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Tax Penalties for Liquidating Mutual Funds

Original post by Michael Evans of Demand Media

Liquidation of mutual funds typically requires payment of capital-gains taxes.
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Mutual funds offer professional management of your money, along with diversification of investments. Mutual-fund managers pool money invested by multiple investors and use the funds to reinvest in securities such as bonds or stocks. If you invest in mutual funds, you may face a reduction in earnings due to management fees and taxes. The short-term and long-term taxes you pay when liquidating your shares of a fund can depend on the type of fund in which you invest.

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Mutual-Fund Taxation

Depending on the type of fund in which you invest, the Internal Revenue Service (IRS) typically levies taxes on dividends, from earnings made by the fund, and capital gains when you sell your shares. When you liquidate your shares, you may also face higher taxes if the sale places your income in a higher tax bracket. The IRS considers fund earnings as short-term gains, which require higher tax rates than long-term earnings. Typically, the IRS considers long-term capital gains as earnings from investments held for one year or more at the time you sell shares. For this reason, the tax you pay when liquidating shares can depend on how long you hold your investment. The type of fund in which you invest may also allow you to minimize your overall tax risk during the life of your investment.

Tax-Exempt Funds

Certain tax-exempt funds, such as municipal-bond funds, may allow you to lower your overall tax risk during the life of your investment. The IRS, and certain states, typically don't levy taxes on a portion or all of your dividends received from a municipal-bond fund. However, if your income falls within a high tax bracket, you may face alternative-minimum taxes, even with earnings from tax-exempt funds. States often exempt you from taxes on dividend earnings on shares of a municipal-bond fund within the state you live. When you sell shares from a tax-exempt fund, you still can face federal and state capital-gains taxes, in states that levy an income tax. The amount you pay at the time of liquidation can depend on the lifetime performance of the investment, your tax bracket or both.

Low-Turnover Funds

Low-turnover funds may minimize the amount of capital-gains taxes you must pay during the life of the investment. In a low-turnover fund, the fund's manager minimizes the amount of selling and buying of investments within the funds, which typically reduces that amount of annual capital gains. While you still may face capital-gains taxes when liquidating shares, your tax liability may be less in a low-turnover fund, due to lower gains, as compared to a high-turnover fund.

Tax-Deferred Accounts

If you own shares of a high-turnover mutual fund, a fund which the manager buys and sells investments frequently, you can place your shares within a tax-deferred account to reduce your tax liability on dividends. Capital gains and sales remain within the the tax-deferred account and do not face taxation until you start making withdrawals. If you begin making withdrawals from a tax-deferred account after reaching retirement age, you could be in a lower tax bracket than when you sold your shares.

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Resources

- U.S. Securities and Exchange Commission: Invest Wisely: An Introduction to Mutual Funds
- Internal Revenue Service: Sales and Trades of Investment Property

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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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