Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Year-end mutual fund purchases

Purchasing a mutual fund with an upcoming distribution can result in an unwanted tax liability

If you are planning to purchase a mutual fund with an upcoming distribution, you may face an unexpected tax liability. This article summarizes the potential impact of purchasing a mutual fund late in the year and provides you with a few possible solutions.

What is the Net Asset Value (NAV) of a mutual fund?

The NAV of a fund is the total value of all of its assets. When a mutual fund earns interest or dividends from its investments, the income simply accumulates until the fund's next distribution date. Likewise, when an underlying investment in the fund is sold, triggering a capital gain or loss, the net realized gains also accumulate within the fund. The accumulated income received as well as the net gains realized by the fund increase the fund's NAV. Any increase in the NAV also increases the value of each mutual fund unit.

Changes in the value of the underlying investments (i.e., unrealized capital gains or losses) are another way by which the NAV will increase or decrease. Therefore, accumulated capital gains can represent a significant portion of the fund's NAV, especially in an equity fund.

Distributions from a fund decrease its NAV. Distributions from a fund can occur annually, quarterly or monthly, depending on the type of fund.

What happens when there is a distribution?

When you purchase a mutual fund part way through the year, you purchase the fund at its NAV, which includes any accumulated income and gains that have not yet been distributed. When the fund makes a distribution, the distribution includes these accumulated earnings. This distribution is fully taxable even though you purchased the accumulated earnings with your after-tax dollars. Further, if the fund is set

up to reinvest the distribution, you will not receive cash but instead hold additional units at a lower unit price.

Example of a year-end purchase and distribution

Consider the following example:

At the beginning of the year, XYZ Fund is worth $10 per unit. During the year, XYZ Fund earns interest and dividend income. The unit value of XYZ fund increases to $11.

On December 1, you purchase 100 units of XYZ Fund just before its distribution date, at $11 per unit, for a total investment of $1,100.

Shortly after purchase, the fund pays a distribution of $0.50 per unit. For the 100 units you hold of XYZ Fund, you receive a total distribution of $50. The $50 is fully taxable to you. Because of the distribution, XYZ Fund's unit price falls from $11.00 to $10.50.

XYZ Fund is set-up to automatically reinvest distributions. At the new unit price of $10.50, you now own 4.7619 additional units ($50 ÷ $10.50 = 4.7619) for a total of 104.7619 units.

The original 100 units you purchased are now worth $1,050 (100 x $10.50). The additional 4.7619 units purchased with the distribution are worth $50 (4.7619 x $10.50). The total dollar value of your portfolio has not changed (original 100 units worth $1,050 + 4.7619 new units worth $50 = $1,100) but you received a taxable distribution.

How do distributions affect your Adjusted Cost Base (ACB)?

Reinvesting a mutual fund distribution does not affect the total dollar value of your investment. As seen in the previous example, the value of the mutual fund units at the time you purchased them as well as after the reinvested distribution was $1,100.

Reinvesting a mutual fund distribution will, however, increase the ACB of your investment since you are paying tax on the distribution. For tax purposes, you will need to keep track of the ACB of the mutual fund units for when you eventually dispose of the investment. In the previous example, since you paid tax on the $50 distribution, it increases your overall ACB from $1,100 to $1,150. This increased ACB will decrease your capital gain when you eventually sell your units. As such, you will not be double taxed on the distributed amount but you essentially pre-pay tax on the distribution.

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What to consider?

One way for you to avoid receiving a distribution is to simply purchase the fund after the distribution date. This way, you can purchase the fund without any accumulated income and gains.

If you have already purchased the fund, consider selling the fund prior to the distribution date. Before selling, you should first consider the size of the potential distribution and the resulting tax liability. It is important for you to determine how much you will save by avoiding the receipt of this distribution in comparison to the costs that a sale could trigger (i.e., redemption fees).

Alternatively, you could contribute the mutual fund to your registered account, for example your RRSP or TFSA, before the distribution. This way, your registered account will receive the taxable distribution. If held in your TFSA, you will not be taxed on that distribution or any future distributions. If held in your RRSP, you will only be taxed on the distributions when you make an RRSP withdrawal.

If the fund is in a loss position and you transfer the fund in-kind to your registered account, the capital loss will be denied. This means that you cannot use the capital loss to reduce your capital gains. Instead, in order to be able to claim the loss, consider selling the fund in your non-registered account first. If you ultimately wish to hold the fund within your registered account, be sure to wait at least 30 days before repurchasing it to avoid the superficial loss rules. For more information on these rules, please refer to our article on the Superficial Loss Rules and Planning Strategies.

Who can help?

If you are planning to purchase a mutual fund, speak to an RBC advisor about the merits of delaying the purchase until after the fund makes a distribution.

Review your portfolio to determine if you have recently purchased any mutual funds that are about to make

a distribution. If you expect substantial distributions, speak with a qualified tax advisor and see if it makes sense to sell or switch to another fund that does not make a distribution.

This article may contain several strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax and/or legal advisor before acting on any of the information in this article.

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