MUTUAL FUND INVESTING: COMMON QUESTIONS FOR TAX SEASON

As a mutual fund investor, you may have questions about tax issues relating to your investment portfolio. Some frequently asked questions and answers are provided below.

What's a T3 tax slip and what do I need to do with it?

A T3 tax slip (also known as a *Statement of Trust Income Allocations and Designations*) is produced whenever a mutual fund held in a non-registered account makes a distribution of taxable income to unitholders. The manager of the fund produces a T3 tax slip for every unitholder, as required by the Canada Revenue Agency (CRA).

A T3 tax slip (*Relevé 16* for Quebec residents) indicates the amount of income distributed by the fund in the previous year. The slip also shows the amount of each type of taxable income distributed (dividend, capital gain, etc.). All income (except for return of capital, which is discussed in a later question) shown on a T3 tax slip must be declared on a tax return.

What are distributions?

Funds may earn dividends and interest from their underlying investments, and they may realize capital gains or losses when investments are sold. This income may be fully or partially offset by fund expenses. The fund allocates any remaining income or capital gains to unitholders by way of distributions, which are taxed at the investor's marginal tax rate. This is preferable to having the income taxed at the highest marginal tax rate, as would be the case if it was retained by the fund. Income is distributed in the same form as it's earned by the fund: interest income, Canadian dividends, net capital gains or foreign non-business income – or a combination of the four.

What's return of capital?

Any distributions you received in 2013 are comprised of a taxable portion (interest, dividends and/or capital gains) and a non-taxable/tax-deferred portion (return of capital), and will be reported on your T3 tax slips. Return of capital (ROC) is a tax term used to describe distributions in excess of a fund's earnings (income, dividends, and capital gains). For tax purposes, ROC represents a return to the investor of a portion of your own invested capital. ROC allows you to receive higher cash flows now, but defer paying related taxes until your ROC exceeds your cost of the investment for tax purposes, or until your investment is sold.

Mutual Fund Distribution Summary

Type of Mutual Fund Distribution	Description	Tax Treatment	Distribution Schedule	Example of RBC Fund
Interest income	Earned on the following investments: treasury bills, commercial paper, bonds, debentures, mortgages	Is fully taxable at the same rate as employment income (your marginal tax rate)	Monthly on money market funds; quarterly on others	RBC Canadian Money Market Fund
Canadian dividends	Occurs when funds invest in shares of Canadian public companies that pay dividends	Have preferential tax treatment with a dividend tax credit for personal tax returns	Quarterly or annually	RBC Canadian Dividend Fund
Capital gains	Incurred when an investment within the fund is sold for more than its original price	Only 50% of a capital gain is subject to tax	Annually (usually in December)	RBC Canadian Equity Fund
Foreign non-business income	Earned when the fund receives dividends from or income on non-Canadian investments	Is fully taxable at the same rate as employment income (your marginal tax rate)	Annually (usually in December)	RBC European Equity Fund
Return of capital	Distribution or payout that returns your original invested capital	Non-taxable	Annually (usually December)	RBC Managed Payout Solution

This makes ROC different from other types of distributions, such as interest, dividends and capital gains, which all must be included in taxable income in the year received. ROC will reduce your adjusted cost base for the fund, which results in a higher capital gain or smaller capital loss on subsequent redemptions. As the tax impact is deferred until the fund is sold, ROC can be very tax-efficient.

For additional information on ROC and how it impacts taxes, please ask your advisor for a copy of the *Taxes and Investing in Mutual Funds* brochure or download it from our website at **rbcgam.com/taxes-and-investing.** For specific tax advice, please contact your tax advisor.

Why would I receive a T3 tax slip if my mutual fund return is negative?

It's possible a fund will have a negative rate of return in a given year while still paying distributions. Securities in a mutual fund may pay interest or dividends even if the market value of the security has decreased. Mutual funds distribute income earned by the securities they hold in order to minimize the overall amount of taxes paid by the fund. This is the case because mutual funds are taxed at a rate equivalent to the highest personal tax rate. Any income retained by a mutual fund would typically be subject to more tax than if it was taxed in the hands of individual investors.

I sold some mutual funds during the past year and realized some capital gains. Will the capital gains be included on my T3 tax slip?

Only capital gains that the fund distributes to unitholders are reported on a T3 tax slip. T3 tax slips do not include capital gains realized from selling units of a mutual fund. Unitholders are responsible for reporting on their tax returns any capital resulting from the sale of mutual fund units.

Do I have to include distributions I receive as part of my taxable income?

The answer depends on whether or not your mutual funds are held in a registered plan or a non-registered plan. Income earned on investments held in a registered plan is not immediately taxable and a T3 tax slip is not issued.

However, a T3 tax slip will be issued if mutual funds are held in a non-registered plan and there's a taxable distribution. Annual tax has to be paid on any distributions received other than return of capital.

What if I didn't receive distributions from my non-registered investments in cash? Are they still taxable?

Distributions for non-registered investments (other than amounts classified as return of capital) are taxable whether they're received in cash or reinvested in additional units. Distributions on RBC Funds® held in non-registered plans are automatically reinvested in additional units of the fund, unless you or your advisor notifies us otherwise.

All taxable distributions, whether reinvested or paid out in cash, are reported on a T3 tax slip.

Will I receive T3 tax slips for mutual funds held in my Tax-Free Savings Account (TFSA)?

No. TFSA is a registered account where all investment earnings in the account – interest, dividends and capital gains – are tax-free, even when withdrawn from the account. Since withdrawals from a TFSA are tax-free, they will not impact your taxable income.

Ask your qualified tax advisor to assist you in making informed investment decisions and understanding the impact of tax on your mutual funds.

RBC Global Asset Management

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