Income Distribution FAQs

May 2021

These FAQs explain income distributions from MLC's managed funds. Managed funds are also known as managed investment trusts and unit trusts.

We update this 'Income Distributions FAQ' each financial year. The latest is available on mlc.com.au under 'Prices & Performance > Income Distributions'.

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Distribution basics

1. How is the level of distributions determined?

Distributions reflect the income earned by a managed fund from its underlying assets and are paid to investors after fees are deducted. These assets may include shares, property, fixed income, alternatives or cash, or a combination of these. This means a distribution could include interest earned, dividends, rental income and capital gains realised when assets are sold. For global assets, currency movements resulting in changes in the value of hedging contracts can also affect income distributions.

Realised capital gains and currency gains can vary significantly from year to year and are passed through to investors in the last quarter of the fund's financial year.

The value of a fund's assets influences the unit price of the fund, but not the distributions paid.

2. Why does a fund's unit price fall after a distribution?

A managed fund's unit price reflects the value of the underlying assets and income that's been accumulating in the fund. The accumulated income includes gains 'realised' when assets are sold during the year. The income is reduced by fees and expenses.

After a distribution is paid to investors, the value of the fund falls by the amount of the distribution because accumulated income of the fund is paid to investors, usually into their bank accounts.

Let's look at an example. Below is a sample managed fund balance sheet showing its net asset value before a distribution, and after a distribution (ie ex-distribution).

	Value immediately before the distribution	**Value immediately after the distribution**
Assets: Shares $800 and cash $200	$1,000 (ie shares $800 and cash $200)	$800 (ie shares)
Liabilities: Management fees to be paid	($100)	($100)
Net asset value	**$900**	**$700**
Accumulated income	($200)	-
Unitholders' equity	($700)	($700)
Total unitholders' equity	**($900)**	**($700)**

The income that was accumulated in the fund of $200 is paid out to investors at the time of distribution – the assets reduce by the amount of the distribution paid to investors, in this case cash of $200, and the accumulated income (effectively a liability to pay investors) is extinguished.

Unit prices are calculated as the net asset value of the fund, divided by the number of units on issue. In the example above, if the number of units issued to investors is 1,000, the unit price will drop from $0.90 to $0.70. The difference in the unit price before and after the distribution is $0.20 which is the amount of distribution investors were paid.

Investors haven't lost any money; the value of their investment in the fund has dropped by the amount of income they've received.

It's similar to when a listed company goes ex-dividend – its price drops by the dividend paid.

3. How can a managed fund have a zero distribution?

A managed fund's expenses are offset against its income, with the net income after deducting expenses distributed to investors. Sometimes the income can be lower than the expenses and therefore no net income is available to distribute. Additionally, if a fund has carried forward losses from previous years, these losses will also significantly reduce the level of distributions. A fund's distribution may be zero until carried forward losses are offset against future income.

4. How are managed funds taxed?

For Australian income tax purposes, managed funds are generally taxed on a 'flow through' basis in respect of their taxable income. That is:

- the managed fund itself is not subject to Australian income tax
- Australian resident investors will be subject to tax on their share of the fund's taxable income for the year to which the income relates (not the income year in which it is received), and
- withholding tax will be deducted from distributions to non-resident investors.

The taxable income of managed funds retains its character as it passes to investors. Taxable income may comprise dividends, interest, foreign income, net capital gains and other income. Each of these income components has different tax implications for investors. Some examples are:

- Dividends from a fund's investment in Australian companies can have associated franking (also known as imputation) credits. A franking credit is a way of passing on the tax a company has already paid, as a credit to investors to offset against their own tax. This way, company profits are not 'double taxed' to Australian investors. If an Australian investor's top tax rate is less than the company's tax rate (ie the investor would have paid less tax on the income than the company did) the Australian Tax Office will refund the difference to the investor.
- Foreign income may include foreign tax credits that may be used to reduce Australian tax payable on foreign income.
- Net capital gains made by a managed fund when securities are sold are distributed to investors in the financial year they were sold.

In addition to any net capital gains attributed to investors, capital gains and losses may also be made when investors sell, switch or transfer any part of their unit holdings in a fund. Individuals are eligible for a 50% tax discount on gains made on assets held for a year or more.

Investors are notified of their taxable income components in their tax statement eg MLC MasterKey Unit Trust investors are notified through their AMIT Member Annual Statements and investors in MLC funds through platforms will be notified in their tax statement from the platform.

5. How does hedging to the Australian dollar (AUD) impact income distributions?

If you invest in managed funds that hold overseas assets, such as global shares, property or bonds, your income and capital are exposed to currency fluctuations. This can impact your return positively or negatively, depending on your exposure to various currencies and movements in their exchange rates.

If a fund has an AUD currency hedging strategy, it helps reduce the impact of currency movements on global exposures and smooth out the overall return on your investment. However, the income and growth components of the overall return, particularly for share and property investments, can still be quite volatile. That's because any hedging gains or losses the fund realises when the hedging contract expires (usually after a month) impact the fund's income distributions. Hedging gains are treated as income, while hedging losses are offset against other sources of income such as interest and dividends.

6. How do redemptions impact distributions?

Funds can go through periods when redemptions increase, resulting in a net outflow of money. This often happens when a fund is closed to new investors. To fund the redemptions we may need to sell securities, which may cause the fund to 'realise' capital gains or other income. The fund distributes its net capital gains and other income each financial year.

If redemptions are exceptionally high in a fund's financial year, the net capital gains could be substantial. Other income may also increase as a result of the redemptions.

Under our funds' constitutions, we need to consider how we make a fair and reasonable attribution to investors of the capital gains and other income generated by redemptions in exceptional circumstances, such as when redemptions are exceptionally high.

The constitution gives us the ability in exceptional circumstances to attribute the capital gains and income that result from selling securities to fund redemptions to the redeeming investors. More information is available in the section *Distributions in 'exceptional circumstances'*.

7. Why is the distribution for MLC MasterKey Unit Trust – MLC IncomeBuilder paid in two parts?

The May distribution for MLC MasterKey Unit Trust - MLC IncomeBuilder is paid in two parts:

- the first part includes dividends, interest and concessional capital gains. Investors may request to have it paid to their bank account or as additional units, and
- the second part is the net taxable realised gains accumulated by the fund. This is only paid as additional units.

This ensures the investor's capital base, from which the dividend income is generated, is not eroded by paying capital gains out of the fund.

The fund has operated in this way since it was established as it helps investors maintain a growing income stream.

8. Why do managed funds have an income and a growth return?

The return of a managed fund comprises:

- income generated by the fund's assets, and
- changes in the unit price resulting from movements in the value of the fund's assets.

A fund's income accumulates in the unit price until it's paid to investors as an income distribution.

A fund's 'income return' reflects the income distributions paid to investors while the 'growth return' reflects movements (up and down) of the unit price.

A fund's total return includes both the income and growth return.

9. How can a fund that has a negative return still distribute realised capital gains to investors?

A fund comprises many assets, often hundreds, and these are all included in the unit price used to calculate a fund's return. When the total of all the fund's assets falls in value, the fund's unit price will fall and it will produce a negative return.

Within the fund, there will usually be assets that have grown in value since the assets were purchased. If these assets are sold, a capital gain (or profit) will be realised. The capital gain will be distributed to the fund's investors by the end of the financial year. Or if the fund has capital losses, the gain can be offset against the losses.

As a result, while a fund could have a negative return over, say, the past year, if it sells assets that had grown in value since they were purchased, the fund may have realised capital gains to distribute to investors.

10. What are carried forward losses, and how do they affect distributions?

Carried forward losses generally reduce a fund's distribution until they're offset. Funds can have two types of losses:

- **Capital** losses: During periods of significant investment market falls, such as during the GFC in 2008-9 and the first few years afterwards, many funds suffered large unit price falls and many assets within the fund, when sold, realised capital losses. These capital losses are kept in the fund and carried forward until they can be offset against future capital gains. Funds with carried forward capital losses can still distribute revenue income such as dividends and interest.
- **Revenue** losses: When a fund's expenses are higher than its income, it has a revenue loss. Revenue income includes dividends and interest and is also impacted by foreign currency gains (and losses) and returns from certain assets. Capital gains are separate to revenue income. Revenue losses are kept in the fund and are

generally able to be carried forward until they can be offset against future revenue income and capital gains. Until a fund’s revenue losses are offset, the fund will generally have a zero distribution.

Distributions in ‘exceptional circumstances’

11. Why is our approach to distributions different if a fund has ‘exceptional circumstances’ such as high redemptions?

Managed funds that have opted into the Attribution Managed Investment Trusts (AMIT) regime in recent years, are required to ‘attribute’ a fund’s taxable income to investors on a ‘fair and reasonable’ basis. The attribution of a fund’s taxable income determines how investors are taxed.

Most funds will attribute taxable income to investors based on the distributions made to investors, in a similar way to how they allocated taxable income before the AMIT regime applied.

However, there may be occasions when the taxable income you’re attributed is not based on distributions made to you. For example, in ‘exceptional circumstances’, such as when withdrawals of money, or ‘redemptions’, are exceptionally high, we have changed our approach to attributing a fund’s taxable income.

Our funds’ constitutions give us the ability in exceptional circumstances to attribute the capital gains and income that result from selling securities to fund redemptions to the redeeming investors.

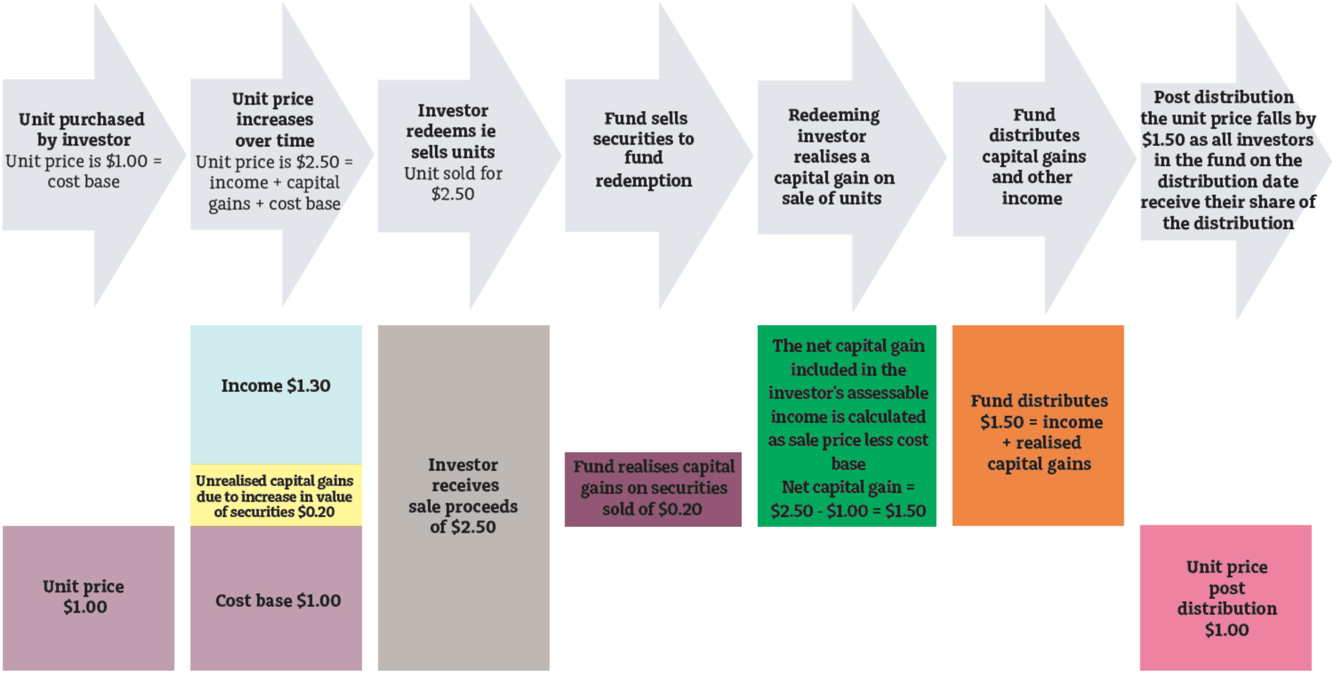
12. Why is our approach to distributions in ‘exceptional circumstances’ considered ‘fair and reasonable’?

In ‘exceptional circumstances’, if we attribute the capital gains and income that result from selling securities to fund redemptions to the redeeming investors, investors who have redeemed are treated reasonably and investors who haven’t redeemed aren’t taxed on the increased capital gains and other taxable income resulting from the redemption. This is a fair outcome for all investors and is a benefit of the AMIT regime.

13. How are taxable gains on redemptions attributed in ‘exceptional circumstances’?

The following diagrams provide a simple example of how investors may be impacted both in a ‘normal’ year when there aren’t redemptions made in exceptional circumstances, and in a year where there are redemptions made in exceptional circumstances. It shows how the attribution of taxable income resulting from redemptions may be different.

Scenario 1: redemption in a 'normal' year

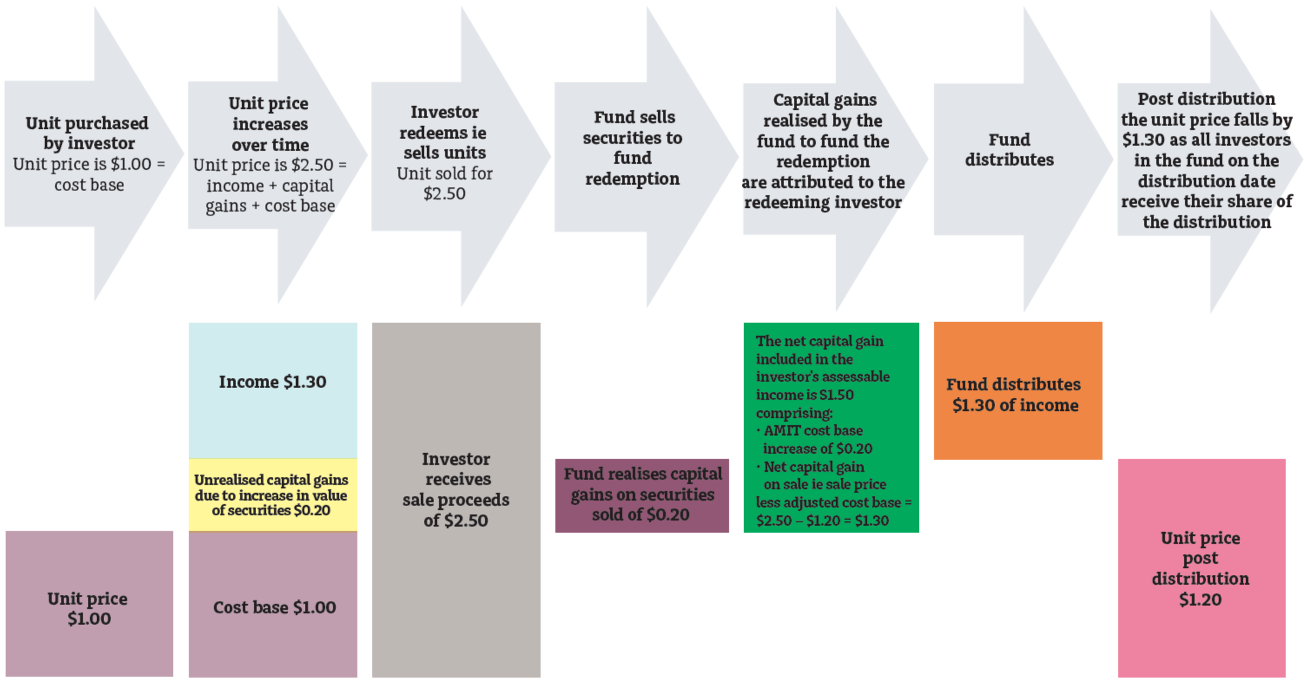


When an investor redeemed they would make a capital gain on the sale of their units in the fund. This capital gain would be included in their assessable income for the financial year.

If securities were sold to fund the redemption and a capital gain was realised, remaining investors in the fund would receive the realised capital gain as a distribution.

Therefore, the redeeming investor would be taxed on the net capital gain from the redemption of their units and remaining investors would be taxed on the net capital gain that is included in their distribution for that financial year – the taxable income is effectively taxed twice.

Scenario 2: redemption in a year of ‘exceptional circumstances’



In exceptional circumstances, the trustee may decide to attribute taxable income – in the example the net capital gains – from the securities sold to fund the redemptions to the investor that has redeemed.

Therefore, only the redeeming investor is taxed on the taxable income arising from their redemption.

In the example, the redeeming investor’s total capital gains and redemption proceeds are the same in both scenarios. However, there are three differences:

- In a year where there are redemptions made in exceptional circumstances the redeeming investor’s net capital gains (**green box**) comprises two amounts: the capital gain attributed to them and the capital gain on disposal of the units. The capital gain on the disposal of the investor’s units in the fund is reduced by the capital gain attributed to them.
- The fund’s distribution (**orange box**) is lower in the year where there are redemptions made in exceptional circumstances. This is because the capital gains are attributed to redeeming investors.
- The unit price for a continuing investor (**pink box**) does not decrease as much in the year where there are redemptions made in exceptional circumstances. This is because the fund doesn’t make a cash distribution to investors of the capital gains attributed to the redeeming investor.

To keep the example simple, we haven’t shown:

- if a capital loss had arisen from the redeeming investor disposing of their units or from the fund selling its securities.
- capital gains resulting from the fund selling securities in the normal course of managing the fund. These capital gains would continue to be included in the fund’s distribution (**orange box**) in both scenarios.
- other taxable income that may be attributed to the redeeming investor.
- a situation where either the securities sold or the redeemed units were held for more than 12 months, in which case the capital gains may be discounted.

In these cases, the impact of redeeming units may be different to that shown in the diagrams.

14. How will I know if a fund has ‘exceptional circumstances’?

We’ll let you know if you’ve made a redemption in a year of ‘exceptional circumstances’ as soon as we can after we make that determination. This determination will usually occur at the end of a fund’s financial year.

15. Why is the decision about ‘exceptional circumstances’ made at the end of the financial year?

The trustee will make its decision about the attribution of the capital gains and income at the end of a fund’s financial year, when the fund’s redemptions and capital gains are calculated for the year. The trustee won’t have the detailed information about the fund’s realised net capital gains until the end of the financial year, when all transactions are finalised.

16. When will redeeming clients receive details of their net capital gains if a fund has ‘exceptional circumstances’?

If a fund has exceptional circumstances and a client has redeemed, they’ll receive details of the capital gains resulting from their personal redemption in their personal MLC MasterKey Unit Trust Tax Statement. This is similar to the way they would have been advised by us of the capital gains resulting from their redemptions in the past. Their tax statement will also include details of the tax component of the fund’s distributions, as they have in the past.