The tax consequences of selling mutual funds

Do you invest in mutual funds or are you interested in putting some money into them? If so, you're part of a large group. According to the Investment Company Institute, 116 million individual U.S. investors owned mutual funds in 2023. But despite their widespread use, the tax rules involved in selling mutual fund shares can be complex.

Review the basic rules

Let's say you sell appreciated mutual fund shares that you've owned for more than one year. The resulting profit will be a long-term capital gain. As such, the *maximum* federal income tax rate will be 20%, and you may also owe the 3.8% net investment income tax. However, most taxpayers will pay a tax rate of only 15% and some may even qualify for a 0% tax rate.

When a mutual fund investor sells shares, gain or loss is measured by the difference between the amount realized from the sale and the investor's basis in the shares. One challenge is that certain mutual fund transactions are treated as sales even though they might not be thought of as such. Another problem may arise in determining your *basis* for shares sold.

A sale may unknowingly occur

It's obvious that a sale occurs when an investor redeems all shares in a mutual fund and receives the proceeds. Similarly, a sale occurs if an investor directs the fund to redeem the number of shares necessary for a specific dollar payout.

It’s less obvious that a sale occurs if you’re swapping funds within a fund family. For example, you surrender shares of an income fund for an equal value of shares of the same company’s growth fund. No money changes hands, but this is considered a sale of the income fund shares.

Another example is when investors write checks on their funds. Many mutual funds provide check-writing privileges to their investors. Although it may not seem like it, each time you write a check on your fund account, you’re making a sale of shares.

Figuring the basis of shares

If an investor sells all shares in a mutual fund in a single transaction, determining basis is relatively easy. Simply add the basis of all the shares (the amount of actual cash investments), including commissions or sales charges. Then, add distributions by the fund that were reinvested to acquire additional shares and subtract any distributions that represent a return of capital.

The calculation is more complex if you dispose of only part of your interest in the fund and the shares were acquired at different times for different prices. You can use one of several methods to identify the shares sold and determine your basis:

- **First-in, first-out.** The basis of the earliest acquired shares is used as the basis for the shares sold. If the share price has been increasing over your ownership period, the older shares are likely to have a lower basis and result in more gain.
- **Specific identification.** At the time of sale, you specify the shares to sell. For example, “sell 100 of the 200 shares I purchased on June 1, 2020.” You must receive written confirmation of your request from the fund. This method may be used to lower the resulting tax bill by directing the sale of the shares with the highest basis.
- **Average basis.** The IRS permits you to use the average basis for shares that were acquired at various times and that were left on deposit with the fund or a custodian agent.

As illustrated, mutual fund investing may result in complicated tax situations. We can answer any questions you may have and explain how the rules apply to your situation.