Investing Essentials:

Demystifying Distributions

Mutual funds are widely known for providing investors many benefits, including diversification, professional money management, affordability, and convenience. While a popular investment choice for Canadians, the income mutual funds produce in the form of distributions is often much less understood. In this article, we define and demystify mutual fund trust* distributions and how they impact your mutual fund investments.

Distributions 101

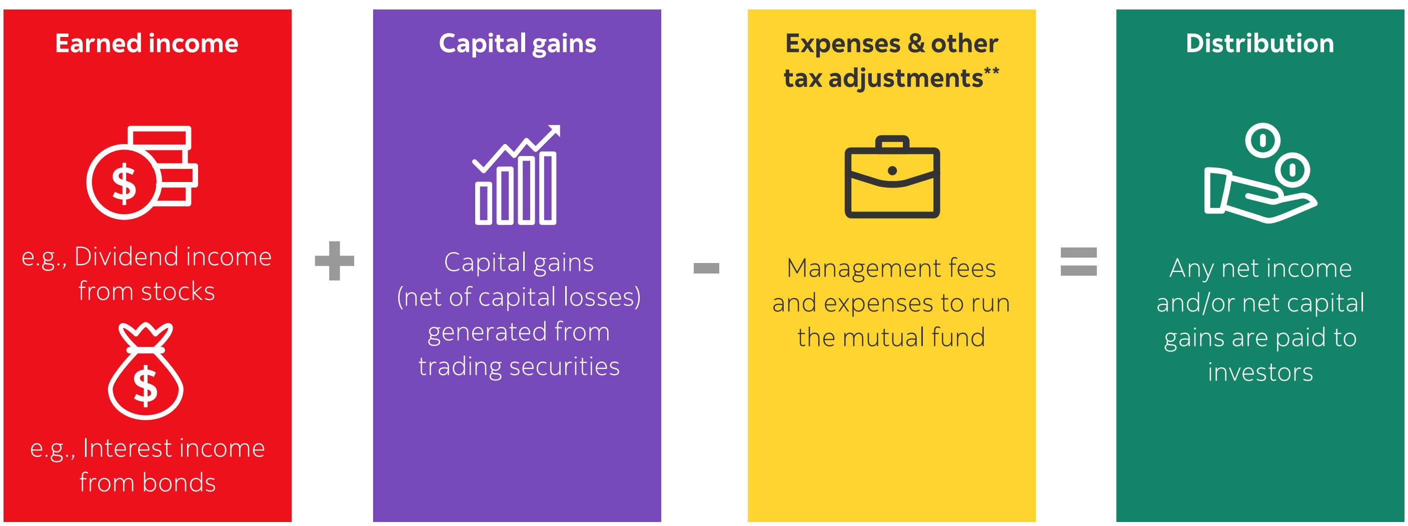
In the broadest terms, a **mutual fund distribution** represents the earnings generated by the investments held in the fund and are subject to taxation. Since earnings retained by a mutual fund would be subject to the highest marginal tax rate within the fund, they are passed on to investors in the form of a distribution to be taxed at their own – often lower – marginal tax rate. Reducing the amount of tax paid by the fund can improve overall investment returns. Importantly, distributions received in a registered account, such as a Registered Retirement Savings Plan (RRSP) or Tax-Free Savings Plan (TFSA), are not subject to taxation.

What's in a distribution?

Generally speaking, there are **two ways** a fund can generate a taxable distribution. The **first** results from any earned income from the investments that the fund holds – such as coupon payments from bonds or dividend payments from stocks.

The **second** is when investments are traded within the fund. If an investment is sold at a profit, a capital gain is realized. Likewise, if an investment is sold for less than the cost, a capital loss is realized. The fund is required to distribute any net capital gains to investors by the end of the calendar year. **Figure 1** below illustrates how a mutual fund trust generates different types of income, which is then distributed to investors.

Figure 1: Mutual fund trust distributions



For illustration purpose only

* This article only covers mutual fund trusts. Different rules apply to corporate class mutual funds.

**Mutual fund trusts are entitled to certain tax credits that may be available to reduce income and capital gains distributions.

Did you know?

Investors are generally required to include distributions in their taxable income for the year, regardless of whether they receive the distributions in cash or as a reinvestment for additional units of the fund, unless the distributions were received inside a registered plan such as an RRSP or a TFSA. The amount of tax owing would depend on the type of income that was included in such taxable distribution (see **Table 1**).

Distributions quick facts

Are distributions fixed?
Some funds offer set distribution amounts (usually monthly or quarterly) based on a target distribution yield. These fixed distributions are not guaranteed and may be subject to change at the discretion of the fund manager. If a fund earns net income and net capital gains exceeding the total fixed distribution amount for the year, the fund will be required to distribute the excess by the end of the calendar year, usually in late December. On the other hand, if a fund paid total fixed distribution in excess of the fund's net income and net capital gains for the year, the excess distribution is treated as a return of capital (ROC).

How often are distributions made?
The frequency of a distribution varies by fund and can be paid monthly, quarterly, or annually. These distribution frequencies are usually stipulated in the distribution policy within the fund's offering document.

How are they allocated to units held?
Net income and/or net capital gains are distributed on a per-unit basis. Investors holding a certain number of units on the distribution record date will receive a distribution amount equal to the proportionate number of units held.

How are they paid?
While distributions can be paid in **cash**, they are more commonly **reinvested** in additional units of the fund. At Scotiabank, distributions are automatically reinvested unless you instruct otherwise.

Are distributions the same as fund performance?
A fund's distribution and the taxable component of such distribution are influenced by a variety of factors, including the amount of dividend and interest income received, realized gains or losses on investments sold during the year, the level of purchases and redemptions, and tax adjustments applicable to the fund. As such, a fund's distribution should not be confused with the total return or performance of the fund.

Types of distributions and tax treatment

Not all distributions are taxed equally. **Table 1** outlines the different types of mutual fund distributions and their tax treatment outside of registered accounts.

Table 1

Type of Distribution	Description	Tax treatment
Interest and other income	Interest income earned by the fund from fixed income securities such as bonds, and other money market instruments. Other income also includes income from certain derivatives.	Fully taxed at the unitholder's marginal tax rate.
Foreign source income	Income earned by the fund from non-Canadian sources, such as dividends or interest from foreign investments.	Fully taxed at the unitholder's marginal tax rate. Investors may be entitled to foreign tax credits with respect to related foreign withholding taxes.
Canadian dividends	Dividends represent a distribution of a company's earnings to shareholders. A fund receives dividend income when it invests in shares of publicly traded Canadian companies that pay dividends.	The dividend income received from a taxable Canadian corporation is taxed at a preferential rate after taking into consideration the dividend gross-up and applicable federal and provincial tax credits.
Capital gains	Capital gain is generated when a fund's investment is sold for more than it was purchased for.	Currently, 50% of realized capital gains are taxed at the investor's marginal tax rate.
Return of capital (ROC)	Many mutual funds offer a fixed distribution amount to be paid out of the fund on a periodic basis, such as monthly or quarterly. When this fixed distribution amount exceeds the total net income and net capital gains of the fund, the excess component of the distribution is considered a return of capital (ROC). For tax purposes, a ROC distribution represents a **return of a portion of your own** invested capital.	Generally, it is not taxable when received. ROC reduces the cost base of the investor's investment in the fund, resulting in an increase in capital gain or decrease in capital loss when the investor disposes of the investment.

Did you know?

Record Date: The date on which the fund determines the eligible units that will receive the distribution from the fund.

Distribution Date: The date on which a mutual fund pays out the distribution amount to investors as cash or reinvests them in additional units of the fund.

Net Asset Value (NAV)

Net Asset Value (NAV) per unit represents the mutual fund's assets less its liabilities divided by the number of units outstanding and will change due to fluctuations of the market value of the mutual fund's investments. A fund's NAV is generally calculated daily using the price of the securities in the mutual fund at the market close.

Impact of distributions on Net Asset Value

A distribution can impact a mutual fund in different ways. As investments in a fund earn income, dividends or increase in value, the daily price – also known as net asset value (NAV) per unit – will increase. When a distribution is made, the fund's price will go down because the fund now holds fewer assets after the distribution. The reduction in NAV is equivalent to the amount of the distribution (without accounting for any market fluctuation).

Consider the following example. If an investor held 100 units of a mutual fund in a non-registered investment account on the record date and the distribution was $0.30/unit, they would receive a taxable distribution of $30. The amount of tax owing would depend on the type of taxable distribution received (refer to **Table 1**). The impact to the fund value is illustrated in **Figure 2**.

Figure 2: Distribution payout scenarios:

Option 1 – receiving the distribution as cash or Option 2 – reinvesting it into additional units of the fund. To illustrate the impact of the distribution, we have assumed that there are no market fluctuations.

Option 1: Distribution received as cash

Value of your investment **before** distribution	100 units	X	$10	=	$1,000
Distribution	100 units	X	$0.30	=	$30
Impact of distribution on NAV per unit	$10	-	$0.30	=	$9.70
Post distribution value	100 units	X	$9.70	=	$970
Total cash received plus value of your investment **after** distribution	$30 **Cash distribution paid to you**	+	$970 **Post-distribution value of your investment**		

Option 2: Distribution reinvested on your behalf to buy new units

Value of your investment **before** distribution	100 units	X	$10	=	$1,000
Distribution	100 units	X	$0.30	=	$30
Impact of distribution on NAV per unit	$10	-	$0.30	=	$9.70
The distribution is reinvested to purchase **new units**	$30	÷	$9.70	=	3.09 units
Total value of your investment **after** distribution	103.09 units **You have more units as a result of reinvested distribution**	X	$9.70	=	$1,000 **Total portfolio value**

Consider this: purchasing mutual funds close to year-end

Purchasing a mutual fund in a non-registered account before it pays an annual distribution could trigger an unwelcome tax bill. While the exact timing of year-end distributions depends on the fund company, most occur in December. Consider speaking to a Scotiabank advisor about the best approach for you.

Distributions and adjusted cost base (ACB)

Figure 3: ACB calculation

Adjusted cost base (ACB)	=	**Total amount paid** for all your units of the fund	+	**Distributions reinvested** in additional units of the fund	-	**Return of capital (ROC)** component of distributions received (in cash or reinvested)	-	**ACB** of any units you have **previously sold**

The adjusted cost base (ACB) is the total cost paid for all of the mutual fund units owned plus or minus certain adjustments as illustrated in **Figure 3**. The ACB is compared with the sale price to determine if a capital gain or capital loss is realized when you sell the mutual fund units.

Distributions paid in cash and distributions that are reinvested in additional units of the fund have different impacts on the ACB (see **Table 2**).

Table 2: The impact of distributions on fund value and ACB.

Distribution option	Impact on Fund value	Impact on ACB
Cash distribution	Unit price decreases by the amount of the distribution and the total fund value decreases. (as shown in option 1 of **Figure 2**)	No impact on ACB unless the distribution consists of ROC, which will reduce the ACB by the ROC amount.
Reinvested distribution	Unit price decreases by the amount of the distribution; however, since the distribution is reinvested, the total fund value does not change. (as shown in option 2 of **Figure 2**)	The total ACB increases by the reinvestment distribution amount less any ROC component of such distribution.

The bottom line: Understanding distributions, their benefits and tax implications are key to tax-efficient investing when holding mutual funds in a non-registered account. Since each individual investor has specific tax circumstances, it's always wise to seek professional investment and tax advice to help you achieve your long-term investment goals.

Contact your Scotiabank advisor to learn more about mutual funds and to develop a plan that takes your unique income needs into consideration.

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Investors holding funds in a non-registered account should be aware that distributions are taxable. The amount and the tax characteristics of distributions made to non-registered accounts will be reported on tax slips that will be sent to investors. Distributions made to registered accounts such as an RSP or RIF are not taxable.

Target distributions are not guaranteed and may change at any time at the discretion of the fund's Manager. If distributions paid by the fund are greater than the net income and net capital gains of the fund, distributions paid may include a return of capital. A return of capital is not taxable to the investor but will generally reduce the adjusted cost base of the securities held for tax purposes. If the adjusted cost base falls below zero, investors will realize capital gains equal to the amount below zero. Distributions are automatically reinvested unless an investor elects to receive them in cash. Investors should not confuse a fund's distribution rate with its performance, rate of return or yield. Distributions may consist of net income, and/or dividends, and/or net realized capital gains and are taxable in the hands of the investor. Target monthly distributions are determined based on the target payout rate for the indicated series of the fund. Monthly distributions are made by the last business day of each month, or the last business day of each calendar quarter for quarterly paying fund series, other than in December. The final distribution in respect of each taxation year will be paid or payable by December 31 of each year or at such other times as may be determined by the fund's Manager.

Commissions, trailing commissions, management fees and expenses may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed or insured by the Canada Deposit Insurance Corporation or any other government deposit insurer, their values change frequently, and past performance may not be repeated.

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