CPA Practice Advisor

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Many know that capital gains taxes are what you owe when you sell an investment that has gained value since you bought it. What's less well-known is that you can end up owing capital gains taxes on an investment that has *lost* value since you purchased it *and* that you haven't even sold!

Getting caught in that capital gains tax trap has led many to unpleasant and expensive surprises come tax season. There's a way to avoid this problem, but only if you understand why it happens.

has to pay them the value of their shares. Because the mutual fund itself doesn’t usually maintain large amounts of cash assets, when it owes money, it must raise those funds by selling its assets.

If those assets are worth more when the mutual fund sells them than they were when it bought them, the fund will owe capital gains taxes that its remaining members must pay. Members with large stakes in a mutual fund that sells a lot of assets that have greatly appreciated in value can find themselves owing tens of thousands of dollars in capital gains taxes, even if the overall value of the mutual fund went down in that tax year!

You might think an easy way to save members from owing large tax bills at the end of the year would be for a mutual fund to structure its asset sales such that some are sold at a loss in order to offset the assets that gained in value via tax-loss harvesting. You’d be right! Balanced selling would be a good solution, but for many mutual funds, there’s an incentive not to do that.

Highly focused on performance metrics

Mutual fund performance metrics are based on how much value the mutual fund’s assets gain. Selling only assets that have gained in value increases the mutual fund’s performance assessment. Investors looking for a mutual fund to buy into are understandably more likely to choose one that reports highly positive performance than one that reports middling or negative performance.

In order to attract new investors by showing the highest performance possible, mutual funds often make decisions that negatively impact their current investors’ tax picture. There are several ways to avoid this problem:

If your mutual fund is part of an employer-sponsored 401(k), you'll automatically

make your investment worthwhile. Fund managers will naturally make decisions that prioritize the survival of the mutual fund itself rather than focusing on the tax implications for their investors. If those decisions aren't in your favor, your retirement savings can suffer.

Avoiding the tax bomb: Exchange-traded funds

Another option, and one we often steer our clients toward, is to avoid the mutual fund altogether and instead consider an ETF. In the past, people invested in mutual funds for diversification, even with small investments. Being able to spend $1,000 to invest in 3,000 companies is attractive because of the automatic diversity of your investment.

Today, ETFs do the same thing, but you avoid the risk of stumbling into the capital gains trap. We much prefer to see our clients invest in individual securities and ETFs for their taxable retirement accounts. The investor can derive the same portfolio diversity as with a mutual fund while gaining the ability to direct their investments personally. We feel that, when possible, it's good practice to be completely in control of your investments.

It's important to work with a fiduciary

The mutual fund tax bomb is one that's often encountered by people whose financial professionals lack an individualized approach to each client and who have been incentivized to sell certain products — it's common to encounter investment firms that are motivated to sell certain products.

If a broker receives a commission every time a client invests in a mutual fund, there's a natural tendency for that broker to want *every* client to invest in that mutual fund! That's why it's important to choose an independent *fiduciary* advisor who does not get paid based on which products their clients choose. Only with such independence

Taxes