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Personal Finance: Mutual Fund Taxes

UNDERSTANDING TAX CONSEQUENCES OF MUTUAL FUNDS

KEY POINTS

- Mutual funds must distribute any dividends and net realized capital gains earned on their holdings over the prior 12 months, and these distributions are taxable income even if the money is reinvested in shares in the fund.
- Investors concerned about tax exposure might want to consider investing in tax-efficient equity funds. Such funds typically are managed with an eye toward limiting capital gain distributions, when possible, by keeping holdings turnover low and harvesting losses to offset realized gains.
- While tax considerations may play an important role in investment decisions, T. Rowe Price financial planners strongly encourage investors to focus primarily on their long-term financial goals. Making investment decisions based solely on tax considerations could result in expensive mistakes that reduce overall returns.

All investors want to see their investments grow in value. At the same time, mutual fund shareholders—equity fund shareholders in particular—face potential tax consequences toward the end of each year. That's because mutual funds must distribute any dividends and net realized capital gains earned on their holdings over the prior 12 months. For investors with taxable accounts, these distributions are taxable income, even if the money is reinvested in additional fund shares and they have not sold any shares.

Investors in tax-advantaged accounts such as individual retirement arrangements (IRAs), 401(k) accounts, and other tax-deferred savings plans do not pay taxes on dividends and capital gain distributions in the year they are received, as long as the money remains in the account and no withdrawals are made.

Dividend distributions reflect the dividend and/or interest income earned on the securities held by the fund.¹ Net capital gains distributions reflect gains from the fund's sale of securities after deducting any realized losses, including net losses carried over from previous years.

Capital gains from sales of securities held by the fund for one year or less are considered short-term gains and are taxed at the same rates applied to ordinary income. Gains on sales of securities held for more than one year are taxed at the lower capital gains rates.

Keep in mind that funds may hold securities for several years, and any appreciation in the value of the shares during that time is not distributed as taxable capital gains until after they are sold. Fund managers may sell holdings—and thereby realize gains—for

a variety of reasons, such as concerns about earnings growth, or if a stock has become fully valued in the manager's opinion, or to reinvest the proceeds in a more attractive opportunity. Corporate mergers and acquisitions also may result in a taxable sale of shares in the company being acquired.

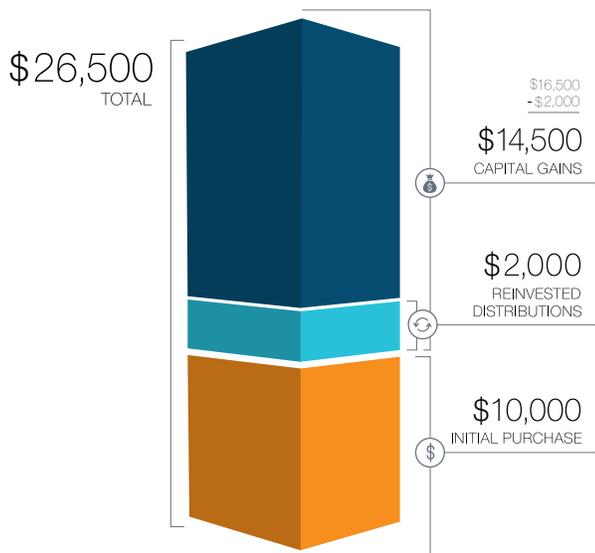
Taxable gains in a fund potentially could be offset by realized losses on other sales.

When dividend and net capital gains distributions are made, the net asset value (NAV) per share of the fund drops by the amount distributed. Importantly, the shareholder has not lost money because of this decline in the NAV. They either have taken the distribution in cash or, more likely, reinvested the money in additional fund shares purchased at the lower adjusted NAV.

Fund shareholders who reinvest their distributions in fund shares—and most fund investors do—could benefit if the acquired shares rise in value. Those purchases tend to be spread out over time, so reinvesting annual distributions in fund shares is inherently a form of dollar cost averaging.

While no investor enjoys paying taxes on income that they have not actually received in cash, reinvested distributions are considered part of the investor's cost basis. This could significantly reduce the taxable capital gains realized when fund shares ultimately are sold by the investor, especially if the fund has been held for a long time.

For example, consider the hypothetical scenario illustrated below: suppose you bought \$10,000 of an equity mutual fund on January 1, 2013. Over the next five years, the fund paid distributions totaling about \$2,000, which you reinvested in the fund account and included on your tax returns. If you sold all your shares on June 30, 2018, you would have received \$26,500—\$16,500 above the \$10,000 you originally invested. But you wouldn't pay taxes on the whole \$16,500 since you had already been taxed on the \$2,000 of distributions over the prior five years. You would only include \$14,500



This example is for illustrative purposes only and does not reflect the performance of any specific investment.

as your capital gain on your 2018 tax return.

Investors in taxable accounts planning new or additional investments in a fund may decide to wait until after a dividend or capital gains distribution is made in order to buy fund shares at the lower NAV and avoid having to pay tax on the distribution. Depending on how long the investor has to wait, however, this strategy could result in missing out on appreciation of the fund shares in the interim. The longer the investor has to delay his or her purchase, the greater this risk becomes.

Some investors also may consider selling fund shares before a distribution to avoid the tax due, then buy them back afterward. However, if the investor had gains on the shares at the time of the sale, the realized gains would be taxable in the year the shares were sold. And if the shares sold were held for 12 months or less, that gain would be taxed at ordinary income rates.

On the other hand, if an investor sells fund shares at a loss to avoid a distribution and then repurchases shares in the same fund within 30 days, the “wash sale rule” prevents them from claiming a capital loss for that tax year. Instead, the loss is deferred and added to the investor's cost basis for the new shares acquired. This may reduce

taxable gains, or increase tax losses, on future sales. The investor's holding period for the shares sold also is tacked on to the holding period for the new shares acquired.

Investors concerned about tax exposure might want to consider investing in tax-efficient equity funds. Such funds typically are managed with an eye toward limiting capital gains distributions when possible by keeping holdings turnover low and harvesting losses to offset realized gains.

While tax considerations may play an important role in investment decisions, T. Rowe Price financial planners strongly encourage investors to focus primarily on their long-term financial goals. Making investment decisions based solely on tax considerations could result in expensive mistakes that reduce returns overall—making it harder, not easier, for investors to achieve their objectives.

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¹ Most dividends from non-REIT (non-real estate investment trust) equity funds are likely to be “qualified dividends” and are taxed at the lower rate applied to long-term capital gains. This generally refers to dividends the fund has received from domestic (U.S.) corporations and from qualified foreign corporations (including corporations incorporated in a U.S. possession, foreign corporations eligible for benefits of a comprehensive tax treaty with the U.S., and foreign corporations listed on a U.S. stock exchange). Dividend distributions may be taxed at ordinary income rates. T. Rowe Price funds report that information to our shareholders on Form 1099-DIV, which is mailed to shareholders and provided on our website (<https://www3.troweprice.com/usis/personal-investing/planning-and-research/tax-planning/prepare-your-taxes/fund-specific-tax-and-reclassification-info/qualified-dividend-income-percentage.html>).

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