

Understanding distributions: Issues and strategies for the tax-smart investor

TAX-SMART INVESTING®

In a country like Canada, where taxes can be almost 50% of your taxable income, saving taxes should always be a priority.

At AIC, our investment approach incorporates tax planning to minimize your investment tax bill each year. This approach to maximize your after-tax returns is evidenced by our commitment to tax-smart education, a strong corporate philosophy grounded in tax minimization and our tax-smart investment products.

A tax-smart portfolio is a portfolio that focuses on maximizing after-tax investment returns. After all, it's not how much you earn, but how much you keep that matters most.

AIC believes in maximizing after-tax wealth (i.e. your bottom-line cash flow). We are proud of being Canada's tax-smart investment manager and a committed educator of Canadians in matters of investing, tax planning and an integrated tax-smart investment approach.

This brief is one in a series on tax-smart investing. We believe you will find this brief, along with our tax-smart investment products, helpful in maximizing the value of your taxable investment portfolio.

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How closely do you monitor your mutual fund distributions?

Chances are that if you hold certain mutual funds as part of your taxable investment portfolio, in March of every year you will receive a T3 slip in the mail related to your funds. What does this slip mean? It means that the mutual fund you've invested in has distributed a portion of the income and capital gains earned within the fund to you, the unitholder.

This brief introduces you to mutual fund distributions, what they are, and why they should be disliked by the tax-smart investor who is focused on minimizing their tax bill.

What is a mutual fund distribution?

Mutual funds, when they are created, are set up as trusts or a corporation by the mutual fund company. When you invest in a mutual fund, your money is pooled with the money of other investors who have also purchased units in the same fund. Together you are known as "unitholders." The mutual fund, in turn, invests your money in a portfolio of investments that generates a return of some kind for you, based on the type of fund you buy. The annual return may be either interest, dividends or capital gains (unrealized and realized). For example, if an equity mutual fund generates a one-year return of 10%, the return may be comprised of 2% dividends from stocks in the portfolio, 3% interest from any cash in the portfolio, 1% realized capital gains from any appreciated stocks sold in the portfolio in the year and 4% unrealized capital gains from any appreciated stocks that continue to be held in the portfolio.

A mutual fund trust is a separate entity under the Income Tax Act of Canada and is taxed on all income, dividends, and capital gains earned in the trust that is not distributed out to investors (unitholders). Since mutual fund trusts are taxed at the highest marginal rate on all forms of income earned, fund companies typically avoid paying this high rate of tax inside the trust by "flowing out" or "distributing" to investors the income and capital gains earned within the fund on all investments since the last distribution date. This is generally wise because investors themselves can then pay tax on the distributions, hopefully at a lower rate of tax.

When a mutual fund trust distributes income and capital gains, the type of income or capital gains retains its character in the hands of the investor, whether it be dividends, capital gains, or interest. That means you, as an investor, pay tax on these distributions at your marginal tax rate according to the type of income or capital gains received.

Distributions can be made by cash payment to your account or can be automatically reinvested in additional units of the fund. Whether the distributions are made in cash or are reinvested as part of an automatic savings plan, you still pay tax on the distributions when the fund is owned in a taxable account.

Your T3 slip: a treasure chest of tax planning opportunities

When a T3 slip from a fund company arrives in the mail during tax season, it is common for many Canadians to simply ignore what these slips really are and pass them to their accountant for processing on their tax return.

At AIC, we both dislike and value T3 slips. But overall, we treat them as a valuable measure of the tax effectiveness of an investment, and of your portfolio.

What we dislike about T3 slips

We dislike T3 slips because the very fact that you received one means that you are about to pay tax that may have been avoidable. The T3 slip was generated because somewhere during the year you received a taxable mutual fund distribution of income or capital gains and now it is time to pay tax on this amount. Had the mutual fund's management style been focused on tax minimization, it may have been possible to avoid sending you a distribution at all, increasing your portfolio tax effectiveness.

At AIC, we go to great lengths to minimize taxable distributions of any kind to our investors – meaning AIC unitholders will rarely receive a T3 slip...often a sign of exceptional tax effectiveness.

What we value about T3 slips

We do however, find some value in T3 slips and encourage your financial advisor to do so as well. T3 slips by their nature, are a tremendous source of information on tax planning opportunities. By examining the type of information summarized on the slip, you and your advisor can get a snapshot of the tax effectiveness of your mutual fund and your investment portfolio.

For example, if you receive a T3 slip showing a large amount of interest income which is generally taxed at the highest rates in Canada – this is usually not a very tax-smart investment to hold in a taxable portfolio. It may be more tax-smart to own any fixed income elements of your

portfolio in an RRSP or RRIF when focusing on tax-smart investing factors alone.

If you receive a T3 slip showing dividend income from Canadian stocks owned by the fund, two tax-smart strategies come to mind: if you absolutely need income to live off, dividend income from Canadian companies is tax-smart and generally preferable before interest income. However, if you don't need any income to live off, then why do you own a fund that is generating income at all?

Capital gains distributions

Seeing a capital gain distribution on your T3 slip indicates that stocks owned in the fund were sold in the year and the capital gain realized is now being distributed out to you to pay tax on. While capital gains are taxed at a lower rate in Canada today, the bigger question is would you be better off in a fund that does not frequently sell its stocks? By considering a fund with a buy-and-hold investment approach, excellent stocks would continue to be held in the fund for the long term and in many cases, no annual capital gains would be realized. This means you would not receive a T3 slip and no tax would be paid in the short term. This is more tax-smart for your investments overall.

A T3 Slip: Used to summarize mutual fund distributions annually by fund companies.

In short, getting a T3 slip may indicate tax inefficiency with a mutual fund and a money manager's investment style. You should ask if he/she is doing everything to minimize your tax bill associated with that mutual fund. Secondly, if you do get a T3 slip, have your financial advisor analyze the nature of the income and capital gains summarized on the slip. It may be possible to cut your tax bill by making modifications to your investment portfolio such that the nature of investment income you receive can be more tax-smart positioned. Note: this may involve changing your investment holdings.

Conduct tax-smart fund analysis before making a fund purchase in December each year

Another interesting tax attribute of mutual funds relates to being cautious around the timing of fund purchases. If you're thinking about investing in certain mutual funds in your taxable portfolio, you may want to think twice before you buy into a fund immediately prior to a distribution date (i.e. December for some funds, quarterly for others).

Here's why

If a mutual fund has appreciated in value or produced income or capital gains since the last distribution date and you buy into it immediately before the distribution occurs, you are purchasing the fund at a price that reflects all the accumulated income sitting inside the fund that is potentially about to be distributed. Since you own the fund as of the distribution date, you will also receive a distribution amount and pay tax on it, despite the fact you may not have been in the fund long enough to earn it. In simpler terms, you're paying tax on someone else's income or capital gains. It is generally desirable to avoid this by waiting to purchase until after any distribution date.

Cheer up

Even if you purchase a fund before a distribution date and then receive a distribution amount, it's not so bad. The distribution amount you will pay tax on this year is added to your original cost of the fund. This will reduce your

capital gain and tax bill when you ultimately sell the fund. So in the end, receiving a distribution and paying tax on it today amounts to no more than a pre-payment of tax that would be payable at some point in the future.

Note: This assumes the distribution was a capital gain and the capital gain rate is the same in each year and is reinvested.

What investors can do about distributions from mutual funds in a taxable investment account

Ultimately, it is up to you and your advisor to act as gatekeeper over tax-inefficient mutual funds. One easy way to spot a potentially tax-inefficient fund is to watch for any fund that generates a T3 slip with large distributions on a regular basis. Receiving a T3 may indicate a tax-inefficient fund, which warrants investigation whether this is true or not.

Here are some other steps you and your advisor can take to manage distributions and the tax efficiency of your portfolio:

- Pay attention and organize the types of distributions you receive in your taxable account. Ask yourself if you really need this income at all and whether the type of income you are receiving from this fund is appropriate based on an after-tax evaluation;
- If you find yourself with a capital gains distribution, consider offsetting these gains by triggering a capital loss on another investment whose time is due. Under the Income Tax Act, capital gains and losses are offset, with tax due on the net gains, if any. Refer to the

What AIC does about distributions from our mutual funds

At AIC, our philosophy is to minimize all distributions to unitholders. Any distribution you receive results in a premature and unnecessary payment of tax on your investment portfolio that often can be avoided. Here are some of the ways that we minimize distributions on our mutual funds:

- AIC takes advantage of the capital gains refund mechanism in the Income Tax Act. We use a process called crystallization where the fund sells securities, triggering a capital gain and then immediately repurchases those securities. To learn more about this process, please refer to AIC Investor Series "Understanding Mutual Fund Capital Gains."
- Most importantly, at the heart of our investment philosophy is our buy-and-hold management style. At AIC, we buy excellent companies with the intent of holding them for a very long time. This disciplined approach to investing ensures the preservation of strong after-tax returns with minimal annual taxation.

superficial and loss denial rules if you intend to realize your losses;

- Pay close attention to the management style of a particular fund. If the fund manager has a mandate of regularly holding large amounts of cash, buying and selling stocks frequently or a general disregard for tax considerations for the fund and unitholders, re-think your purchase of this fund for your taxable portfolio. Consider moving this fund into your RRSP, RRIF or selling it outright;
- Overall, focus on the importance of tax considerations in investing and search out companies like AIC that are just as concerned about your tax bill as you are.

Next steps

AIC continues to help Canadians understand tax issues related to mutual funds. Contact your financial advisor for more information on taxation and mutual fund issues that concern you.

This brief is adapted from Kurt Rosentreter's book, "50 Tax-Smart Investing Strategies," published by Stoddart Publishing.

Canadian provinces and territories impose their own tax rates in addition to the federal tax rates. Therefore, depending on where an investor lives, that individual's tax rate may differ from any examples shown. The content of this article is for informational purposes only and in no way should be construed as tax advice. Please consult a professional tax advisor for advice related to your specific situation.

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