RBC Global
Asset Management

TAXES & INVESTING IN MUTUAL FUNDS

What you need to know

CONTENTS

OVERVIEW

Why understanding taxes is important

Understanding how your investments are taxed is an important part of developing an effective investment plan. This guide provides general tax information related to the purchase and sale of mutual fund investments in a non-registered account, with a specific focus on how mutual fund distributions are taxed. The goal is to help you gain a better understanding of tax considerations related to mutual fund investments.

With greater knowledge, you can become a more informed investor and make better investment decisions.

What is a mutual fund?

The majority of mutual funds in Canada are known as mutual fund trusts. Investors in mutual funds receive units of the trust and are referred to as unitholders. In recent years, however, there has also been a steady increase in popularity in mutual funds that are set up as corporations. Mutual fund corporations are structures set up with multiple share classes. Each share class, often referred to as a “corporate class fund,” represents a different mutual fund. For more information on corporate class funds, refer to page 12.

At a basic level, mutual funds use money received from unitholders or shareholders to buy securities. The securities purchased depend on the fund’s investment objective, but generally include cash, bonds and stocks. These investments may generate income in the form of interest or dividends. In addition, capital gains or losses may be realized when securities held in the fund are sold.

Income earned within a fund is first used to pay its management and administration fees. When added together, the management fee and the administration fee make up the Management Expense Ratio (MER). The income that is left over is distributed to unitholders.

When do I pay taxes on my mutual fund investments?

Generally, tax considerations related to your mutual fund investments can be grouped into two categories:

- Taxes associated with selling or switching a mutual fund’s units.
- Taxes related to the distributions received from a mutual fund.

Principles related to taxes and investing

Structure your overall portfolio to be tax efficient
Structuring your portfolio with tax efficiency in mind plays an important role in building wealth and determining how much tax you pay. The types of investments you own and where you hold them (inside or outside of a registered plan) have a bearing on the tax effectiveness of your overall portfolio.

Maximize cash flow in retirement with a tax-efficient portfolio
In retirement, the cash flow you receive from your investments becomes increasingly important. One way to maximize cash flow is to minimize taxes. Choosing investments that benefit from favourable tax treatment can help you keep more cash in your pocket.

Work with an advisor
Working with a knowledgeable investment professional can help you learn about how different types of investments are taxed and how you can build a tax-efficient portfolio.

This guide discusses the impact of taxation on mutual funds in non-registered accounts. Mutual funds held within tax-sheltered plans, such as TFSAs, RRSPs, RRIFs and RESPs, may not be subject to tax until money is withdrawn. This is not covered in this guide.

TAXES ASSOCIATED WITH SELLING OR SWITCHING YOUR MUTUAL FUND

As with any investment, there are tax considerations related to the purchase and sale of mutual funds. Here is what you need to know:

- **If you sell a mutual fund investment for *more* than what you purchased it for, plus any taxable distributions reinvested, you realize a *capital gain*.** Realized capital gains must be reported for tax purposes in the year of sale. They are taxed more favourably than regular income. Under current tax rules, only 50% of a capital gain is subject to taxes.
- **If you sell a mutual fund investment for *less* than what you purchased it for, plus any taxable distributions reinvested, you realize a *capital loss***. Most capital losses can be applied against capital gains to reduce the amount of taxes payable. If you have no realized capital gains in the year a capital loss is realized, the loss can be carried back and applied against taxable capital gains from any of the previous three years. You are also allowed to carry the loss forward indefinitely to offset gains in future years.

In general, you can calculate your capital gain or capital loss using the following formula:

Capital gain (or capital loss)	=	*Proceeds from sale of an investment*	–	*Cost of investment**

* Also known as the adjusted cost base (ACB). See page 3 for more information about the calculation of ACB.

Switching between mutual funds

If you switch between mutual funds in a non-registered account, you are deemed to have sold units of one fund and purchased units in another. If the units you sold are worth more than what you originally purchased them for, the switch will generate a capital gain. If the units you sold are worth less than what you originally paid, the switch will generate a capital loss.

When switching between funds, keep in mind that you are required to keep track of your capital gain and include its taxable portion in your taxable income in the year of sale.

When switching between mutual funds in a corporate class structure, an investor can switch between funds with no tax cost. This is possible because each fund in the corporate class structure is a class of shares in a single mutual fund corporation. And switching from one class of shares to another class in the same corporation is not deemed to be a taxable event. So, as long as you stay in funds under the same corporate class funds umbrella, you will defer tax on gains. Of course, when you eventually redeem out of the corporation, you will pay tax on any gains you realize – just like any other investment. For more information on the benefits of corporate class funds, see the section beginning on page 12 titled Corporate class funds.

HELPFUL TIPS

While we recommend that you refer to your own investment records to calculate the ACB you use in determining your capital gain or loss, average cost information may be provided to you by the fund company on an ongoing basis as part of your account statement. This could be provided in addition to transaction history, account balances and a personal rate of return on your investments.

What is adjusted cost base (ACB)?

In the capital gain (loss) calculation, the ACB plays an important role. It can be thought of as the average price paid for units owned. When you sell your mutual fund, it is the ACB that determines whether you have realized a capital gain or a capital loss.

How to calculate ACB

The following example shows how ACB is calculated and whether a capital gain or a capital loss results.

	Jason's investments
Jason purchases 100 units of a fund for $10 per unit	$1,000
At some point later, Jason buys 50 more units of the same fund at $12 per unit	$600
Jason has a total of 150 units and a total investment of $1,600	**$1,600**

Jason's ACB can be calculated as follows:

$$\text{ACB per unit} = \frac{\$1{,}600 \text{ total investment}}{150 \text{ mutual fund units}} = \$10.6667$$

How to calculate the taxable capital gain (or capital loss)

The following example shows how ACB is calculated and whether a capital gain or a capital loss results.

- Assume Jason later sells the holdings at a unit price of $11.00. Because the ACB of each unit is $10.6667, it results in a capital gain of $0.3333 per unit:
  $11.00 – $10.6667 = $0.3333
- The total capital gain is $50.00:
  $0.3333 per unit capital gain x 150 units owned = $50.00
- Under the current rules, only 50% of the capital gain (i.e. $25.00) would be subject to tax:
  $50.00 x 50% = $25.00
- Assuming a marginal tax rate of 29%, it would result in taxes payable of $7.25:
  $25.00 x 29% = $7.25

MUTUAL FUND DISTRIBUTIONS AND TAXES

Why do mutual funds make distributions?

Distributing income earned by mutual fund holdings benefits unitholders by minimizing overall taxes paid by the fund. Since mutual fund trusts are taxed at a rate equivalent to the highest personal tax rate, any income retained by a mutual fund is typically subject to more tax than if it were taxed in the hands of individual investors.

Distributing income to unitholders, most of whom are taxed at a lower marginal tax rate than the mutual fund, generally results in a lower amount of total taxes paid. By reducing tax paid by the fund, more income can be distributed to investors, which improves the return on their investment.

Mutual fund corporations, however, only provide a limited flow-through in that only Canadian dividends and capital gains can be passed on directly to investors. Interest and foreign income earned inside a mutual fund corporation are taxable first inside the corporate structure and can only be distributed to its investors after tax in the form of a taxable Canadian dividend.

What do I do with distributions?

When mutual funds make distributions, you have two options:

1. Take the distributions as a cash payment.
2. Reinvest the distributions by purchasing more units at the prevailing unit price.

Regardless of which option you choose, you are generally required to include distributions as part of your taxable income for the year in which you received them. The exception is return of capital (ROC) distributions, which are discussed on page 14.

HELPFUL TIPS

As an investor in mutual funds, you will receive all of the information you need from the fund company to accurately report income you have earned from your investments during the year.

The T3 tax slip (Relevé 16 in Quebec) shows the interest, dividends, capital gains, ROC and foreign income you received during the year, as well as any foreign income taxes paid. Income that benefits from favourable tax treatment, such as amounts eligible for the enhanced dividend tax credit, are also clearly identified.

The T5 tax slip (Relevé 3 in Quebec), or Statement of Investment Income, is issued to investors who own mutual funds in a corporate structure.

See page 17 of this guide to view examples and learn more about T3 and T5 slips.

Tax slips are still issued when returns are negative

It is possible that 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 their market value has decreased. Mutual funds distribute income earned on the securities they hold in order to minimize the overall amount of taxes paid by the fund, because they are taxed at a rate equivalent to the highest personal tax rate. Any income retained by a mutual fund is typically subject to more tax than if it were taxed in the hands of individual investors.

What are the different types of distributions?

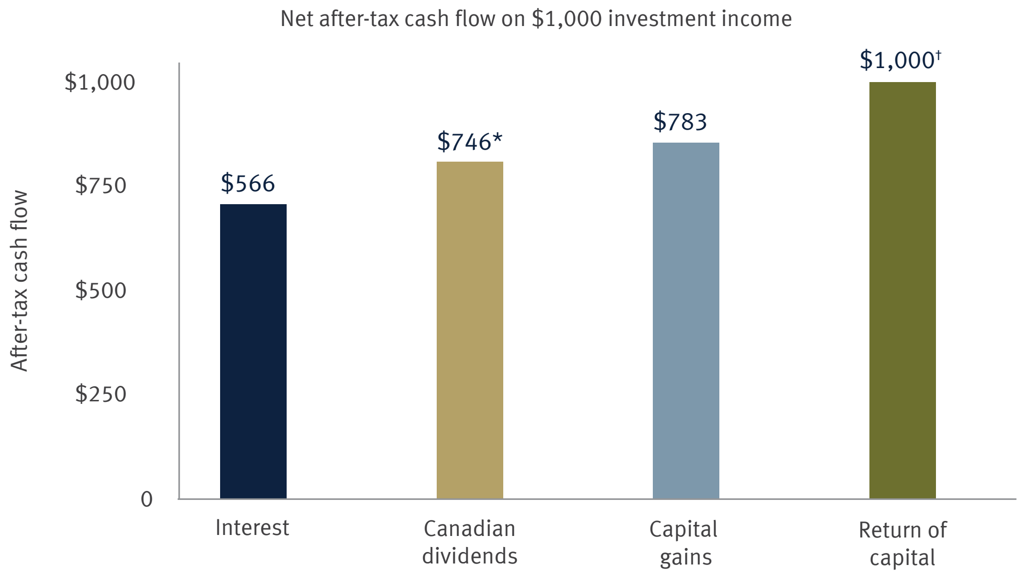
Below we provide a brief description of each type of distribution that unitholders may receive from a mutual fund and how they are taxed.

Type of Distribution	Description	Tax Treatment	Mutual Fund Example
Interest	Earned on investments such as treasury bills and bonds	Fully taxable at the same marginal tax rate as employment income	▪ RBC Canadian Money Market Fund ▪ PH&N Canadian Money Market Fund
Canadian dividends	Occurs when funds invest in shares of Canadian public corporations that pay dividends	Preferential tax treatment for individuals through the dividend tax credit	▪ RBC Canadian Dividend Fund ▪ PH&N Dividend Income Fund
Capital gains	Realized when an investment within the fund is sold for more than the ACB	Preferential tax treatment, as only 50% of a capital gain is taxable	▪ RBC Canadian Equity Fund ▪ PH&N Canadian Equity Fund
Foreign non-business income	Earned when the fund receives dividends from, or interest on, non-Canadian investments	Fully taxable at the same marginal tax rate as employment income	▪ RBC European Equity Fund ▪ PH&N Overseas Equity Fund
Return of capital (ROC)	ROC is used to describe distributions in excess of a fund's earnings (income, dividends and capital gains). For tax purposes, ROC represents a return of an investor's own invested capital	Not taxable in the year received, but reduces the ACB, which generally results in a larger capital gain or a smaller capital loss when the investment is sold	▪ RBC U.S. Monthly Income Fund ▪ PH&N Monthly Income Fund ▪ RBC Managed Payout Solutions

Interest income, dividends and capital gains earned by your mutual fund may be distributed to you on a monthly, quarterly or annual basis. The different types of income you receive are reflected on your T3 or T5 tax slip, which is mailed annually, usually in February. Samples of these tax slips can be found starting on page 17. The information that appears on these slips helps you accurately report different types of income on your tax return.

As shown below, distributions are treated differently where taxes are concerned.

It's Not What You Earn – It's What You Keep



Tax rates applied are based on an Ontario resident with taxable income of $100,000 and include assumed surtaxes. Combined Federal and Ontario 2016 marginal tax rates on interest, dividends and capital gains are, respectively: 43.41%, 25.38% and 21.7%. Please note that rates are unique to the tax circumstances of each individual and are provided herein for illustrative purposes only.

* Represents eligible Canadian dividends with a federal tax credit of 15.02%. The Ontario Dividend Tax Credit is also applied (please note that this rate varies from province to province).

† ROC distributions are not taxable in the year they are received, but do lower your ACB, which could lead to a higher capital gain or a smaller capital loss when the investment is eventually sold.

Note: All figures are rounded to the nearest whole number. Tax rates are subject to change.

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 your regular employment income. Interest distributions are reported as "Other Income" on the T3 tax slip.

Dividend income

Dividend income may be earned when a fund invests in shares of public companies that pay dividends. Individuals who receive dividends from Canadian companies receive a federal tax credit (a provincial dividend tax credit may also apply) to indicate
that the company paying the dividend has already paid tax on its profits. Because of their tax efficiency, dividend-paying stocks are popular with investors seeking to maximize cash flow from their investments.

HELPFUL TIPS

A clear summary of any eligible dividends received during the year will be provided for mutual fund investors on their tax slips. This information makes it easy for you to determine the amounts eligible for the federal dividend tax credit and the enhanced federal dividend tax credit.

How does the federal dividend tax credit work?

The dividend tax credit reduces the amount of tax you pay on dividend income. Dividends are classified as either “eligible” or “non-eligible” to reflect whether the issuing company paid tax at the high corporate rate (eligible) or the small business rate (non-eligible), respectively. Non-eligible dividends receive the federal dividend tax credit and eligible dividends receive the enhanced federal dividend tax credit.

Non-eligible Canadian dividends:

- Grossed up by 17%. That is, you add 17% to the amount of dividends you received.
- The grossed-up amount is shown as income from dividends on your tax return.
- The federal dividend tax credit is 10.52%. This number is multiplied by the grossed-up amount and the resulting amount is deducted from your federal tax.

Eligible Canadian dividends:

- Grossed up by 38%. That is, you add 38% to the amount of dividends you received.
- The grossed-up amount is shown as income from dividends on your tax return.
- The federal dividend tax credit is 15.02%. This number is multiplied by the grossed-up amount and the resulting amount is deducted from your federal tax.
- The net effect is a lower tax bill for your dividend income (as indicated in the graph on the previous page).

It is important to note that the Canada Revenue Agency (CRA) provides specific guidelines regarding which dividends can be classified as “eligible” or “non-eligible.”

How are dividends taxed?

Below we show the steps required to calculate federal taxes payable on dividends under both categories. For more specific information regarding the federal dividend tax credit and eligible dividends, please speak with your advisor or a qualified tax specialist.

2016		Non-Eligible Dividends	Eligible Dividends
Dividend	a	$1,000	$1,000
Dividend gross-up	b	17%	38%
Grossed-up dividend (a x (1 + b)) (This amount reported as taxable income)	c	$1,170	$1,380
Federal taxes payable (c x 26%)	d	$304.20	$358.80
LESS federal dividend tax credit (Federal tax credit x c)	e	$123.08 (Federal tax credit = 10.52%)	$207.28 (Federal tax credit = 15.02%)
Net federal tax (d – e)	f	$181.12	$151.52
Federal tax rate on dividend (f ÷ a)	g	18.11%	15.15%

1. The example assumes that an investor is in the 26% Federal tax bracket for federal purposes with a taxable income of $100,000 in 2016.
2. In addition to the federal taxes noted in the example, provincial taxes are required to be paid. The amount of provincial taxes will vary according to province (provincial dividend tax credits also apply). When combined, the total of the federal and provincial taxes equals the taxes owing on taxable Canadian dividends.

DID YOU KNOW?

Mutual funds can also distribute capital gains

Capital gains can also be incurred if a fund has realized more gains than losses during the year's trading activities. This situation makes it possible for a fund to distribute capital gains to investors at the end of the year.

Capital gains

As indicated on page 2, capital gains are realized when an investment is sold for more than its original purchase price. Because only 50% of a capital gain is subject to tax, these distributions are considered to be very tax efficient.

Here's an example:

Market value at time of sale	a	$1,500
Original cost of investment	b	$1,000
Capital gain on sale of investment (a – b)	c	$500
Capital gains inclusion rate for tax reporting (50% of c)	d	$250
Federal tax payable (d x 26%)	e	$65
Federal tax rate on capital gain (e ÷ c)	f	13%

The example assumes that an investor is in the 26% federal tax bracket. Note that provincial taxes would also apply and tax rates vary according to province.

Foreign non-business income

Foreign non-business income may be earned by mutual funds that invest in foreign securities. While you must report 100% of income earned from foreign sources on your tax return, you may be able to claim a foreign tax credit for any taxes already paid to foreign governments. If applicable, both of these amounts will be shown on your year-end tax slips.

Return of capital (ROC) distributions

Unlike other types of mutual fund distributions, an ROC distribution is a payout from a mutual fund that returns part of your invested capital. ROC is often distributed when a fund's objective is to pay a regular set monthly distribution to unitholders, but the underlying fund holdings have not generated enough interest or dividends, or realized capital gains during that period.

ROC distributions reduce the ACB, which could result in a higher capital gain or a lower capital loss when you eventually sell your investment. See the detailed explanation on page 14.

Why does a fund's price go down when it pays a distribution?

Most investors do not keep track of unit prices or the number of units they own. Instead, they focus on the dollar value of their portfolio. For this reason, investors who reinvest distributions often do not even notice that distributions have been paid.

If you do reinvest your distributions, it is important to understand how distributions affect the unit value of your mutual fund and what it means for your investment. The following example shows why:

The scenario

- Amy purchases 100 units of a fund at $10 per unit, for a total investment of $1,000.
- When the fund is purchased, it is set up to automatically reinvest distributions.
- During the year, interest and dividend income, as well as growth in the value of securities in the fund, increase the value of each unit from $10 to $11, thus increasing the value of the investment to $1,100.
- At year-end, the fund pays out a distribution of $0.50 per unit.

The impact

- Amy holds 100 units, so the distribution of $0.50 per unit gives a total distribution of $50.
- The $0.50 per unit distribution results in the unit price falling to $10.50 from $11.00.
- Amy's $50 distribution is automatically reinvested in additional fund units. At the new unit price of $10.50, she buys 4.7619 units ($50 ÷ $10.50 = 4.7619).
- Amy now owns 104.7619 units.

The result

- The original 100 units Amy purchased are now worth $1,050 (100 x $10.50).
- The additional 4.7619 units purchased with the distribution are worth $50 (4.7619 x $10.50).
- The total dollar value of the portfolio has not changed. It is still $1,100: (original 100 units worth $1,050) + (4.7619 new units worth $50) = $1,100.

In general, when you automatically reinvest distributions, you will see your mutual fund's unit value decline, but the number of units you own goes up. As a result, the total dollar value of your portfolio does not change.

How do mutual fund distributions affect ACB?

You should be aware that reinvested distributions cause the ACB to increase. In the example on the previous page, we saw how reinvesting distributions did not affect the total dollar value of the investment: the unit price fell to $10.50 from $11.00, but the number of units increased to 104.7619 from 100. However, the ACB did change in that example (recall that it can be thought of as the average price paid for units owned).

Let us continue with Amy's scenario to see how this works.

Recall that Amy originally owned 100 units purchased for $10 per unit. When the $50 distribution was automatically reinvested at the new unit price of $10.50, she acquired an additional 4.7619, for a total of 104.7619 units.

The ACB per unit for Amy can be calculated as follows:

$$\text{ACB} = \frac{(100 \text{ units x } \$10 \text{ per unit}) + (4.7619 \text{ units x } \$10.50 \text{ per unit})}{\text{Total number of units purchased}}$$

$$\text{ACB} = \frac{\$1{,}000 + \$50}{104.7619}$$

ACB = $10.02

In this example, reinvesting the distributions caused the ACB to increase to $10.02 from $10.

What happens when distributions are not reinvested?

If you choose to receive your distributions in cash instead of having them reinvested, the ACB will not be affected. Referring back to Amy's example, if she had taken the distribution in cash instead of reinvesting it, the ACB would remain at $10 per unit. She would receive $50 in cash and would have 100 units worth $10.50 each.

What happens when I purchase a fund close to year-end?

If you buy units of a fund just before it makes a distribution, you will be taxed on the distribution paid. For example, if you buy units of a fund in a non-registered account late in the year and the fund distributes income and capital gains in December, you may have to pay taxes on the income and capital gains it earned before you purchased the units. Depending on your circumstances, you may want to wait until a distribution has been made before investing. Please speak with your advisor or a tax specialist if you plan on purchasing units of a mutual fund close to year-end.

CORPORATE CLASS FUNDS

What is a corporate class fund?

Corporate class funds are set up as mutual fund corporations with multiple share classes. Each share class, often referred to as a "corporate class fund," represents a different mutual fund. For example, Class A may be a Canadian balanced fund; Class B, a U.S. equity fund; Class C, an international equity fund; and so on.

Two ways to defer tax with corporate class funds

1. Tax-free switching between funds

With corporate class funds, you can switch between funds with no tax cost, which is possible because each fund is a class of shares in a single mutual fund corporation – and switching from one class of shares to another in the same corporation is not a taxable event. Therefore, as long as you remain invested in funds that are under the same corporate class fund umbrella, you will defer any tax on gains when switching between funds.

When your investment is eventually redeemed out of the corporation, you will pay tax on any gains realized – just like any other investment. However, the ability to defer tax payments for long periods is a valuable benefit of corporate class funds because more money remains invested and working for you.

2. Reduced taxable distributions

Compared to standard mutual fund trusts, corporate class funds give you an opportunity to pay less tax on income earned inside of a fund. Corporate class funds can manage the taxable income and deductions generated by all of the funds under its corporate umbrella. This way, the losses or expenses in one fund can be used to shield taxable income in another. This is how corporate class funds can help reduce the taxable distributions you receive.

DID YOU KNOW?

Corporate class funds are suitable for investors who:

- Hold taxable accounts (i.e. non-registered).
- Have any income level and tax rate.
- Have any risk profile.

Corporate class fund distributions

At year-end,* mutual funds of all types generally distribute taxable income to avoid the high rate of taxation on that income if taxed inside of the fund. While mutual fund trusts permit all types of income and capital gains earned to flow through to investors and retain their tax characteristics in investors' hands, mutual fund corporations only provide a limited flow-through in that only Canadian dividends and capital gains can be passed on directly to investors. Interest and foreign income earned inside of a mutual fund corporation are taxable first inside the corporate structure and can only be distributed to its investors after tax in the form of a taxable Canadian dividend. Distributions are reported on a T5 tax slip (Relevé 3 in Quebec).

What happens to the ACB when switching between corporate class funds?

The examples below show how cost calculations differ when switching between mutual fund trusts and corporate class funds.

When switching between mutual fund trusts (Example 1), any capital gain or loss is realized and the cost of the newly acquired units equals the value of the switched units.

When switching between corporate class funds (Example 2), any capital gain or loss is deferred and the cost of the newly acquired shares equals the cost of the switched shares.

Example 1: Switching Between Two Mutual Fund Trusts

Investor buys a mutual fund trust (Fund 1), reinvests a distribution and then switches 10% of the market value to another mutual fund trust (Fund 2).

	Transactions					Balances				
	Value($)	Unit Price ($)	Units	Cost ($) (Units x Cost/Unit)	Realized Gain/Loss($) (Value - Cost)	Units	Value ($)	Cost ($)	Cost / Unit ($) (Cost / Units)	Embedded Gain/Loss ($) (Value - Cost)
Fund 1										
Buy	100,000	10.0	10,000			10,000	100,000	100,000	10.0	0
Dist Reinv.	8,000	12.0	667			10,667	128,000	108,000	10.1	20,000
Switch 10% out to Fund 2	(12,800)	12.0	(1,067)	**10,800**	**2,000**	9,600	115,200	97,200	10.1	18,000
Fund 2										
Switch in from Fund 1	**12,800**	20.0	640	n/a	n/a	640	12,800	**12,800**	20.0	**0**

cost of Fund 2 = value of units switched

capital gain is realized

Example 2: Switching Between Two Fund Classes in the Same Corporate Class Structure

Same transactions as Example 1 (above), but with share classes in the same fund corporation instead of mutual fund trusts.

	Transactions					Balances				
	Value($)	Share Price ($)	Shares	Cost ($) (Shares x Cost/Share)	Realized Gain/Loss($) (Value - Cost)	Shares	Value ($)	Cost ($)	Cost / Share ($) (Cost / Shares)	Embedded Gain/Loss ($) (Value - Cost)
Class 1										
Buy	100,000	10.0	10,000			10,000	100,000	100,000	10.0	0
Dist Reinv.	8,000	12.0	667			10,667	128,000	108,000	10.1	20,000
Switch 10% out to Class 2	(12,800)	12.0	(1,067)	**10,800**	**0**	9,600	115,200	97,200	10.1	18,000
Class 2										
Switch in from Class 1	**12,800**	20.0	640			640	12,800	**10,800**	16.9	**2,000**

cost of Class 2 = cost of shares switched

capital gain is deferred

* RBC Funds and PH&N Funds (mutual fund trusts) have a year-end of December 31st. RBC Corporate Class Funds have a year-end of March 31st.

RETURN OF CAPITAL (ROC) DISTRIBUTIONS

What is ROC?

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 investors of a portion of their own invested capital. However, the inclusion of ROC in a distribution does not indicate whether a fund has gained or lost value, since it may have unrealized capital gains that have not yet been paid out.

ROC distributions typically occur when a fund's objective is to pay a regular set monthly distribution. If interest, dividends and realized capital gains earned by the fund are less than the regular set distribution, an ROC distribution is added to make up the remainder. ROC distributions help stabilize the amount of cash flow you receive on a regular basis from a particular investment.

RBC Funds and PH&N Funds that typically have ROC distributions include:

- PH&N Monthly Income Fund and Class
- RBC U.S. Monthly Income Fund
- RBC Managed Payout Solutions
- T-Series of RBC Funds

ROC distributions reduce your ACB. You should not confuse this type of cash flow distribution with mutual fund rates of return or yield.

What are the main benefits of ROC?

ROC distributions offer a solution for investors who require a regular income stream from their investments. They provide three main benefits:

- **Tax efficiency:** Unlike interest, dividends and capital gains, income classified as ROC is not taxable in the year it is received.
- **Cash flow stability:** Funds that distribute ROC are particularly appealing for investors seeking regular cash flow from their portfolios. ROC is used to help fund managers distribute predictable monthly cash flow.
- **Tax deferral:** Tax payments can be deferred until your investment is sold, helping maximize your current cash flow and giving you control over when you pay tax.

It is important to understand the long-term tax impact of ROC distributions. While ROC is not taxable in the year it is received, it reduces the ACB of your investment, which will typically result in a higher taxable capital gain or a lower capital loss when you eventually sell your mutual fund. If the ACB reaches zero, any future ROC distributions will be taxed as capital gains, because you are getting more back than you originally invested.

HELPFUL TIPS

Unitholders of mutual funds that distribute ROC may receive updated ACB information on their year-end statements, so they can easily track the impact of ROC distributions on their investment. However, it is recommended that unitholders refer to their own statement records to calculate the ACB that is specific to their circumstances. Speak with your advisor or tax specialist for more information.

$$\text{Monthly distribution (cents/unit)} = \frac{\text{Previous year December 31 NAV per unit} \times 5\%}{\text{12 months}}$$

ROC in action

Consider a hypothetical fund which in 2015 paid a regular set monthly distribution of $0.05 per unit ($0.60 over the course of the year). The following hypothetical example illustrates how ROC works in this fund:

1. On January 1st, units of the fund are acquired at a unit price of $12.
2. By the end of December, the unit value increases by $2 to $14 as a result of:

$0.40	→	Interest and dividend income earned by securities in the fund
+ $1.60	→	Unrealized growth in the value of the securities in the fund
= $2.00	→	**Total increase in value per unit**

3. The set distribution of $0.05 per unit on a monthly basis amounts to $0.60 for the year and exceeds the income earned by the fund. ROC is used to make up the difference:

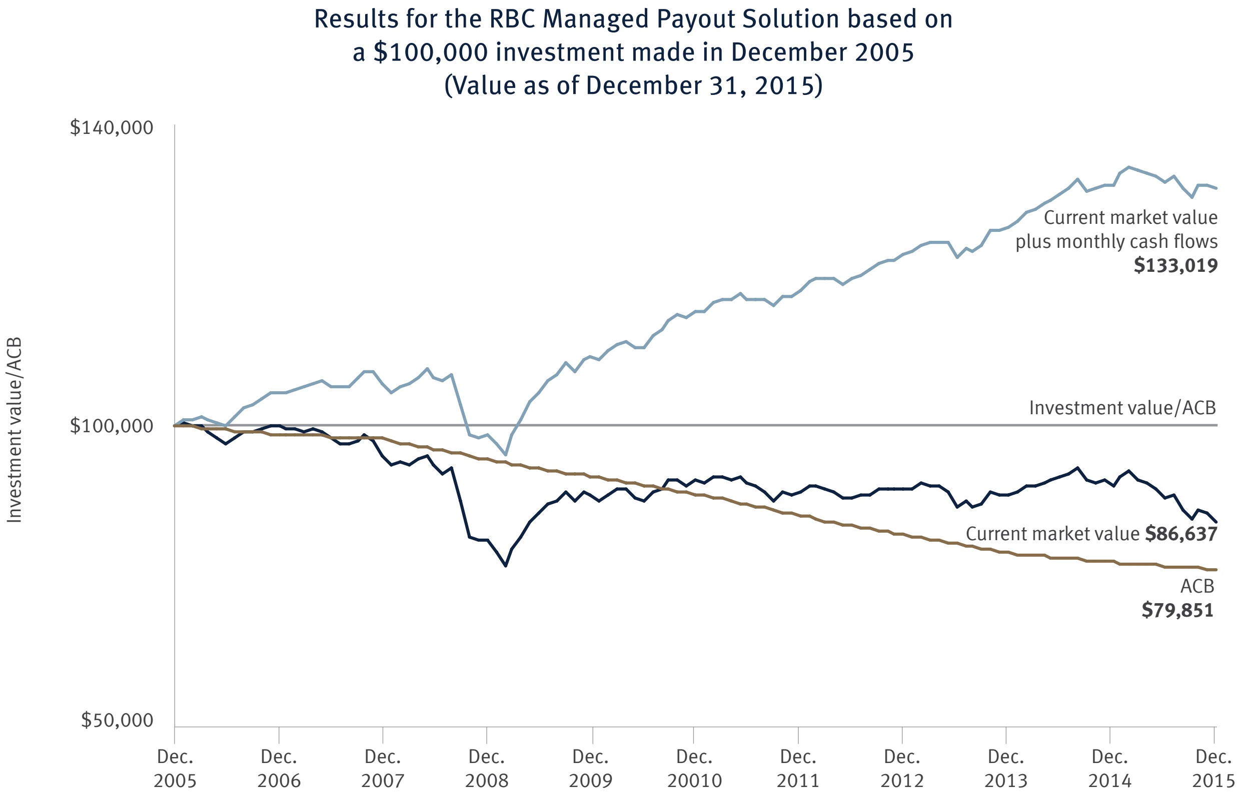
$0.40	→	Interest and dividend income earned by securities in the fund
+ $0.20	→	ROC required to maintain a consistent monthly payout rate of $0.05
= $0.60	→	**Total annual distribution per unit**

Distributions are classified at year-end and the total amount of ROC distributed throughout the year is allocated evenly across all monthly distributions.

The long-term impact of ROC distributions

Assume you invested $100,000 in RBC Managed Payout Solution in December 2005. Every month, the Fund paid its regular monthly distribution, a portion of which was ROC. Over time, the ROC distribution has reduced the ACB of your units. At the end of 2015, you decide to sell your investment. The chart on the next page shows how ROC distributions reduce the ACB, resulting in a higher taxable capital gain.

Impact of ROC Distributions



Key points:

Over the holding period, the current market value plus monthly cash flows amounted to **$133,019**, providing a total benefit of **$33,019** (**$46,382** in monthly cash flow minus a **$13,363** decrease in the initial investment).

Total monthly cash flow payments included ROC distributions of **$20,149**, which reduce your ACB to **$79,851** (**$100,000 – $20,149**).

The remaining cash flow of **$26,233** consists of a combination of interest, dividends, and capital gains (**$46,382 – $20,149**).

If all units were sold on December 31, 2015, the difference between the market value and the ACB generates a capital gain for tax purposes (**$86,637 - $79,851 = $6,786**).

ROC and Old Age Security (OAS) benefits

OAS benefits and other government income are typically reduced if your income exceeds a certain threshold (for 2015, the OAS clawback threshold is $72,809). Amounts that affect government income-tested benefits typically include employment income, investment income and capital gains. However, ROC distributions are not considered taxable income, so your OAS benefits will not be affected by them. When you do decide to sell your investment, OAS benefits and any other income-tested amounts, such as tax credits and other allowances, could be impacted by the potentially larger capital gain.

UNDERSTANDING YOUR YEAR-END TAX SLIPS

When a mutual fund you hold in a non-registered account distributes any form of income, you will receive a T3 or T5 tax slip indicating the amount and type of income that the fund has distributed to you for the previous year.

This section explains what information is contained on these slips and provides answers to some commonly asked questions.

Sample T3 Tax Slip

BOX 23 and BOX 49 – ACTUAL AMOUNT OF DIVIDENDS

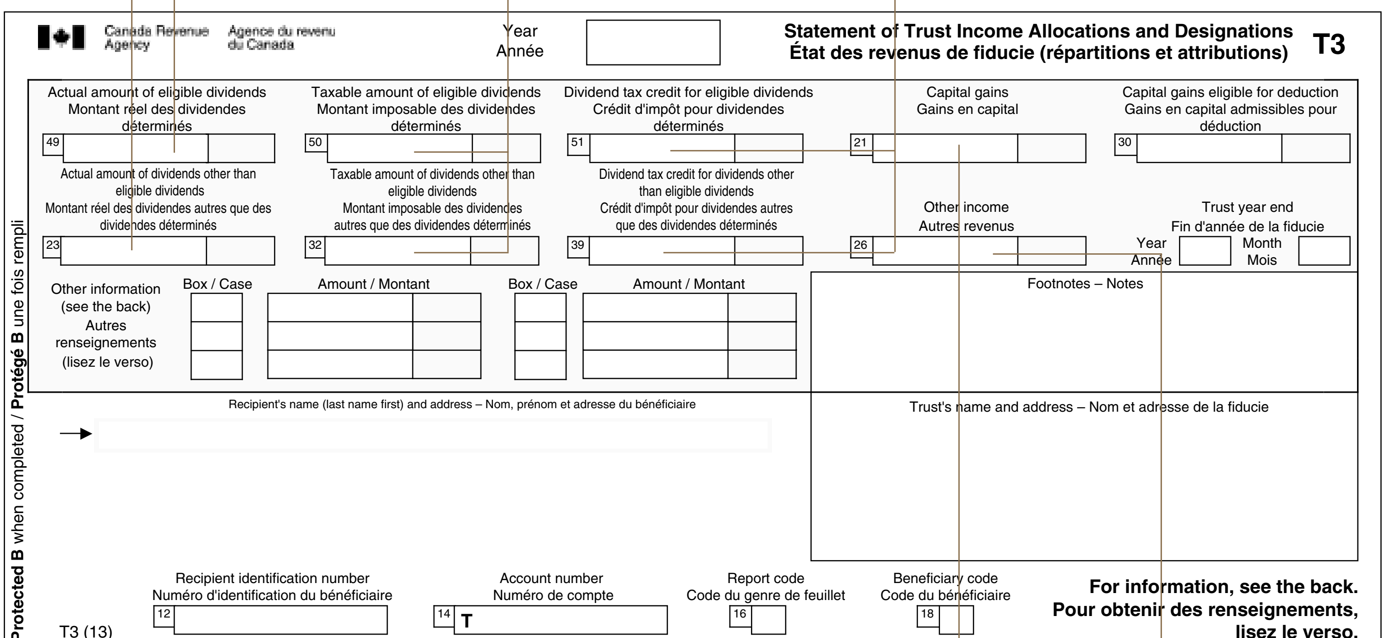
Information only – this amount is not included on your tax return.

BOX 32 and BOX 50 – TAXABLE AMOUNT OF DIVIDENDS

Include this amount in Part I of Schedule 4.

BOX 39 and BOX 51 – FEDERAL DIVIDEND TAX CREDIT

Include this amount on line 425 of Schedule 1.



Canada Revenue Agency / Agence du revenu du Canada

Year / Année

Statement of Trust Income Allocations and Designations
État des revenus de fiducie (répartitions et attributions) T3

Actual amount of eligible dividends / Montant réel des dividendes déterminés — 49

Taxable amount of eligible dividends / Montant imposable des dividendes déterminés — 50

Dividend tax credit for eligible dividends / Crédit d'impôt pour dividendes déterminés — 51

Capital gains / Gains en capital — 21

Capital gains eligible for deduction / Gains en capital admissibles pour déduction — 30

Actual amount of dividends other than eligible dividends / Montant réel des dividendes autres que des dividendes déterminés — 23

Taxable amount of dividends other than eligible dividends / Montant imposable des dividendes autres que des dividendes déterminés — 32

Dividend tax credit for dividends other than eligible dividends / Crédit d'impôt pour dividendes autres que des dividendes déterminés — 39

Other income / Autres revenus — 26

Trust year end / Fin d'année de la fiducie — Year / Année — Month / Mois

Other information (see the back) / Autres renseignements (lisez le verso) — Box / Case — Amount / Montant — Box / Case — Amount / Montant

Footnotes – Notes

Recipient's name (last name first) and address – Nom, prénom et adresse du bénéficiaire

Trust's name and address – Nom et adresse de la fiducie

Recipient identification number / Numéro d'identification du bénéficiaire — 12

Account number / Numéro de compte — 14 T

Report code / Code du genre de feuillet — 16

Beneficiary code / Code du bénéficiaire — 18

For information, see the back.
Pour obtenir des renseignements, lisez le verso.

Protected B when completed / Protégé B une fois rempli

T3 (13)

BOX 26 – OTHER INCOME

Include this amount on line 130 of your return.

BOX 21 – CAPITAL GAINS

Subtract any amount in box 30 from the amount in box 21. Include the difference on line 176 of Schedule 3.

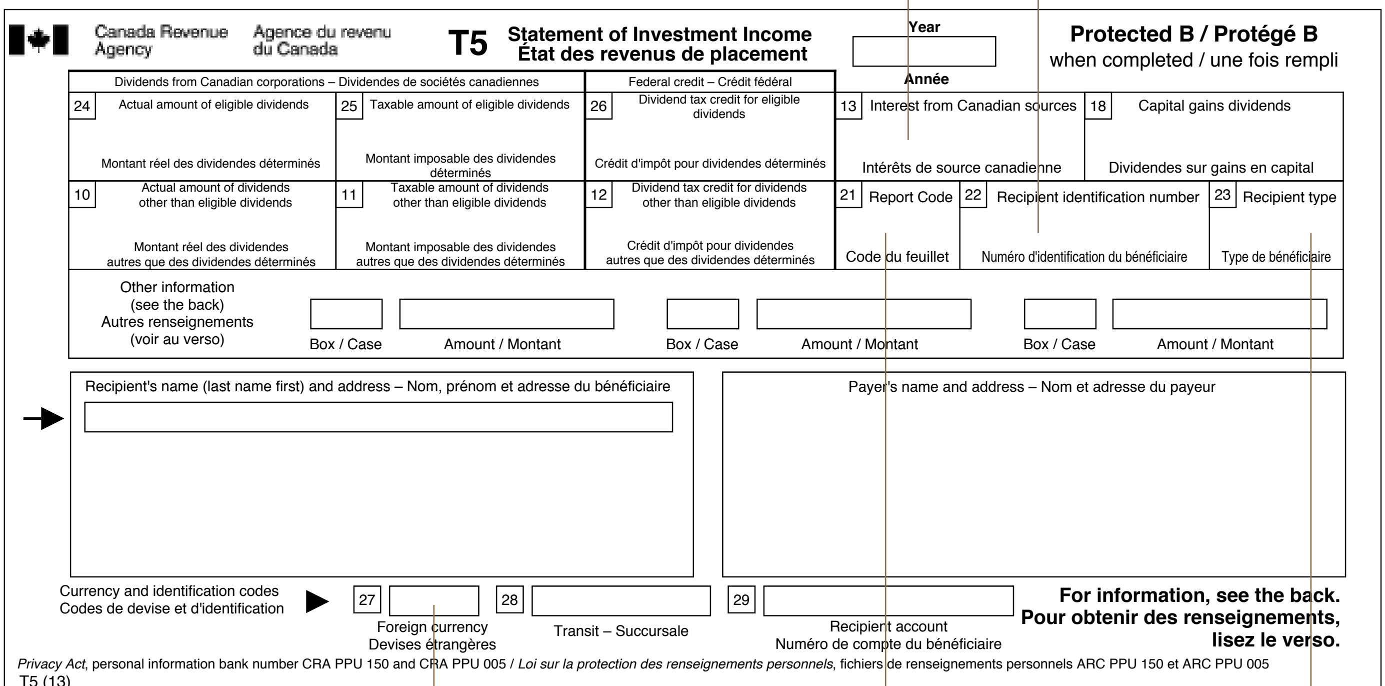
Sample T5 Tax Slip

BOX 13 – INTEREST FROM CANADIAN SOURCES

For information on how to report this amount on your return, see line 121 in your tax guide.

BOX 22 – RECIPIENT IDENTIFICATION NUMBER

If you are an individual (other than a trust), the number in this box is your Social Insurance Number. In all other cases, the number is your 9-character business number.



Canada Revenue Agency / Agence du revenu du Canada

T5 Statement of Investment Income / État des revenus de placement

Year / Année

Protected B / Protégé B when completed / une fois rempli

Dividends from Canadian corporations – Dividendes de sociétés canadiennes

Federal credit – Crédit fédéral

24 Actual amount of eligible dividends / Montant réel des dividendes déterminés

25 Taxable amount of eligible dividends / Montant imposable des dividendes déterminés

26 Dividend tax credit for eligible dividends / Crédit d'impôt pour dividendes déterminés

13 Interest from Canadian sources / Intérêts de source canadienne

18 Capital gains dividends / Dividendes sur gains en capital

10 Actual amount of dividends other than eligible dividends / Montant réel des dividendes autres que des dividendes déterminés

11 Taxable amount of dividends other than eligible dividends / Montant imposable des dividendes autres que des dividendes déterminés

12 Dividend tax credit for dividends other than eligible dividends / Crédit d'impôt pour dividendes autres que des dividendes déterminés

21 Report Code / Code du feuillet

22 Recipient identification number / Numéro d'identification du bénéficiaire

23 Recipient type / Type de bénéficiaire

Other information (see the back) / Autres renseignements (voir au verso)

Box / Case — Amount / Montant — Box / Case — Amount / Montant — Box / Case — Amount / Montant

Recipient's name (last name first) and address – Nom, prénom et adresse du bénéficiaire

Payer's name and address – Nom et adresse du payeur

Currency and identification codes / Codes de devise et d'identification

27 Foreign currency / Devises étrangères

28 Transit – Succursale

29 Recipient account / Numéro de compte du bénéficiaire

For information, see the back. Pour obtenir des renseignements, lisez le verso.

Privacy Act, personal information bank number CRA PPU 150 and CRA PPU 005 / *Loi sur la protection des renseignements personnels*, fichiers de renseignements personnels ARC PPU 150 et ARC PPU 005

T5 (13)

BOX 27 – FOREIGN CURRENCY

Leave this area blank if you are reporting amounts in Canadian dollars. For more information, see box 27 in the *T4015 – T5 Guide – Return of Investment Income*.

BOX 21 – REPORT CODE

The code in this box indicates that this is the original ("O"), an amended ("A") or a cancelled ("C") slip.

BOX 23 – RECIPIENT TYPE

The code in this box indicates if the amount was paid to an individual ("1"); a joint account ("2"); a corporation ("3"); an association, trust, club or partnership ("4"); or a government ("5").

COMMON MUTUAL FUND QUESTIONS FOR TAX SEASON

Do I have to include the distributions I receive as part of my taxable income?
Yes. Except for ROC distributions, you will have to pay tax on any distributions you receive each year in a non-registered account. You will be issued a T3 or T5 tax slip annually for any interest income, dividends or capital gains distributed to you by the mutual fund you own. These amounts must be reported on your tax return.

If I reinvested the distributions from my non-registered investments, are they still taxable?
Yes. Distributions from your non-registered investments are taxable, whether you receive them in cash or reinvest them in additional units of the fund. Unless you advise us otherwise, distributions on RBC Funds, PH&N Funds and RBC Corporate Class Funds are automatically reinvested in additional units of the fund. All distributions, whether reinvested or paid out to you, are reported on your T3 or T5 tax slip. The key advantage of reinvesting your distributions is that you benefit from the effects of compounding, which can accelerate growth in the value of your investment.

I sold some mutual funds during the year and realized some capital gains. Do these capital gains appear on my tax slips?
No. The capital gains reported on year-end tax slips include only those gains that were realized within a mutual fund and distributed to unitholders. Tax slips do not indicate capital gains you may have realized by selling your own mutual fund units. You are responsible for reporting capital gains resulting from the sale of mutual fund units on your tax return. Please see pages 2 and 9 for information on calculating capital gains and losses.

Is there any way of knowing in advance how much interest, dividends, capital gains or ROC will be paid by a mutual fund in a given year?
Mutual fund distributions are not known until the end of the year when a fund accounts for the income generated by the various securities. As a result, it is not possible to specify in advance what the income breakdown of distributions will be. However, estimates based on the long-term averages of interest, dividends, capital gains and ROC paid in previous years may be available. Investors in RBC Funds, PH&N Funds and RBC Corporate Class Funds are provided with a breakdown of each type of income paid to them each year on their tax slips. RBC Funds and PH&N Funds have a December 31st year-end, while RBC Corporate Class Funds have a year-end of March 31st.

Are tax slips issued for mutual funds held in my Tax-Free Savings Account?
No. A Tax-Free Savings Account (TFSA) is a registered account in which all investment earnings – interest, dividends and capital gains – are tax-free, even when withdrawn. Since withdrawals from a TFSA are tax-free, they will not impact your taxable income.

What if I made a capital gains election in 1994?
Some investors took advantage of the capital gains election in 1994, when the $100,000 lifetime capital gains exemption was eliminated, which would have created an exempt capital gains balance (ECGB) for funds you owned at that time. If you are in this situation, you may have been able to use the ECGB pool to change the ACB of a particular fund. For further information, please refer to the CRA's *Capital Gains Guide*, available at **www.cra-arc.gc.ca**, or ask your tax specialist.

Triggering a capital loss before year-end may reduce taxes

If you are considering selling a mutual fund investment that has declined in value, you may want to do so in time for the sale to settle by December 31st. Any capital loss triggered by the sale can be used to offset taxable capital gains earned on other investments, which may help reduce your overall taxes payable. If you have no net capital gains in the current year, you can use the capital loss to reduce taxable capital gains in the three preceding years or carry it forward indefinitely for use in future years.

The superficial loss rule

If you are planning to sell your mutual funds to trigger a capital loss, be mindful of the "superficial loss rule." Under this rule, if you or someone affiliated with you (such as your spouse or your company) acquires the same funds in the period beginning 30 days before, and ending 30 days after, the date of the sale on which you are claiming the loss, your capital loss may be disallowed.

What you need to know about owning U.S.-dollar mutual funds

You should know that Canadian tax reporting must be done in Canadian dollars (CAD), even when you own a fund that is denominated in U.S. dollars (USD). This has two main consequences.

First, whenever you redeem a USD fund in a taxable account, you'll need to calculate your purchase and redemption amounts in CAD to report an accurate capital gain or loss. Here's an example to show how that works:

On March 31, 2013:

- Investor buys 100 units of RBC U.S. Equity Fund (US$)
- Fund's Net Asset Value (NAV) = $10 (USD)
- U.S./Canada exchange rate on date of purchase: $1.10 (USD)
- Cost in Canadian dollars: $1,100 (100 X $10 (USD) X $1.10 (USD/CAD))

On September 30, 2015:

- Investor sells 100 units of RBC U.S. Equity Fund (US$)
- Fund's NAV = $10 (USD)
- U.S./Canada exchange rate on date of sale: $1.30 (USD)
- Proceeds of sale in Canadian dollars: $1,300 (100 X $10 (USD) X $1.30 (USD/CAD))

In this example, the investor would report a capital gain of $200 ($1,300 - $1,100) on the transaction on their 2015 tax return. For simplicity, please note that the $200 gain is due to currency fluctuation and not a change in the NAV of the Fund.

Second, if you receive a taxable distribution from a USD fund, you'll receive a T3 or T5 tax slip for reporting that income on your tax return. The amounts reported on a T3 or T5 slip are in Canadian dollars and do not require currency conversion when filing your tax return.

SUMMARY

An effective investment plan is tax efficient

Structuring your investments to be tax efficient can help you achieve your long-term financial goals sooner. Investing in mutual funds offers several advantages, including diversification, flexibility and professional management. And being aware of possible tax implications associated with mutual fund investing will help you choose the right investments for your individual needs and specific situation. Talk with your advisor today about the different types of investments available and which ones can help you structure a tax-efficient portfolio.

GLOSSARY

Adjusted cost base (ACB): It is the total price you paid for all of the units of a fund series in your account, including reinvested distributions and less any ROC.
The ACB per unit of a series is the weighted average price paid per unit.

Capital gain: You have a capital gain when you sell, or are considered to have sold, an investment for more than the ACB.

Capital loss: You have a capital loss when you sell, or are considered to have sold, an investment for less than the ACB.

Dividend: A distribution of after-tax profits to the shareholders of a corporation.

Interest income: Income earned from investments, such as treasury bills and bonds.

Management Expense Ratio (MER): The total fees and expenses a fund paid during a year divided by its average assets for that year.

Marginal tax rate: The rate of tax that someone pays on each additional $1 of taxable income they earn. As income increases, so does a person's marginal tax rate.

Mutual fund: A type of investment that pools money from many individuals and invests it according to a stated investment objective. Professional money managers oversee investment decisions within the fund by buying and selling investments, such as money market investments, stocks and bonds.

Return of capital (ROC): Commonly seen in mutual funds that pay a regular set monthly distribution to investors. 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 their own invested capital. ROC distributions are not taxable in the year they are received, but they reduce the
ACB of an investment.

T3 (Statement of Trust Income Allocations/Designations): A tax document reporting the amount and type of investment income distributed by the mutual funds owned in the previous year.

T5 (Statement of Investment Income): A tax document reporting the amount and type of investment income distributed from the corporate class fund owned in the previous year. Income reported on T5 tax slips includes most dividends, royalties and interest from bank accounts, accounts with investment dealers or brokers, insurance policies, annuities and bonds.

Tax-Free Savings Account (TFSA): A registered account that was introduced by the federal government effective January 1, 2009. With this account, all investment earnings – interest, dividends and capital gains – grow tax-free.

Unitholder: An investor in a mutual fund trust or mutual fund corporation.

For more information about the taxation of investments, please speak with your advisor or a qualified tax specialist.

RBC Global Asset Management

08280 (02/2016)

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