TD Wealth

# Return of Capital

Investors in search of income from their portfolios often look to do so with tax efficiency in mind. One common approach is to invest in products which generate a return of capital. The following is a summary of the unique tax attributes surrounding this form of income.

Return of capital is defined as a distribution received from an investment which is not classified as income but rather as a return of a portion of your investment (capital). These distributions are typically not immediately taxable. Investments that may generate return of capital distributions include, but are not limited to the following:

- Income trusts
- Certain mutual funds
- Real estate investment trusts
- Mortgage backed securities

Although return of capital distributions are typically not taxable upon receipt, it is important to note that such distributions reduce the adjusted cost base (ACB) of the investment. The reduction in ACB from a return of capital distribution would generally result in the investor realizing on disposition a larger capital gain or a smaller capital loss, all else being equal. In essence, a return of capital becomes a tax-deferred distribution.

# Why is capital returned?

The reasons for capital distributions vary. The following are a few examples:

## Real Estate Investment Trusts (REITs)

A REIT is required to distribute a large portion of its cash flow (prior to deductions) to unitholders. Rental income earned by a REIT is partly sheltered through Capital Cost Allowance deductions on buildings owned by the REIT. These deductions reduce the REIT's taxable income but not the funds available to be distributed. The return of capital distribution is the amount that exceeds the REIT's taxable income.

## Mutual Funds

Where annual distributions exceed earned investment income, return of capital may be used to fund the difference. A return of capital is generally a distribution of a portion of your invested capital.

**Note:** A return of capital is recorded on a T3 slip (Relevé 16 slip in Quebec) for mutual fund trusts or in the footnotes on a T5 (Relevé 3 slip in Quebec) for corporate class mutual funds.

# Example

Jane purchases 100 units of ABC Mutual Fund Co. at $25.00/unit on January 1 and sells 100 units on December 31.

| | | |
|---|---|---|
| Adjusted cost base of ABC units as at January 1st | $2,500 | |
| March Reported Return of Capital | $100 | $1.00/unit return of capital x 100 units |
| June Reported Return of Capital | $30 | $0.30/unit return of capital x 100 units |
| September Reported Return of Capital | $40 | $0.40/unit return of capital x 100 units |
| **Adjusted cost base as at December 31st** | $2,330 | |
| Proceeds from December 31st sale | $3,000 | 100 units sold at $30.00/unit |
| Adjusted cost base as at December 31st | $2,330 | |
| **Gain on sale of ABC** | **$670** | |

*The above example does not include regular distributions, brokerage fees, etc.

**Note:** Where distributions of return of capital are paid over an extended period, it is possible that an investor's ACB drops below zero. Where this occurs an investor will be deemed to realize a capital gain equal to the negative ACB amount and the ACB would then be reset to zero. Any further return of capital distributions will result in a capital gain (all else being equal).

## Return of Capital and Impact of Interest Deductibility on Borrowed Funds

Investors who are deducting interest expenses from an investment loan should be mindful when investing in products that generate a return of capital. If the returned capital is not used for the purposes of earning income and instead used for personal purposes, the portion of interest expense relating to the returned capital may become non-deductible.

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