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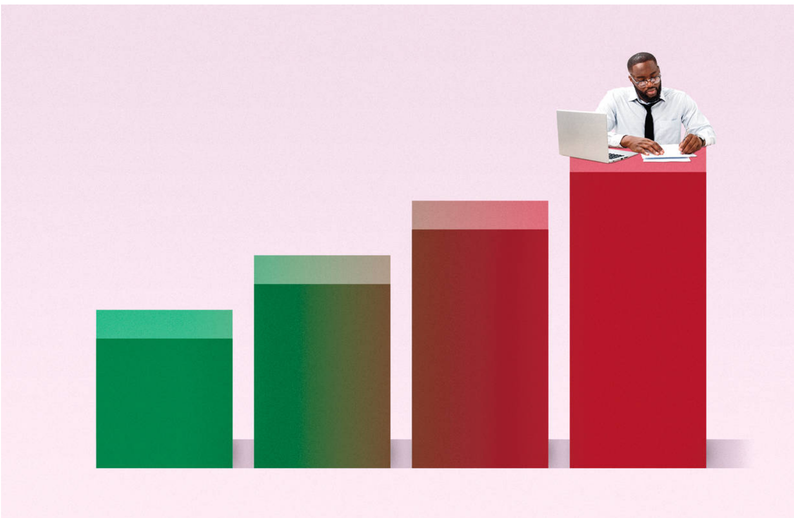
JOURNAL REPORTS: WEALTH MANAGEMENT

A Tax Trap Many Fund Investors Fall Into

Don't buy a mutual fund just before a big capital-gains distribution



Mark Wilson of CapGainsValet.com says 539 funds made capital-gains distributions during 2018 of 10% or more of net asset value. **PHOTO:** MIKEL JASO

By Tom Herman

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Getting a large payment from your favorite stock-market mutual fund late in the year may feel like an early Christmas gift.

Or maybe not. In certain cases, that seemingly welcome distribution could result in a tax headache that could easily have been avoided with a small amount of homework.

It's time for a reminder about a tax trap that often catches investors by surprise when they invest in equity funds for a taxable account late in the year. When it comes to taxes, ignorance definitely isn't bliss, and this is another example of how it can be dangerous to your wealth to rely on common sense.

"Taxes are an important piece to the puzzle with mutual funds," says Russel Kinnel, director of manager research for Morningstar. "Because some of the rules on mutual funds are a little archaic," he warns, "you could be in for some unhappy surprises" unless you do some research on the amount and timing of a fund's anticipated capital-gains distributions.

Capital-gains distributions represent “a fund’s net gains, if any, from the sale of securities held in its portfolio,” the Investment Company Institute says in its latest Fact Book. During 2018, mutual funds distributed $511 billion in capital gains to shareholders, the ICI says. About 31% of that amount went to taxable household accounts. Most distributions typically occur in the fourth quarter, usually during November and December. For investments in taxable accounts, those distributions typically are taxable—even if the taxpayer made an investment in the fund shortly before the date to qualify for the payout.

When investing for a taxable account, “you don’t want to buy a fund just before a big distribution,” says Bob Gordon, president of Twenty-First Securities Corp.

That’s why homework is so important. Here are a few annual reminders:

Before investing for a taxable account, find out whether that fund is planning a year-end distribution, how much and when, says Drew Moss, a certified financial planner and principal of the Executive Wealth Group at Summit Financial LLC.

Mark Wilson, president of MILE Wealth Management in Irvine, Calif., says most large mutual-fund organizations post this information on their website. Mr. Wilson, who monitors capital-gains distributions on his site, CapGainsValet.com, recently posted this reminder: “Don’t Buy a Tax Headache!”

If you’re investing for a taxable account and are interested in a fund planning a payout soon, consider doing some number crunching to gauge the potential impact on your taxes, or ask your tax adviser for help. If the impact will be significant, consider waiting to invest in that fund until after the date to qualify for that payout—or consider “a more tax-efficient alternative,” Mr. Moss says.

This was an especially large issue last year, says Mr. Wilson. He counted 539 funds (mostly equity funds) that made capital-gains distributions during 2018 of 10% or more of net asset value, or NAV.

"This is a huge hot-button issue" for many mutual-fund investors who don't understand the fine print and wind up getting stung by an unexpected tax bill, says Mr. Moss. "People are shocked" when they discover the additional tax hit.

However, investors don't need to worry about this subject if they're investing in funds through a tax-sheltered account such as an IRA or a 401(k), says Christine Benz, director of personal finance at Morningstar.

As she wrote in a recent column: "You won't be paying taxes on capital-gains distributions that occur as the years go by, provided your money remains within the confines of that account; you'll only owe taxes when you cash out, and those taxes will be based on your total appreciation, not on these year-to-year distributions. Thus, to the extent that you own active funds in your portfolio, your tax-sheltered accounts are a good spot to hold them."

For more details on the tax rules, see Internal Revenue Service Publication 550.

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Many key tax numbers are adjusted by law each year for inflation. Although official government numbers haven't yet been released, here are a few projections for 2020 by Wolters Kluwer Tax & Accounting, based on recent inflation data from the U.S. Labor Department. These numbers apply to returns for the 2020 tax year, to be filed typically the following year.

• The basic standard deduction will rise slightly. For single taxpayers, the standard deduction—which most taxpayers take instead of itemizing—is expected to increase to $12,400 for 2020 from $12,200 for 2019. For married couples filing jointly, it's expected to rise to $24,800 from $24,400. (There are additional amounts for those 65 and older, or who are blind. Wolters Kluwer says these amounts are expected to remain unchanged.)

• The top 37% rate for married couples filing jointly will begin on taxable income of more than $622,050. That's up from more than $612,350 for 2019. The top rate for most singles will begin at taxable income of more than $518,400, up from $510,300 for 2019.

• The annual gift-tax exclusion is projected to remain unchanged at $15,000 for gifts to each recipient.

• The 2020 foreign earned income exclusion will rise to $107,600 for 2020, from $105,900 for 2019.

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