TD Asset Management

Return of Capital (ROC) – How it works

If you're like most people who are moving into retirement, you've got a lot to look forward to. Working less means more time for the things you want to do. But working less means that your investments have to work harder to generate the money you want every month. In today's investment environment, that can be a challenge. There just aren't a lot of options that will give you the cash flow you want. And when you receive income from GICs or from selling mutual fund units regularly, a portion of it can go to taxes.

At TD Asset Management Inc. (TDAM) we understand the challenges facing retirees and offer a wide variety of mutual funds that feature ROC distributions to help you get the money you want every month now and into the future.

Mutual fund investments may provide different types of distributions, such as interest income, dividends, capital gains and ROC.

This guide will help explain ROC and how it's a tax efficient way of receiving a steady flow of income.

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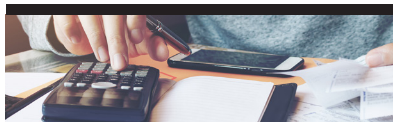
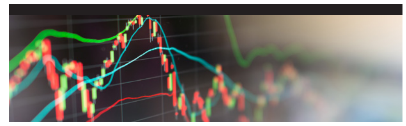
What is ROC?

ROC is a portion of an investor's original investment amount, or capital, being returned to them by a mutual fund. It typically occurs when the amount distributed by a fund exceeds the total net income and net capital gains earned by the fund



Unlike other types of distributions such as interest income or dividends and because it's your own money coming back to you, ROC is not taxable when received



A ROC distribution reduces the Adjusted Cost Base (ACB) of your investment, so receiving one may result in a larger capital gain or smaller capital loss when you eventually sell units. This may affect the capital gains taxes payable when you sell your mutual fund

Other Types of Distributions:

Interest income:

Interest income is earned on securities, such as treasury bills and bonds, and is not eligible for any special tax treatment. It is taxed at the same rate as ordinary income.

Dividend income:

Dividend income may be earned when a fund invests in shares of public companies that pay dividends. To reflect the fact that the company paying the dividend has already paid Canadian tax on its profits, dividends received from Canadian companies are generally eligible for federal and provincial tax credits. Your T3 tax slip (or Relevé 16 in Quebec) will indicate if the dividend you received is subject to this favorable treatment. Also, tax rates on dividends vary from province to province.

Capital Gains:

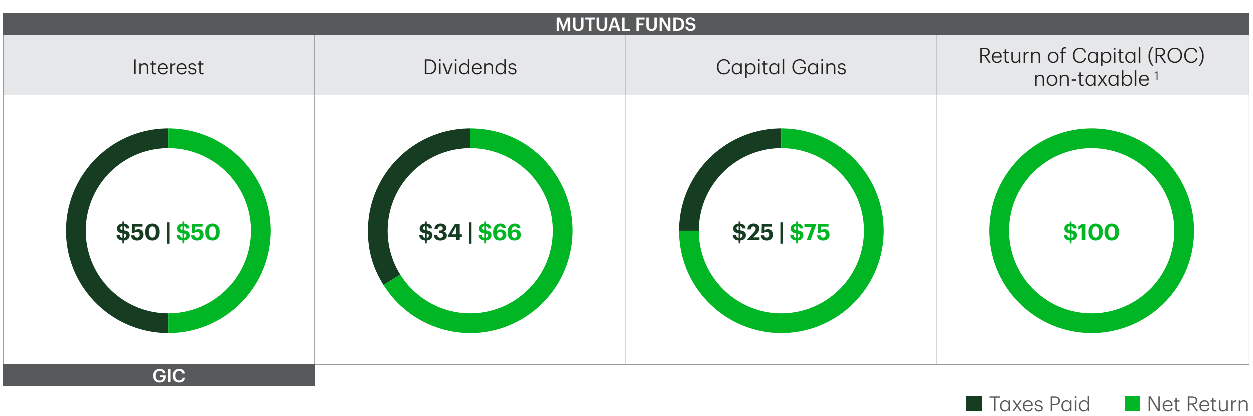
Over the course of the year, a fund will buy and sell various investments within its portfolio. If this trading activity generates more realized gains than losses, 50% of these net realized gains will be considered taxable income to the fund. Generally, a fund will distribute such taxable capital gains to its unitholders.

Typical Income received by various mutual fund types

	Interest	Canadian dividends	Capital gains	Foreign non-business income	ROC
Fixed income	◆				
Canadian equities		◆	◆		
U.S. equities			◆	◆	
International equities			◆	◆	
Emerging markets equities			◆	◆	
Balanced Funds/ Funds of Funds	◆	◆	◆	◆	
TD Cash Flow Series/TD Monthly Fixed Pay Solutions	◆	◆	◆	◆	◆

How Different Distributions are Taxed:

Consider the after-tax value of receiving $100 of investment income.



Example shown for illustrative purposes only. Tax rate assumptions (Ontario): 49.53% marginal income tax rate; 33.82% dividend income marginal tax rate; 24.77% capital gains marginal tax rate. Percentages have been rounded. [1]As long as the adjusted cost base of the investment is greater than zero. Capital gains taxes may be payable when the units of a fund are sold or to some extent when their adjusted cost base goes below zero. Return of capital (ROC) distributions do not constitute part of a fund's rate of return or yield. ROC reduces the adjusted cost base of the units to which it relates. ROC is not considered taxable income as long as the adjusted cost base of the investment is greater than zero. Capital gains taxes that may be deferred when ROC distributions are received, will be payable when the units of the fund are sold or when their adjusted cost base goes below zero.

As you can see from the chart above, ROC distributions are not subject to taxes at the time they are received which may mean more cash in your pocket!

How ROC impacts ACB and Your Taxes

ROC distributions are not part of a fund's rate of return or yield, but instead reduce the ACB of your investments which may impact the capital gains (or losses) you realize when you eventually sell your investments. ACB is the adjusted cost base of your investment and is used in calculating whether you have a capital gain or loss when you sell units of a mutual fund. ACB is the average price you paid for the units you own.

Here's how it works:

Kate's Mutual Fund Purchase

Kate purchases 100 units of a fund at $10.00/unit	$10	$1,000
At another time, Kate purchases 100 more units of a fund at $12.00/unit	$12	$1,200
Kate now has 200 units with a total investment of $2,200		**$2,200**

Kate's ACB without any distributions:

$$\text{ACB per unit} = \frac{\$2{,}200 \text{ total investment}}{200 \text{ units}} = \$11.00/\text{unit}$$

If Kate sold her units for $15.00/unit and has an ACB of $11.00/unit she would realize a capital gain.

Capital gain per unit =	Total capital gain =
$15.00 - $11.00 = **$4.00/unit**	$4.00 x 200 units = **$800**

Bringing ROC and ACB together

Let's now take a look at how Kate's ACB would be affected if she received an ROC distribution during the time she owned units of a fund.

We know that Kate owns 200 units of a fund at an ACB of $11.00/unit.

ACB per unit = $11.00

This same fund has a monthly distribution of $0.3334/unit or approximately $4.00/unit each year, giving Kate a total yearly distribution of approximately $800.00 (200 units x $0.3334 x 12 months).

200 units x $0.3334 x 12 months = $800

Of that $4.00/unit distribution, $3.00/unit is from interest and income earned by the fund, and the remaining $1.00/unit of the distribution paid is classified as ROC. Kate's ACB of $11.00 will need to be reduced by the ROC she received. Kate's new ACB is $10.00/unit ($11.00 – $1.00 = $10.00).

New ACB per unit after ROC = $10.00

If Kate sells her 200 shares at the current per unit value of $15.00 and her ACB is $10.00, her realized capital gain would be approximately **$5.00/unit or $1000**.

Additional consideration:

We now know that ROC distributions will affect your ACB, but what happens if your ACB reaches zero and, if so, what then?

ROC distributions can reduce your ACB to zero, which means that you have been given back all the money you have invested in a fund through the ROC distributions you have received. If your ACB has been reduced to zero, you will continue to receive ROC distributions on the units you hold. ROC distributions received once the ACB of your units is reduced to zero will be taxed as capital gains.

Why Invest in Mutual Funds that have ROC?

Monthly cash flow

Since a ROC solution aims to provide you with a regular cash flow, you'll know what to expect each month which may allow you to plan ahead

Tax efficiency

Generally, ROC is not taxable in the year you receive it (unless your ACB is zero) unlike interest, dividends and capital gains, ROC allows you to defer capital gains tax until you sell your investment. This flexibility helps you determine the best time to sell your investment according to your personal situation. For example, being in a lower tax bracket when you decide to sell your units could impact the tax rate applicable on all income, including realized capital gains

Growth potential

Even though part of your original investment is being returned to you each month, your investment can grow, as long as the return earned by the fund is higher than the amount distributed to you

Potential to minimize government clawbacks

Generally, ROC distributions increase your monthly cash flow without increasing your taxable income. That means your eligibility for government programs such as Old Age Security, the Guaranteed Income Supplement, spousal tax credits and medical expense credits is not affected

Simplified tax reporting

Details of all ROC distributions are conveniently provided on your year-end tax slip. This generally simplifies your tax reporting for ROC distributions unlike Systematic Withdrawal Plan transactions where you must calculate taxable capital gains or losses for each redemption

Why TDAM?

Supported by a globally recognized TD Brand

The Toronto Dominion Bank is the 19th most valuable bank brand in the world[22]

Canada's largest

Money manager in pension assets[23]

Known for our risk management

One of the first in Canada to launch low volatility solutions[24]

3rd Largest

Mutual fund company in Canada[25]

To learn more about TDAM's cash flow series, talk to your investment professional today.

[22]Source: "Banking 500 2018: The most valuable banking brands of 2018" Brand Finance. [23]Source: "The Top 40 Money Managers (as of December 31, 2017)" Benefits Canada, May 2018. [24]Source: TD Asset Management Inc. TD Low Volatility Strategies Smart Beta Report (0116) [25]Source: IFIC PIM view and Strategic Insights as of June 30, 2018. The statements contained herein are based on material 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. This sales tool does not provide individual financial, legal, tax or investment advice and is for information purposes only. Particular investment or trading strategies should be evaluated relative to each individual's objectives and risk tolerance. Commissions, trailing commissions, management fees and expenses all may be associated with mutual fund investments. Please read the fund facts and prospectus, which contain detailed investment information, before investing. Mutual funds are not guaranteed or insured, their values change frequently and past performance may not be repeated. I A return of capital (ROC) distribution reduces your adjusted cost base. This could lead to a higher capital gain or a smaller capital loss when the investment is eventually sold. If your adjusted cost base goes below zero you will have to pay capital gains tax on the amount below zero. The payment of ROC distributions should not be confused with a fund's performance, rate of return or yield.TD Asset Management Inc. is a wholly-owned subsidiary of The Toronto-Dominion Bank.