



Wealth
Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES



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Return of capital

Certain types of investments may make return of capital (ROC) distributions to you. ROC represents a return of all or a portion of your original invested capital and thus is generally not immediately taxable to you. This article describes the types of investment vehicles which may make ROC distributions and also explains the tax implications of receiving ROC distributions.

What are the benefits of return of capital?

ROC distributions provide three key benefits:

- **Tax efficiency:** Unlike interest, dividends and capital gains, distributions classified as ROC are generally not taxable in the year they are received.
- **Cash flow stability:** Investments that distribute ROC are particularly appealing if you're seeking regular cash flow from your portfolios. ROC is typically used to help fund managers distribute a predictable monthly cash flow.
- **Tax deferral:** Tax associated with the investment may be deferred until you sell the investment, helping you maximize your current cash flow and giving you control over when you pay tax.

ROC investment vehicles

There are types of investments that could make ROC distributions to you.

These include, but are not limited to, certain mutual funds, exchange traded funds (ETFs), real estate investment trusts (REITs), and limited partnerships (LPs).

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 set distribution amount, ROC is used to make up the remainder of the distribution. This means some of the fund's original capital is returned to you in order to cover the distribution.

ETFs

Like a mutual fund, an ETF may distribute ROC to its unitholders to ensure that the unitholders receive a certain amount of income from the fund. An ETF may also flow out ROC distributions it has received from its own underlying investments to its unitholders.

REITs

A REIT is allowed certain tax deductions such as depreciation. These deductions result in a lower taxable income for the REIT but do not reduce the cash available for distributions. This permits the REIT to make cash distributions to you in excess of its income. Any distribution in excess of the REIT's net income represents ROC.

LPs

An LP will generally not pay tax on the income it earns. Instead, the LP will allocate its income less any expenses to its partners or investors. This allocation is known as net allocated income. Any cash distributions you receive from the LP that are in excess of the LP's net allocated income represents ROC.

ROC taxation

It is important to understand the long-term tax impact of ROC distributions. ROC distributions are generally not taxable in the year you receive them. Instead, any ROC distributions you receive reduce the adjusted cost base (ACB) of your investment for tax purposes. This 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 immediately deemed to be a capital gain in the year it occurs and the ACB of your investment is deemed to be zero.

Tax reporting

Certain types of investments may make distributions to you throughout the year. However, the income sources that make up the distribution (i.e., interest, dividends, capital gains or ROC) may not be known at that time of the payment. The amount of ROC will only be known once the investment calculates its income for the year, generally early in the following year. After the calculations are completed, the investment will report the make up of any distributions you received to you.

You are not required to report ROC distributions on your tax return, but you should keep track of the ROC payments to accurately calculate the ACB of your investments. Keep in mind that if the ACB of your investment becomes negative, the negative amount is taxable as a capital gain for the year. You also need to maintain the correct ACB in order to calculate your gain or loss when you eventually sell the investment.

Certain government benefits, such as old age security (OAS) and the age amount, are income-tested benefits. In other words, these benefits are reduced if your income exceeds a certain threshold.

Other ROC considerations

Government income-tested benefits

Certain government benefits, such as old age security (OAS) and the age amount, are income-tested benefits. In other words, these benefits are reduced if your income exceeds a certain threshold. Amounts that affect government income-tested benefits typically include pension income, investment income and taxable capital gains. Since ROC distributions are not considered taxable income, these income-tested benefits will not be affected by the ROC distributions. However, keep in mind that when you do decide to sell your investment, these benefits could be impacted by the potentially larger capital gain.

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. If you don't plan on reinvesting your ROC distributions, you may no longer be able to fully deduct the interest. 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 distribution for personal purposes (i.e., vacation, clothing, etc.) and not for purposes of earning income. Alternatively, if you reinvest the ROC payment to acquire more income-producing investments, you should be able to continue deducting the interest.

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.

Conclusion

If you're planning to purchase or you already own investments that may make ROC distributions, it's important to understand how these distributions affect your financial situation. While the immediate tax-free nature of ROC distributions is attractive, keep in mind that there are tax implications associated with these distributions in the future. Speak with your RBC advisor about whether these investments are right for you.

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