# Return of Capital

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 not 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 is not taxable upon receipt, it is important to note their effect on the adjusted cost base (ACB) of the investment in question. Essentially, these distributions lower the ACB of the investment such that upon sale of the investment, either the capital gain will be larger, or the capital loss will be smaller. In essence, this return of capital becomes a tax-deferred distribution.

**Why is capital returned?**

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

**<u>Real Estate Investment Trusts</u>**

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.

**<u>Mutual Funds</u>**

Annual distributions may exceed earned investment income in that year. The mutual fund manager must now use a portion of the fund's original capital to cover distributions. These distributions represent a return of capital.

***Note:** A return of capital is recorded on a T3 slip (Relevé 16 slip in Quebec).*

**<u>Example</u>**

Jane purchases 100 units of ABC Mutual Fund Co. at $25.00/unit on January 1, 2010 and sells 100 units on December 31, 2012.

| | | |
|---|---|---|
| Adjusted cost base of ABC units as at January 1, 2010 | $2,500 | |
| 2010 Reported Return of Capital | $100 | $1.00/unit return of capital x 100 units |
| 2011 Reported Return of Capital | $30 | $0.30/unit return of capital x 100 units |
| 2012 Reported Return of Capital | $40 | $0.40/unit return of capital x 100 units |
| **Adjusted cost base as at December 31, 2012** | $2,330 | |
| Proceeds from December 31, 2012 sale | $3,000 | 100 units sold at $30.00/unit |
| Adjusted cost base as at December 31, 2012 | $2,330 | |
| **Gain on sale of ABC** | **$670** | |

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

***Note:** If the ACB drops below zero during a taxation year, the client will be deemed to realize a capital gain equal to the negative amount. The ACB is then reset to zero.*

*Last Revised: April 18, 2012*

The information contained herein has been provided by TD Waterhouse and is for information purposes only. The information has been drawn from sources believed to be reliable. Where such statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, trading or tax strategies should be evaluated relative to each individual's objectives and risk tolerance.

TD Waterhouse, The Toronto-Dominion Bank and its affiliates and related entities are not liable for any errors or omissions in the information or for any loss or damage suffered.

TD Waterhouse represents the products and services offered by TD Waterhouse Canada Inc. (Member – Canadian Investor Protection Fund), TD Waterhouse Private Investment Counsel Inc., TD Waterhouse Private Banking (offered by The Toronto-Dominion Bank) and TD Waterhouse Private Trust (offered by The Canada Trust Company).

®/ The TD logo and other trade-marks are the property of The Toronto-Dominion Bank or a wholly-owned subsidiary, in Canada and/or in other countries.