Sorting out the tax slips

A Calculated Look at Capital Gains Distributions from Mutual Fund Trusts

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When winter winds finally give way to warmer breezes, you know that a new season is once again upon you – tax season. And with this new season, you may find the arrival of a tax slip for capital gains distributions from your mutual fund company.

Many individuals are uncertain about capital gains distributions and how they should be reported for tax purposes. Simply put, mutual funds buy and sell securities. Mutual fund investments may generate investment income in addition to gains if securities within the fund are sold for more than their purchase price. While some of the income and gains will go towards paying fees and expenses for the fund, any profit is subject to tax within the fund. Since a mutual fund trust may be subject to a high rate of tax, but does not pay tax on net income and gains distributed to its investors, distributions are the normal course of action. Distributions are then taxed in the hands of the recipient at his or her marginal tax rate.

Need more information? Here are some straight answers to the most commonly asked questions about capital gains distributions from mutual fund trusts.

- ***Are fund returns and fund distributions the same thing?*** No. Fund returns are a measure of how the fund has performed over time, including distributions and changes in its price. Fund distributions are what the fund distributes to its investors, and are often driven by tax considerations.
- ***Under what circumstances am I liable for taxes on capital gains in my mutual fund investments?*** The first circumstance is when you dispose of fund units at a price higher than their cost base. The second occurs when the fund distributes gains that have resulted from the fund selling holdings in its portfolio during the year at prices higher than their cost.
- ***How does a mutual fund trigger capital gains?*** A mutual fund buys and sells stocks, bonds, T-bills or other assets. If a security is sold for more than its purchase price, a capital gain will result. If over the course of the year, the fund's realized capital gains exceed its capital losses and its expenses, it may have to pay tax on those gains to the extent that they are not allocated to unitholders.
- ***Why does a mutual fund distribute capital gains?*** To avoid paying net taxes at the highest marginal tax rate for individuals, a mutual fund trust distributes net capital gains to its investors prior to the calendar year end. Generally the capital gain distribution is reinvested in additional units of the same fund.
- ***Why is the actual distribution amount not known until year end?*** The formula for determining the amount of the capital gains distribution is based on information that is not known until the taxation year-end of the fund. This information includes income, expenses, net realized and unrealized gains, net assets and redemptions during the year.

continued on next page

continued from previous page

- ***Does reinvesting the capital gains distribution in a mutual fund reduce my tax bite?*** No. Capital gains distributions are automatically reinvested in additional units of the same fund and are taxable to you.
- ***Does the length of time I held my investment affect my distribution and tax position?*** You'll receive the same distribution whether you've held the fund for the full year or only a few days.
- ***Must I include capital gains distributions on my current tax return?*** Yes. Within the first few months of the year following the distribution, you'll receive a tax slip (T3) from the fund company reporting income and capital gains distributed to you. These amounts must be included with your annual tax return.
- ***Do I pay taxes on distributions from all my mutual fund investments?*** Not necessarily. You pay taxes on any distributions from your non-registered investments, but not from funds held within your RRSP. When you withdraw money from your registered plan, it is taxed as ordinary income.
- ***Can I do anything to reduce the amount of tax I pay due to my mutual fund investments?*** There are a variety of strategies, including using losses to offset capital gains and choosing to invest in more "tax-friendly" mutual funds. Taxes are only one consideration when investing. Most importantly, your strategies should address your individual goals and risk tolerance and be part of your overall financial plan.

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