

How Are Mutual Funds Taxed?

Many people have heard the Benjamin Franklin quote, “In this world nothing is certain but death and taxes.” Mutual fund taxes can be onerous. However, if you understand the complexities of mutual fund taxes and are prepared when tax season comes around, you may be able to lessen the blow.

Dividends and Capital Gains

The first thing to remember is that you generally must report any mutual fund distributions as income. Even if you reinvest your profits, the federal government still views this as personal income. Your mutual fund will send you a Form 1099-DIV describing what earnings to report on your income tax return. There are two main ways that mutual funds are taxed: dividends and capital gains.

Dividends represent the net earnings of the fund and will be taxed at a 20% tax rate for qualified dividends for taxpayers in the 39.6% federal income tax bracket, at a 0% tax rate for individuals in the 10% and 15% federal income tax brackets, and at a 15% tax rate for all other tax brackets. Qualified dividends, with some exceptions, are dividends received from domestic and foreign corporations after 2002. Foreign dividends must be securities that are traded on U.S. exchanges or have IRS approval.

Capital gains are profits from investor trading or distributions given to shareholders after revenue is taken in from the fund manager’s sales of securities. Provisions in the tax law allow you to pay lower capital gains taxes on the sale of assets held more than one year. These are referred to as “long term” capital gains.

Long-term gains are profits on assets held longer than 12 months before they are sold. The American Taxpayer Relief Act of 2012 instituted a 20% long-term capital gains tax rate for taxpayers in the 39.6% income tax bracket and extended both the 0% capital gains tax rate for individuals in the 10% and 15% tax brackets and the 15% capital gains tax rate for all other tax brackets. Short-term gains — those resulting from the sale of assets held less than one year — are taxed at your ordinary income tax rate.

Higher-income taxpayers should be aware that they may be subject to an additional 3.8% Medicare unearned income tax on net investment income (unearned income includes dividends) if their adjusted gross income exceeds \$200,000 (single filers) or \$250,000 (married joint filers). This is an outcome of the Patient Protection and Affordable Care Act of 2010.

This means that if you've been buying shares in a stock or mutual fund over the years and are considering selling part of your holdings, your tax liability could be significantly impacted by the timing of your sale.

Tax-Exempt Funds

One way to potentially reduce the amount of mutual fund taxes you could pay is by utilizing a tax-exempt bond fund. Distributions from these types of funds are attributable to interest from state and local municipal bonds, so they are exempt from federal income tax (not necessarily state tax). If a bond was issued by a municipality outside the state in which you reside, the interest could be subject to state and local income taxes. Some municipal bond interest could be subject to the federal alternative minimum tax.

Investing in tax-exempt bond funds potentially could lessen the blow of taxes, but it's important to remember that they may offer lower yields than comparable taxable funds. If you are in a high tax bracket, the tax benefits may make it advantageous for you to invest in lower-yielding tax-exempt funds. Bond funds are subject to the same inflation, interest-rate, and credit risks associated with their underlying bonds. As interest rates rise, bond prices typically fall, which can adversely affect a bond fund's performance. If you sell a tax-exempt bond fund at a profit, you could incur capital gains taxes.

Mutual fund taxes can be cumbersome, but there may be ways to help you potentially pay as little as possible. Remember that there are tax-advantaged accounts that you possibly could utilize, such as IRAs or 401(k)s, to defer taxes until you withdraw funds in retirement. You may want to consider tax-deferred accounts for high-income funds that come with lofty tax rates. Regardless of how you handle your mutual funds, be sure to consult with a tax professional.

The return and principal value of mutual fund shares fluctuate with changes in market conditions. Shares, when redeemed, may be worth more or less than their original cost.

Mutual funds are sold by prospectus. Please consider the investment objectives, risks, charges, and expenses carefully before investing. The prospectus, which contains this and other information about the investment company, can be obtained from your financial professional. Be sure to read the prospectus carefully before deciding whether to invest.

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