



PASS-THROUGH TAXATION OF MUTUAL FUNDS

While it is widely understood that taxes must be paid on investment income, many investors may not be aware of the specific tax rules for certain investments. Mutual funds are popular investments that have many benefits but also may bring an unexpected tax bill because the funds themselves do not pay the taxes, instead passing on the responsibility to the investors.

- **Mutual fund distributions pass tax liability to investors (shareholders).**
- **Annual taxes from mutual funds vary by strategy.**
- **Tax deferral allows investors to use higher tax funds without concern about distributions.**

Mutual funds hold securities such as stocks and bonds, so they may earn income from dividends and interest (typically taxed at the ordinary income tax rate), and capital gains. The difference in the federal income tax rates for ordinary income and long-term capital gains is significant (see chart). For example, funds that invest heavily in bonds are more likely to distribute income taxed at ordinary rates. Growth funds may distribute capital gains, which are subject to lower tax rates.

2020 Tax Rates

Taxable Income	Income Tax
Single	
\$0–\$9,875	10% of taxable income
\$9,875–\$40,125	\$987.50 plus 12% of the excess over \$9,875
\$40,125–\$85,525	\$4,617.50 plus 22% of the excess over \$40,125
\$85,525–\$163,300	\$14,605.50 plus 24% of the excess over \$85,525
\$163,300–\$207,350	\$33,271.50 plus 32% of the excess over \$163,300
\$207,350–\$518,400	\$47,367.50 plus 35% of the excess over \$207,350
Over \$518,400	\$156,235 plus 37% of the excess over \$518,400

Taxable Income	Income Tax
Married Filing Jointly / Qualifying Widow or Widower	
\$0–\$19,750	10% of taxable income
\$19,750–\$80,250	\$1,975 plus 12% of the excess over \$19,750
\$80,250–\$171,050	\$9,235 plus 22% of the excess over \$80,250
\$171,050–\$326,600	\$29,211 plus 24% of the excess over \$171,050
\$326,600–\$414,700	\$66,543 plus 32% of the excess over \$326,600
\$414,700–\$622,050	\$94,735 plus 35% of the excess over \$414,700
Over \$622,050	\$167,307.50 plus 37% of the excess over \$622,050

Long-term capital gains rates are not tied to specific tax brackets, rather based on certain income levels.

2020 Individual Income Tax Rates on Long-Term Capital Gains

0% Tax Rate	15% Tax Rate	20% Tax Rate
Single		
Up to \$40,000	\$40,000–\$441,450	Over \$441,450
Married Filing Jointly / Qualifying Widow or Widower		
Up to \$80,000	\$80,000–\$496,600	Over \$496,600

Long-term capital gains rates are not tied to specific tax brackets, rather based on certain income levels.

Another consideration is the fund portfolio turnover rate, as the portfolio also generates income through the sale of securities. Thus higher portfolio turnover rates that generate capital gains can add to shareholders' tax bills. The investment manager may sell certain securities to avoid short-term capital gains (which are taxed at ordinary individual rates) and use other strategies to minimize the tax consequences for shareholders.

Managing Mutual Fund Taxation

Investors need to understand the tax consequences of investing in mutual funds when developing a comprehensive investment strategy. Investors can gravitate towards funds with a lower expected tax burden, but this creates fundamental limitations, particularly within certain sectors and actively managed strategies.

However, investors don't need to avoid particular mutual funds out of concern for unexpected and unpredictable tax bills. Funds that have higher annual distributions, whether because of the underlying investments or high turnover, can reside within a tax-deferred account or product such as a variable annuity.

THE STEALTH TAX HIDDEN IN MUNICIPAL BOND FUNDS

Municipal bonds, and mutual funds that invest primarily in these bonds, are one way for investors to reduce their current federal income taxes. However, investors should be aware that some municipal bonds pay interest that is subject to the federal alternative minimum tax (AMT¹).

Municipal bonds are generally free from regular federal income taxes. They generally are free from state or local taxes as well, for investors who live in the same state as the issuer, but under certain circumstances, they can be taxable. For example, private activity bonds are a type of municipal bond used to fund private projects that have public benefit, such as utilities and mass transportation facilities. These bonds may be subject to the AMT.

1. The AMT was designed to prevent certain high income taxpayers from avoiding tax liability through certain deductions and tax preference items. Read more: Alternative Minimum Tax (AMT) <https://www.investopedia.com/terms/a/alternativeminimumtax.asp#ixzz50W9zbUvW>.

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