Mutual obligations – tax tips for mutual fund investors

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Jamie Golombek
Managing Director, Tax and Estate Planning, CIBC Private Wealth

While many investors are familiar with the taxation of mutual funds, there are two fundamental issues that seem to come up regularly and that warrant special attention. The first is the requirement to report not just amounts that show up on your T3 tax slip, but also to report any capital gains associated with any redemption of mutual funds during the year. The second is how to deal with Box 42, "Amount resulting in cost base adjustment" that sometimes appears on your mutual fund's T3 slip.

This report will provide a brief overview of how mutual fund trusts are taxed and then delve deeper into each specific issue: Reporting redemptions of mutual fund units and handling a return of capital.

Overview: how mutual funds are taxed in a non-registered investment account

A mutual fund is a pooled investment vehicle in which investors' money is pooled with the money of other investors and professionally managed by the mutual fund manager. While mutual funds can be organized as either mutual fund trusts or mutual fund corporations, this tax report will focus exclusively on mutual fund trust investors, but the main principles are also valid for corporate fund investors.

For tax purposes, mutual fund trusts are considered to be “flow-through entities” meaning that the taxable income earned inside the fund may be flowed through to the investor. The income maintains its “tax identity” as if earned directly by the investor. For example, a fund that receives eligible Canadian dividends from investments it made in Canadian dividend-paying public companies may be flowed out (or distributed) to you, and would therefore be taxed in your hands as eligible Canadian dividends. You can claim the related federal and provincial or territorial dividend tax credits on such amounts. Similarly, capital gains earned by the fund manager, when stocks or bonds are sold at a profit, also maintain their tax characteristics when distributed.

Income, or capital gains, from mutual funds is taxed in one of two fundamental ways:

- While you own the units, you are taxed annually on any fund distributions that are flowed out to you. Just after year end, the fund will send you a T3 slip, “Statement of Trust Income Allocations and Designations” showing the amount of capital gains, dividends, foreign income, other income or return of capital you received during the prior year. Note that even if the income and gains received were reinvested in additional fund units, you are still required to pay tax on these distributions. Information included with the T3 tax slip indicates how each amount should be reported on your personal tax return.
- When you redeem (sell) units of the mutual fund, you are taxed on the capital gain, if any. You will receive either a formal T5008 slip, “Statement of Securities Transactions” or an account statement from the mutual fund company or broker reporting the disposition of the units.

1. Reporting redemptions of mutual fund units

Capital gains (losses) on the redemption of mutual fund units should be reported on lines 13199 (“Total proceeds of disposition”) and 13200 (“Gain/Loss”) of Schedule 3, “Capital Gains (or Losses)” of your personal tax return.

Your capital gain (loss) is equal to your:

- Proceeds of disposition, which is the amount you received when you redeemed your mutual fund units, LESS
- Adjusted Cost Base (ACB), which is the cost of your units, plus any expenses you incurred to acquire them, such as any front-end commissions, LESS
- Outlays or expenses, which represent any costs of selling the fund units such as a deferred sales charge (DSC).

When calculating your total ACB, be sure to include any reinvested distributions that you paid tax on during your holding period (as discussed above) or you will risk paying tax twice on the same amount. For example, say you bought mutual fund units for $10,000 and you sold the units two years later for $11,000. During the two years you owned the fund, you received $100 in distributions, on which you paid tax when they were reported on your T3 slip, and which you reinvested. Your capital gain calculation would be $900 ($11,000 minus $10,100, which is the purchase price plus reinvested distributions).

If you received a “return of capital”, then you should be reducing your total ACB, as we will discuss below.

Capital losses can only be used to offset capital gains. If the total of your capital losses are more than the total of your capital gains in the current year, your net capital loss can be applied to reduce taxable capital gains in any of the three previous years, or in any future year.

The tax rules require that you report all dispositions (which includes redemptions) of non-registered mutual fund units. A failure to do so could subject you to penalties and arrears interest. Given that the brokerage or fund companies all provide the CRA with an electronic copy of all securities dispositions in a given year, the CRA therefore has the ability to match the securities dispositions up with what you actually report.

Take the 2005 tax case (*Rajah v The Queen*, 2005 TCC 637) when Sahadevan E. Rajah bought and sold securities through various securities dealers in the years 1995, 1996 and 1997. Mr. Rajah failed to disclose any of his securities dealings on his tax returns for those years, and certified in writing that the returns were “correct and complete.”

The CRA was able to obtain information about the proceeds of disposition from the T5008 filings reported. The CRA then wrote to Mr. Rajah asking him to provide supporting monthly brokerage statements, trading slips and his calculations of the ACB for each disposition.

Having received no response, the CRA advised Mr. Rajah that it was proposing to reassess him. In the reassessment, the CRA indicated it would include the full amount of proceeds in Mr. Rajah's income for each respective year, because he had not provided any evidence as to the appropriate ACB to be used.[1]

The judge was somewhat critical of the CRA's approach, saying that “it must have been obvious... that [Mr. Rajah] had not obtained the securities sold at no cost. Even a novice assessor must know that... the [Income Tax] Act provides [that] 'a taxpayer's income for a taxation year... is the taxpayer's profit... for the year.' Yet, Revenue made no effort to determine the cost, or allow for it, except by way of demand to [Rajah] for documented proof. If this was an attempt to mete out an extra-legal penalty, it can hardly be justified”.

After Mr. Rajah was reassessed, he objected and retained an accountant that submitted various brokerage slips to the CRA, establishing the ACB of some, but not all, of the securities that were disposed of in the years in question. The CRA then further reassessed and reduced the income inclusion by the ACB for the securities that Mr. Rajah was able to provide.

The judge concluded that, “in the end, it does not affect the validity of the assessments under appeal.” However, he did rebuke the CRA's assessor for not making any enquires whatsoever about the ACB of the securities, or any effort to recognize any cost other than the ACB established by Mr. Rajah through his own documents.

The judge indicated that the onus was on Mr. Rajah to establish “on the balance of probabilities that he incurred costs in excess of those allowed” by the CRA's reassessment. Since Mr. Rajah did not provide any additional ACB evidence, the CRA's reassessments were upheld.

It is important to note that the CRA also imposed gross negligence penalties. Under the *Income Tax Act*, a gross negligence penalty can be imposed on a taxpayer who has either “knowingly,” or “under circumstances amounting to gross negligence,” made a false statement or omission in a return.

Given that Mr. Rajah's tax returns failed to disclose any income from the sale of securities, the judge found that the “failure to refer to the transactions when made by a person with [Mr. Rajah's] education and experience in the business world can only have been made in circumstances amounting to gross negligence.”

Two obvious lessons can be learned from this case. First, be sure to report all taxable dispositions on your tax returns or you risk being subject to gross negligence penalties on top of the tax and arrears interest that you will owe. Second, be sure to keep meticulous records of your ACB, so if the CRA ever asks you to justify the ACB reported on your return, you have clear, documentary evidence to substantiate the reported amounts.

2. Handling a "return of capital" ROC – box 42

What is a ROC and where does it come from? ROC distributions are distributions made from a fund that are neither income nor capital gains. It is generally made by funds with targeted distributions. A distribution of ROC may either represent unrealized capital gains that have not yet been realized (return on capital), or a distribution of the fund's capital (return of capital). For example, suppose a fund has a targeted yield of 6% but only realized income and capital gains of 3%, but had unrealized capital gains of 2%. A distribution of 6% could consist of 3% realized income and capital gains, 2% ROC (return on capital) from unrealized capital gains, and 1% ROC (return of capital) from invested amounts.

Often investors choose the T-Series of a mutual fund so they can receive regular cash flow while deferring as much tax as possible on the amounts received until the units are actually sold.

If you received ROC during the year, it will be reported to you in Box 42, “Amount resulting in cost base adjustment” of your T3 tax slip. But given that this number does not go on your tax return, what are you supposed to do with it?

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[1] Note that Mr. Rajah was not eligible for the 50% capital gain inclusion rate since he was considered a frequent trader in securities, and thus any profit or loss was to be treated on income account and not on capital account. Mr. Rajah agreed with this finding.

This box was included in the T3 because of concern that investors were receiving large amounts of “non-taxable distributions” which constituted an ROC.

Indeed, under tax law, these amounts are not currently taxable, but they do reduce the investor's ACB of the units held, generally resulting in a capital gain (or a reduced capital loss) when the units are ultimately sold.

The CRA may have been justifiably worried that investors would simply “forget” to include this downward cost base adjustment when computing their ultimate gains or losses when they sold their units, thus under-reporting their capital gain or over-reporting their loss.

It's therefore important to track these Box 42 amounts so that you can properly compute your ACB, as discussed above, when you redeem units and must report the resultant capital gain (loss) on ultimate disposition.

Conclusion

While tax reporting for mutual funds is generally straightforward and is made easier by the tax slips and record-keeping by fund companies, it's important to keep in mind the two most-often missed tips: report all dispositions and reduce your fund's ACB by any ROC received.

Jamie Golombek, FCPA, FCA, CPA (IL), CFP, CLU, TEP is the Managing Director, Tax and Estate Planning with CIBC Private Wealth, Toronto.

jamie.golombek@cibc.com