Financial Planning Quick Tip

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SUBJECT: RETURN OF CAPITAL

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There are certain types of investments that could make distributions classified as Return of Capital. Some examples are as follows:

- Certain mutual funds;
- Mortgage back securities;
- Income Trusts & Real Estate Investment Trusts;
- Some individual equities that have gone through a very special type of corporate reorganization.

In order to determine the adjusted cost base (ACB) of an investment for tax purposes, any return of capital distributions received must be **subtracted** from the ACB. Return of capital distributions are non-taxable upon receipt. However, by reducing the ACB for to return of capital distributions, on disposition of the investment in the future, the capital gain will be larger or the capital loss will be smaller. As a result, return of capital distributions can be thought of as tax-deferred distributions.

The reason for return of capital distributions varies and must be determined on a case-by-case basis.

For example, in the case of certain mutual funds, the fund's annual distributions and/or fees may **exceed** the fund's investment income earned (i.e. interest, dividends, realized capital gain, etc) for that particular year. As a result, the fund manager is required to utilize some of the fund's original capital in order to cover the distributions. This use of the fund's capital creates a return of capital.

Another example is the case of a Real Estate Investment Trusts (REIT). The REIT is allowed certain non-cash deductions such as Capital Cost Allowance (CCA), which results in reduced taxable income for the REIT without reducing the funds available for distributions. This permits the REIT to make cash distributions in excess of the trust's taxable income allocated to the unitholders. The difference between the cash distribution and the allocated taxable income represents a return of capital.

Resource based income trusts can pay tax-deferred return of capital distributions for various reasons. The tax deductions or tax pools that certain Canadian resource companies are permitted to accumulate result in low taxable income to some resource companies. As a result, the monthly distributions that the income trust made during the year may be treated as non-taxable.

If you have any questions or require clarification of any of the issues discussed in this document, do not hesitate to discuss these with your advisor.

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