Be tax-smart with your mutual fund investments

Mutual funds offer an easy way to invest in a diversified portfolio compared to buying individual stocks and bonds. But the tax treatment of mutual funds isn't so simple.

How are mutual funds taxed?

If you sell appreciated mutual fund shares, the resulting profit will be taxable. If you've held the shares for one year or less, you have a short-term gain subject to your marginal ordinary-income rate, which might be as high as 37%.

If you've held the shares for more than one year, your lower long-term capital gains rate applies. The maximum federal long-term gains rate is 20%. But most taxpayers pay a long-term gains rate of 15%, and some may even qualify for a 0% rate.

However, whether it's a short- or long-term gain, you may also be subject to the 3.8% net investment income tax. Taxpayers with modified adjusted gross income (MAGI) over $200,000 per year ($250,000 for married couples filing jointly and $125,000 for married individuals filing separately) are subject to this extra 3.8% tax on the lesser of their net investment income or the amount by which their MAGI exceeds the applicable threshold.

When you sell mutual fund shares, your gain (or loss) is measured by the difference between the amount realized from the sale and your tax basis in the shares. This is generally the amount you paid for the shares, with certain adjustments.

When does a sale occur?

One challenge is that certain mutual fund transactions are treated as sales even though they might not be thought of as such. It's obvious that a sale occurs when you sell all shares in a mutual fund and receive the proceeds. Similarly, an obvious sale occurs if you direct the fund to sell 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, let's say 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. While this was much more common 20+ years ago, some mutual funds still provide check-writing privileges to their investors. Although it may not seem like it, if you write a check on your mutual fund account, you're making a sale of shares.

What's your basis?

Another challenge may be determining your basis for shares sold. If you sell 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 these 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, 2025." 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, reducing the taxable gain.

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. This is easier than the specific identification method and may reduce your taxable gain compared to the first-in, first-out method.

More to consider

There are tax factors to consider beyond what we've discussed here. For example, mutual fund capital gains distributions are also generally taxable, even when reinvested in the fund. If you have questions about the tax treatment of mutual funds, contact us. We can help you be a tax-smart mutual fund investor.