# The Ins and Outs of Cash Flow from an Investment Fund

AGF SOUND CHOICES

**Many investors today seek out investment funds with income-producing features, but how do you know which product is right for you?**

When it comes to distributions, why you choose a cash-flow-producing investment fund and the various sources of cash flow are crucial to your decision-making process.

From conservative fixed-income funds, to equity funds that offer maximum cash flow, balanced funds with a steady income stream, or even complete one-ticket income solutions, there are many choices available to you.

## Distributions – What are they?

Many investors believe receiving distributions from an investment fund are always representative of an increase in value to the fund and have the same tax treatment. However, these distributions come in many forms – dividends, return of capital, interest or even capital gains. They all have specific purposes and they all have an impact on your long-term goals.

### Know your fund choice

Before investing in a fund it is important to know what type of distribution you are going to be receiving. Investment funds that contain dividend-paying stocks can offer an attractive source of cash flow, whether monthly, quarterly or semi-annually. When you take into account that the stock can also provide capital growth potential, you can have an extremely attractive solution.

For investors seeking cash flow necessary for living expenses, a fund distributing dividends may not always provide steady and predictable cash flow. This is in part due to the irregularity of both payment frequency and dollar amounts distributed. Here an investor may want to look to other options available such as a Systematic Withdrawal Plan.

## Distributions Do Not Create Wealth

Wealth gets created when a fund receives dividends and interest from the underlying holdings, and through realized capital gains when holdings are sold at a profit. A distribution, when reinvested, creates units without changing the total value of the investment.

**Here is an example to illustrate how it works:**

| | Units | Price | Total |
|---|---|---|---|
| **Day 1 Pre-Distribution** | 1000 | $10.00 | $10,000 |
| **Declared Distribution: $0.10/unit** | 10 | $9.90 | $100 |
| **Day 2 Ex-Distribution** | 1000 | $9.90 | $9,900 |
| **Post-Distribution Reinvestment** | 1010 | | $10,000 |

**When the fund declares a distribution of $0.10 per unit and reinvests it, there are two results:**

1. The unit price drops by the amount of the distribution paid ($0.10) presuming the market is steady.
2. The number of units owned increases when the value of the distribution is used to buy additional units of the fund at the post-distribution price ($100 distribution buys 10 units of the fund at $9.90/unit).

Although you now own additional units of the fund, the distribution does not affect the total dollar value of the investment as you own more units valued at a lower price.

For illustrative purposes only.

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## Different Sources of Distributions

### Dividends

Dividends are distributions that companies pay from their earnings on a regular basis to shareholders. Typically dividends are paid by mature, profitable companies. Since these companies are no longer growing as rapidly, they give a portion of their earnings directly to the shareholders instead of reinvesting all of it back into their businesses.

Dividends are a signal that the company's fundamentals are healthy and that management is optimistic about future performance. While dividends aren't guaranteed, companies take these payments seriously and will typically go to great measures not to cut them for fear of reducing investor confidence.

When you receive a dividend payment from a Canadian public company, you are eligible for a dividend tax credit. Dividends received from Canadian public corporations are tax preferred, so it can be beneficial to consider keeping these dividends outside your RRSP.

### Return of Capital

A return of capital is part of the distributions made by the fund that exceeds the amount of taxable income of the fund in that year. A return of capital is generally a distribution of some of the investor's invested capital in the fund. An investor doesn't pay tax on this amount and doesn't include it in their taxable income for the year.

As a result, this return of capital distribution is not immediately taxable but decreases the adjusted cost base of the original purchase (tax deferral until redemption). When it comes time to sell in the future, providing that there is a gain, the capital gains tax will be paid on the proceeds less the amount of the adjusted cost base.

Investment funds sometimes pay return of capital to the investor on a regular basis, which represents a return of the investment the investor originally contributed to. This can be ideal for investors looking for regular streams of cash with minimum tax consequences applicable since they are drawing from their principal invested.

## How do investors determine their portfolio's Adjusted Cost Base (ACB)?

To determine ACB, investors must keep track of all transactions resulting in the purchase, sale, reinvestment of distributions or transfer of fund units or shares. Distributions received in cash do not affect the ACB (with the exception of return of capital). Acquisition fees paid for the purchase of funds increase the ACB.

### Interest Income

Interest income is a gain to the portfolio (an example would be a money market fund). It is typically received from GICs, corporate bonds, government bonds and T-Bills and can have a positive impact on the performance of the fund by adding more units. However, it is important to keep in mind that interest income is 100% taxable. That means that if you earn $1,000 in interest for the year, $1,000 is added to your income and taxed at your marginal tax rate. Because of this, it can be beneficial to have these types of investments inside a registered account such as an RRSP or TFSA.

For investors looking for a regular source of income, this type of income in today's market may not be suitable as interest rates are generally lower and you may typically receive small payout amounts.

### Capital Gains

Capital gains result when you sell an investment higher than the price you purchased it at. The difference is taxable at 50% of your marginal tax rate.

Capital losses can also occur if your sale results in receiving less money than you had originally invested. Because of the favourable tax implications, they are an efficient source of cash flow and can be beneficial to hold outside of a registered account.


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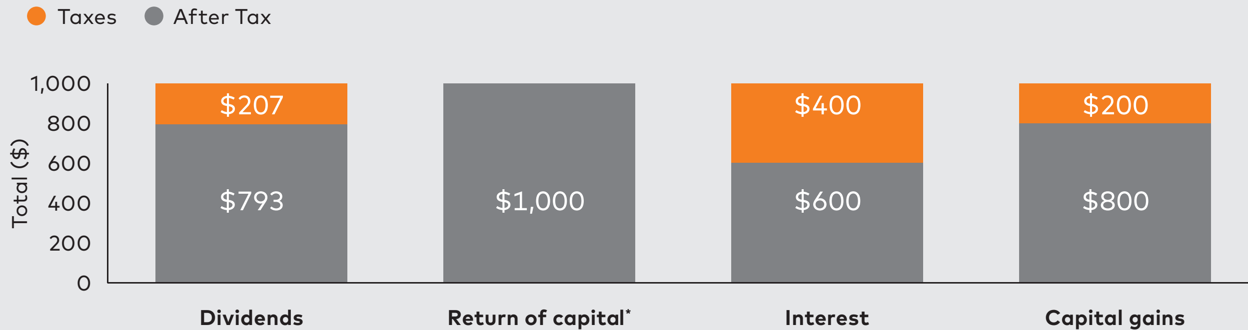
## Are all Distributions Created Equal?




**Here are four different sources of distribution income from an investment, each paying $1,000. While they all may look the same, they all have very different tax implications, which affects the value of a portfolio.****

* Return of Capital: The returned capital amount is not taxable in the year received, but reduces the adjusted cost base, which generally results in a larger capital gain when the investment is sold, hence taxes are effectively deferred.

** **This information is for illustrative purposes only.** A hypothetical marginal tax rate of 40% is used for this illustration. **Assumptions:** Interest: Fully taxable. $1,000 in interest will return $600 after tax. **Dividends:** (Assuming the individual is taxed in Ontario and the dividend is eligible) a $1,000 dividend gets grossed up by 38% in 2022 to $1,380. Then the assumed 40% marginal tax is applied to result in taxes of $552 (40% × $1,380). The $552 in taxes are reduced by the provincial and federal tax credit of 10% (including surtax) and 15.02%, respectively (10% × $1,380 + 15.02% × $1,380), which creates a tax credit of $345. This amount is subtracted by the taxes otherwise payable to give $207 tax payable ($552 – $345). Therefore, a $1,000 Canadian dividend would provide an after-tax value of $793. **Return of Capital:** The returned capital amount is not taxable in the year received, but reduces the adjusted cost base of the investment, which generally results in a larger capital gain when the investment is sold, hence taxes are effectively deferred. **Capital Gains:** Have preferential tax treatment where only 50% of the gain is taxable. Only 50% of a $1,000 capital gain is taxable, which means that only $500 would be subject to the 40% marginal tax. $500 × 40% = $200 taxes payable, therefore a $1,000 capital gain would result in an $800 after-tax return. This information is provided as a general source of information and should not be considered personal investment or tax advice. Investors should consult with their financial and tax advisors before making any investment or tax-planning decisions.

## What Type of Investor Are You?

### De-accumulator

If you are retired, investing in a product that pays return of capital may be an ideal choice. There are some common risks that you may face in your retirement since you may be seeking to maintain a portfolio of investments to last over the long term, including:

1. **Longevity risk** – living too long
2. **Market risk** – premature portfolio depletion
3. **Purchasing power** – inflation

One approach is to invest in funds that pay primarily return of capital. These are generally conservative products that can help protect your investment by not eroding your capital on the downside, a crucial component when drawing income in retirement. There are a number of funds categories that may be ideal for this strategy; asset allocation funds, balanced funds or other generally conservative products that can protect against the potential for huge downward swings from the markets.

### Accumulator

If you are an investor who has not yet reached retirement but are looking to supplement your income for other purposes, then a fund containing stocks that pay dividends, or a fund that seeks to offer maximum cash flow, may be the right choice for you.

These funds are usually more aggressive and, in turn, provide the opportunity for higher capital growth potential. This type of fund can experience more volatility than a more conservative product, resulting in the erosion of your principal.

## So What Does This All Mean?

**It is important to determine what your cash flow, tax and short- and long-term goals are before you and your advisor decide what type of investment is right for you.**



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**Speak to your financial advisor to find out more about the ins and outs of cash flow from an investment fund.**

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