

## Why is There a Reverse Share Split?

Central Plains Advisors, Inc. uses the American Century Target Maturities 2025 (BTTRX) mutual fund for all client investments. This fund is made up of several different bonds, many of them zero-coupon US Treasury Bonds. These bonds do not make regular interest payments, but pay all interest in a lump sum at the time the bond matures. Since there are no interest payments, there would usually be no dividends paid. However, the mutual funds are required by the IRS to distribute dividends based on the bond's imputed interest. For example:

Let's say you buy a zero on December 1, 2003 for \$1,000. The zero matures on December 1, 2033 with a face value of \$10,000. You will receive your profit of \$9,000 (the difference between the face value and the purchasing price) when the zero matures. But rather than taxing you on the full \$9,000 in 2033, the IRS requires you to declare a portion of the \$9,000 as imputed interest each year on your tax return.

The imputed interest for the zeroes in the American Century Target Maturities 2025 is distributed as a dividend annually in December, along with any capital gains earned by the portfolio. Because the imputed interest has accrued in the share price throughout the year, the share price falls by the dividend amount on the distribution date. This plunge in share price makes it impossible for the fund to reach its anticipated value by the target year (2025). The reverse share split allows each portfolio to distribute a dividend without a corresponding decrease in share price.

### Before the Distribution

| <b>Bob</b>                         | <b>Sue</b>                         |
|------------------------------------|------------------------------------|
| 100 Shares @ \$50/Share \$5,000.00 | 100 Shares @ \$50/Share \$5,000.00 |

On December 19<sup>th</sup>, 2003 American Century will pay a dividend to each share of BTTRX owned. The price of each share will be dropped by the amount of the dividend. For example:

|  |      |
|--|------|
| Price before dividend                        | \$50 |
| Dividend to be paid                          | \$10 |
| Share price after dividend                   | \$40 |
| <hr/> Total share value                      | \$50 |
| remains the same (share price plus dividend) |      |

Each shareholder can choose to either take their dividends as a payout or reinvest them. In our example, Bob takes his shares in a cash payout and Sue reinvests hers. So, Bob receives a check for \$1,000 and still has his 100 shares of BTTRX at the new price of \$40/share for a total investment of \$4,000. Sue, meanwhile, has her dividends reinvested there by preserving her \$5,000 total investment. In order to accomplish this, American Century pays the dividend in the

form of more shares. So now Sue has 125 shares at \$40/shre for a total of \$5,000. Please note that Central Plains Advisors, Inc. reinvests all dividends in order to achieve higher total returns.

## After the Distribution

| <b>Bob</b>                            | <b>Sue</b>                            |
|---------------------------------------|---------------------------------------|
| 100 Shares @ \$40/Share    \$4,000.00 | 125 Shares @ \$40/Share    \$5,000.00 |

Immediately following the distribution, the reverse share split is performed. The fund’s share price is raised to the original price, while the amount of shares in each account is reduced proportionally. To accomplish this, the fund calculates a “reverse share split factor” by dividing the share price after the reverse share split by the share price before the reverse share price. In our example with Bob and Sue, the reverse share split factors is 0.8 ( $\$40 / \$50 = 0.8$ ). The number of shares in each account is the multiplied by the reverse share split factor. Bob’s and Sue’s accounts now look like this:

| <b>Bob</b>  | <b>Sue</b>   |
|---|--|
| 80 Shares ( $100 * 0.8$ ) @<br>\$50/Share                    \$4,000.00 | 100 Shares ( $125 * 0.8$ ) @<br>\$50/Share                    \$5,000.00 |

With the share price restored to \$50, Sue ends up with exactly the same share and dollar amounts as before the dividend was paid. Bob ends up with fewer shares and a lower account value, but he has received a \$1,000 in cash. **Bob and Sue must each report dividend income of \$1,000 on their tax returns.**

## How Does This Affect My Cost Basis?

Each time a reverse share split is performed, you are allowed to adjust your per-share cost basis proportionally in order to avoid overpaying on taxes when you sell your shares. To accomplish this you will need to reduce the number of shares and increase the share price using the reverse share split factor.

From the previous example, suppose both Bob and Sue purchased their 100 shares at \$20 per share. Sue also purchased 25 shares at \$40 per share when she reinvested her dividends. Using the reverse share split factor (0.8), they would adjust their respective cost basis as follows:

| <b>Bob</b>                            |                    | <b>Sue</b>                            |                       |
|---------------------------------------|--------------------|---------------------------------------|-----------------------|
| <b>Original Cost Basis</b>            |                    |                                       |                       |
| 100 Shares @ \$20/Share               | \$2,000.00         | 100 Shares @ \$20/share               | \$2,000.00            |
|                                       |                    | 25 shares @ \$40/share                | \$1,000.00            |
| <b>Adjusted Cost Basis</b>            |                    |                                       |                       |
| 80 Shares @ \$25/share<br>(100 x 0.8) | (20 / 0.8) \$2,000 | 80 Shares @ \$25/share<br>(100 x 0.8) | (20 / 0.8) \$2,000.00 |
|                                       |                    | 20 Shares @ \$50/share<br>(25 x 0.8)  | (40 / 0.8) \$1,000.00 |

Notice that the *total purchase amount* does not change; it is only the *per-share cost basis* that is adjusted. Noticed also that the total number of shares after the cost basis adjustment equals the total number of shares owned after the reverse share split (80 for Bob, 100 for Sue).

Information from American Century Investments.

Please call our office if you have any questions. 888-735-CPAI (2724)