KIM: Be wary of mutual fund capital gain distribution season

Mickey Kim
November 5, 2016

It's never easy, but this is a particularly tricky time of year for investors who own or are considering purchasing mutual funds in taxable accounts.

If you sell your mutual fund shares at a profit, you'll owe capital gains taxes on the difference between your purchase price (or cost basis) and the sale price. This is the same as for any other type of investment owned in a taxable account.

However, mutual fund investors can also incur capital gains taxes even if they don't sell any shares.

According to Christine Benz, Morningstar's Director of Personal Finance, "that happens when the fund itself has sold appreciated holdings and realized a gain; in turn, the fund is required to distribute those gains to shareholders, who in turn must pay taxes on them."

A fund's manager may sell a security because of valuation or to raise cash to pay departing fund shareholders. Regardless of the reason, the fund realizes a capital gain or loss based on the difference between the sale price and what the fund paid for the security.

Because mutual funds are required to "distribute" realized capital gains and income to shareholders at least annually, unwary investors who own or are considering buying shares in taxable accounts (i.e. ***not*** in 401-K or IRA accounts) could face an unpleasant surprise.

Many funds elect to make their required annual distributions at year-end. A fund will net its realized capital gains and losses. If there is a net gain, that amount is distributed to shareholders. If there is a net loss, that amount can be "carried forward" and used to offset gains in future years.

A fund calculates its distribution by dividing the net capital gain by the number of shares outstanding on the "record date." Assume Fund A has $100 million in assets, a net capital gain of $10 million for 2016 and 1 million shares outstanding on the record date of December 28, 2016.

Fund A will make a capital gains distribution of $10/share ($10 million gain/1 million shares) to all shareholders (taxable shareholders will pay taxes on it). Fund A's net asset value (NAV) will immediately drop from $100 ($100 million assets/1 million shares) to $90 (($100 million assets - $10 million capital gain distributed)/1 million shares).

Shareholders can elect to receive the distribution in cash or reinvest the amount in additional shares. So, if a shareholder owns 1000 shares worth $100,000 on the record date, she can either take a check for $10,000 (reducing the value of her investment to $90,000) or reinvest the $10,000 in additional shares (leaving the value of her investment constant at $100,000).

Importantly, she receives the same $10/share taxable distribution ***whether she owned the shares one day or ten years as of December 28.*** In sum, while the distribution is a nonevent from an investment point of view, it can be a very big deal for taxes.

Taxable shareholders should generally avoid buying shares of a fund in front of a distribution. As Benz says, "The last thing you want to do is buy into a fund and pay taxes on a distribution that you did not enjoy in any way, shape or form."

Most funds post estimates of upcoming distributions on their websites. Alternatively, the free http://www.capgainsvalet.com/ tracks distributions.
