EDGEPOINT®

UNDERSTANDIING DISTRIBUTIONS

What is a mutual fund distribution?

It's when the net investment income earned by a mutual fund is passed on to individual investors.

Why is it beneficial for investors to pay the tax instead of the mutual fund?

Mutual funds are taxed at the equivalent of investors' highest marginal tax rate. If the fund doesn't distribute the investment income it will pay tax on the lump sum at the highest rate. By distributing its investment income to investors the income is typically taxed at a much lower rate (or none at all if it's held in a registered account). It's in everyone's best interest to have the mutual fund pay a distribution. Reducing the tax paid by the fund increases the income that can be distributed to investors, which improves the return on their investment.

What gives? Why do investors have to pay the tax instead of the mutual fund?

As we said above, mutual funds are taxed at the equivalent of investors' highest marginal tax rate. To avoid getting hit with a big tax bill, the fund distributes its investment income to investors who typically pay a much lower tax rate (or none at all if it's held in a registered account). It's in everyone's best interest to have the mutual fund pay a distribution.

Who pays what?

Distributions are allocated to investors according to the number of units they own of the fund on the day prior to the distribution (record date).

Why does net asset value (NAV) drop when a distribution is paid?

Distributions reduce the fund's NAV/units per share by the amount of the distribution because after the payout, the fund holds less assets. Said another way, the NAV is the value of the underlying assets so when a mutual fund pays out a distribution, it stands to reason that the NAV would drop by that same amount.

This table explains what we just said above but with numbers:

5% distribution for a fund with a $10 NAV/unit

If the distribution is paid in cash:

Pre-distribution value of investment	1,500 units @ $10 = $15,000
Distribution	1,500 units @ $0.50 = $750
Cash paid to investor	$750
Post-distribution value of investment	1,500 units @ $9.50 = $14,250

If the distribution is reinvested:

Pre-distribution value of investment	1,500 units @ $10 = $15,000
Distribution	1,500 units @ $0.50 = $750
Reinvested distribution	$750/$9.50 = 78.9474 units
Post-distribution value of investment	1,578.9474 units @ $9.50 = $15,000

In both scenarios, the overall value of the investor's portfolio is the same before and after the distribution (before accounting for taxes). One has mutual fund units worth $14,250 and cash of $750 for a total value of $15,000 while other has mutual fund units worth $15,000.

How do capital gains distributions differ from capital gains generated by selling my fund?

Mutual fund distributions are distinct from any gains or losses you may have when you sell a mutual fund.

Capital gains can be made either by selling units in a fund (this isn't reported on your T3 but rather on your statement and T5008) and getting back more money than you originally paid or by receiving a capital gains distribution from the fund itself due to portfolio managers selling companies within the fund for a profit.

Is the taxman double dipping?

Annually, when you receive your distribution (reported on your T3) and reinvest it, the amount that you receive gets added to your investment's Adjusted Cost Base (ACB). So when you eventually sell your investment, you have a lower capital gain because the ACB is higher. It's kind of like a prepayment of tax on your eventual capital gain. If you look at your investment's cost base in your account, at the end of the year, you should notice that it's higher than the amount that you originally invested. That increase would be the distribution that you receive and the end of the year which will be reported on your T3.

Can a mutual fund pay a distribution for years with negative performance?

Yes. Investment performance is a function of investment income (interest, dividends, etc.), net realized capital gains or losses ("locked in" gains/losses from the sale of a security), net unrealized capital gains or losses (gains/losses of a holding's value on paper) and expenses.

Mutual fund trusts are annually required to distribute out their investment income and net realized capital gains, net of expenses, to unitholders the same year transactions occur. In years when net unrealized capital losses exceed these amounts, the investment performance of the mutual fund could be negative while there would still be a distribution of the investment income and net realized capital gains for the year.

Unitholders are required to pay taxes on realized capital gains but not on unrealized capital gains. This means they may have to pay income taxes on those distributions even in years that overall the mutual fund experienced negative investment performance.

At the surface, it looks like unit holders end up paying something (capital gains taxes) for nothing (negative returns!), but looking deeper shows that it's just a by-product of our investment approach. Capital gains are the result of selling businesses at a profit, ideally when the market prices them to match our proprietary insights. These profits are then reinvested in ways that the Investment team believes will result in future returns.

See "*Is the taxman double dipping?*" as to why unitholders aren't getting taxed twice.

How do distributions impact my book value?

Distributions can be paid out in cash or reinvested in additional mutual fund units. If you elect to receive the fund distributions in units, your book value is adjusted by the automatic reinvestment of distributions. In simple terms, when a fund pays a distribution you get taxed on it, but when the distribution is in fund units, the book value increases at the same time by the amount of the distribution to avoid double taxation. This information is reported on your T3 slip (Relevé 16 for Quebec residents).

See Clarifying book value, where we explain what your book value represents, common misconceptions and show you the right way to find out how your investments have done.

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