A Primer on the Taxable Consequences of Mutual Fund Investing

American consumers who invest in mutual funds with taxable savings (not IRA or other tax-sheltered dollars) can expect to pay federal tax for four types of earnings on their mutual fund investments. These are capital gains, capital gains distributions, dividends, and interest.

Types of Earnings

As with any investment, you incur a **capital gain** if you sell your shares of a mutual fund for more than you initially paid. If you sell your shares for less than you originally paid, you incur a capital loss. There are currently two categories of capital gains and losses: short term (held for fewer than 12 months) and long term. The tax rate on short term gains is significantly higher (currently your normal income tax rate, compared to 10% to 20%, depending on your tax bracket, for long term capital gains).

Losses can be used to offset capital gains for the purpose of calculating taxable gains within a tax year. As a simple example, if you sold fund ABCDX for a long term *gain* of $20 and sold fund BBCDX for a long term *loss* of $15, you would only be taxed for your net long term capital gain of $5.

While the value of your mutual fund shares is constantly changing, you do not incur any capital gains or losses until you sell those shares. However, you can incur capital gains distributions just by investing in a mutual fund.

A mutual fund incurs a **capital gains distribution** when it sells a stock for more than the initial purchase price. Capital gains distributions are also classified as either short term or long term, following the same definition as for capital gains. Also like capital gains, if a fund sells two stocks within the same year, one with a gain and one with a loss, the amount of the gain is reduced by the amount of the loss for the purpose of calculating taxable gains. The capital gains distribution made by a mutual fund at the end of the year is the net of all gains less any losses. Funds typically distribute capital gains once per year, usually in mid- to late-December.

Regardless of how long you have held a mutual fund, if you hold it at the time of the capital gains distribution, you receive the full distribution and are responsible for paying any resulting tax obligations. If you sell your shares in a fund prior to the capital gains distribution, you do not receive any of the capital gains.

A mutual fund earns **dividends** when the stocks that it owns pay dividends to the fund as a stockholder. Stock dividends are paid by the individual companies out of their operating profits. Mutual fund dividends are paid to the shareholders who own the fund as of the day that the fund declares (i.e., states its intention to pay) its accumulated dividends, not as of the day the dividends were received by the fund. Since dividends may be declared retroactively and the actual payment of the dividends usually follows their declaration by at least several days, it is not uncommon for an investor to be paid dividends on a mutual fund that he or she sold weeks or even months earlier. By federal law, a mutual fund must distribute the dividends that it receives to its investors (shareholders) within 12 months of receiving those earnings. Many funds distribute the bulk of their dividends at the end of the calendar year, but they may do so at any time. Funds with significant bond investments usually distribute dividends monthly or quarterly.

A mutual fund will have **interest** earnings only if it itself is a money market fund. Mutual funds that invest in stocks and bonds do not pay interest to their shareholders. Any interest which the fund may earn from cash or cash-equivalent holdings is paid to shareholders as dividends.

How Earnings Are Reported

The companies managing the individual mutual funds are responsible for calculating and tracking the various types of earnings. At year-end, they must report the annual totals to each account

holder, whether an individual consumer or a custodial “middle man” (such as First Trust Corporation or a brokerage house like Schwab or Fidelity). These custodians must then allocate the reported earnings to each of the hundreds or thousands of individuals and institutions that purchased the mutual fund through them, and report that information on the investors’ year-end account statements.

Common Strategies for Minimizing the Tax Impact of Mutual Fund Investments

As an investor, don’t think of paying federal taxes on your investment earnings as completely undesirable: even after the taxes, you’re still making money, and that’s always better than a loss or nil growth. You should be concerned with maximizing your net return after taxes, not with minimizing your taxes.

But there are better and worse ways to pay taxes. Some of the more common strategies that are used to reduce taxes and increase net return on taxable investments in mutual funds are presented here:

1. One of the more obvious ways to reduce your tax bill is to hold onto your investments until any gains from their sale are long term instead of short term. If you are in the 28% tax bracket, this reduces your tax rate from 28% to 10%, thereby saving $18 on every $100 of gains. Of course, if your investment is rapidly losing value and you have little hope that it will recover, you may not want to delay selling.

2. Some investors, recognizing that not every investment will be a winner, choose to make the best of a bad bet by selling some investments at a loss in order to offset capital gains on another investment. While many people associate this strategy only with stock investments, it works as well with mutual funds, or with a combination of the two or many other capital investments. (You can use a stock loss to offset a mutual fund gain, or vice versa.)

3. Don’t look at your mutual fund investments in isolation. If you have other investments, look at the total spectrum of your investment activity when designing ways to be a smarter taxpayer. Just as a diversified portfolio reduces your overall investment risk, it also gives you more opportunities to be tax efficient.

As always, not every strategy is suitable for each investor’s situation. Consider these strategies as starting points for developing your own strategy to make your unique combination of investments more tax efficient.

For do-it-yourselfers, guidance and information are available by phone, mail and on the web from the IRS and other sources. For those who prefer to hire expertise, most communities have at least one CPA, tax attorney or Certified Financial Planner who specializes in tax issues.