distributions to buy more shares. The tax treatment of dividends and capital gains is an important part of the investment decision-making process and will be discussed later in this paper.

Distribution Timeline

Due to government regulations, most funds distribute annually the dividends and capital gains earned throughout the year. There are three important dates of which to be cognizant when dealing with mutual fund distributions. They include the following: Record Date, Ex-Dividend Date, and Payable Date.

The Record Date is the date used to determine who will receive distribution payments. Any investors holding fund shares on the Record Date will be entitled to receive distribution payments. The Ex-Dividend Date is one day following the Record Date because mutual fund trades settle one day following the trade date. The settlement date is the time the transfer of shares is made between the two parties, marking the official transfer of ownership from the seller to the buyer. The Payable Date is the date determined by the fund company to complete payment of distributions to fund shareholders.

The illustration below is a visual timeline of the distribution process for the SA U.S. Market Fund (SAMKX) for dividends that are scheduled to be paid in December, 2010.

```
<table>
<thead>
<tr>
<th>Record Date</th>
<th>Ex-Dividend Date</th>
<th>Payable Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>December 15th</td>
<td>December 16th</td>
<td>December 17th</td>
</tr>
</tbody>
</table>
```

Distribution Accounting

The accounting for mutual fund distributions is not complicated, but it is often misunderstood by investors. What some investors fail to understand is that when a mutual fund pays a distribution, the distribution results in a drop in the fund’s net asset value (NAV) equal to the amount of the distribution. This happens because the NAV is calculated as the portfolio value divided by the total number of shares. For example, if a mutual fund had total net assets of $10,000,000 and 1,000,000 shares outstanding, each share would have a NAV of $10. If this same fund paid $1,000,000 in distributions to its shareholders, the remaining pool of assets would have a value of $9,000,000 and each share would now be worth $9 ($9,000,000/1,000,000), assuming no market fluctuations. An investor’s total wealth is
unchanged as a result of the distribution, because money has in essence, shifted from one pocket to another. An investor who owned one $10 share before the distribution date now owns one $9 share and $1 in cash — total wealth is unchanged.

If an investor reinvests his or her shares, the value of their account will be the same immediately before and immediately after the distribution, assuming no market fluctuations. The table below illustrates this concept.

<table>
<thead>
<tr>
<th>Shares Owned prior to distributions</th>
<th>Price per Share</th>
<th>Value of Shares Owned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares owned prior to distribution</td>
<td>100</td>
<td>$10</td>
</tr>
<tr>
<td>Shares purchased with reinvestment</td>
<td>25</td>
<td>$8</td>
</tr>
<tr>
<td>Total account value</td>
<td></td>
<td>$1,000</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Shares owned prior to distribution</th>
<th>Price per Share</th>
<th>Value of Shares Owned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares owned prior to distribution</td>
<td>100</td>
<td>$8</td>
</tr>
<tr>
<td>Shares purchased with reinvestment</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Total account value</td>
<td></td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Source: Mutual Fund Tax Guide, American Century Investments. For illustrative purposes only, does not represent an actual investment.

### Synthetic Dividend

Investors often use yield measures when selecting investments to meet a specific income goal. For example, an investor with $1,000,000 of investible assets, needing $100,000 per year of income to meet living expenses may choose to invest in a mutual fund yielding 10% or more. Investors may often use yield as the sole investment criteria when needing cash flow, ignoring total return.

We feel that yield should not be used as the only criteria for selecting a mutual fund because cash flow can be generated synthetically by redeeming appreciated shares. As illustrated in the chart below, an investor can receive cash from a mutual fund in the form of a dividend or by redeeming appreciated shares. The net result is the same, assuming that the funds have the same total return and no transaction costs.

<table>
<thead>
<tr>
<th>Shares Owned prior to distribution</th>
<th>Price per Share</th>
<th>Value of Shares Owned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shares owned prior to distribution</td>
<td>100</td>
<td>$8</td>
</tr>
<tr>
<td>Shares purchased with reinvestment</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Total account value</td>
<td></td>
<td>$1,000</td>
</tr>
</tbody>
</table>

Source: Mutual Fund Tax Guide, American Century Investments. For illustrative purposes only, does not represent an actual investment.

### Yield

Yield is a measure used to calculate the amount of income — interest and dividend payments — generated from an investment based on the investment’s cost. There are several yield calculations used to measure and compare mutual funds in the U.S including: 7-Day Yield, 30-Day Yield, 12-Month Yield.

- **7 Day Yield** — used to measure interest rates of money market mutual funds offered by U.S. mutual fund companies.
- **30-Day Yield** — also referred to as SEC Yield, a standardized yield measure specified by the U.S. Securities and Exchange Commission (SEC) for comparing bond fund yields.
- **12 Month Yield** — yield measure reported by Morningstar to compare yield among mutual funds. It is the percentage of income a mutual fund returned over the past 12 months.

In a world with no friction — transaction costs, taxes, etc. — an investor would be indifferent between Fund A and Fund B. Both investments have the same total return and generate the same cash flow. Thus, we feel that an investor should focus on the total return of a fund, which not only includes dividends and capital gains when selecting a fund, but also takes into account the funds contribution to total return and overall wealth creation.

We realize that drawing cash from investment principal instead of from income can be difficult for an investor because regular cash payments feel secure, especially to retired investors who are no longer earning a steady paycheck and do not want to dip into their life savings. This is where we feel a qualified financial advisor adds a tremendous value to an investor by providing education and discipline to fend off emotional biases and do what is in the best interest of the client.
In the end, it is the size of an investor’s wealth that is important, and not how the cash flow is generated. In a perfectly efficient world an investor would be neutral when choosing between high yield and low yield mutual funds with equal returns. However, taxes must be taken into consideration, since they flow directly from income generating activities, and can take a large bite out of cash flow.

**Tax Considerations**

If returns from dividends and capital gains existed in a vacuum the decision between the synthetic dividend approach and the conventional yield approach would be one of indifference. However, taxation can play an important role in determining actual yield apart from the theoretical basis for maximum return. If one distribution is taxed at the top marginal rate of 35 percent (based on current ordinary income tax rates as of 2010) and another taxed at a lower rate of 15 percent (based on current long-term capital gains tax rates as of 2010), it becomes apparent that not all types of income are equal. Given the fickle nature of Congress and its constant change to the tax code it is important to explore the history of tax policy as applied to dividends and capital gains, review the current tax situation, and finally try to prognosticate where the tax code may go in years to come.

**A Brief History**

Taxes are the economic embodiment of social decisions. What a culture chooses to tax, and how heavily, is determined by political movements and history separate from the tax itself. Thus, it should not be surprising that as the whims of a people change so should its tax policy. The taxation of capital gains and dividends are no exception to this rule, and both have been subject to major recent changes.

Capital gains tax, in particular, has been constantly tinkered with by Congress over the last 100 years. Congress enacted the federal income tax in 1913, and set the top marginal rate at 7 percent with capital gains being taxed at ordinary rates. However, through 1922, due to World War I, tax rates were increased significantly. Concerned that an exceptionally high capital gains tax would actually reduce revenues Congress allowed for a 12.5 percent capital gains rate on assets held for at least two years. For the next twelve years the 12.5 percent rate remained in effect.

Beginning in 1934 Congress experimented with excluding certain portions of capital gains from taxable income. In 1934 and 1935 taxpayers were allowed to exclude 20 percent of capital gains for assets held one year, 40 percent for assets held two years, 60 percent of assets held five years, and 70% of gains held longer than ten years. This taxing regime lasted through 1942, as World War II ramped up. Beginning in 1942, taxpayers could exclude 50 percent of capital gains on assets held at least six months or elect a 25 percent alternative tax rate if their ordinary tax rate exceeded 50 percent.

The Tax Reform Act of 1969 changed the landscape once again by raising capital gains rates significantly, imposing a 10 percent minimum tax, and excluding capital gains from regular tax altogether. Congress limited the alternative tax to no more than $50,000 of gains. The minimum rate changed drastically through 1977. Relief came in 1978 when Congress reduced capital gains tax rates by eliminating the minimum tax on excluded gains and increasing the exclusion of capital gains to 60 percent, and reducing the maximum rate to 28 percent.

In 1986 the comprehensive Reagan Tax Reform Act repealed any exclusion of long-term gains, and raised the maximum ordinary rate to 28 percent (33% for certain high income taxpayers). When the 1990 and 1993 budget acts increased top ordinary tax rates, Congress provided an alternative tax rate of 28 percent on capital gains, although the effective rate was greater due to interactions with other tax code sections. Rates continued to change with holding period requirements throughout the 1990s.

The current capital gains tax regime began with the Jobs and Growth Tax Relief Reconciliation Act of 2003 (JGTRRA), which is discussed below.

Dividends have a distinct history from capital gains. From 1913 to 1935 dividends were tax exempt. From 1936 to 1939 they were fully taxable. The Revenue Act of 1940 made dividends tax exempt once again, and they stayed that way until 1954 when only the first $50 were exempt. The Revenue Act of 1964 raised the exemption to $100 which was the status quo through 1980. Congress experimented with the amount of dividends subject to taxation in the early 1980’s until 1985 when dividends became fully taxable and remained as such until 2003 when JGTRRA created qualified dividends to be discussed below.
**Current Tax Treatment of Dividends and Capital Gains**

Dividends are defined as, “... distributions of money, stock, or other property paid to [a taxpayer] by a corporation”\(^{33}\) Some dividends are not dividends at all, and are considered to be return of principal. This happens when a company does not pay out of their earnings and profits, but makes a cash distribution to stock holders anyways.\(^{34}\) If this happens the taxpayer must reduce the basis in the underlying security by the amount received from the stock or mutual fund.\(^{35}\) For true dividends, there are two types recognized under the law which lead to drastically different results.

The first type of dividend is what is called an “ordinary dividend.” The ordinary dividend has the same definition as laid out in the previous paragraph. The tax treatment is straightforward: ordinary dividends are taxed at ordinary rates. Thus, if an equity holder is issued an ordinary dividend by either a stock or a mutual fund that dividend is subject to the same marginal tax rate as wages or rental income.\(^{36}\)

For instance, Tim Taxpayer, a single individual, owns shares of mutual fund Y. Furthermore, Tim has taxable wages of $500,000. Mutual fund Y purchased shares in Exxon on December 1, 2009. On December 12, 2009 Exxon declares a dividend of 10 cents a share. On December 28, 2009 mutual fund Y receives a check from Exxon for $100. Mutual fund Y then sells the stock on December 31, 2009. Because of the short holding period mutual fund Y does not have qualified dividends,\(^{37}\) the dividends that are passed on to Tim are subject to Tim's marginal tax bracket which (assuming he does not itemize) in 2009 would be 35% at the federal level.\(^{38}\)

Under current tax code, “qualified” dividends are taxed differently. When a mutual fund has a qualified dividend, and passes it out to the investors, the recipients of a qualified dividend receive a special rate of taxation dependent on their individual tax bracket.\(^{39}\) A qualified dividend is defined as a dividend on a stock which is: (1) issued by a United States or qualified foreign corporation,\(^{40}\) (2) dividends that are not specifically excluded as qualified dividends,\(^{41}\) and (3) the taxpayer must have held the stock for more than 60 days during the 121-day period that begins 60 days before the ex-dividend date.\(^{42}\) Preferred dividends must be held more than 90 days during the 181 day period that begins 90 days before the ex-dividend date.\(^{43}\)

In the previous example mutual fund Y purchased shares of Exxon on December 1, 2009. But what if mutual fund Y had purchased the shares on October 1, 2009? Since it would have had the shares for over 60 days during the 121 day period beginning 60 days prior to the ex-dividend date, the dividends passed on to Tim would no longer be treated as ordinary dividends. They would be taxed as qualified dividends, so long as he held the shares in the mutual fund company 60 days during the 121 day period beginning 60 days prior to its ex-dividend date.\(^{44}\)

The main factor on how much tax is paid on qualified dividends is based on the taxpayer’s marginal tax bracket. The taxpayer must calculate his income without the qualified dividends being taken into consideration. If the tax payer is below the 25% tax bracket then the qualified dividends are not subject to taxation at all.\(^{45}\) If they are at or above the 25 percent marginal rate, then the qualified dividends are taxed at 15 percent.\(^{46}\)

Thus in our continuing example of Tim Taxpayer, with $500,000 of taxable wages we can be certain that Tim’s rate of tax on qualified dividends would be 15% since he would be in the highest tax bracket (assuming he does not itemize).\(^{47}\) But if Tim did not have any other income besides the qualified dividends, then his tax due for 2009 would be $0.

The custodian of the mutual fund shares will issue a 1099-Div to detail how investors should report the income they have received from their individual investments. Below is what 1099-Div looks like:

---

Capital gains can be more complex. Capital assets are defined in the tax code in the negative.\(^{48}\) Investment property is undisputedly a capital asset,\(^{49}\) thus for purposes of this paper all investments are assumed to be capital in nature. Capital gains or losses occur when a capital asset is sold. The gain or loss is calculated by comparing
the amount realized with the adjusted basis of the property.\footnote{50} The adjusted basis of an individual share of stock is generally the purchase price plus the costs of purchase, dividends reinvested, and reverse stock splits, less return of principal\footnote{51} and stock splits.\footnote{52}

Capital gains have a similar treatment to that of dividends, but with a few key differences. Instead of qualified and non-qualified sub-categories, capital gains are segregated between short-term and long-term. Short term capital gains (STCG) are those gains derived from a security held for one year or shorter,\footnote{53} and long term capital gains (LTCG) are those whose holding period is greater than one year.\footnote{54}

STCGs are taxed exactly the same as ordinary dividends. However, unlike dividends, STCGs can be negated by short term capital losses (STCL).\footnote{55} Should the losses exceed the gains, then the excess loss can be used to offset STCG.\footnote{56} If the STCL exceeds that of the LTCG, then $3,000 of the loss can be used against ordinary income, and the balance of the loss carried forward to the next tax year, retaining its character as a STCL.\footnote{57}

As an example, Tim Taxpayer has $9,000 of STCL for tax year 2009. He has $1,000 of STCG, and $2,000 of LTCG. He will first use the $9,000 loss to wipe out the $1,000 STCG, and then he will apply the remaining $8,000 of loss to the $2,000 of LTCG. Then he will take $3,000 of the remaining $6,000 STCL and put it on page one of his tax return to be used against other ordinary income. The unused $3,000 of STCL will be carried forward to tax year 2010.

LTCGs again are taxed akin to their qualified dividend counterparts. Taxpayers in tax brackets below 25% are subject to a 0% tax rate, and those at 25 percent or above are taxed at 15 percent.\footnote{58} As with STCGs, LTCGs are offset by capital losses. However, LTCGs are first negated by LTCLs, and then STCLs.\footnote{59} A taxpayer can use up to $3,000 of excess LTCLs to reduce ordinary income in each tax year, with the balance being carried forward to future tax years, and retaining its character as a LTCL.\footnote{60}

Tim Taxpayer has $6,000 in LTCG for tax year 2009. He also has $2,000 of LTCL, and $3,000 of STCL. First, he will net the LTCG and the LTCL leaving him with a $4,000 net LTCG. Next, he will net the STCL leaving him with $1,000 of LTCG to be taxed at special rates.

Even though LTCGs and qualified dividends get a 15 percent rate for taxpayers in regular tax brackets, under the scenario where an individual is subject to the Alternative minimum tax (AMT) they will sometimes pay 28 percent effectively.\footnote{61} Congress developed the AMT in 1969 as a way to catch wealthy taxpayers who found ways to avoid regular taxation by using particular deductions and exemptions.\footnote{62} In recent years, more and more taxpayers are finding themselves paying AMT, despite their lack of affluence.\footnote{63} This is caused by a glitch in the calculation which does not allow for inflation indexing for deductions.\footnote{64}

So when potential returns are compared on a net taxable basis both dividends and capital gains both have advantages and disadvantages to their tax attributes. Qualified dividends do not have to be held for as long of a period of time as LTCG. On the other hand, dividends must be from certain types of corporations. Also dividends cannot be avoided as easily as capital gains since the timing of distributions are controlled by the corporation not the investor.

Capital gains and losses have advantages over dividends because when losses occur they can be harvested to shelter future gains. If there is a capital loss carryforward, but no capital gains in any subsequent year then $3,000 of the capital loss can be used to offset ordinary income with the balance carried forward indefinitely. Also, since taxpayers can choose when to sell securities they can decide when to realize, and ultimately recognize, gains.

The Future of Capital Gains and Qualified Dividend Taxation

After examining the history of capital gains, dividends, and the current situation there is no reason to think that an investor can breathe a sigh of relief when it comes to prognosticating future tax burdens. Indeed, the tax cuts of 2003, which were extended through 2010 will cease to exist shortly.\footnote{65} Most expect that by 2011 tax rates will be higher.\footnote{66} Many are now questioning the logic of tax deferral especially when capital gains rates are at an all time low.\footnote{67}

President Obama, before being elected had several ideas on how he wanted to form the income tax. First, he wanted to restore the pre-JGTRRA ordinary tax rates, which would push the maximum rate from 35 percent to 39.6 percent.\footnote{68} He wanted to move the maximum capital gains rate back to 20 percent, and possibly only implement that higher rate for families with AGI’s over $250,000.\footnote{69}
It is impossible to divine what will actually occur. Congress has its own agenda, and will not necessarily follow the President, especially in an election year, especially when it comes to raising taxes in an economic recovery period following one of the worst recessions in world history. Experts advise that despite the appearance of inevitability of tax hikes investors can only rely on information at hand, and should not base economic decision on legislative speculation.

Behavior and Yield

Investors are regularly urged to focus on the total return of a mutual fund rather than on its dividend yield. This makes sense. A fund with a dividend yield of 5% and a 5% capital appreciation has a total return of 10% and so does a fund with a 10% capital gain and no dividend. Neither is better than the other any more than two $5 bills are better or worse than a single $10 bill. So why do so many investors prefer mutual funds that pay much of their return and no dividend. Neither is better than the other any more since mutual funds that pay much of their total return in dividends are not taxed until they are realized. The solution to the puzzle is in mental accounting and self control. We tend to place dividends in one mental account labeled “income” while capital gains are in another mental account labeled “capital.” We use these mental accounts to control spending through the application of the self-control rule of “don’t dip into capital.” Imagine a retired investor who is using her portfolio as a source of retirement income. She needs money for food, clothing, utilities, travel, and other normal expenses. But she is concerned that weak self control might lead her to spend too much and that she might eventually run out of money. A 5% dividend coupled with the “don’t dip into capital” rule stops her from spending more than 5%. Alternatively, she can hold the fund yielding 10% total return and spend 5% by dipping into capital, selling some shares. But what if her self-control fails and she dips 7% into capital? And what happens if she dips 12% into capital? She exposes herself to the risk that she might spend too much and run out of money too soon. The advantage of dividend-paying mutual funds is the advantage of self-control. But that advantage comes at a price, exacted in higher taxes.