TD Mutual Funds

# Distributions Demystified

## What you need to know about mutual fund distributions

While the basic structure of mutual funds is widely understood, some people still struggle with the concept of mutual fund distributions. It's important, however, to understand what mutual fund distributions are, why they exist and how they're calculated. Meeting with your financial advisor to go through what mutual fund distributions might mean to you can be an important part of your overall financial plan and has the added bonus of helping you minimize any tax implications that may be associated with your investments.

A mutual fund is essentially a basket of individual investments, such as stocks and bonds. If you purchased all the individual securities within a particular mutual fund you would have to pay taxes every year on interest and dividends generated by those investments. In addition, taxes on capital gains would be due on investments that had increased in value since their purchase and that were sold at any point during the year. (Interest, dividends and capital gains generated on investments held inside a registered account, such as an RSP, are tax-deferred.)

Mutual funds are subject to many of the same tax rules as individuals. However, the net investment income earned by a mutual fund is passed on to individual investors through what's known as a "mutual fund distribution." That way, investors are taxed on this income in their own hands, rather than it being taxed in the mutual fund.

So, distributions benefit both mutual funds (by eliminating taxes due on investment income) and investors (who don't see their funds' assets decrease in order to pay those taxes).

It's important to note that the payment of distributions should not be confused with a fund's performance, yield or rate of return.

### How distributions are calculated

Mutual fund distributions are allocated to unitholders in proportion to the number of units they hold on a specific date, known as the "record date." For example, if you held 200 mutual fund units on the record date and the distribution was $0.50 per unit, you would receive a taxable distribution of $100.

One aspect of distributions that can sometimes confuse people is that they can receive and pay tax on distributions even if their fund's net asset value (NAV) declined during the year. This is because the NAV of a mutual fund includes both realized and unrealized gains and losses, whereas the distribution is comprised of only realized taxable income and gains.

Also potentially confusing is that while the calculation of mutual fund distributions is independent of a mutual fund's NAV, distributions do have an after-the-fact effect on the NAV since it always decreases by the amount of the distribution.

### Tax Slips

Investors receive either a T3 or T5 slip reporting the income generated by investments within a mutual fund, depending on whether they hold units of a mutual fund trust or mutual fund corporation. They do not receive a tax slip if they hold mutual fund units in a registered account, such as an RSP, RIF, RESP or TFSA. For more information on how to report your investment income, speak to your financial advisor.

Let's take a closer look at a simple "before and after" example of a general mutual fund distribution:

***Fund's position before distribution***

Current market value of the individual securities held within the fund: $10,000.00
Current cash balance within the fund: $350.00
Total fund assets: $10,350.00
Number of fund units: 1,000
Net asset value (NAV) per unit: $10.35

In this example, we assume that the mutual fund sold a particular stock, and there is a realized capital gain of $350.00. This gain is taxable and, to avoid paying the tax itself, the fund makes a distribution of $350 to its unitholders ($0.35 per unit). The unitholders are now responsible for paying the taxes due on this amount.

Now let's examine what happens within the fund after the distribution:

***Fund's position after distribution***

Current market value of the individual securities held within the fund: $10,000.00
Current cash balance within the fund: $0.00
Total fund assets: $10,000.00
Number of fund units: 1,000
Net asset value (NAV) per unit: $10.00

Note that the total assets within the mutual fund declined after the distribution by the amount of the distribution. Accordingly, the NAV per unit also declined.

Now that we've examined the effects of a distribution on the mutual fund itself, let's see how the distribution would affect you if you held a position in the fund. Consider what would happen if you held 100 units of the mutual fund described above.

**Mutual fund units held:** 100
**Mutual fund NAV per unit:** $10.35
**Investment in mutual fund:** $1,035.00
**Cash:** $0.00
**Overall position:** $1,035.00

You would now have an important decision to make: either take the distribution as cash or reinvest it to buy additional units of the fund. Reinvesting is the more popular choice when it comes to mutual fund distributions and most mutual funds offer an automatic reinvestment option to help simplify the process.

Here's what would happen if you chose to take the distribution as cash:

**Mutual fund units held:** 100
**Mutual fund NAV per unit:** $10.00
**Investment in mutual fund:** $1,000.00
**Cash:** $35.00
**Overall position:** $1,035.00

Even though the NAV per unit dropped from $10.35 to $10.00, your overall position would remain the same. Assuming the fund units are held in a non-registered account, you would pay tax on the $35.00 received as a distribution. The amount of tax due would depend on the nature of the distribution (interest, dividends, capital gains or return of capital) as well as your marginal tax rate.

Here's what would happen if you chose to reinvest the distribution:

**Mutual fund units held:** 103.5
**Mutual fund NAV per unit:** $10.00
**Investment in mutual fund:** $1,035.00
**Cash:** $0.00
**Overall position:** $1,035.00

In this case the $35.00 distribution would be used to buy more fund units. Since this transaction occurs immediately after the distribution, the fund units would cost $10.00 each at the time of purchase. You would therefore purchase an additional 3.5 mutual fund units, increasing your position in the fund from 100 to 103.5 units. It's important to remember that the $35.00 that is reinvested would still be taxable in your hands—here's where it becomes very important to work with your financial advisor to help keep track of the adjusted cost base (ACB) of those units to avoid being taxed again later when you ultimately sell your holdings in the mutual fund.

Understanding mutual fund distributions can be an important part of mutual fund investing. Discussing mutual fund distributions with your financial advisor can also help ensure your investments are tax-effective as many financial advisors have access to tax experts who can help you plan for the tax implications mutual fund distributions can present.

## Bottom Line

The impact mutual fund distributions can have on an investor's personal tax situation can be complex. Some important things to note:

- Mutual funds are subject to many of the same tax rules as individual investors; they distribute net investment income to investors to keep from paying tax at the highest rate.
- Mutual fund distributions in non-registered accounts are taxed in the hands of the fund's investors but do have an affect on the net asset value (NAV) per unit.
- There are different effects that can result from taking a distribution as cash versus reinvesting it in additional units of the fund.

**For more information, talk to your Financial Advisor today.**