



# 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

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# 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

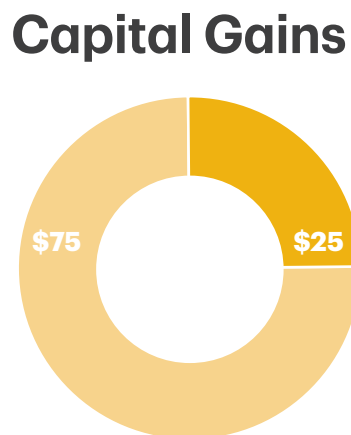
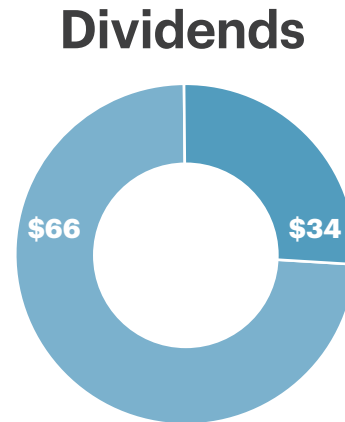
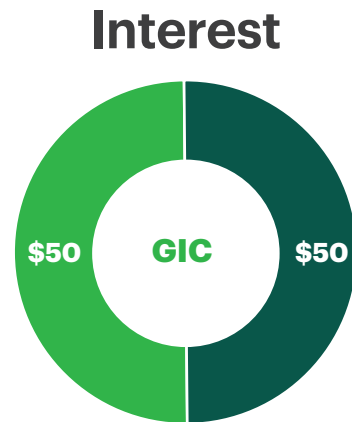
## What are the different types of distributions?

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"> <li>Fully taxable at the same marginal tax rate as ordinary income</li> <li>Reported on your T3 tax slip (Relevé 16 in Quebec)</li> </ul>	<ul style="list-style-type: none"> <li>Fixed Income</li> <li>Balanced Funds</li> <li>Fund of Funds</li> <li>TD Cash Flow Series</li> <li>TD Monthly Fixed Pay Solutions</li> </ul>
Canadian dividend income	Received when a fund invests in shares of public companies that pay dividends.	<ul style="list-style-type: none"> <li>Generally eligible for federal and provincial tax credits</li> <li>Tax rates vary by province</li> <li>Reported on your T3 tax slip (Relevé 16 in Quebec)</li> </ul>	<ul style="list-style-type: none"> <li>Canadian equities</li> <li>Balanced Funds</li> <li>Fund of Funds</li> <li>TD Cash Flow Series</li> <li>TD Monthly Fixed Pay Solutions</li> </ul>
Capital Gains	Generated when the trading activity within a fund results in an overall gain.	<ul style="list-style-type: none"> <li>Only 50% of the capital gain is taxable to unitholders</li> <li>Reported on your T3 tax slip (Relevé 16 in Quebec)</li> </ul>	<ul style="list-style-type: none"> <li>Canadian equities</li> <li>U.S. Equities</li> <li>Emerging Markets Equities</li> <li>Balanced Funds</li> <li>Fund of Funds</li> <li>TD Cash Flow Series</li> <li>TD Monthly Fixed Pay Solutions</li> </ul>
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"> <li>Fully taxable at the same marginal tax rate as ordinary income</li> <li>Reported on your T3 tax slip (Relevé 16 in Quebec)</li> </ul>	<ul style="list-style-type: none"> <li>U.S. Equities</li> <li>Emerging Markets Equities</li> <li>Balanced Funds</li> <li>Fund of Funds</li> <li>TD Cash Flow Series</li> <li>TD Monthly Fixed Pay Solutions</li> </ul>
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 distributions.	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"> <li>TD Cash Flow Series</li> <li>TD Monthly Fixed Pay Solutions</li> </ul>

# 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:



\*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 do distributions impact mutual funds?

Distributions can affect your mutual fund in different ways. They can impact the Net Asset Value (NAV) or price of your funds and, if re-invested, your ACB and book value.

**Net Asset Value (NAV) represents the price of a mutual fund.** The NAV per share represents the mutual fund's assets less its liabilities and will change due to fluctuations of the market value of your mutual fund's investments. A fund's NAV is calculated daily using the price of the securities in the mutual fund at the market close.

**How do distributions affect the price of a fund?** 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.

### Note

Taxable income in an 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 registered. 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

## Impact of distributions: 2 ways to receive a distribution

**\$1000**

Initial Purchase



**\$50.00**

Distribution

(Fund distributes  
\$0.50/unit each year)

### 100 units purchased at \$10/unit

The following example shows the difference between receiving the distribution in cash versus being reinvested to purchase additional units

- NAV increases to \$11 due to income earned (\$11/unit x 100 = \$1,100 market value)
- NAV increase triggers a distribution
- Distribution reduces the NAV/unit to \$10.50 (100 units x \$10.50 = \$1050)

## Final Portfolio Value

### Option 1: Cash

The \$50 distribution gets paid out in cash, the units you hold remain the same

**100**

Unit Holdings

**\$50**

Received in Cash

**\$1050**

Total Value of Portfolio

**\$1100**

(Cash + Portfolio Value)

### Option 2: Re-invest

The \$50 distribution gets reinvested to purchase additional units at the current NAV of \$10.50. This increases your holdings by 4.7619 units

**\$50.00 / \$10.50 = 4.7619 units**

**104.7619**

Unit Holdings

**\$50**

Reinvested Distribution

**\$1100**

Total Value of Portfolio

# 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

### 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:

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

Fund distributes \$0.50/unit each year

### New Book Value:

$$\text{\$1,000} + \text{\$1,200} + \text{\$50} = \text{\$2,250}$$

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**

$$= [(\text{Current market value} - \text{Amount invested}) / \text{Amount Invested}] \times 100$$

$$= [(\$1,100 - \$1,000) / \$1,000] \times 100$$

$$= (\$100 / \$1000) \times 100$$

$$= 0.1 \times 100$$

- **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.

## ACB 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

### Distributions the following two types of distributions can affect the ACB of your mutual fund investment:

1. Reinvested distributions.
2. Return of capital distribution.

## ACB Calculation

### 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

$$\frac{\text{\$2200}}{200 \text{ units}} = \text{\$11.00/Unit}$$

### Per unit capital gain from sale:

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

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 does a reinvested distribution affect your ACB?

### ACB with reinvested distributions

#### Purchase

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

Distributions are set up to be reinvested: 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:

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

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

#### ACB:

Total Investment ÷ Number units = ACB

$$\frac{\text{\$2200} + \text{\$50}}{204.7619 \text{ units}} = \text{\$10.99/Unit}$$

#### Per unit capital gain from sale:

$$\text{\$15/unit} - \text{\$10.99/unit} = \text{\$4.01/unit}$$

204.7619 units sold at \$15/unit

#### Total capital gain from sale:

$$\text{\$4.01/unit} \times 204.7619 \text{ units} = \text{\$821.19}$$

For illustrative purposes only.

# Capital G

# 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.

### Note

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: A TD Fund has an upcoming capital gain distribution of 5% on December 10<sup>th</sup>.**

## Option 1: Pre-distribution

**\$1000**

December 9th Purchase  
(100 units purchased at \$10/unit)

**\$50**

December 10th  
Re-invested distribution  
NAV drops \$9.50 NAV  
(New units purchased =  $\$50/\$9.50 = 5.26$ )

## Option 2: Post-distribution

**\$1000**

December 11th Purchase  
(105.26 units purchased at \$9.50/unit)

## Final Portfolio Value

**105.26**

Total Unit Holdings

**105.26**

Total Unit Holdings

**\$1000**

Total Value

**\$1000**

Total Value

**\$50**

Taxable Income

**\$0**

Taxable Income

# 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 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.

### 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.

### 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, 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 is 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.



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