Mutual Funds in Taxable Accounts: Despite Losses, You May Incur Sizable Capital Gains Tax

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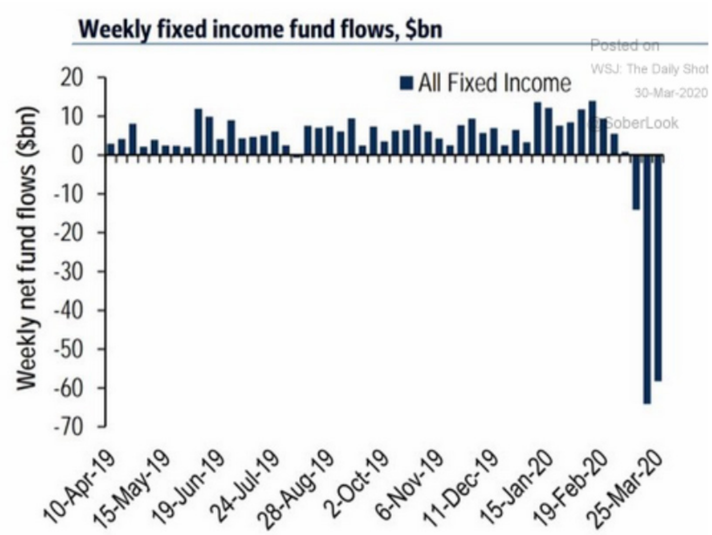
As investors and advisors alike look to realign/re-balance their portfolios this year, we wanted to provide a reminder about how mutual funds are taxed. Like any investment, if you buy a mutual fund, own it for more than one year, and sell it at a profit, you must pay federal (and for most states) capital gains tax on your gain. If you own the position for less than one year, you will have to pay ordinary income tax on your gain. Yet many do not realize that if you keep owning a mutual fund (you don't sell it), there may be short- and long-term capital gains taxes pushed through to you even if you have a loss on the fund since your initial investment. **This year, these gains may be massive.**

Before we address 2020, let's revisit a "calm" year where the greatest drawdown for the S&P 500® Index was less than 3% (2017) and a more volatile year (2018) when stocks fell ~14% in the fourth quarter and ended the year down ~5%. In 2017, 65% percent of mutual funds paid a capital gain distribution. In 2018, that number lept to 86% of funds distributing gains, and the average capital gain payout was 11%.[1] Put into numbers, if you have a $100,000 fund portfolio, on average you were handed an $11,000 capital gain. Yet even in these less-extreme years, certain funds can pack a tax wallop. As an example, in 2017 the Hennessy Focus fund paid out a paltry 0.005% capital gain. In 2018, despite losing 10.47%, it distributed a 21.3% capital gain![2] If a 14% drawdown can create this kind of tax liability, what will 2020's volatility create?

The Current Scenario for Mutual Funds

The longest stock bull market in history, an 11-year run, ended rather abruptly with the COVID-19 outbreak. In 1Q20, the S&P 500® Index was down about 33% peak to trough. Sales of stock-based funds has been massive and wide-spread. With the rush to safety, many bonds, especially those with lower credit ratings and extended durations, also participated in a sharp sell-off.

Bond fund redemptions, as the chart to the right illustrates, were massive. In fact, most major asset classes endured significant redemptions as they sold off during February and March, so this warning likely applies to most mutual funds of *any* asset class.



Note: the flows data is for US-domiciled funds and ETFs. The flows include the following asset classes: high grade (corporate and government), high yield, mortgage backed, floating rate, total return, municipals, inflation protected. Source: WSJ Daily Shot, from 3/30/2020

In volatile markets, such as the beginning of 2020, in order to meet large and persistent liquidation requests, fund managers typically must sell positions in their portfolios. If these positions were bought years ago during the beginning or middle of the bull market, then sales of shares with years' worth of gains will cause capital gain tax liability at the fund level. By law, these gains, along with any income distributions, must be distributed to current holders of the mutual fund each year, usually in December. By simply owning a mutual fund in a taxable account, you might inadvertently be made to pay tax on the gains of holdings that previous shareholders enjoyed for years. For example, if your fund manager bought Amazon stock in 2012 for $180 per share and had to sell some in 2020 at $1,880 per share, this $1,700 per share long-term gain must be distributed to the current owners of the fund. This tax liability would be passed on even if you have a loss or if you just recently invested in the fund!

It is important to re-emphasize that this phenomenon is likely to affect most asset classes and most mutual funds. Please remember that this warning only applies to taxable accounts—retirement accounts are tax-deferred and thus this potential issue is not relevant in these types of accounts.

What can we do?

Mutual funds' supplemental prospectuses will publish undistributed capital gains data. You may have to wait a month or two for the next supplemental prospectus to be published. If you don't want to wade through the paperwork, call the fund family and ask what the estimated capital gains distributions will be for each fund you own. Also find out the dates of any distributions so you don't get caught off guard on the timing. If large capital gain distributions are in the cards, there are things you can do. Here are a few suggestions:

1. Weigh your unrealized gain versus keeping the position. If your personal gain is small or negative, consider closing the position in favor of alternatives. Is there a similar or identical ETF that you can switch to? Many mutual funds now have ETFs that follow the same index…Google is your friend! Look into switching now if you have losses or modest gains in your fund. If the markets do recover, you may become "stuck" with your own gain on the mutual fund versus switching now and letting any future gain accrue in the replacement ETF.

2. Do you use model portfolios partially or fully built with mutual funds? Mutual fund based model portfolios may get a "bloody nose" from this bull to bear selling. Losses are one thing, piling on unnecessary capital gains is another. How many clients might deem this the last straw and fire their investment manager over it?

Using underlying mutual funds has advantages and disadvantages. As a consumer of these strategies, you need to know…and act on…relevant information including future mutual fund capital gains distributions. Since ETFs do not typically distribute capital gains like funds do, is there a suitable ETF based model manager you can switch to? How about an individual stock or bond manager? Still no luck? We're here to help!

In the investment world, there are often choices. It is rare to have ample time to act on a probable event that will cause your portfolio so much potential harm. COVID-19 and the broad market declines are bad enough. Now, it is up to you to be proactive and potentially save yourself a significant amount of unnecessary tax.

Need some guidance making the switch and implementing ETF solutions into your portfolios? Reach out to our regional consultants:

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Sources and Disclosures:

[1] Pepe, Frank. "2018 capital gains: Adding insult to injury." The Russell Investments Blog. Russel Investments, January 29th, 2019. https://russellinvestments.com/us/blog/2018-capital-gains-adding-insult-to-injury

[2] Kinnel, Russel. "An Early Warning on Capital Gains Tax Distributions." Fund Spy Collection. Morningstar.com, September 17th, 2019. https://www.morningstar.com/articles/946044/an-early-warning-on-capital-gains-tax-distributions

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