
# Beware of Mutual Fund Capital Gains in 2022

*Just because markets are negative in 2022, you might still see a tax bill*

When an investor sells a stock for more than the purchase price, the investor experiences a capital gain (I like to call it a profit, but let's stick to some technical terms for a minute). For example, if you bought Microsoft at $100 back in November of 2018 and sold it for $225 in November of 2022, the capital gain would be $125.

Mutual funds operate in much the same way, although it gets a little more complicated. When a mutual fund sells a stock for a profit, it too receives a capital gain and is required by law to pay most of the gain to its shareholders in the form of distributions – after deducting the fund's operating expenses.

## Types of Mutual Fund Capital Gains

There are two types of mutual fund capital gains – short-term and long-term.

- If the mutual fund – not the mutual fund investor, the mutual fund itself – has held the stock for more than one year, then the profit from the sale is treated as long-term capital gain, which is subject to a maximum of 20% tax rate for mutual fund shareholders.
- On the other hand, if the mutual fund has held the stock for less than one year, then the profit from the sale is treated as short-term capital gains, and is then taxed at the fund investor's ordinary income tax rate.

## Mutual Fund Capital Gains in 2022

It should come as no surprise that the major equity indices are all down significantly through October 31st of this year. In theory, this will give mutual fund managers a lot of opportunities to sell holdings in order to harvest losses which can offset possible gains.

But, investors should not assume that just because 2022 saw a lot of negative performance, then there won't be any capital gains. The reason? Many mutual funds performed well in 2021 and are holding onto stocks that were purchased well before that too.

To underscore this point, mutual fund tracker Morningstar is anticipating mutual funds from the value and blend categories will have sizeable distributions this year. And there will be plenty of growth mutual funds with cap gains this year too.

From Morningstar.com:

"American Funds offerings are estimating year-end distributions as high as a range of 6% to 9% of net asset value. JP Morgan estimates go as high as 12% to 23% of NAV for some funds. BNY Mellon has issued estimates for some funds to be 12% to 17%. T. Rowe Price estimated year-end distributions of 10% to more than 20% of NAV for some funds."

## What to Know

Mutual fund firms usually begin estimating and publishing their capital gain distributions in the fall and then make final distributions before the end of the year.

You should know that mutual funds don't all make distributions on the same day – they just need to do so before December 31st. And to help you keep track of the distributions and whether they are short- or long-term, mutual funds report this information to shareholders on IRS Form 1099-Div after the end of every year.

Given all this, investors should be aware of purchasing mutual fund shares right before the mutual fund makes a distribution – a term called "buying the dividend." Generally speaking, investors planning a large lump-sum investment in a mutual fund though their taxable account should avoid buying-the-dividend.

Finally, keep in mind that there are four types of mutual fund distributions that have tax implications for investors – capital gains, ordinary income (ordinary dividends), qualified dividends and non-dividend distributions (often called return of capital).

As such, it's important to discuss the implications of mutual fund investing and taxes with your financial advisor.