‘Tis the Season for the Mutual Fund Tax Trap

Mutual fund ownership has become nearly ubiquitous, and for good reason. Funds offer easy diversification, professional management, and they are accessible to even the smallest investors – all while eliminating much of the time and effort that would otherwise be required to construct and monitor a portfolio of individual securities. As useful as mutual funds are, there exists one tax trap that often befalls the unwary. First, however, a quick mutual fund primer…

As regulated investment companies, mutual funds are generally organized as corporations. Unlike most publicly-traded corporations, however, mutual funds are able to escape income taxation at the corporate level, but only if they distribute substantially all of their investment earnings to their underlying shareholders at least annually. Such distributions are then taxable to the underlying shareholders – and then, only if the shares are held in a taxable account. As a practical matter, many funds distribute a substantial portion of their earnings to shareholders during November and December each year.

Here’s the rub: Say you buy $100,000 of some fund in December which might happen to be the day before it declares a 10% distribution. Although the fund is actually distributing profits it earned before you became a shareholder, in the eyes of the IRS you would have a $10,000 profit (10% times $100,000) subject to federal taxes at rates as high as 35%. Your reward for investing in a fund at an inopportune time? Tax owed on other people’s profits.

The lesson? If you’re thinking of purchasing mutual fund shares in a taxable account, simply call the fund ahead of time and ask about the probable size and timing of any upcoming distributions. While there’s nothing wrong with paying taxes on profits, it’s worth your while to try to make sure that the profits you’re paying taxes on are your own profits.

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