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Return of capital

Tax-free distributions

Certain investments will distribute a non-taxable payment to you called a "return of capital" (ROC). ROC represents a return of all or a portion of your original invested capital. This article describes the types of investment vehicles which may make ROC distributions to you. It also explains the tax implications as well as the tax reporting associated with receiving ROC distributions.

The information in this article is not intended to provide legal or tax advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax advisor before acting on any of the information in this article.

What are the main benefits of return of capital?

ROC distributions offer a solution if you require a regular income stream from your investments. ROC distributions provide 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:** Investments that distribute ROC are particularly appealing if you are seeking regular cash flow from your portfolios. ROC is used to help fund managers distribute predictable monthly cash flow.
- **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.

ROC investment vehicles

There are certain types of investments that could make ROC distributions to you. These include, but are not limited to certain mutual funds, Real Estate Investment Trusts (REITs), Limited Partnerships (LPs), and Mortgage-Backed Securities (MBSs).

Mutual funds

ROC distributions typically occur when a fund's objective is to pay a regular set monthly or annual distribution. If the fund earns income (i.e., interest, dividends and realized capital gains) that is less than the regular set distribution, a ROC distribution is added to make up the remainder. This means that some of the fund's original capital is returned to you in order to cover the distribution.

Real Estate Investment Trusts

A REIT is allowed certain non-cash deductions such as depreciation. These deductions result in a lower taxable income for the REIT, without reducing the cash available for distributions. This permits the REIT to make cash distributions to you in excess of its taxable income. Any distribution in excess of the REIT's net income represents ROC.

Limited partnerships

The income that an LP generates less its expenses is known as its net allocated income. In an LP structure, the net allocated income may be distributed to you, the partner or investor. Any distribution that you receive or withdrawal that you make, in excess of the LP's net allocated income represents ROC.

Mortgage-Backed Securities

A Mortgage-Backed Security (MBS) is an investment that is secured by many mortgages. These mortgages are then sold to lending institutions and packaged together into a security that can be sold to you, the investor. As homeowners make their mortgage payments (consisting of interest and principal) to the lending institutions, the payments are collected and then redistributed to you as monthly payments of principal and interest. These principal repayments represent ROC.

ROC taxation

Canadian mutual funds, REITs and LPs are "flow-through structures" for tax purposes. This means the income that the investment earns as well as any ROC is distributed to you is reported on your tax return.

Although ROC distributions are not taxable in the year you receive it, it is important to understand the long-term tax impact of ROC distributions. Any ROC distributions you receive reduce the adjusted cost base (ACB) of your investment for tax purposes, which will typically result in a larger capital gain or a smaller capital loss when you eventually dispose of your investment.

If the ACB of your investment is reduced below zero during the tax year, the negative amount is deemed to be a capital gain in the year it arises. Any future ROC distributions will be taxed as a capital gain as well because you are getting back more than you originally invested. The ACB of your investment is deemed to be zero.

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. 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.

Although ROC distributions are not taxable in the year you receive it, it is important to understand the long-term tax impact of ROC distributions.

You are not required to report the ROC on your tax return but you should keep track of your ROC payments.

Interest deductibility

When you borrow money to put into an investment that returns capital to you, you should be aware of the interest deductibility rules where you don't plan on reinvesting those ROC distributions. Since the ROC distribution represents a return of all or a portion of your original invested capital, the portion of the interest that relates to the ROC distribution will not be deductible if you use the payment for personal purposes (i.e., vacation, clothing, etc.) and not for purposes of earning income. If you continue to spend your ROC distributions for personal purposes, your interest deduction will continue to decrease, making your borrowing to invest strategy less and less effective over time. Alternatively, if you reinvest the ROC payment to acquire more income-producing investments, then you should be able to continue deducting the entire interest expense on your borrowed money.

It is important to note that using borrowed money to finance the purchase of securities involves greater risk than a purchase using cash resources only. Should you borrow money to purchase securities, your responsibility to repay the loan as required by its terms remains the same even if the value of the securities purchased declines. You should obtain professional advice from a qualified tax advisor before implementing any borrowing to invest strategy.

ROC tax reporting

For residents of Canada

Flow-through investments make distributions to you throughout the year. However, the income sources that make-up the distribution (i.e., interest, dividends, capital gains, or ROC) are not known at that time of the payment. The amount of ROC will only be known once the underlying investment calculates its income for the taxation year, generally early in the following year. Your accounts are then adjusted for ROC distributions a couple of months later, usually in April.

For these flow-through investments, you will receive a tax slip that reports the various sources of income that make up the distribution. You will enter these amounts on your tax return. You are not required to report the ROC on your tax return but you should keep track of your ROC payments. This is so you can accurately calculate your ACB to determine if your ROC distribution is taxable as a capital gain each year. It will also help you calculate your gain or loss when you eventually sell the investment.

For non-residents of Canada

You are not generally subject to Canadian non-resident withholding tax on ROC distributions. However, you will be subject to a 15% non-resident withholding tax on ROC distributions if more than 50% of the fair market value of the investment is attributable to Canadian real estate or Canadian resource properties. If you subsequently sell the investment at a loss, some or all of the 15% non-resident withholding tax paid may be recouped. In order to recoup the withholding tax, you will be required to file a special Canadian income tax return in the year the investment is sold. If you are a non-resident

If you are a non-resident of Canada, you should seek advice from your professional tax advisor regarding your investments in Canada which return capital to you.

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Conclusion

There are various reasons ROC distributions can be paid to you, depending on the type of investment you own. Although ROC distributions are generally not taxable in the year you receive them, they may become taxable once the capital you receive begins to exceed your original investment. ROC distributions also have a long-term impact on your investment. If you have any questions on ROC distributions or want to discuss any of the information in this article, please do not hesitate to contact your RBC advisor.

Please contact us for more information about the topics discussed in this article.

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