ALASKA HIGHWAY NEWS

Smart Money: Don’t pay tax on someone else’s gains

Brad Brain / Smart Money
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Brad Brain: "It’s a good idea to ask your investment advisor about expected year-end tax distributions, and how to properly plan the taxes on your investments." | Getty Images

I am a big fan of mutual funds. They offer professional management, diversification, convenience, and potentially good returns.

But they also have a little quirk that investors looking to make a large purchase late in the year need to know about. This only applies in specific situations, but when it does you could end up paying tax on money that you did not make, and that’s not fun. Further, it is particularly important to pay attention to this in years like 2021, when some funds are up as much as 45%.

The key to understanding this is twofold; how tax is generated with mutual funds, and who gets the tax slips. Tax is generated with mutual funds in two ways. The first is by what you do as an investor. If you buy and sell units of the mutual fund you can trigger taxable capital gains. You get to control this, deciding when to buy and sell units of the fund. But this is not what we are talking about today.

The second way that tax is generated on mutual funds is what happens inside the fund, and you don't have any control over that. The fund manager will be buying and selling investments inside the fund, and that can trigger capital gains too. In addition, the investments in the fund can earn interest and dividends. Investors will receive a tax slip for any capital gains, dividends, and interest income that the fund produced during the year.

Some of the taxable events will be allocated through the year, but some are not distributed until the end. The question is, who gets the tax slips for any year-end distributions? Answer: the investors who owned the fund at the end of the year. In other words, if you bought the fund in December, you may get a tax slip for the full year, even if you were not in for a full year's worth of growth.

Here's what I mean. Let's say a mutual fund starts the year selling at a price of $10 a share. The fund has a really good year. The fund manager makes some astute trades inside of the fund, and the fund finishes the year at a price of $12.

Roger notices the good performance of the fund, and he wants in. On the last day of the year he invests $100,000 at a price of $12 per share in a taxable account. And he's feeling pretty good about that. Until he gets the tax slip for the year-end tax distribution.

Because Roger is an owner of the fund, he shares in the tax liability for the year-end distributions. The fund has appreciated from $10 to $12, a 20% gain. The only thing is, Roger didn't get in at $10, he got in at $12. He ends up paying tax on money he didn't make.

So who needs to watch out for this? Just mutual fund investors looking to make large purchases in taxable accounts before the end of the year. If you are buying individual securities you are safe because they won't have these type of year-end distributions. If you are buying mutual funds in a tax-sheltered account like an RRSP or a TFSA you are safe because any distributions are tax sheltered. And, realistically, if you are making a small mutual fund purchase you may be just fine because the tax bill may not be a noticeable amount.

It's a good idea to ask your investment advisor about expected year-end tax distributions, and how to properly plan the taxes on your investments. Nobody wants to pay more tax than they need to, and paying tax on money that you didn't even earn is just mean.

Brad Brain, CFP, R.F.P., CIM, TEP is a Certified Financial Planner in Fort St John, BC. This material is prepared for general circulation and may not reflect your individual financial circumstances. Brad can

be reached at www.bradbrainfinancial.com.

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