Mutual Funds

More Cash, Potentially Less Tax

Here's How You Can Save Taxes While Receiving a Monthly Cash Flow

As you move into retirement, your investment profile can change dramatically. Your portfolio, originally constructed to achieve capital growth, may have to be re-engineered to produce cash flow. At this stage, it may be in your best interest to explore various strategies that make it possible to draw cash flow from investments in a tax efficient manner.

Tax efficiency is a priority for most investors. One way to achieve tax efficiency is to keep as much of your money as possible compounding inside registered plans. This can make drawing tax-efficient cash flow from non-registered accounts a complex task.

Here's a solution that can help. A mutual fund that has return of capital (ROC) distributions is designed to provide a tax-efficient monthly cash flow from a non-registered account, and can be a valuable tool for you to structure a tax-efficient solution in your portfolio.

What is ROC?

ROC is a portion of an investor's original investment paid back to him or her. It is an amount received from a fund that is not income or capital gains. Therefore, any portion of a distribution that is classified as ROC is not taxable.

How does ROC work?

A ROC distribution will decrease your adjusted cost base (ACB) of the mutual fund units. That means you may face a larger taxable capital gain when the units are eventually sold.

Depending on a fund's performance and how long you keep your investment, it is possible that ROC distributions will reduce your ACB to zero. This means that you have effectively taken out all the money that you have invested, but it does not necessarily mean that the value of your investment has disappeared. You could continue to receive distributions once your ACB is reduced to zero, but the distributions will now be taxed as a capital gain. No matter when you sell your investment, a capital gain or capital loss will be realized on the difference between the proceeds of disposition and your ACB.

Rate of Return vs. Distribution

It's important not to confuse a fund's rate of return with its distributions. A fund will usually offer several different distribution rates but a fund's rate of return in each case remains the same.

If a distribution rate is lower than a fund's annual rate of return, you could expect the market value of your investment to increase over time. If the distribution rate is equal to a fund's annual rate of return, you could expect the market value of your investment to remain steady over time. However, when a distribution rate is higher than a fund's annual rate of return, a fund is effectively paying out more than it is earning, so you could expect the market value of your investment to decrease over time.

Tax Treatment of Distributions

Distributions are amounts paid out by a mutual fund to investors, and they can be in the form of interest, dividends, capital gains, return of capital or a combination of these.

Distributions are taxed at your marginal tax rate, but the tax treatment varies according to the type of distribution received:

Interest: Every dollar received as interest is added to your income in the year it is received and is fully taxable. This is the least "tax friendly" form of income.

Eligible Dividends: Thanks to the dividend tax credit, eligible taxable Canadian dividends are taxed more favourably than interest. Dividends received from foreign corporations, are not eligible for this credit.

Capital gains: Only 50 percent of a capital gain is taxable. This makes capital gains an attractive form of investment income.

Return of capital: You will not be taxable on amounts distributed as ROC. This is because ROC is a return of your original capital. As noted earlier, ROC distributions in excess of the original investment will be taxable as capital gains.

Benefits of Funds that Offer ROC Distributions

ROC distributions offer several benefits if you require cash flow from your investments. You could:

- Receive a consistent monthly cash flow from non-registered investments – note, however, that the cash flow could increase or decrease over time according to a fund's rate of return
- Defer taxes – ROC distributions allow you to draw capital from your portfolio without triggering an immediate tax consequence. Moreover, a ROC solution can provide a larger tax deferral relative to a mutual fund with a systematic withdrawal plan ("SWP").
- The possibility of lower taxes – The ROC solution allows you to defer capital gains tax until you redeem your investment or until your ACB is reduced to zero. This flexibility lets you determine the best time to sell your investment according to your personal tax situation. For instance, you could be in a lower tax bracket in the future and, when you sell your investment, you will be taxed at the capital gains tax rate in effect at that time.
- Take advantage of capital gains tax rates – when the invested capital runs out and your ACB reaches zero, distributions are taxed as capital gains and upon redemption, proceeds may also receive favourable capital gains tax treatment
- Simplified tax reporting – Details of all ROC distributions are conveniently provided on your year-end tax slip, as opposed to SWP transactions where you must calculate taxable capital gains or losses for each redemption.
- Grow your investment – provided that a fund's distribution rate is less than its annual rate of return, your mutual fund investment can grow.

TD Mutual Funds offers tax efficient solutions that can allow you to get a consistent monthly cash flow, and are available in various purchase options. For more information on TD Mutual Funds that pay ROC distributions, please contact your Financial Advisor today.