



**RBC Global  
Asset Management**



## **TAXES AND INVESTING IN MUTUAL FUNDS**

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## Why Understanding Taxes Is Important

Understanding how your investments are taxed is an important part of developing an effective investment plan. This guide provides general tax information related to the purchase and sale of mutual fund investments in a non-registered account, with a specific focus on how mutual fund distributions are taxed. The goal is to help you gain a better understanding of tax considerations related to mutual fund investments.

With greater knowledge, you can become a more informed investor and make better investment decisions.

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This guide discusses the impact of taxation on mutual funds in non-registered accounts. Mutual funds held within registered plans, such as RRSPs, RRIFs and RESPs, are not subject to tax until money is withdrawn and are not covered in this guide.

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## What Is a Mutual Fund?

The majority of mutual funds in Canada are known as mutual fund trusts. Investors in mutual funds receive units of the trust and are referred to as unitholders. In recent years, however, there has also been a steady increase in popularity in mutual funds that are set up as corporations. Mutual fund corporations are structures set up with multiple share classes. Each share class, often referred to as a “corporate class fund,” represents a different mutual fund. For more information on corporate class funds, refer to page 13.

At a basic level, mutual funds use money received from unitholders or shareholders to buy securities. The securities purchased depend on the fund’s investment objective, but they generally include stocks and/or bonds. These investments may generate income in the form of interest or dividends. In addition, capital gains or losses may be realized when securities held in the fund are sold.

Income earned within a fund is first used to pay the fund’s management and administration fees. When added together, the management fee and the administration fee make up the Management Expense Ratio (MER). The income that is left over is distributed to unitholders.

*Investors in RBC Funds, PH&N Funds and RBC Corporate Class Funds benefit from MERs that are among the lowest in the industry.*

## When Do I Pay Taxes on My Mutual Fund Investment?

Generally, tax considerations related to your mutual fund investments can be grouped into two categories:

- Taxes associated with selling or switching fund units
- Taxes related to the distributions received from a mutual fund

## Principles Related to Taxes and Investing

### **Structure your overall portfolio to be tax efficient**

Structuring your portfolio with tax efficiency in mind plays an important role in building wealth and determining how much tax you pay. The types of investments you own and where you hold them (inside or outside of a registered plan) have a bearing on the tax effectiveness of your overall portfolio.

### **Maximize cash flow in retirement with a tax-efficient portfolio**

In retirement, the cash flow you receive from your investments becomes increasingly important; one way to maximize cash flow is to minimize taxes. Choosing investments that benefit from favourable tax treatment can help you keep more cash in your pocket.

### **Work with an advisor**

Working with a knowledgeable investment professional can help you learn about how different types of investments are taxed and how you can build a tax-efficient portfolio.

## Taxes Associated With Selling or Switching Your Mutual Fund

As with any investment, there are tax considerations related to the purchase and sale of mutual funds. Here is what you need to know:

- **If you sell a mutual fund investment for *more* than what you purchased it for, plus any taxable distributions reinvested, you realize a *capital gain*.** Realized capital gains must be reported for tax purposes in the year of sale. They are taxed more favourably than regular income. Under current tax rules, only 50% of a capital gain is subject to taxes.
- **If you sell a mutual fund investment for *less* than what you purchased it for, plus any taxable distributions reinvested, you realize a *capital loss*.** Most capital losses can be applied against capital gains to reduce the amount of taxes payable. If you have no realized capital gains in the year a capital loss is realized, the loss can be carried back and applied against taxable capital gains from any of the previous three years. You are also allowed to carry the loss forward indefinitely to offset gains in future years.

In general, you can calculate your capital gain or loss using the following formula:

Capital gain (or capital loss)	=	Proceeds from sale of an investment	–	Cost of investment*
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\* Also known as the adjusted cost base. See page 4 for more information about the calculation of adjusted cost base.

### Switching Between Mutual Funds

If you switch between mutual funds in a non-registered account, you are deemed to have sold units of one fund and purchased units in another. If the units you sold are worth more than what you originally purchased them for, the switch will generate a capital gain. If the units you sold are worth less than what you originally paid, the switch will generate a capital loss.

When switching between funds, keep in mind that you are required to keep track of your capital gains and include the taxable portion of the capital gain in your taxable income in the year of sale.

When switching between mutual funds in a corporate class structure, an investor can switch between funds with no tax cost, which is possible because each fund in the corporate class structure is a class of shares in a single mutual fund corporation. And switching from one class of shares to another class in the same corporation is not deemed to be a taxable event. So, as long as you stay in funds under the same corporate class funds umbrella, you'll defer tax on gains. Of course, when you eventually redeem out of the corporation, you'll pay tax on any gains you realize – just like any other investment. For more information on the benefits of corporate class funds, see the section beginning on page 13 titled Corporate Class Funds.

## HELPFUL TIPS

While we recommend that you refer to your own investment records to calculate the adjusted cost base you use in determining your capital gain or loss, average cost information may be provided to you by the fund company on an ongoing basis as part of your account statement. This information could be provided in addition to transaction history, account balances and a personal rate of return on your investments.

## What Is Adjusted Cost Base?

In the capital gain (loss) calculation, the adjusted cost base (ACB) plays an important role. **Adjusted cost base can be thought of as the average price paid for units owned.** When you sell your mutual fund, it is the ACB that determines whether you have realized a capital gain or a capital loss.

### How to calculate ACB

The following example shows how ACB is calculated and whether a capital gain or loss results.

Jason purchases 100 units of a fund for \$10 per unit	Jason's investments \$1,000
At some point later, Jason buys 50 more units of the same fund at \$12 per unit	\$600
Jason has a total of 150 units and a total investment of \$1,600	\$1,600

### Jason's ACB can be calculated as follows:

$$\text{ACB per unit} = \frac{\$1,600 \text{ total investment}}{150 \text{ mutual fund units}} = \$10.6667$$

### How to calculate the taxable capital gain (loss)

- Assume Jason later sells the holdings at a unit price of \$11.00. Because the ACB of each unit is \$10.6667, this results in a capital gain of \$0.3333 per unit:  
 $\$11.00 - \$10.6667 = \$0.3333$
- The total capital gain is \$50.00:  
 $\$0.3333 \text{ per unit capital gain} \times 150 \text{ units owned} = \$50.00$
- Under the current rules, only 50% of the capital gain (i.e. \$25.00) would be subject to tax:  
 $\$50.00 \times 50\% = \$25.00$
- Assuming a marginal tax rate of 35%, this would result in taxes payable of \$8.75:  
 $\$25.00 \times 35\% = \$8.75$

## Mutual Fund Distributions and Taxes

### Why Do Mutual Funds Make Distributions?

Distributing income earned by mutual fund holdings benefits unitholders by minimizing overall taxes paid by the fund. Since mutual fund trusts are taxed at a rate equivalent to the highest personal tax rate, any income retained by a mutual fund is typically subject to more tax than if it were taxed in the hands of individual investors.

Distributing income to unitholders, most of whom are taxed at a lower marginal tax rate than the mutual fund, generally results in a lower amount of total taxes paid. By reducing tax paid by the fund, more income can be distributed to investors, which improves the return on their investment.

Mutual fund corporations, however, only provide a limited flow-through in that only Canadian dividends and capital gains can be passed on directly to investors. Interest and foreign income earned inside a mutual fund corporation are taxable first inside the corporate structure and can only be distributed to its investors after tax in the form of a taxable Canadian dividend.

### What Do I Do With Distributions?

When mutual funds make distributions, you have two options:

1. You can take the distributions as a payment of cash.
2. You can reinvest the distributions by purchasing more units at the prevailing unit price.

Regardless of which option you choose, you are generally required to include distributions as part of your taxable income for the year in which you received them (the exception is return of capital distributions, which is discussed in the In Focus section on page 15).

#### HELPFUL TIPS

As an investor in mutual funds, you will receive all of the information you need from the fund company to accurately report income you've earned from your investments during the year.

The T3 tax slip (Relevé 16 in Quebec) shows the interest, dividends, capital gains, return of capital and foreign income you received during the year, as well as any foreign income taxes paid. Income that benefits from favourable tax treatment, such as amounts eligible for the enhanced dividend tax credit, are also clearly identified.

The T5 tax slip (Relevé 3 in Quebec), or Statement of Investment Income, is issued to investors who own mutual funds in a corporate structure.

See page 18 of this guide to view examples and learn more about T3 and T5 slips.

#### Tax slips are still issued when returns are negative

It is possible a fund will have a negative rate of return in a given year while still paying distributions. Securities in a mutual fund may pay interest or dividends even if the market value of the security has decreased. Mutual funds distribute income earned by the securities they hold in order to minimize the overall amount of taxes paid by the fund because they are taxed at a rate equivalent to the highest personal tax rate. Any income retained by a mutual fund is typically subject to more tax than if it were taxed in the hands of individual investors.



## What Are the Different Types of Distributions?

The following table provides brief descriptions of the different types of distributions that unitholders may receive from mutual funds and how each type is taxed.

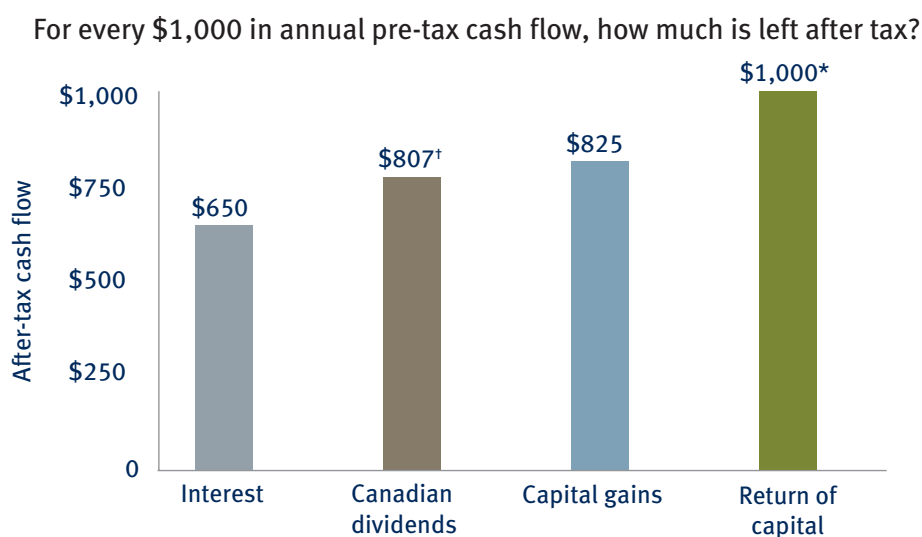
Type of Distribution	Description	Tax Treatment	Mutual Fund Example
Interest	Earned on investments such as treasury bills and bonds	Fully taxable at the same marginal tax rate as employment income	<ul style="list-style-type: none"> <li>■ RBC Canadian Money Market Fund</li> <li>■ PH&amp;N Canadian Money Market Fund</li> </ul>
Canadian Dividends	Occurs when funds invest in shares of Canadian public corporations that pay dividends	Preferential tax treatment for individuals through the dividend tax credit	<ul style="list-style-type: none"> <li>■ RBC Canadian Dividend Fund</li> <li>■ PH&amp;N Dividend Income Fund</li> </ul>
Capital Gains	Realized when an investment within the fund is sold for more than its original price	Preferential tax treatment, as only 50% of a capital gain is taxable	<ul style="list-style-type: none"> <li>■ RBC Canadian Equity Fund</li> <li>■ PH&amp;N Canadian Equity Fund</li> </ul>
Foreign Non-Business Income	Earned when the fund receives dividends from, or interest on, non-Canadian investments	Fully taxable at the same marginal tax rate as employment income	<ul style="list-style-type: none"> <li>■ RBC European Equity Fund</li> <li>■ PH&amp;N Overseas Equity Fund</li> </ul>
Return of Capital	Return of capital (ROC) is used to describe distributions in excess of a fund's earnings (income, dividends and capital gains). For tax purposes, ROC represents a return of an investor's portion of their own invested capital	Not taxable in the year received, but reduces the ACB, which generally results in a larger capital gain or a smaller capital loss when the investment is sold	<ul style="list-style-type: none"> <li>■ RBC \$U.S. Income Fund</li> <li>■ PH&amp;N Monthly Income Fund</li> <li>■ RBC Managed Payout Solutions</li> </ul>



Interest income, dividends and capital gains earned by your mutual fund may be distributed to you on a monthly, quarterly or annual basis. The different types of income you receive are reflected on your T3 tax slip or your T5 tax slip, which is mailed annually, usually in February. Samples of these tax slips can be found starting on page 18. The information that appears on these slips helps you accurately report different types of income on your tax return.

As shown below, various types of distributions are treated differently where taxes are concerned.

### It's Not What You Earn – It's What You Keep



<sup>†</sup> Represents eligible Canadian dividends with a federal tax credit of 15.02%. Provincial credits also apply.

<sup>\*</sup> Return of capital distributions are not taxable in the year they are received, but do lower your adjusted cost base, which could lead to a higher capital gain or a smaller capital loss when the investment is eventually sold.

Based on an investor with a 29% marginal tax rate.

### Interest income

Interest income is earned on securities, such as treasury bills and bonds, and is not eligible for any special tax treatment. It is taxed at the same rate as your regular employment income. Interest distributions are reported as “Other Income” on the T3 tax slip.

## HELPFUL TIPS

A clear summary of any eligible dividends received during the year will be provided for mutual fund investors on their tax slips. This information makes determining amounts eligible for the federal dividend tax credit and the enhanced federal dividend tax credit easy for you.

## Dividend income

Dividend income may be earned when a fund invests in shares of public companies that pay dividends. Individuals who receive dividends from Canadian companies receive a federal tax credit (a provincial dividend tax credit may also apply) to reflect the fact that the company paying the dividend has already paid tax on its profits. Because of their tax efficiency, dividend-paying stocks are popular with investors seeking to maximize cash flow from their investments.

### How does the federal dividend tax credit work?

The dividend tax credit reduces the amount of tax you pay on dividend income. Dividends are classified as either “eligible” or “non-eligible” to reflect whether the issuing company paid tax at the high corporate rate (eligible) or the small business rate (non-eligible), respectively. Non-eligible dividends receive the federal dividend tax credit and eligible dividends receive the enhanced federal dividend tax credit. The following points summarize how this works:

#### Non-eligible dividends:

- Non-eligible Canadian dividends received in the hands of individual investors are grossed up by 25%. That is, you add 25% to the amount of the dividend you received.
- The grossed-up amount is shown as income from dividends on your tax return.
- The federal dividend tax credit is 13.33%. This number is multiplied by the grossed-up amount and the resulting amount is deducted from your federal tax.

#### Eligible dividends:

- Eligible Canadian dividends received in the hands of individual investors are grossed up by 38% (for 2012). That is, you add 38% to the amount of the dividend you received.
- The grossed-up amount is shown as income from dividends on your tax return.
- The federal dividend tax credit is 15.02% (for 2012). This number is multiplied by the grossed-up amount and the resulting amount is deducted from your federal tax.
- The net effect is a lower tax bill for your dividend income (as indicated in the graph on the previous page).

It is important to note that the Canada Revenue Agency (CRA) provides specific guidelines regarding which dividends can be classified as “eligible” or “non-eligible.”

**How are dividends taxed?**

The table below shows the steps involved in calculating federal taxes payable on dividends under both categories. For more specific information regarding the federal dividend tax credit and the eligible dividends, please speak with your advisor or a qualified tax specialist.

		2012	
		Non-Eligible Dividends	Eligible Dividends
Dividend	a	\$1,000	\$1,000
Dividend Gross-Up	b	25%	38%
Grossed-Up Dividend (a x (1 + b)) (this amount reported as taxable income)	c	\$1,250	\$1,380
Federal Taxes Payable (c x 29%)	d	\$362.50	\$400.20
LESS Federal Dividend Tax Credit (federal tax credit x c)	e	\$166.63 (federal tax credit = 13.33%)	\$207.28 (federal tax credit = 15.02%)
Net Federal Tax (d - e)	f	\$195.88	\$192.92
Federal Tax Rate on Dividend (f ÷ a)	g	19.59%	19.29%

(1) The example assumes that an investor is in the top marginal tax bracket (29%) for federal purposes with a taxable income of more than \$128,800 in 2012.

(2) In addition to the federal taxes noted in the example, provincial taxes are required to be paid. The amount of provincial taxes will vary according to province (provincial dividend tax credits also apply). When combined, the total of the federal and provincial taxes equal the taxes owing on a taxable Canadian dividend.

## DID YOU KNOW?

### Mutual funds can also distribute capital gains

Capital gains can also be incurred if a fund has realized more gains than it has losses to offset during the year's trading activities. This situation makes it possible for a fund to distribute capital gains to investors at the end of the year.

## Capital gains

As indicated on page 3, capital gains are realized when an investment is sold for more than its original purchase price. Because only 50% of a capital gain is subject to tax, these distributions are considered to be very tax efficient.

The following example shows how this works:

Original cost of investment	a	\$1,000
Market value at time of sale	b	\$1,500
Capital gain on sale of investment (b - a)	c	\$500
Capital gains inclusion rate for tax reporting (50% of c)	d	\$250
Federal tax payable (d x 29%)	e	\$72.50
Federal tax rate on capital gain (e ÷ c)	f	14.50%

The example assumes that an investor is in the 29% federal tax bracket. Note that provincial taxes would also apply and tax rates vary according to province.

## Foreign non-business income

Foreign income may be earned by mutual funds that invest in foreign securities. While investors must report 100% of income earned from foreign sources on their tax return, they can claim a foreign tax credit for any taxes already paid to foreign governments. If applicable, both of these amounts will be shown on your year-end tax slips.

## Return of capital distributions

Unlike other types of mutual fund distributions, a return of capital (ROC) distribution is a payout from a mutual fund that gives you back part of your invested capital. Return of capital is often distributed when a fund's objective is to pay a regular set monthly distribution to unitholders, but the underlying fund holdings have not generated enough interest or dividends, or realized capital gains during that period.

Return of capital distributions reduce the ACB, which could result in a higher capital gain or a lower capital loss when you eventually sell your investment. Return of capital distributions are explained in detail in the In Focus section on page 15.

## Why Did the Fund's Price Go Down When It Paid a Distribution?

Most investors do not keep track of unit prices or the number of units they own. Instead, they focus on the dollar value of their portfolio. For this reason, investors who reinvest distributions often do not even notice that distributions have been paid.

If you do reinvest your distributions, it is important to understand how distributions affect the unit value of your mutual fund and what it means for your investment. The following example shows why:

### The scenario

- Amy purchases 100 units of a fund at \$10 per unit, for a total investment of \$1,000.
- When the fund is purchased, it is set up to automatically reinvest distributions.
- During the year, interest and dividend income, as well as growth in the value of securities in the fund, increase the value of each unit from \$10 to \$11, which increases the value of the investment to \$1,100.
- At year-end, the fund pays out a distribution of \$0.50 per unit.

### The impact

- Amy holds 100 units, so the distribution of \$0.50 per unit gives a total distribution of \$50.
- The \$0.50 per unit distribution results in the unit price falling to \$10.50 from \$11.00.
- Amy's \$50 distribution is automatically reinvested in additional fund units. At the new unit price of \$10.50, she buys 4.7619 units ( $\$50 \div \$10.50 = 4.7619$ ).
- Amy now owns 104.7619 units.

### The result

- The original 100 units purchased are now worth \$1,050 ( $100 \times \$10.50$ ).
- The additional 4.7619 units purchased with the distribution are worth \$50 ( $4.7619 \times \$10.50$ ).
- The total dollar value of the portfolio has not changed. It is still \$1,100.  

$$[(\text{original 100 units worth } \$1,050) + (4.7619 \text{ new units worth } \$50)] = \$1,100$$

In general, when you automatically reinvest distributions, you will see your mutual fund's unit value decline, but the number of units you own goes up. As a result, the total dollar value of your portfolio does not change.

## How Do Distributions Affect Adjusted Cost Base?

You should be aware that reinvested distributions cause the ACB to increase. In the example on the previous page, we saw how reinvesting distributions did not affect the total dollar value of the investment; the unit price fell to \$10.50 from \$11.00, but the number of units increased to 104.7619 from 100. However, the ACB did change in the example (recall that ACB can be thought of as the average price paid for units owned).

Let us continue with our previous example to see how it works.

Recall that Amy originally owned 100 units purchased for \$10 per unit. When the \$50 distribution was automatically reinvested at the new unit price of \$10.50, she acquired an additional 4.7619 for a total of 104.7619 units.

**The ACB per unit for Amy can be calculated as follows:**

$$\text{ACB} = \frac{(100 \text{ units} \times \$10 \text{ per unit}) + (4.7619 \text{ units} \times \$10.50 \text{ per unit})}{\text{Total number of units purchased}}$$

$$\text{ACB} = \frac{\$1,000 + \$50}{104.7619}$$

$$\text{ACB} = \$10.02$$

In this example, reinvesting distributions caused the ACB to increase to \$10.02 from \$10.

## What Happens When Distributions Are Not Reinvested?

If you choose to receive your distributions in cash instead of having them reinvested, the ACB will not be affected. Referring back to the example, if Amy took the distribution in cash rather than reinvesting it, the ACB would remain at \$10 per unit. She would receive \$50 in cash and would have 100 units worth \$10.50 each.

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### Making purchases close to year-end

If you buy units of a fund just before it makes a distribution, you will be taxed on any distributions paid. For example, if you buy units of a fund in a non-registered account late in the year and the fund distributes income and capital gains in December, you may have to pay taxes on the income and capital gains it earned before you purchased your units. Depending on your circumstances, you may prefer to wait until distributions have been made before investing. Please speak with your advisor or a tax specialist if you plan on purchasing units of a mutual fund close to year-end.

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## Corporate Class Funds

### What Is a Corporate Class Fund?

Corporate class funds are set up as mutual fund corporations with multiple share classes. Each share class, often referred to as a “corporate class fund,” would represent a different mutual fund. For example, Class A may be a Canadian balanced fund; Class B, a U.S. equity fund; Class C, an international equity fund; and so on.

### Two Ways to Defer Tax With Corporate Class Funds

#### Tax-free switching between funds

With corporate class funds, an investor can switch between funds with no tax cost, which is possible because each fund is a class of shares in a single mutual fund corporation – and switching from one class of shares to another in the same corporation is not a taxable event. Therefore, as long as an investor stays in funds that are under the same corporate class fund umbrella, they will defer any tax on gains when switching between funds.

When the investment is eventually redeemed out of the corporation, the investor will pay tax on any gains realized – just like any other investment; however, the ability to defer tax payments for long periods is a valuable benefit of corporate class funds because more money remains invested and working for the investor.

#### Reduced taxable distributions

Compared to standard mutual fund trusts, corporate class funds give investors an opportunity to pay less tax on income earned inside of a fund. Corporate class funds can manage the taxable income and deductions generated by all of the funds under its corporate umbrella. This way, the losses or expenses in one fund can be used to shield taxable income in another. This is how corporate class funds can help reduce the taxable distributions investors receive.

#### HELPFUL TIPS

As part of the RBC Corporate Class Funds, investors can use capital class bond funds to help reduce tax costs on their fixed income investments.

With bonds or bond funds, interest income earned is taxed at the investor’s highest tax rate. Corporate class funds offer bond funds that generate tax-efficient capital gains, which are taxed at half the rate of interest income.



## Corporate Class Funds Distributions

At year-end\*, mutual funds of all types generally distribute taxable income to avoid the high rate of taxation on that income if taxed inside the fund. While mutual fund trusts permit all types of income and capital gains earned by the trusts to flow through to investors and retain their tax characteristics in investors' hands, mutual fund corporations only provide a limited flow-through in that only Canadian dividends and capital gains can be passed on directly to investors. Interest and foreign income earned inside a mutual fund corporation are taxable first inside the corporate structure and can only be distributed to its investors after tax in the form of a taxable Canadian dividend. Distributions are reported on a T5 tax slip (Relevé 3 in Quebec).

## What Happens to ACB When Switching Between Corporate Class Funds?

The examples below show how cost calculations differ when switching between mutual fund trusts and corporate class funds.

When switching between mutual fund trusts (Example 1), any capital gain or loss is realized and the cost of the newly acquired units equals the value of the switched units.

When switching between corporate class funds (Example 2), any capital gain or loss is deferred and the cost of the newly acquired shares equals the cost of the switched shares.

### Example 1: Switching Between Two Mutual Fund Trusts

Investor buys a mutual fund trust (Fund 1), reinvests a distribution and then switches 10% of the market value to another mutual fund trust (Fund 2).

	Transactions					Balances				
	Value(\$)	Unit Price (\$)	Units	Cost (\$) (Units x Cost/Unit)	Realized Gain/Loss(\$) (Value - Cost)	Units	Value (\$)	Cost (\$)	Cost / Unit (\$) (Cost / Units)	Embedded Gain/Loss (\$) (Value - Cost)
<b>Fund 1</b>										
Buy	100,000	10.0	10,000			10,000	100,000	100,000	10.0	0
Dist Reinv.	8,000	12.0	667			10,667	128,000	108,000	10.1	20,000
Switch 10% out to Fund 2	(12,800)	12.0	(1,067)	10,800	2,000	9,600	115,200	97,200	10.1	18,000
<b>Fund 2</b>										
Switch in from Fund 1	12,800	20.0	640	n/a	n/a	640	12,800	12,800	20.0	0

cost of Fund 2 = value of units switched

capital gain is realized

### Example 2: Switching Between Two Fund Classes in the Same Corporate Class Structure

Same transactions as Example 1 (above) but with share classes in the same fund corporation instead of mutual fund trusts.

	Transactions					Balances				
	Value(\$)	Share Price (\$)	Shares	Cost (\$) (Shares x Cost/Share)	Realized Gain/Loss(\$) (Value - Cost)	Shares	Value (\$)	Cost (\$)	Cost / Share (\$) (Cost / Shares)	Embedded Gain/Loss (\$) (Value - Cost)
<b>Class 1</b>										
Buy	100,000	10.0	10,000			10,000	100,000	100,000	10.0	0
Dist Reinv.	8,000	12.0	667			10,667	128,000	108,000	10.1	20,000
Switch 10% out to Class 2	(12,800)	12.0	(1,067)	10,800	0	9,600	115,200	97,200	10.1	18,000
<b>Class 2</b>										
Switch in from Class 1	12,800	20.0	640			640	12,800	10,800	16.9	2,000

cost of Class 2 = cost of shares switched

capital gain is deferred

\* RBC Funds and PH&N Funds, mutual fund trusts, have a year-end of December 31. RBC Corporate Class Funds have a year-end of March 31.

## In Focus: Return of Capital Distributions

### What Is Return of Capital?

Capital can be defined as a blend of the total amount you have invested into a mutual fund plus any reinvested distributions. An ROC distribution gives you back part of that capital. Return of capital should not be misinterpreted as earned income, such as interest, dividends or capital gains. Instead, it represents a return to the investor of a portion of their own invested capital.

Return of capital distributions typically occur when a fund's objective is to pay a regular set monthly distribution. If interest, dividends and realized capital gains earned by the fund are less than the amount of the regular set distribution, an ROC distribution is added to make up the remainder. Return of capital distributions help stabilize the amount of cash flow an investor receives on a regular basis from a particular investment.

RBC Funds and PH&N Funds that typically have ROC distributions include:

- PH&N Monthly Income Fund
- RBC \$U.S. Income Fund
- RBC Managed Payout Solutions

### What Are the Main Benefits of Return of Capital?

Return of capital offers a solution to investors who require a regular income stream from their investments. Return of capital provides three main benefits:

- **Tax efficiency:** Unlike interest, dividends and capital gains, income classified as ROC is not taxable in the year it is received.
- **Cash flow stability:** Funds that distribute ROC are particularly appealing for investors seeking regular cash flow from their portfolios. Return of capital is used to help fund managers generate predictable monthly cash flows and offers a solution to individuals who require stable income from their investments.
- **Tax deferral:** Tax payments can be deferred until your investment is sold, helping to maximize your current cash flow and giving you control over *when* you pay tax.

It is important to understand the long-term tax impact of ROC distributions. While ROC is not taxable in the year it is received, it reduces the ACB of your investment, which will typically result in a higher taxable capital gain or a lower capital loss when you eventually sell your mutual fund. If the ACB reaches zero, any future ROC distributions will be taxed as capital gains because you are getting back more than you originally invested.

## HELPFUL TIPS

Unitholders of mutual funds that distribute ROC may receive updated ACB information on their year-end client statements, so they can easily track the impact of ROC distributions on their investment. However, it is recommended unitholders refer to their own statement records to calculate the ACB that is specific to their own circumstances. Speak with your advisor or tax specialist for more information.

## Return of Capital in Action

Consider the RBC Managed Payout Solution – Enhanced Plus, which in 2012 paid a regular set monthly distribution of \$0.0435 per unit (\$0.522 annually). The following hypothetical example illustrates how ROC works in this fund:

1. On January 1, John purchases units in the RBC Managed Payout Solution – Enhanced Plus at a unit price of \$10.
2. By the end of January, the unit value increases from \$10 to \$10.15, which is the result of the following:  
$$\begin{aligned} &\$0.03 \rightarrow \text{Interest and dividends earned by securities in the Fund} \\ &+ \$0.12 \rightarrow \text{Growth in the value of the securities held in the Fund} \\ &= \$0.15 \rightarrow \text{Total increase in value per unit} \end{aligned}$$
3. On January 31, the Fund pays its regular set distribution of \$0.0435 per unit. The distribution, which includes a portion of return of capital, is calculated as follows:  
$$\begin{aligned} &\$0.0300 \rightarrow \text{Interest and dividends earned by securities in the Fund} \\ &+ \$0.0135 \rightarrow \text{ROC to maintain a consistent monthly payout rate of } \$0.0435 \\ &= \$0.0435 \rightarrow \text{Total distribution per unit} \end{aligned}$$

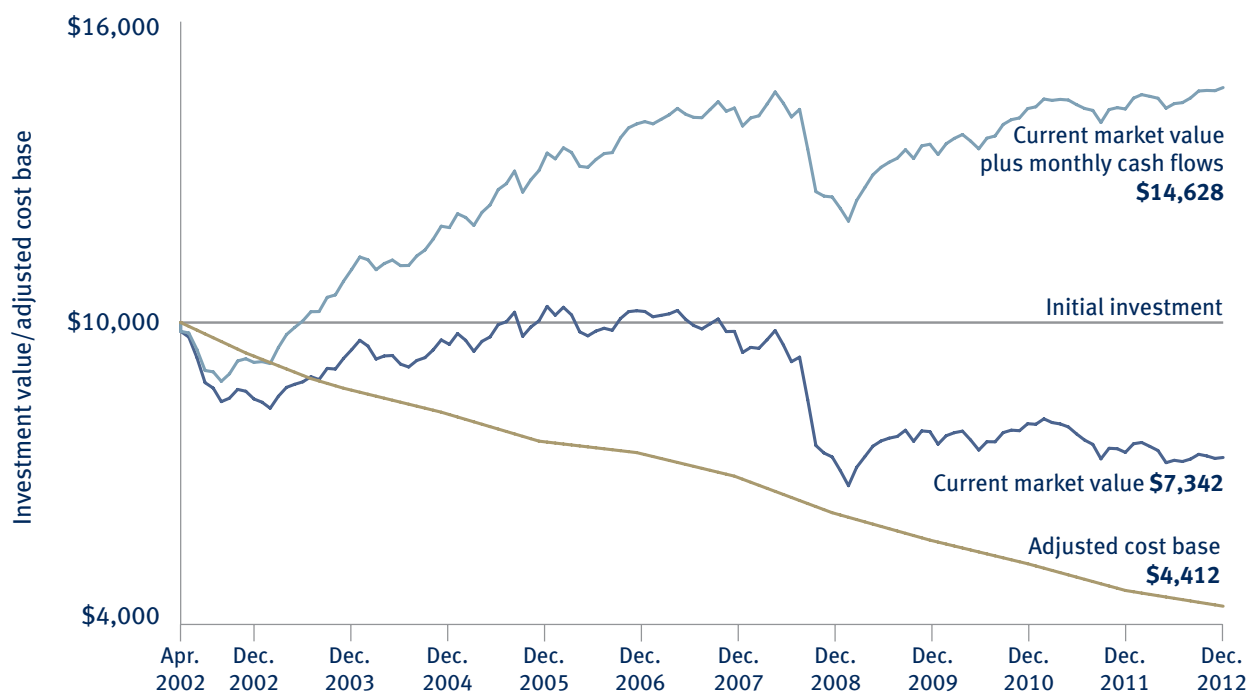
In the above example, the portion of the distribution classified as ROC is \$0.0135. It is added to the interest and dividends paid out (\$0.0300) to make up the monthly \$0.0435 distribution.

## The Long-Term Impact of Return of Capital Distributions

Assume you invested \$10,000 in the RBC Managed Payout Solution – Enhanced Plus when it was launched in April 2002. Every month, the Fund paid its regular monthly distribution, a portion of which was ROC. Over time, the ROC distribution has reduced the ACB of your units. At the end of 2012, you decide to sell your investment. The chart on the next page shows how ROC distributions reduce the ACB, resulting in a higher taxable capital gain.

## Impact of Return of Capital Distributions

Actual results for a \$10,000 investment in the RBC Managed Payout Solution – Enhanced Plus made in April 2002, redeemed in December 2012.

**Key Points:**

- Over the holding period, the current market value plus monthly cash flows amounted to \$14,628, providing a total benefit of \$4,628 (\$7,286 in monthly cash flow minus a \$2,658 decrease in the initial investment).
- Total monthly cash flow payments included ROC distributions of \$5,588, which reduce the client's ACB to \$4,412 (\$10,000 - \$5,588).
- The remaining cash flow of \$1,698 consisted of a combination of interest, dividends and capital gains (\$7,286 - \$5,588).
- If all units were sold on December 31, 2012, the difference between the market value and the ACB generates a capital gain for tax purposes (\$7,342 - \$4,412 = \$2,930).

## Return of Capital and Old Age Security Benefits

Old age security (OAS) benefits and other government income are typically reduced if your income exceeds a certain threshold (for 2012, the OAS clawback threshold is \$69,562). Amounts that affect government income-tested benefits typically include employment income, investment income and capital gains. However, ROC distributions are not considered taxable income, so your OAS benefits will not be affected by them. When you do decide to sell your investment, OAS benefits and any other income-tested amounts, such as tax credits and other allowances, could be impacted by the potentially larger capital gain.

# Understanding Your Year-End Tax Slips

When a mutual fund you hold in a non-registered account distributes any form of income, you will receive a T3 or T5 tax slip indicating the amount and type of income that the fund has distributed to you for the previous year.

This section explains what information is contained on these slips and provides answers to some commonly asked questions.

## Sample T3 Tax Slip

**BOX 23 and BOX 49 —  
ACTUAL AMOUNT  
OF DIVIDENDS**

Information only — this amount is not included on your tax return.

**BOX 32 and BOX 50 —  
TAXABLE AMOUNT  
OF DIVIDENDS**

Include this amount in Part I of Schedule 4.

**BOX 39 and BOX 51 —  
FEDERAL DIVIDEND TAX CREDIT**

Include this amount on line 425 of Schedule 1.

Canada Revenue Agency Agence du revenu du Canada		<b>STATEMENT OF TRUST INCOME ALLOCATIONS/DESIGNATIONS ÉTAT DES REVENUS DE FIDUCIE (RÉPARTITIONS ET ATTRIBUTIONS) T3</b>								
Trust year ending Year  Année  Month  Mois  Fin d'année de la fiducie	49	Actual amount of eligible dividends  Montant réel des dividendes déterminés	50	Taxable amount of eligible dividends  Montant imposable des dividendes déterminés	51	Dividend tax credit for eligible dividends  Crédit d'impôt pour dividendes déterminés	21	Capital gains  Gains en capital	30	Capital gains eligible for deduction  Gains en capital admissibles pour déduction
	23	Actual amount of dividends other than eligible dividends  Montant réel des dividendes autres que des dividendes déterminés	32	Taxable amount of dividends other than eligible dividends  Montant imposable des dividendes autres que des dividendes déterminés	39	Dividend tax credit for dividends other than eligible dividends  Crédit d'impôt pour dividendes autres que des dividendes déterminés	26	Other income  Autres revenus	12	Recipient identification number  Numéro d'identification du bénéficiaire
	25	Foreign non-business income  Revenu étranger non tiré d'une entreprise	34	Foreign non-business income tax paid  Impôt étranger payé sur un rev. non tiré d'une entreprise	42	Cost Base Adjustment  Montant nécessitant un rajustement du prix de base	14	Account Number  Numéro de compte	16	Report Code  Code de genre de feuillet
									18	Beneficiary Code  Code du bénéficiaire
Recipient: Last name first, and full address - Bénéficiaire : Nom de famille, prénom et adresse					Name of Trust - Nom de la Fiducie					

**BOX 25 —  
FOREIGN NON-BUSINESS INCOME**

Include this amount on line 121 of your return and on line 433 of Schedule 1.

**BOX 42 —  
RETURN OF CAPITAL**

These are amounts resulting in a cost base adjustment.  
Use this information to keep track of your adjusted cost base.

**BOX 26 —  
OTHER INCOME**

Include this amount on line 130 of your return.

**BOX 34 —  
FOREIGN NON-BUSINESS INCOME TAX PAID**

Include this amount on line 431 of Schedule 1.

**BOX 21 —  
CAPITAL GAINS**

Subtract any amount in box 30 from the amount in box 21. Include the difference on line 176 of Schedule 3.

## Sample T5 Tax Slip

**BOX 13 —  
INTEREST FROM CANADIAN  
SOURCES**


For information on how to report this amount on your return, see line 121 in your tax guide.

**BOX 21 —  
REPORT CODE**

The code in this box indicates that this slip is the original ("O"); an amended ("A"); or a cancelled slip ("C").

**BOX 22 —  
RECIPIENT IDENTIFICATION  
NUMBER**

If you are an individual (other than a trust), the number in this box is your social insurance number. In all other cases, the number is your 9 characters business number.

 <b>Canada Revenue Agency</b> Agence du revenu du Canada		<b>T5</b>		<b>STATEMENT OF INVESTMENT INCOME</b> <b>ÉTAT DES REVENUS DE PLACEMENTS</b>	
Year  Année	<b>13</b> Interest from Canadian Sources Intérêts de source canadienne	<b>21</b> Report Code Code du feuillet	<b>22</b> Recipient Identification Number Numéro d'identification du bénéficiaire	<small>IF YOUR SOCIAL INSURANCE NUMBER (SIN) DOES NOT APPEAR IN THE BOX #22 TO THE LEFT, PLEASE WRITE IT IN THE BOX AND PROVIDE YOUR SIN TO YOUR BRANCH.</small> <small>SI VOTRE NUMÉRO D'ASSURANCE SOCIALE (NAS) N'EST PAS INDiqué DANS LA CASE À GAUCHE, VEUILLEZ L'INSCRIRE DANS LA CASE ET LE COMMUNIQUER À VOTRE SUCCURSALE.</small>	
<small>RECIPIENT: SURNAME FIRST, AND FULL ADDRESS          BÉNÉFICIAIRE: NOM DE FAMILLE D'ABORD, ET ADRESSE COMPLÈTE</small>					
<small>Name and Address of Payer - Nom et adresse du payeur ou du fiduciaire</small>					
		<b>23</b> Recipient Type Type de bénéficiaire	<b>27</b> Foreign Currency Devises Étrangères	<div style="font-size: 2em; float: left; margin-right: 10px;">3</div> <ul style="list-style-type: none"> <li>• To be kept by recipient SEE INFORMATION ON REVERSE</li> <li>• À conserver par le bénéficiaire VOIR LES INDICATIONS AU VERSO</li> </ul>	
<small>Privacy Act, Personal Information Bank number CRA PPU 150 and CRA PPU 005 / Loi sur la protection des renseignements personnels, Fichiers de renseignements personnels ARC PPU 150 et ARC PPU 005          T5 (12)</small>					

**BOX 23 —  
RECIPIENT TYPE**

The code in this box indicates if the amount was paid to an individual ("1"); a joint account ("2"); a corporation ("3"); an association, trust, club or partnership ("4"); or a government ("5").

**BOX 27 —  
FOREIGN CURRENCY**

Leave this area blank if you are reporting amounts in Canadian dollars. For more information, see box 27 in the *T4015 – T5 Guide – Return of Investment Income*.

## Common Mutual Fund Questions for Tax Season

### **Do I have to include the distributions I receive as part of my taxable income?**

Yes. Except for return of capital (ROC) distributions, you will have to pay tax on any distributions received each year in a non-registered account. You will be issued a T3 or T5 tax slip annually for any interest income, dividends or capital gains distributed to you by the mutual fund you own. These amounts must be reported on your tax return.

### **If I reinvested the distributions from my non-registered investments, are they still taxable?**

Yes. Distributions from your non-registered investments are taxable, whether you receive them in cash or reinvest them in additional units of the fund. Unless you advise us otherwise, distributions on RBC Funds, PH&N Funds and RBC Corporate Class Funds are automatically reinvested in additional units of the fund. All distributions, whether reinvested or paid out to you, are reported on your T3 or T5 tax slip. The key advantage of reinvesting your distributions is that you benefit from the effects of compounding, which can accelerate growth in the value of your investment.

### **I sold some mutual funds during the year and realized some capital gains. Do these capital gains appear on my tax slips?**

No. The capital gains reported on year-end tax slips include only those gains that were realized within a mutual fund and distributed to unitholders. Tax slips do not indicate capital gains you may have realized by selling your own mutual fund units. You are responsible for reporting capital gains resulting from the sale of mutual fund units on your tax return. Please see pages 3 and 10 for information on calculating capital gains and losses.

### **Is there any way of knowing in advance how much interest, dividends, capital gains or ROC will be paid by a mutual fund in a given year?**

Mutual fund distributions are not known until the end of the year, when a fund accounts for the income generated by the various securities. As a result, it is not possible to specify in advance what the income breakdown of distributions will be. However, estimates based on the long-term averages of interest, dividends, capital gains and ROC paid in previous years may be available. Investors in RBC Funds, PH&N Funds and RBC Corporate Class Funds are provided with a breakdown of each type of income paid to them each year on their tax slips. RBC Funds and PH&N Funds have a December 31 year-end while RBC Corporate Class Funds have a year-end of March 31.



**Are tax slips issued for mutual funds held in my Tax-Free Savings Account?**

No. A Tax-Free Savings Account (TFSA) is a registered account in which all investment earnings – interest, dividends and capital gains – are tax-free, even when withdrawn. Since withdrawals from a TFSA are tax-free, they will not impact your taxable income.

**What if I made a capital gains election in 1994?**

Some investors took advantage of the capital gains election in 1994, when the \$100,000 lifetime capital gains exemption was eliminated, which would have created an exempt capital gains balance (ECGB) for funds that you owned at that time. If you are in this situation, you may have been able to use the ECGB pool to change the adjusted cost base of a particular fund. For further information, please refer to the CRA's Capital Gains guide, available at [www.cra-arc.gc.ca](http://www.cra-arc.gc.ca), or ask your tax specialist.

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**Triggering a capital loss before year-end may reduce taxes**

If you are considering selling a mutual fund investment that has declined in value, you may want to do so in time for the sale to settle by December 31. Any capital loss triggered by the sale can be used to offset taxable capital gains earned on other investments, which may help reduce your overall taxes payable. If you have no net capital gains in the current year, you can use the capital loss to reduce taxable capital gains in the three preceding years, or carry it forward indefinitely for use in future years.

**The superficial loss rule**

If you are planning to sell your mutual funds to trigger a capital loss, be mindful of the “superficial loss” rule. Under this rule, if you or someone affiliated with you (such as your spouse or your company) acquires the same funds in the period beginning 30 days before and ending 30 days after the date of the sale on which you are claiming the loss, your capital loss may be disallowed.

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## Summary

### **An Effective Investment Plan Is Tax Efficient**

Structuring your investments to be tax efficient can help you achieve your long-term financial goals sooner. Investing in mutual funds offers several advantages, including diversification, flexibility and professional management. And being aware of possible tax implications associated with mutual fund investing will help you choose the right investments for your individual needs and specific situation. Talk with your advisor today about the different types of investments available and which ones can help you structure a tax-efficient portfolio.

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For more information about the taxation of investments, please speak with your advisor or a qualified tax specialist.

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## Glossary

**Adjusted cost base (ACB):** In general terms, it is the total price you paid for all of the units of a series of a fund in your account, including reinvested distributions and less any return of capital. The ACB per unit of a series is the weighted average price paid per unit.

**Capital gain:** You have a capital gain when you sell, or are considered to have sold, an investment for *more* than the ACB.

**Capital loss:** You have a capital loss when you sell, or are considered to have sold, an investment for *less* than the ACB.

**Dividend:** A distribution of after-tax profits to the shareholders of a corporation.

**Interest income:** Income earned from investments, such as treasury bills and bonds.

**Management expense ratio (MER):** The total fees and expenses a fund paid during a year divided by its average assets for that year.

**Marginal tax rate:** The additional rate of tax that someone pays on each \$1 increase of their taxable income. As income increases, so does a person's marginal tax rate.

**Mutual fund:** A type of investment that pools money from many individuals and invests it according to a stated investment objective. Professional money managers oversee investment decisions within the fund by buying and selling investments, such as money market investments, stocks and bonds.

**Return of capital (ROC):** Commonly seen in mutual funds that pay a regular set monthly distribution to investors. ROC is a tax term used to describe distributions in excess of a fund's earnings (income, dividends and capital gains). For tax purposes, ROC represents a return to the investor of a portion of their own invested capital. ROC distributions are not taxable in the year they are received, but they reduce the ACB of an investment.

**T3 (Statement of Trust Income Allocations/Designations):** A tax document reporting the amount and type of investment income distributed by the mutual funds owned in the previous year.

**T5 (Statement of Investment Income):** A tax document reporting the amount and type of investment income distributed from the corporate class fund owned in the previous year. Income reported on T5 tax slips includes most dividends, royalties and interest from bank accounts, accounts with investment dealers or brokers, insurance policies, annuities and bonds.

**Tax-Free Savings Account (TFSA):** A registered account that was introduced by the Federal Government effective January 1, 2009. With this account, all investment earnings – interest, dividends and capital gains – grow tax-free.

**Unitholder:** An investor in a mutual fund trust or mutual fund corporation.

RBC Funds and PH&N Funds are offered by RBC Global Asset Management Inc. and distributed through authorized dealers. There may be commissions, trailing commissions, management fees and expenses associated with mutual fund investments. Read the prospectus before investing. Mutual fund securities are not guaranteed, their values change frequently, and past performance may not be repeated.

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