Five Things You Need to Know about Taxes on Mutual Funds and Exchange-Traded Funds

By Jim Weil, CIMA®, CFP®

Many investors are not fully aware of the tax treatment on mutual funds and exchange-traded funds (ETFs) or how they can differ. As a result, opportunities are missed, which causes unnecessary taxes to be paid. Here are five things you need to know about taxes on mutual funds and ETFs.

Mutual funds distribute gains and retain losses. Mutual funds, by law, must distribute 95 percent of their taxable gains in the year they occur to existing shareholders regardless of how long they may have been shareholders. Conversely though, if the fund has losses, the losses do not flow through to shareholders but are retained at the fund level to offset future gains.

You can avoid taxable gains through your choice of mutual funds. Mutual funds offer opportunities for those who plan ahead and possible pitfalls for those who do not. If you expect a mutual fund to incur or distribute a gain in a calendar year, you may want to purchase a different fund to avoid that tax bill. Most funds publish information on unrealized gains. This is important because ignoring this information can result in paying taxes on gains realized before you invested in the fund.

Mutual funds with carry-forward losses can be attractive. Alternatively, if you purchase a fund that has carry-forward losses, you may not incur any capital gains distributions for some time (until they use up the losses on the books). Again, this information is usually available to investors and was an effective strategy for many investors coming out of the 2008 crisis because not all funds held the same degree of carry-forward losses.

ETFs may be more tax-efficient for long-term investors. ETFs are structured differently from mutual funds. The ETF manager accommodates inflows and outflows by creating or redeeming units, which are baskets of assets that approximate the entirety of the investment exposure in that ETF. As a result, investors generally do not incur gains on appreciation unless they actually sell the ETF. For this reason, many consider ETFs to offer more tax efficiency for long-term investors who do not trade frequently.

Some ETFs are less tax-efficient than others. Investors need to be aware of a few additional exceptions regarding ETFs. For example, with ETFs that trade commodities, gains are usually treated as 60-percent long-term and 40-percent short-term regardless of the holding period. Some emerging-market ETFs may have less tax-efficiency because some markets are restricted from performing in-kind delivery of securities. As a result, the ETF may have to sell securities, triggering taxes even if the shareholder did not sell the position. Finally, leveraged or inverse ETFs have proven somewhat tax-inefficient because many use derivatives, so they may incur the 60/40 treatment noted above for commodities.

Regardless of whether you favor mutual funds or ETFs, it is wise to understand the tax issues before you invest. After all, net after-tax returns are really all that matters.

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