There are tax pitfalls associated with buying and selling mutual fund shares.

“Surprise” sales. You may already have made taxable “sales” of part of your mutual fund investment without knowing it.

One way this could happen is if your mutual fund allows you to write checks against your investment in the fund. Every time you write a check against your mutual fund account, you have made a partial sale of your interest in the fund. Except for money market funds where the share value is constant, you may therefore have taxable gain (or a deductible loss) whenever you write a check.

Here's another way you can unexpectedly make a taxable sale. If your mutual fund sponsor allows you to make changes in the way your money is invested—for instance, lets you switch part of your investment from a stock fund to a bond fund—making that switch is treated as a taxable sale of your shares in the stock fund.

Recordkeeping is important. Be very careful about saving all the statements that the fund sends you—not only official tax statements, such as Forms 1099-DIV (or the fund's version of the 1099-DIV), but the confirmations that the fund sends you when you buy or sell shares, or when your dividends are reinvested in new shares in the fund. Unless you keep these records, you won't be able to prove how much you paid for the shares, and thus, you won't be able to establish the amount of gain that is subject to tax (or the amount of loss you can deduct) when you sell them. You will also need to keep these records to prove how long you've held your shares, e.g., more than 12 months if you want to take advantage of favorable long-term capital gain tax rates. (If you get a year-end statement that lists all your transactions for the year, then you can just keep that and discard quarterly or other interim statements or confirmations. But save anything that specifically says it contains tax information.)

Time your purchases and sales. If you're planning to invest in a mutual fund, there are some important tax consequences that you should take into account in timing the investment. For instance, an investment shortly before payment of a dividend is something you should generally try to avoid, since you may, in effect, be buying a tax liability. If you're planning a sale of any of your mutual fund shares near year-end, you should weigh the tax and the non-tax consequences of a sale in the current year versus a sale in the next year.

Identify the shares you sell. Where you sell fewer than all of the shares that you hold in the same mutual fund, there are complicated rules for identifying which shares you have sold. The proper application of these rules can reduce the amount of your taxable gain or qualify the gain for favorable long-term capital gain treatment.

If you would like to find out more about tax planning for buying and selling mutual fund shares, please give me a call.

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