Mutual Fund Tax Bills Are Rising

- A natural consequence of an extraordinarily strong stock market over the past five years has been larger distributions from stock mutual funds.
- In taxable accounts, such as individual, joint, and trust accounts, COMPASS favors tax-managed and tax-efficient stock mutual funds to minimize such taxable distributions.
- We also tend to invest in mutual funds with smaller asset bases. Shareholders of such funds benefit from a tax perspective when the asset base of their funds increase, thereby decreasing their proportional interest in the distributions.

Mutual fund investors' tax bills have been on the rise again recently. The average capital gains distribution (a payment to shareholders of profits realized on the sale of a fund's securities) for U.S. equity funds based on data as of April 2014 is 19.3% of assets, compared with, for example, 6.9% back in 2007. These recent distributions are among the largest seen since the start of the financial crisis in 2008.

The reason for those payouts is of course a good thing. The payouts mean that funds have produced solid returns for a few years running. The distributions were small in 2008, 2009, and 2010 because capital gains were offset by realized losses during the financial crisis. However, most of those losses are long gone.

Mutual funds are required to distribute their capital gains once a year. All of the realized gains are tallied while the realized losses and loss carry forwards from the previous year are subtracted to arrive at the total sum to be paid out. The distributions are made in equal proportions to all shareholders regardless of when they bought the fund. Then all the fund holders who own the fund in a taxable account have to pay taxes on those distributions—even if they reinvest their distribution.

What does all of this mean? Well, mutual fund investors should consider strategies for dealing with future payments. Most funds may still be sitting on sizable gains, so it's quite likely that payouts will continue to grow as funds sell their winners. Thus, fund tax bills can be expected to grow. That's a bad thing, because you'll have more money at the end of the day if you can postpone paying capital gains as far into the future as possible. The reasons are twofold: First, the time value of money means that money in today's dollars is worth more than in the future because inflation will have eroded its value. In addition, if you hold on to the money, it can compound over time in your fund, thus earning you more money.

Here, then, are a few things you can do to limit your tax bill.

1) Max out on tax-sheltered accounts. Taxable distributions are not a problem for 401(k)s, 403(b)s, and IRAs, so invest as much as the law will allow before you put money in taxable accounts.

2) Consider tax-managed funds for your taxable accounts. Tax-managed funds do a great job of avoiding making distributions because they realize losses on some holdings when they have to realize gains on others. After taxes are figured in, these funds generally put up superior returns.

3) Consider exchange-traded funds (ETFs). They don't have all the strategies available as tax-managed funds, but they do have some unique features that help reduce their tax bills. Just make sure you've chosen one that is diversified, has low costs, and has low turnover.

4) Don't buy funds that have had huge returns over the past three years. Buy a fund with huge gains and you're going to get a huge tax bill regardless of whether you make any money yourself. So, tread carefully in hot areas. If you have your heart set on such a fund, at least put it in an IRA or 401(k).

Investors should read the prospectus and carefully consider a fund's investment objectives, risks, fees, and expenses before investing. It is important to note that ETFs are not immune from capital gains distributions; ETFs may make capital gains distributions if changes in the underlying index occur. 401(k) and IRA plans are long-term retirement-savings vehicles. Withdrawal of pretax contributions and/or earnings will be subject to ordinary income tax and, if taken prior to age 59 1/2, may be subject to a 10% federal tax penalty. Please consult with a legal, financial, or tax professional for advice specific to your situation.