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Tax Impacts of Selling Mutual Funds at Losses

Original post by Michael Evans of Demand Media

Losses on mutual fund sales can offset tax liability on other investments.
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If you lose investment money on the sale of mutual fund shares, you can typically use the loss as a tax advantage. The Internal Revenue Service allows you to report capital losses on investments, and these losses can offset gains on your other investments. Reporting capital losses can decrease your taxable income, which can lower your overall tax liability. The IRS limits the amount of capital loss you can claim in a single year.

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Mutual Fund Taxation

The IRS typically requires you to pay taxes when you sell shares of a mutual fund for a profit, unless your shares are in a tax-deferred account such as an individual retirement account or a 401(k) plan. If your state levies personal income taxes, you might face additional taxation on your earnings. The IRS typically taxes any mutual fund distributions on fund earnings and capital gains earned when you sell your shares. The IRS taxes most long-term capital gains -- earnings made on investments held for more than one year -- at a rate no higher than 15 percent as of the 2010 tax year. However, tax rates and rules can change from year to year, and as of late August 2011 that percentage had not been set for 2011. If you earn money on the sale of shares you owned for less than one year, you must typically pay taxes according to your regular income tax rate. However, if you sell your shares at an overall investment loss, you might be able to use the capital loss as a tax advantage to lower your taxable income.

Basis

To determine whether your mutual funds investment has earned or lost money, you must know the cost basis of your mutual fund shares. In the majority of cases, the cost basis is the amount you paid for mutual fund shares. If you sell shares for less than you paid, you can typically report a capital loss. You might own shares with different purchase dates. The IRS gives you numerous methods for identifying sales of mutual fund shares, including: identifying specific shares sold; using a first-in first-out method, which presumes the sale of shares in an oldest-to-newest order; or averaging the cost basis of all of your shares for reporting capital gains or losses. The reporting method you choose might also determine whether your gains or losses qualify as long-term or short-term.

Types of Losses

You can claim a capital loss only for realized losses, which means losses incurred by selling shares of your mutual fund below your cost basis. You cannot report unrealized losses -- reduction in value of currently held shares -- as capital losses.

Capital Loss Limits

The IRS allows you to only report a specific amount of capital losses each year. As of the 2010 tax year, you could report a maximum of $3,000 in capital losses if you filed as a single taxpayer. If you were married but filed separately from your spouse, you could report no more than $1,500 in capital losses. However, if your losses in a single year exceed the allowable limit, the IRS enables you to carry over additional capital losses to subsequent years.

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Resources

- IRS: Publication 550 (2010), Investment Income and Expenses
- IRS: Publication 551 (07/2011), Basis of Assets

References

- Janus: Tax Center / Buying and Selling
- Investment Company Institute: Frequently Asked Questions About Taxation for Mutual Fund Investors
- Prudential: Tax Strategies: Mutual Funds
- IRS: Topic 409 -- Capital Gains and Losses

About the Author

Michael Evans was born in Memphis, Tenn. He graduated from The University of Memphis, earning a Bachelor of Arts degree in communication. His primary course of study was photography and film production. He first began writing professionally for iOwn Inc. in 1997, and was published by LensWork Magazine in 2003.

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