

The Mutual Fund Trap

Similar to investing in individual securities, investing in mutual funds has benefits and detriments. The biggest downside to investing in mutual funds is what I call the “mutual fund trap”. As we are all aware, the equity markets have performed poorly this year and the value of your investments at the end of the year may be less than their value at the beginning of the year, which is unsettling. If you hold individual securities and you continue to hold them throughout the year, the only income tax implication is the tax on the dividend income that you receive throughout the year. This seems logical and fair as you do receive the dividends in cash.

Conversely, if you hold mutual funds throughout the year, not only are you subject to income tax on the dividends you receive, you will also be subject to income taxation on capital gains distributions. Throughout the year, managers of the mutual funds buy and sell securities. At the end of the year, the capital gains realized throughout the year at the fund level are distributed to the shareholders in the form of additional shares in the fund. You end up with more shares at the end of the year; however, the value of what you have does not increase. Let me explain why.

The value of the shares of the mutual fund immediately prior to the distribution of the capital gains equals the total value of all of the securities held in the fund. This includes any increases due to capital gains realized by the fund throughout the year because the excess funds are reinvested in more securities at the fund level. Upon distribution of the capital gains, the value of the overall fund does not change because it still equals the total of all of the securities held in the fund; however, because the capital gains are distributed to mutual fund shareholders in the form of additional shares in the fund, there are more outstanding shares of the fund.

Because the value of the fund has not changed, but the total number of outstanding shares of the fund has increased, the price per share decreases. So there you are at the end of the year with less value to your mutual fund holdings, but having to pay income tax on the capital gains distributed from the fund. You have been caught in the “mutual fund trap”.

Avoiding the Mutual Fund Trap

Mutual funds generally distribute capital gains once or twice per year. Virtually all funds distribute gains at the end of the year, usually late December. Other funds also distribute gains in either May or June. You can avoid the mutual fund trap with respect to distributions made in December by selling your mutual fund holdings prior to the distribution date. This will have income tax consequences as the sale will result in either a realized capital gain or loss. If you have held the fund for years, even though the markets have performed poorly this year, you may still have a capital gain and it may therefore not be worthwhile to avoid the mutual fund trap.

If you are considering selling to avoid the mutual fund trap, there are a couple of other issues that should be considered. First, selling your fund shares must be consistent with your investment objectives. Second, if you sell at a loss, you can not recognize that loss if you re-purchase shares in the same mutual fund within thirty days of the sale. This is called the wash sale rule. Without such a rule, it would be easy to avoid the mutual fund trap by selling on December 15th and repurchasing on January 2nd.

Investing in individual securities allows you to control the timing of capital gains on each specific security. Holders of individual securities will often sell a poorly performing security at the end of a year to realize a capital loss and, if they still like the security from an investment perspective, purchase the security back in thirty-one days to avoid the wash sale rule. Overall, investing in individual securities as opposed to investing in mutual funds allows an investor to control the tax implications and thus enables the investor to be proactive from a tax perspective as opposed to the mutual fund investor.

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