

How do mutual fund distributions work?

This guide will help provide you with an understanding of different types of mutual fund distributions and how they can impact investments.

Distributions paid by mutual funds represent earnings generated by different types of investments held in the fund. As these investments earn income or are sold by the fund, the earnings are distributed in various ways. Depending on the source of the earnings, mutual fund distributions can have different tax implications and should be clearly understood for efficient tax planning.

Contents

Fundamentals of Distributions	2
Types of Distributions	3
Impact of Distributions	5
ROC Distributions	11
Corporate Class Funds	13
Other Considerations	14

Distribution Fundamentals

Q: What is a distribution?

A mutual fund distribution represents the earnings of a fund being passed on to the individual investor or unitholder of the fund.

Q: How often are distributions made?

The frequency varies by the specific fund – distributions can be paid monthly, quarterly or annually.

Q: Why do mutual funds make distributions?

Earnings retained by a mutual fund are generally subject to tax at the highest marginal rate. Distributions received by individual investors are taxed at their own marginal tax rates, which may be lower than the rate applicable to the fund.

Q: How are distributions calculated?

Distributions are allocated to unitholders in proportion to the number of units they hold on a specific date, known as the “record date”.

Example: If you held 100 mutual fund units on the record date, and the distribution was \$0.50 per unit, you would receive a taxable distribution of \$50.

Q: Are distributions made for a set amount?

While some mutual funds have a target or fixed distribution, the sustainability of the fixed distribution is based on market performance. As a result, a fund may change the distribution amount without notice.

Note

The different types of distributions that are discussed in this guide include interest income, Canadian dividend income, capital gains, return of capital and foreign income.

Fundame

Types of Distributions

Type of distribution	Definition	Taxation	Mutual fund type
Interest Income	Occurs when the fund earns income on debt securities (e.g. treasury bills and bonds).	<ul style="list-style-type: none"> Fully taxable at the same marginal tax rate as ordinary income Reported on your T3 tax slip (Relevé 16 in Quebec) 	<ul style="list-style-type: none"> Fixed Income Balanced Funds Fund of Funds TD Cash Flow Series TD Monthly Fixed Pay Solutions
Canadian Dividend Income	Received when a fund invests in shares of companies that pay dividends.	<ul style="list-style-type: none"> Generally eligible for federal and provincial tax credits Tax rates vary by province Reported on your T3 tax slip (Relevé 16 in Quebec) 	<ul style="list-style-type: none"> Canadian Equities Balanced Funds Fund of Funds TD Cash Flow Series TD Monthly Fixed Pay Solutions
Capital Gains	Generated when the trading activity within a fund results in an overall gain.	<ul style="list-style-type: none"> Only 50% of the capital gain is taxable to unitholders Reported on your T3 tax slip (Relevé 16 in Quebec) 	<ul style="list-style-type: none"> Canadian Equities U.S. Equities Emerging Markets Equities Balanced Funds Fund of Funds TD Cash Flow Series TD Monthly Fixed Pay Solutions
Foreign Non-business Income	Occurs when the fund receives dividends, interest or other types of distributions from foreign investments.	<ul style="list-style-type: none"> Fully taxable at the same marginal tax rate as ordinary income Reported on your T3 tax slip (Relevé 16 in Quebec) 	<ul style="list-style-type: none"> U.S. Equities Emerging Markets Equities Balanced Funds Fund of Funds TD Cash Flow Series TD Monthly Fixed Pay Solutions
Return of Capital (ROC)	Generated when an investor's original investment amount, or capital, being returned to them by a mutual fund. Typically occurs when the fund's objective is to generate regular monthly or quarterly distributions.	<ul style="list-style-type: none"> Not taxable since it's a return of investor's own invested capital (which has already been subject to taxation). Reduces the ACB of the fund which typically results in bigger capital gain (or smaller capital loss) when the units are sold. 	<ul style="list-style-type: none"> TD Cash Flow Series TD Monthly Fixed Pay Solutions

Types of Distributions

How Different Distributions are Taxed:

The example below shows the after-tax value of \$100 for the different types of mutual fund distributions:

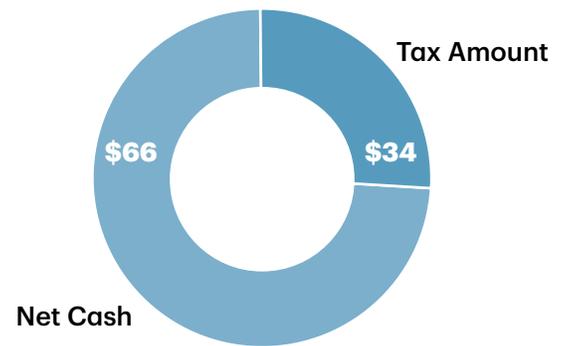
Interest

Interest is fully taxable at the investor's marginal tax rate.



Dividends

Dividend tax rates can range, depending on your income.



Capital Gains

Capital gains only tax at half your regular tax rate.



Return of Capital

Non-taxable - Return of Capital is your own money coming back to you.



*Example shown for illustrative purposes only. Tax rate assumptions (Ontario): 49.53% marginal income tax rate; 33.82% dividend income marginal tax rate; 24.77% capital gains marginal tax rate. Percentages have been rounded. As long as the adjusted cost base of the investment is greater than zero. Capital gains taxes may be payable when the units of a fund are sold or to some extent when their adjusted cost base goes below zero. Return of capital (ROC) distributions do not constitute part of a fund's rate of return or yield. ROC reduces the adjusted cost base of the units to which it relates. ROC is not considered taxable income as long as the adjusted cost base of the investment is greater than zero. Capital gains taxes that may be deferred when ROC distributions are received, will be payable when the units of the fund are sold or when their adjusted cost base goes below zero.

Impact of Distributions

How Distributions Impact Mutual Funds:

When a mutual fund pays a distribution, it can impact the **Net Asset Value**, your **Adjusted Cost Base** and **Book Value** of your holdings.

Net Asset Value (NAV) represents the price of a mutual fund.

- The NAV per share denotes the mutual fund's assets, less its liabilities and will change due to market value fluctuations
- A fund's NAV is calculated daily using the price of the securities in the mutual fund at the market close
- Distributions can affect the NAV price during the year, as interest, dividend income and capital gains are accumulated in the fund, the NAV will increase. If a distribution is made, the NAV per unit drops as the fund holds fewer assets after the distribution.

Adjusted Cost Base is the average price paid for the units you own. ACB is used to calculate whether you have a capital gain or loss when selling a mutual fund.

Book Value is the amount you paid for your investments.

Note: Registered Plans

Taxable income in a Registered Plan, such as a Retirement Savings Plan (RRSP) or a Tax-Free Savings Account (TFSA) is treated differently.

An RRSP defers the tax payable on investment income for as long as the funds remain in the RRSP. Investment income in a TFSA is tax free.

Reinvested distributions do not count as contributions and therefore do not affect the contribution room for either account type.

Distributions

Impact of Distributions

Distribution Options: Cash or Reinvest

Earned income or realized capital gains may trigger a fund to pay a distribution. When your fund pays a distribution, you can choose to receive it two ways – **in cash** or as **reinvested units**. The following example explains how your holdings are impacted depending on which distribution option you choose.



After your initial purchase, the fund earned income which increased the NAV to \$11/unit and your market value (MV) rose to \$1,100.
($\$11/\text{unit} \times 100 \text{ units} = \$1,100 \text{ MV}$)

Earned income triggers the fund to pay a distribution of \$50.

Option 1: Cash

\$50 Distribution Paid in Cash
 $100 \text{ units} \times \$0.50/\text{unit} = \$50$

NAV Decreases with Distribution
 $\$11/\text{unit} - \$0.50 \text{ distribution} = \$10.50/\text{unit}$

New MV is \$1,050
 $100 \text{ units} \times \$10.50/\text{unit} = \$1,050$

Option 2: Reinvest

\$50 Distribution is Calculated
 $100 \text{ units} \times \$0.50/\text{unit} = \$50$

NAV Decreases with Distribution
 $\$11/\text{unit} - \$0.50 \text{ distribution} = \$10.50/\text{unit}$

\$50 Distribution is Reinvested at New NAV \$10.50
 $\$50 / \$10.50 = 4.7619 \text{ units}$

Units Increase
 $\$50 \text{ distribution} / \$10.50 \text{ NAV} = 4.7619 \text{ units}$
Total Units = $100 + 4.7619 = 104.7619$

New MV is \$1,100
 $104.7619 \text{ units} \times \$10.50/\text{unit} = \$1,100 \text{ MV}$

Impact of Distributions

How Distributions Affect Your Book Value:

- Book value is the amount you paid for your investments, while market value is the amount your investments are worth on a given day
- The market value of your portfolio fluctuates due to changes in the NAV of your mutual fund(s)
- Reinvested distributions are treated as new purchases and therefore impact your book value
- Cash distributions do not affect your book value

Book Value Calculation

Initial purchase

Distributions are set up to be reinvested:

$$\text{\$10/unit} \times 100 = \text{\$1,000}$$

100 units purchased at \$10/unit

Follow-up purchase:

$$\text{\$12/unit} \times 100 = \text{\$1,200}$$

100 units purchased at \$12/unit

Reinvested distribution:

$$200 \text{ units} \times \text{\$0.50} = \text{\$100.00}$$

Fund distributes \$0.50/unit each year

New book value:

$$\text{\$1,000} + \text{\$1,200} + \text{\$100} = \text{\$2,300}$$

For illustrative purposes only.

Note

Book value and market value cannot be used to calculate performance. Instead, you need to compare the amount invested with the current market value. Here's how:

- **Market value of investment = \$1,100**

- **Amount invested = \$1,000**

$$\begin{aligned} &= \text{[(Current market value - Amount invested)/Amount Invested]} \times 100 \\ &= \text{[(\$1,100 - \$1,000) / \$1,000]} \times 100 \\ &= \text{(\$100/ \$1000)} \times 100 \\ &= 0.1 \times 100 \end{aligned}$$

- **Fund Performance = 10.00%**

Impact of Distributions

What happens when your book value is higher than your market value after a distribution?

If there is market volatility close to the time a distribution is issued, it is possible that the market value of your investments may be lower than your book value, even after the distribution.

It's important to remember that, just like a capital gain, a capital loss is not realized until you redeem your units.

Adjusted Cost Base and Distributions:

What is Adjusted Cost Base (ACB)?

- Average price paid for the units you own
- Used to calculate whether you have a capital gain or loss when selling a mutual fund

ACB Calculation

Initial purchase

Distributions are set up to be reinvested:

$$\text{\$10/unit} \times 100 = \text{\$1,000}$$

100 units purchased at \$10/unit

Follow-up purchase:

$$\text{\$12/unit} \times 100 = \text{\$1,200}$$

100 units purchased at \$12/unit

ABC:

Total Investment / Number units = ACB

$$\text{\$2200/200 units} = \text{\$11.00/unit}$$

Per unit capital gain from sale:

NAV at time of sale was \$15/unit

$$\text{\$15/unit} - \text{\$11/unit} = \text{\$4.00/unit}$$

200 units sold at \$15/unit

Total capital gain from sale:

$$\text{\$4/unit} \times 200 \text{ units} = \text{\$800.00}$$

For illustrative purposes only.

Impact of Distributions

How Distributions Affect Your ACB:

- **Cash distribution:** no impact to your ACB
- **Reinvested distribution:** your ACB will increase

ACB with Reinvested Distributions

Purchase

Distributions are set up to be reinvested:

$$\text{\$10/unit} \times 100 = \text{\$1,000}$$

100 units purchased at \\$10/unit

Follow-up purchase:

$$\text{\$12/unit} \times 100 = \text{\$1,200}$$

100 units purchased at \\$12/unit

Re-invested distribution:

$$\text{\$100/\$10.50} = 9.5238$$

\\$100 distribution at \\$10.50/unit NAV added 9.5238 units.

ACB:

Total Investment / Number units = ACB

$$(\text{\$2200} + \text{\$100}) / 209.5238 \text{ units} = \text{\$10.98/Unit}$$

Per unit capital gain from sale:

NAV at time of sale was \\$15/unit

$$\text{\$15/unit} - \text{\$10.98/unit} = \text{\$4.02/unit}$$

209.5238 units sold at \\$15/unit

Total capital gain from sale:

$$\text{\$4.02/unit} \times 209.5238 \text{ units} = \text{\$842.29}$$

For illustrative purposes only.

Capital Gains

Impact of Distributions

Purchasing a Mutual Fund Close to Year-End:

The NAV of a mutual fund will increase as income and/or net realized capital gains are earned and accumulated in the fund but not yet distributed.

If you buy units of a mutual fund just before it makes a distribution, you will receive and be liable for tax on that distribution, even though the value of the distribution was reflected in the unit price you paid for the fund.

Need Advice?

It's best to speak to your investment professional if you plan on buying a mutual fund near year-end. It may be wise to wait until a distribution has been made before investing.

Year-End Purchase Example:

A TD Fund has an upcoming capital gain distribution of 5% on December 10th.

Option 1: Pre-Distribution Purchase

\$1,000 Purchase - December 9th
100 units purchased at \$10/unit

\$50 Reinvested Distribution - December 10th
NAV/unit reduces to \$9.50
(New units purchased = $\$50/\$9.50 = 5.26$)

Option 2: Post-Distribution Purchase

\$1,000 Purchase - December 11th
105.26 units purchased at \$9.50/unit

Final Portfolio Value

105.26
Total Unit Holdings

\$1,000
Total Value

\$50
Taxable Income

-\$50
Unrealized Capital Gain

105.26
Total Unit Holdings

\$1,000
Total Value

\$0
Taxable Income

\$0
Unrealized Capital Gain

Return of Capital Distributions

ROC Distributions:

ROC distributions are slightly more complicated. This type of distribution typically occurs when the fund's objective is to generate regular distributions.

Q: What is ROC?

As we have discussed, ROC is a part of the original investment amount or capital being returned to you by a mutual fund.

Q: ROC and ACB?

ROC distributions are not part of a fund's rate of return or yield, but instead reduce the ACB of your investments. This may impact the capital gains (or losses) realized when you eventually sell your investments.

Q: ROC and taxes?

Unlike other types of distributions, such as interest income or dividends, ROC is not taxable when received because it's your own money coming back to you.

Note

Your ACB can be reduced to zero, which occurs when you've been given back all the money invested in a fund through the ROC distributions received. If you continue to receive ROC distributions on the units you hold once your ACB is zero dollars, these will be taxed as capital gains.

Benefits of ROC Distributions:

Monthly cash flow

Since a fund that pays ROC aims to provide you with a regular cash flow, you'll know what income to expect which may allow you to plan ahead.

Simplified tax reporting

Details of all ROC distributions are conveniently provided on your year-end tax slip. This simplifies your tax reporting, unlike Systematic Withdrawal Plan transactions where you must calculate taxable capital gains or losses for each redemption.

Tax efficiency

Generally, ROC is not taxable in the year received (unless your ACB is reduced below zero). Unlike interest, dividends and capital gains, ROC allows you to defer capital gains tax until you sell your investment. This flexibility can help you determine the best time to sell your investment according to your personal situation. For example, being in a lower tax bracket when selling your units could impact the tax rate applicable on all income, including realized capital gains.

Return of Capital Distributions

Benefits of ROC Distributions:

Potential to minimize government clawbacks

Generally, ROC distributions increase your monthly cash flow without increasing your taxable income. That means eligibility for government programs such as Old Age Security, the Guaranteed Income Supplement, spousal tax credits and medical expense credits are not affected.

Growth potential

Even though part of your original investment is being returned to you each month, your investment can grow, provided the return earned by the fund is higher than the amount distributed.

ACB and ROC

Current ACB

$$\text{\$1000} / \text{100 units} = \text{\$10/ unit ACB}$$

\\$1000 invested and 100 units are owned

Re-invested distribution:

$$\text{100 units} \times \text{\$0.50} = \text{\$50.00}$$

\\$0.50/unit yearly distribution

Re-invested distribution:

$$\text{\$50} / \text{\$10.50} = \text{4.7619}$$

\\$50 distribution at \\$10.50/unit NAV added 4.7619 units.

ACB after ROC Distribution:

Original ACB must be reduced by the amount of ROC received

$$\text{\$10.00} - \text{\$0.10} = \text{\$9.90/unit ACB}$$

\\$0.40/unit is interest income

\\$0.10/unit is ROC

Per unit capital gain from sale:

$$\text{\$15/unit} - \text{\$9.90/unit} = \text{\$5.10/unit}$$

For illustrative purposes only.

Return of

Corporate Class Fund Distributions

Corporate Class Funds

Corporate Class funds are structured differently than mutual funds. In this section we will explore the differences and how they can affect the distributions you receive.

Q: What is the difference between a mutual fund trust and a corporate class fund?

A mutual fund trust is a single legal entity where interest, dividends and capital gains earned in the fund are paid to you.

Corporate Class mutual funds are structured in the form of a mutual fund corporation. This corporation may consist of different mutual funds called 'classes' and often holds the same type of investments as mutual fund trusts. For example, Class A may be a Canadian fixed income fund; Class B, a U.S. balanced fund; Class C, an international equity fund.

These funds may offset income and expenses at the corporate level, which can potentially offset distributions of the mutual fund corporation.

Q: How corporate class funds distribute to investors?

Since interest and foreign income earned inside of a mutual fund corporation are taxable inside the corporate structure, these funds cannot distribute interest or other income to you. However, mutual fund corporations can distribute income as either capital gain dividends or eligible Canadian dividends. Distributions from corporate class funds are reported on a T5 tax slip or Relevé 3 in Quebec.

Note

As of January 2017, switching between classes within a mutual fund corporation is considered a taxable transaction.

Corporate

Other Considerations

Distributions - Other considerations

- Funds may distribute income and issue a tax slip even if its return for the year is negative. This is similar to a stock or bond that pays dividends or interest when its market value has declined.
- Distributions received in your non-registered investments are taxable and will be reported on your T3 or T5 tax slip, whether you receive them in cash or reinvest them in additional units of the fund
- Unless you advise us otherwise, distributions on TD Funds are automatically reinvested in additional units

Summary

There are several types of mutual fund distributions, each of which may be taxed differently. Understanding what distributions are, the unique characteristics of each type and how they are taxed can help inform your investment decisions and contribute to your ability to reach your financial goals.

For more information about distributions and the taxation of distributions, please speak to your Financial Planner or Advisor or a qualified tax specialist.



The information contained herein has been provided by TD Asset Management Inc. and is for information purposes only. The information has been drawn from sources believed to be reliable. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the fund facts and prospectus, which contain detailed investment information, before investing. Mutual funds are not guaranteed or insured, their values change frequently, and past performance may not be repeated. A return of capital (ROC) distribution reduces your adjusted cost base. This could lead to a higher capital gain or a smaller capital loss when the investment is eventually sold. If your adjusted cost base goes below zero you will have to pay capital gains tax on the amount below zero. The payment of ROC distributions should not be confused with a fund's performance, rate of return or yield. TD Asset Management Inc. is a wholly-owned subsidiary of The Toronto-Dominion Bank. All trademarks are the property of their respective owners. © The TD logo and other trade-marks are the property of The Toronto-Dominion Bank