SUMMARY: Mutual funds typically use one of two methods to issue distributions for reinvestment – the traditional method and the notional method. The tax consequences of both methods in a non-registered account are exactly the same. Sometimes mutual funds issue a distribution that includes a portion of your capital. This is referred to as "return of capital," and it has unique tax implications.

Mutual fund distributions: traditional and notional

Many mutual funds make distributions to investors. Distributions are generally made up of the earnings generated by the securities held within the fund, and capital gains that may result from buying and selling those securities. Investors with non-registered accounts typically have the option to receive their distributions in cash, or to reinvest them in the fund. Distributions can be paid monthly, quarterly, or annually, depending on the fund.

When it comes to reinvested distributions, there are typically two ways that funds process them: the traditional method, and the notional method. Whichever method the fund uses, it's important to remember that the tax implications are the same for both methods, and there is no impact on the market value of your holdings.

Traditional distributions

When a traditional distribution is issued, it's used to purchase additional securities of the fund. The total number of securities held increases according to the distribution amount, while the net asset value per security is reduced according to the distribution amount. There is no change in the market value of your holdings as a result of the distribution.

The distribution does affect the adjusted cost base (ACB) of your securities for tax purposes. The ACB is a measure of the average price paid for mutual fund securities over time. The ACB factors in purchases and reinvested distributions in order to provide a "base" from which to calculate capital gains or losses when the securities are sold.

The following table illustrates how this works for a mutual fund trust, which is the most common type of mutual fund. We're assuming that in this case, the distribution contains no return of capital – a subject we'll discuss below.

Activity	Transaction Summary	Market Value	Adjusted Cost Base
Before distribution	You purchase 1,000 units at $20/unit		**$20,000**
	Market value of the units you own is $20,000	**$20,000**	
Distribution declared	Distribution of $1/unit		
	You receive $1,000 in taxable income (1,000 units x $1)		
Security price drops	The security price is now $19		
	($20 - $1)		
Distribution reinvested	You reinvest the $1,000 to buy additional units at $19/unit		
	You receive 52.632 units ($1,000 ÷ $19 = 52.632)		
	You now own 1,052.632 units		
	ACB increases by the amount of the reinvested distribution, to $21,000 ($20,000 + $1,000)		**$21,000**
After the reinvested distribution	You own 1052.63 units at $19/unit	**$20,000**	**$21,000**

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Notional distributions

The second method funds use to process reinvested distributions is the notional distribution method. With a notional distribution, once the distribution is issued and additional securities are purchased, the fund consolidates the securities so the number held *after* the distribution is identical to the number held *before* the distribution. The net asset value per security is *not* affected by the notional distribution as it is when using the traditional method.

In this table, we're showing the mechanics of a notional distribution for a mutual fund trust. We're still assuming that the distribution contains no return of capital.

Activity	Transaction Summary	Market Value	Adjusted Cost Base
Before distribution	You purchase 1,000 units at $20/unit		**$20,000**
	Market value of the units you own is $20,000	**$20,000**	
Distribution declared	Distribution of $1/unit		
	Total taxable distribution is $1,000 (1,000 units x $1)		
Distribution reinvested	The distribution results in the purchase of additional units which are immediately consolidated, returning your holdings to their pre-distribution levels		
	Net asset value per unit does not change		
	You continue to own 1,000 units		
	ACB increases by the amount of the reinvested distribution, to $21,000 ($20,000 + $1,000)		**$21,000**
After the reinvested distribution	You own 1,000 units at $20/unit	**$20,000**	**$21,000**

Keep in mind – as with traditional distributions, notional distributions have no impact on the market value of your holdings.

Summary:

Activity	Traditional	Notional
Initial net asset value per unit	$20	$20
Number of units	1,000	1,000
Pre-distribution ACB	$20,000	$20,000
Market value before distribution	$20,000	$20,000
Distribution	$1 per unit	$1 per unit
Net asset value per unit after distribution	$19	$20
Additional units received	52.632	0
Number of units after distribution	1,052.632	1,000
Post-distribution ACB	$21,000	$21,000
Market value after distribution	$20,000	$20,000

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Return of capital

Distributions are generally made up of the earnings generated by the different security types held within the fund, and capital gains that may result from buying and selling those securities. For example, bond holdings would likely generate interest, and equity holdings may generate dividends and capital gains. Each piece is treated differently for income tax purposes.

Distributions can also contain return of capital, which is *not* a type of income – though it does have tax implications. Return of capital, as the name indicates, occurs when a mutual fund "returns" a portion of your capital – in other words, you're getting back the same money you invested in the fund.

Why would a mutual fund return your capital?

Generally, return of capital distributions occur when a fund's distribution policy is to pay a monthly distribution at a targeted annualized rate, or a fixed rate. If interest, dividends and any realized capital gains earned by the fund are less than the amount of the set distribution, some of your capital is returned to you so the fund can meet its distribution policy.

How is return of capital taxed?

Because your own capital is not income, it's not taxable in the year it's received. However, it does reduce the ACB of your investment. This will typically result in a higher taxable capital gain or a lower capital loss when you eventually sell your mutual funds.

If a return of capital causes your ACB to reach zero or become a negative amount, the negative amount is taxable as a capital gain in the year. Your ACB is then reset to zero to calculate gains or losses on any future sales.

Why might an investor want return of capital?

Some investors might like to receive some or even all of their distributions as return of capital. Remember, you only pay tax related to return of capital when the mutual funds are sold or if the return of capital causes your ACB to go negative. This can help maximize current cash flow, as well as provide more control over when you eventually pay your tax.

Keep in mind however that ongoing return of capital distributions may deplete your investment – particularly if the fund is unable to meet its distribution policy through earnings.

For more information about how distributions work, speak to your financial advisor. You can also refer to a mutual fund's simplified prospectus for its distribution policy. Always consult a tax expert when making decisions about your investments and the distribution options available to you.

Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated.

The payment of distributions is not guaranteed and may fluctuate. The payment of distributions should not be confused with a fund's performance, rate of return, or yield. If distributions paid by the fund are greater than the performance of the fund, then your original investment will shrink. Distributions paid as a result of capital gains realized by a fund and income and dividends earned by a fund are taxable in your hands in the year they are paid. Your adjusted cost base will be reduced by the amount of any returns of capital. If your adjusted cost base goes below zero, then you will have to pay capital gains tax on the amount below zero.

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