IDC Independent Directors Council
Promoting Excellence in Fund Governance

Taxation for Mutual Fund Investors: FAQs

Frequently Asked Questions About Taxation for Mutual Fund Investors

Taxes are a key consideration for all investors, including mutual fund shareholders. This page answers a few basic questions about how mutual fund investors are taxed.

These FAQs are not intended to provide tax advice. Investors should consult their tax advisors before purchasing or redeeming mutual fund shares. Investors are also encouraged to visit the websites of ICI member companies, which provide a wealth of tax information and resources. ICI's policy activity on tax matters is detailed at ICI's taxation resources page.

What taxes do mutual fund shareholders pay?
What are the tax implications of investing in tax-advantaged accounts, such as company retirement plans?
Why are some bond funds described as "tax-exempt"?
What are taxable distributions from mutual funds?
What are the tax implications of selling or exchanging mutual fund shares?
What is a mutual fund share's cost basis?
How important is recordkeeping in calculating taxes?
What kinds of gains and losses can a fund have in its portfolio, and what are their tax implications for investors?
What are realized and unrealized gains?
What are realized and unrealized losses?
Is it true that mutual fund shareholders have to pay "someone else's taxes" if they buy fund shares at a certain time?

What taxes do mutual fund shareholders pay?

Mutual fund shareholders generally pay federal and, in many cases, state and local income taxes, including taxes on dividends and capital gains. Shareholders who own mutual funds outside of tax-advantaged accounts are taxed each year on two types of transactions: distributions from the fund and the sale of the fund shares.

What are the tax implications of investing in tax-advantaged accounts, such as company retirement plans?

More than half of long-term mutual fund assets and roughly 16 percent of money market fund assets are held in tax-advantaged accounts, such as individual retirement accounts (IRAs), 401(k) plans, variable annuities, and other retirement savings vehicles. Investors in these accounts enjoy tax benefits that eliminate or reduce their annual tax obligations. For example:

- 401(k) plans: Under these plans, workers set aside a percentage of their pretax pay in a special account. In many plans, these worker contributions are wholly or partially matched by employer contributions. Taxes on returns earned on investments in 401(k) plans are deferred until earnings are withdrawn, usually at retirement. Thus, 401(k) investors do not pay taxes each year on distributions of capital gains and dividends.
- Traditional IRAs: Contributions to these accounts may be tax-deductible, which may reduce the investor's taxable income. As with 401(k) plans, taxes are deferred on earnings in traditional IRAs.
- Roth IRAs: Contributions to these individual retirement plans are not tax-deductible. Earnings are not taxed, and qualified distributions of earnings and principal are generally tax-free.

Why are some bond funds described as "tax-exempt"?

Interest from municipal bonds generally is exempt from federal income tax and, in some cases, state and local taxes as well. When funds distribute such income to their shareholders, those distributions also are tax-exempt. Tax-exempt money market funds, for example, invest in short-term municipal securities, and also pay tax-exempt dividends.

Even though income from these funds generally is tax-exempt, shareholders must still report it. Tax-exempt mutual funds provide this information annually and explain how to handle tax-exempt dividends on a state-by-state basis.

For some taxpayers, portions of income earned by tax-exempt funds may be subject to the federal alternative minimum tax. Tax professionals can advise investors on this issue. Finally, any gain realized from redeeming shares will be taxable.

What are taxable distributions from mutual funds?

Mutual funds make two basic types of taxable distributions to shareholders every year: ordinary dividends and capital gains distributions. These two types of distributions are reported differently on shareholders' income tax returns.

- Dividend distributions come primarily from the interest and dividends earned by the securities in the fund's portfolio after expenses. They also include net gains from the sale of securities held in the fund's portfolio for one year or less (short-term capital gains).
- Long-term capital gains distributions represent the fund's net gains from the sale of securities held in its portfolio for more than one year. When gains from these sales exceed losses, they are distributed to shareholders.

By February 15 of each year, mutual funds send Form 1099-DIV to most shareholders. This form indicates what earnings shareholders must report on their income tax returns. Shareholders report ordinary dividends as dividend income on tax returns. Capital gains distributions are reported as long-term capital gains, regardless of how long shareholders have owned fund shares.

What are the tax implications of selling or exchanging mutual fund shares?

When a shareholder sells mutual fund shares, he or she will have a capital gain or loss in the year the shares are sold. The shareholder is liable for tax on any capital gains arising from the sale, just as the shareholder would be if he or she sold individual securities. Capital losses may be used to offset other gains in the current year and thereafter.

An exchange of shares from one fund to another in the same fund family is taxed the same as if the shareholder sold the first fund's shares and purchased new shares in the second fund with the proceeds.

What is a mutual fund share's cost basis?

The amount of gain or loss on the sale of fund shares is determined by the difference between the "cost basis" of the shares (generally, the original purchase price) and the sale price. To figure the gain or loss on a sale of shares, it is essential to know the cost basis. Assuming no sales charges, the cost basis of a mutual fund share is simply the purchase price. If there were fees or commissions paid at the time of purchase, they are included in the basis.

For example, let's say a shareholder purchased 100 shares of Blue-Chip Plus Fund at $10 each and paid an up-front sales charge of 2 percent, or $20, on the purchase. The total cost of the transaction is $1,020. The cost basis for each share would be $10.20 ($1,020 divided by 100). If the shareholder later sells the 100 shares for $1,500, the capital gain will be $480 ($1,500 minus $1,020). If the shareholder reinvests dividends and capital gains distributions to buy more shares, he or she must include the cost of those shares in the cost basis of his or her account.

How important is recordkeeping in calculating taxes?

Recordkeeping is critical to calculating taxes due on mutual fund investments. To figure out gains and losses, shareholders need complete records of purchases and sales of fund shares. Fortunately, funds provide their investors with the records that they need to compute cost basis, and shareholders should keep all these records, such as periodic account statements and copies of IRS Form 1099.

In 2008, Congress passed a law that requires brokers and mutual funds to report—to shareholders and to the IRS—the shareholders' cost basis when shares are redeemed. This rule is effective for mutual fund and closed-end fund shares acquired on or after January 1, 2012. It applies to other equities purchased on or after January 1, 2011.

Beginning in 2012, brokers and funds are required to ask their shareholders to choose a basis determination method and to use that method to calculate basis when shares are redeemed from the shareholders' accounts. If a shareholder does not choose a method, the broker or fund applies its default method. When a shareholder redeems shares from an account, the broker reports to the shareholder and the IRS, on Form 1099-B, the gross proceeds from the sale, the cost basis of the shares redeemed, and whether any capital gain on the sale is long-term or short-term. Shareholders generally must use the information provided on the Form 1099-B when completing their tax returns.

These cost basis reporting rules only apply to fund shares acquired beginning in 2012. For shares acquired before 2012, many funds continue to voluntarily provide cost basis information to their shareholders. This information is not provided to the IRS, however, and shareholders are not required to use it when filing their tax returns.

The cost basis reporting requirements substantially change the rules for calculating cost basis on fund shares, including the timing of when a basis method must be chosen. Shareholders thus should consult their tax advisors before redeeming any shares.

What kinds of gains and losses can a fund have in its portfolio, and what are their tax implications for investors?

A mutual fund portfolio may contain four types of gains and losses—realized gains, unrealized gains, realized losses, and unrealized losses—when an investor purchases fund shares. Each type of gain and loss has a different impact on a fund shareholder.

What are realized and unrealized gains?

When the price of a security fluctuates, a fund or other investor holding that security has gains or losses. If the investor continues to hold the security, the gain or loss is said to be "unrealized." (Unrealized gains or losses are sometimes described as "paper" gains or losses.) When the investor sells the security, the gain or loss is "realized."

Under the tax laws, a fund distributes all gains that it has realized (from the sale of portfolio securities), net of realized losses. All shareholders are taxed on the amount of net gains distributed to them; these distributions are calculated under the tax laws on a per-share basis and are paid to all investors who hold the fund on the date of the distribution, regardless of when the gains or losses arose.

Unrealized gains have no immediate tax impact. Unrealized gains are reflected in the net asset value (NAV) of the fund—the price at which fund shares are bought and sold.

What are realized and unrealized losses?

Losses that a fund has realized from the sale of portfolio securities offset any gains realized by a fund. A fund is not required to distribute gains to investors until all losses are utilized fully.

Losses that are unrealized represent depreciation in the value of securities that a fund still holds. A fund that otherwise would be required to distribute capital gains can reduce or eliminate the distribution by selling the depreciated securities and using the realized losses to offset the otherwise distributable gains.

Is it true that mutual fund shareholders have to pay "someone else's taxes" if they buy fund shares at a certain time?

No—fund shareholders do not pay someone else's taxes. Every fund shareholder is taxed only on his or her own economic income over the life of the investment.

Shareholders purchase and sell a fund at the fund's net asset value (NAV), which is calculated daily. A fund accumulates realized and unrealized capital gains, interest, and dividends until it makes distributions. These gains and income increase the fund's NAV until they are distributed. A fund distribution reduces the fund's NAV; thus, amounts that are distributed reduce the gain (or increase the loss) that a shareholder realizes when fund shares later are sold.

Assume an investor purchases fund shares on Monday for $10 per share. The fund distributes a $1 capital gains dividend (attributable to previously realized gains accrued in the fund's NAV) on Tuesday. The $1 distribution reduces the fund's NAV to $9. If the investor sells the fund shares on Wednesday for $9, the investor will have no gain or loss.

- No economic gain or loss: The investor purchased the fund for $10, and received a $1 distribution and $9 upon the sale of the

shares. Thus, the investor paid $10 and received $10, for no net gain or loss.

- No taxable gain or loss: The $1 of capital gains distributed (on which tax would be due) is offset fully by the $1 loss realized when the shares purchased for $10 are sold for $9. Thus, the investor has no taxable gain or loss.

For a more detailed illustration, consider the following two scenarios:

Scenario 1: Assume that Investor A bought 100 shares of a fund for $10 a share. The shares rose in value to $20. Investor A then sells her shares, and owes taxes on $1,000—the capital gain of $10 a share times 100 shares. Investor B buys 100 shares at the fund's new NAV of $20 a share, which includes the embedded gains. If the shares rise to $30 a share, and Investor B sells his shares, he would owe taxes on $1,000—the capital gain of $10 a share, times 100 shares. In other words, Investor A owes taxes on the $10 gain accrued while she owned the fund, and Investor B owes taxes on the $10 gain accrued while he is invested. Each shareholder is paying for his or her own gains earned.

Scenario 2: Now assume this same set of transactions occurs, except that the fund distributes its $10 accrued gain on the day after Investor B bought his shares at $20. Investor A still owes taxes on $1,000—the $10 gain on her shares, bought at $10 and sold at $20, times 100 shares. Investor B must now pay taxes on $1,000—the $10 per-share distribution, times 100 shares. The distribution reduces the fund's NAV to $10. If Investor B pays the taxes from other assets and reinvests the full amount of the $1,000 distribution, he will now own 200 shares. The first 100 shares were purchased at $20 a share, while the second 100 were purchased at $10 a share. Investor B's average cost basis for tax purposes is $15 a share.

The shares then rise by 50 percent, as in Scenario 1, to a new value of $15 a share. When investor B sells his 200 shares at $15 a share, for tax purposes he is treated as having purchased all those shares at his average cost basis of $15 per share. Thus, he has no new tax liability because he has already paid taxes on his own gain.

Is Investor B paying Investor A's taxes when he pays taxes on the $1,000 distribution? No. Investor A paid her own taxes on the $1,000 gain when she sold shares at $20 with a cost basis of $10; she delayed paying taxes until she sold. Investor B paid taxes on the $1,000 distribution up front, but owed no additional taxes when he sold his shares with the same price ($15) as his cost basis. Thus, he pays taxes only on the $1,000 that he earned while he owned the shares.

Compared to other forms of investments, the only issue with a mutual fund is the timing of the taxes paid, not the amount of taxes paid. Taxes may be paid sooner (if gains accrued before purchase are realized and distributed) or later (if losses accrued before purchase offset realized gains), but total taxes paid will be the same.

December 2013

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.