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Taxation of Income from Mutual Funds and Exchange-Traded Funds

(with NEW information on capital gain/loss reporting for 2019 and beyond)

A mutual fund is an arrangement under which shares or units are sold to raise capital. Investors pool their money with other investors, and a fund manager invests the pooled money on their behalf. The mutual fund arrangement can be structured as a mutual fund trust or a mutual fund corporation, the primary difference being how income earned through the trust or corporation is taxed. Investors purchase units if investing in a mutual fund trust and shares if investing in a mutual fund corporation. This concept also normally applies to exchange-traded funds, which are treated similarly for tax purposes.

This paper discusses the taxation of income from mutual funds and exchange-traded funds (ETFs) as it relates to individual and corporate investors. For purposes of this paper, references to mutual funds include ETFs.

How income from a mutual fund is taxed

The taxation of income earned from a mutual fund depends on whether the fund is held within a registered plan or non-registered account. If held within a registered plan (e.g., Retirement Savings Plan or Retirement Income Fund[1], Education Savings Plan, Disability Savings Plan), income earned within the plan accrues on a tax-deferred basis and is not taxable until withdrawn from the plan. Upon withdrawal, amounts withdrawn are fully taxable at the planholder's marginal tax rate for the year. In the case of a Tax-free Savings Account, amounts earned within the account accrue, and can be withdrawn, tax-free.

In the case of non-registered accounts, income from a mutual fund generally results from either a distribution or disposition, both of which are normally taxable, subject to exceptions. As a mutual fund earns income from securities held within the fund, and from gains/losses on the sale of securities within the fund, a **distribution** occurs when the fund pays the income and/or gains to the fund's investors. Distributions can be in different forms depending on the type of mutual fund (i.e., trust or corporation) summarized as follows:

- Mutual fund trust: Other income, foreign income, eligible and non-eligible dividends, capital gains and return of capital (ROC);
- Mutual fund corporation: Eligible and non-eligible dividends, capital gains dividends and return of capital (ROC).

Depending on the fund, distributions can be any of (or a combination of) the above and, with the exception of return of capital amounts, are reportable and taxable on an investor's tax return, normally for the year the distribution is paid. ROC distributions are not taxable but reduce the adjusted cost base (ACB) of the investor's units or shares, often resulting in capital gains tax on the eventual sale of the investment.

By the end of March of the year following a distribution, mutual fund trust investors normally receive a T3 tax slip, *Statement of Trust Income Allocations*, from the trust indicating the amount and characteristics of the fund's distributions for the year. By the end of February of the year following a distribution, investors of mutual fund corporations receive a T5 tax slip, *Statement of Investment Income*, from the corporation providing similar information.

Over a number of years, Kelly purchased units of MEG mutual fund trust and shares of WFG mutual fund corporation. In February, Kelly received the following information slips for the previous tax year showing her distributions for the year; distributions she reinvested to purchase additional units and shares:

- a T3 slip from MEG mutual fund trust showing capital gains of $450 (box 21), other income of $250 (box 26) and a return of capital of $2,400 (box 42);
- a T5 slip from WFG mutual fund corporation showing capital gains dividends of $350 (box 18), taxable eligible dividends of $800 (box 25) and a dividend tax credit of $120 (box 26).

When completing her tax return for the year, Kelly reports $800 ($450 from her T3 and $350 from her T5) as a capital gain, 50%[2] of which is taxable at her marginal tax rate. Other income of $250 would be fully included in taxable income. The taxable amount of her eligible dividends, $800 as noted on her T5, is also taxable, with a dividend tax credit of $120 being available to reduce taxes payable on the dividend.

Box 42 of Kelly's T3 ($2,400 of return of capital from MEG mutual fund trust), would not be reported on her tax return as the amount is not taxable, but it does reduce her ACB for the investment.

[1] Including their locked-in plan equivalents under federal or provincial pension legislation.
[2] Currently, for capital gains, the capital gains inclusion rate is 50%.

The following table shows top marginal tax rates for all provinces and territories for various forms of investment income. Because Canada's tax system is based on graduated tax rates (i.e., the higher the income, the higher the tax rate), not all investors will be taxed at the top rate. However, the top rate is often used for illustrative purposes to highlight differences in taxation between various forms of income.

Province	Interest, foreign and other income	Eligible Dividends	Non-eligible dividends	Capital gains/ Capital gains dividends	Return of capital
BC	49.80%	31.44%	44.64%	24.90%	0%
AB	48.00%	31.71%	42.47%	24.00%	0%
SK	47.50%	29.64%	40.37%	23.75%	0%
MB	50.40%	37.78%	46.67%	25.20%	0%
ON	53.53%	39.34%	47.40%	26.76%	0%
QC	53.31%	40.00%	46.25%	26.65%	0%
NB	53.30%	33.51%	47.75%	26.65%	0%
NS	54.00%	41.58%	48.27%	27.00%	0%
PEI	51.37%	34.22%	45.23%	25.69%	0%
NL	51.30%	42.61%	44.59%	25.65%	0%
YK	48.00%	28.92%	42.17%	24.00%	0%
NT	47.05%	28.33%	36.82%	23.53%	0%
NU	44.50%	33.08%	37.79%	22.25%	0%

*Current to 2019

A **disposition** occurs when an investor sells or redeems units or shares in non-registered accounts. When this occurs, the difference between the investor's ACB (plus outlays and expenses) and proceeds of disposition[3] is normally a capital gain (or loss)[4] reportable for tax purposes and, depending on the investor's income for the year, subject to the above tax rates for capital gains. Until 2019, to provide disposition details to investors for tax reporting purposes, investors normally received a capital gain/loss summary with their year-end statement from their investment provider. While traditionally issued to the Canada Revenue Agency (CRA) to notify them of the transaction(s), the CRA did not require a T5008, *Statement of Security Transactions*, tax slip to be issued to investors. Effective for the 2019 reporting year, the CRA is requiring T5008 slips to be issued to both the CRA and investors in an effort to improve compliance with the taxation of dispositions. See "NEW for 2019 and beyond – investors to receive T5008 tax slips" below for more information.

Calculating capital gains/losses on the sale or redemption of units or shares

When mutual fund units or shares are sold or redeemed, a capital gain or capital loss may result. Currently, the capital gains inclusion rate in Canada is 50%, meaning only 50% of realized capital gains are subject to tax. To calculate a capital gain (or loss) on sale of an investment, the following three amounts are required:

- **Proceeds of disposition:** the amount received for the units or shares, before expenses;
- **Adjusted cost base (ACB):** the investor's cost to purchase the units or shares, plus any expenses incurred to acquire them (e.g., commissions and legal fees), less any returns of capital on the units or shares since the original purchase date;
- **Outlays and expenses:** expenses incurred when selling the units or shares (e.g., redemption fees and commissions)

[3] Normally fair market value (FMV) at the time of sale.

[4] Capital gains/losses occur when property is held on account of capital. In some cases, depending on the circumstances, property can be considered inventory triggering business income (or losses) on sale instead of capital gains/losses.

If the transaction involved a foreign currency, foreign exchange gains and losses might also apply on the sale of capital property.

To calculate capital gains or losses on the sale of units or shares, the following formula is used:

$$\textbf{Capital gains/losses} = \text{proceeds of disposition} - (\text{ACB} + \text{outlays and expenses})$$

In the case of a capital gain (where total capital gains exceed capital losses), 50% of the gain would be included in taxable income subject to tax at the investor's marginal tax rate. In the case of a capital loss, the loss would be used to reduce capital gains in the current year. To the extent that capital losses exceed capital gains in the year, the excess loss can be used to offset capital gains in any of the previous three years or can be carried forward for use in any future year.

Calculating ACB

Generally, units or shares of the same mutual fund are considered identical properties. The purchase of identical properties at different prices over time (for example, when distributions are reinvested to purchase additional units of the same fund) can impact an investor's ACB for the fund.

To calculate the ACB of units sold or shares redeemed, multiply the ACB per unit/share by the number of units or shares sold. The ACB per unit increases or decreases when new units/shares are purchased or when distributions are reinvested, depending on the price when the transaction occurs. Every time additional units/shares are purchased (whether ad hoc or via reinvested distributions), an investor's ACB per unit should be recalculated.

Note: While financial institutions make every effort to calculate ACB information for clients, investors are advised to calculate and keep their own records. Certain transactions (e.g., the transfer of assets to/from certain corporations or trusts, immigration or emigration from Canada, the death of an investor or holding the same fund in multiple accounts or at different institutions) can occur without sufficient documentation or the financial institution's knowledge which can impact ACB calculations.

ROC distributions directly impact ACB. While ROC distributions are not taxable – they represent a return of the investor's after-tax capital – the payments reduce the investor's ACB by the amount of the ROC payment. Once the investor's ACB reaches zero, any subsequent ROC payment is deemed to be a capital gain and is taxed accordingly for the year of payment. ROC payments from a mutual fund trust are normally reported on a T3 tax slip issued to the investor for the applicable tax year. ROC payments from a mutual fund corporation are generally not reported on a tax slip, although some financial institutions include this information as a footnote on a T5 slip as a courtesy to investors. In both cases, trust and corporation, investors should keep track of these amounts so they can correctly calculate the ACB of their units or shares.

Calculating proceeds of disposition

Proceeds of disposition is calculated by multiplying the number of sold or redeemed units/shares by the redemption price per unit.

On August 27, Kelly redeemed 250 units from MEG mutual fund trust at a price of $15 per unit, for a total of $3,750. Her redemption fees were $125. At the time of the redemption, the ACB of Kelly's units was $11 per unit, which included return of capital adjustments to that time.

Kelly calculates the ACB for the redeemed units by multiplying the number of units redeemed by the ACB per unit (250 x $11 = $2,750). To calculate her proceeds of disposition, Kelly multiplies the number of redeemed units by the per unit redemption price (250 x $15 = $3,750).

To determine her capital gain/loss on the transaction, Kelly subtracts the ACB and redemption fee from the proceeds of disposition [$3,750 – ($2,750 + $125)]. Her capital gain in this case is $875.

If, instead of a capital gain, a capital loss occurred, the loss could be used to reduce capital gains from other transactions in the year. If Kelly's capital losses for the year exceeded her capital gains, the net capital loss can be used to reduce taxable capital gains in any of the three previous years (resulting in a potential tax refund for those years) or any future year.

NEW for 2019 and beyond – investors to receive T5008 tax slips

Traditionally, for non-registered accounts, to provide disposition details for capital gain/loss reporting purposes, many financial institutions have provided investors with a capital gain/loss summary with their year-end statements. While the T5008, *Statement of Securities Transactions*, tax slip has routinely been issued by financial institutions to the CRA to notify them of disposition transactions, until 2019 there has been no CRA requirement to issue the slip to investors.

Effective for the 2019 taxation year, in an effort to improve tax compliance, the CRA requires T5008 slips to be issued to both the CRA and investors. Similar to T5 slips, financial institutions are required to issue the T5008 slip to investors by the end of February following the year of the disposition[5]. Cost and proceeds of disposition details are reflected on the slips and investors can use these amounts to calculate applicable gains and losses. As mentioned previously, investors should calculate their own ACB

[5] A T5008 slip is not required in cases where a "deemed disposition" occurs. A deemed disposition normally occurs when no real compensation is received in exchange for assets. Examples include the transfer of property to certain trusts, gifts of property, the death of the owner or cessation of Canadian residency.

and keep appropriate records to support same. For Quebec taxation purposes, an equivalent Relevé 18 (RL-18) tax slip will also be issued to residents of Quebec.

Investors are advised to check with their financial institutions for administrative details regarding their slips as there is some flexibility in how the information can be reported. Below is information on how CI Investments will issue these slips for the 2019 tax year.

Q: Will T5008/RL-18 tax slips be issued per transaction, or will one slip be issued for all dispositions in the year?

Where taxable dispositions occur in the year, CI will issue one T5008/RL-18 tax slip per non-registered account where CI handles the T5008 reporting obligation; it is possible for a CI client to receive multiple T5008/RL-18 tax slips if they have multiple accounts.

CI will issue T5008/RL-18 slips for client-held accounts (i.e., where CI is the account administrator) and for certain nominee-held accounts (i.e., a third-party dealer is administrator) where CI has agreed to issue the slips on behalf of the nominee.

For T5008/RL-18 purposes, the CRA permits aggregate reporting for identical securities. This means, for identical securities, financial institutions can combine disposition details for transactions in the year. CI has elected to adopt aggregate reporting for these purposes; therefore, one slip will be issued for all dispositions in the year aggregated by fund. As per CRA guidelines for aggregated reporting, where there were multiple dispositions throughout the year for the same fund, the disposition date reported on the T5008/RL-18 slip for the fund will be December 31.

Q: Will T5008/RL-18 tax slips be issued in addition to capital gain/loss summaries in statements or in place of capital gain/loss summaries?

For CI client-held accounts, the T5008/RL-18 tax slip will replace capital gain/loss summaries included in year-end statements. For nominee-held accounts, the T5008/RL-18 slip may be issued in addition to, or in place of, the summary depending on who the administrator is.

Q: Will T5008/RL-18 tax slips be issued when there is an exchange of units or shares between different mutual fund trusts or corporations (e.g., a switch between funds)?

Yes. Transactions involving an exchange of units or shares between different mutual funds is normally a taxable event reportable on a T5008/RL-18 tax slip. Exceptions may apply in the case of certain mutual fund reorganizations or amalgamations. Switches between different series or purchase options of the same fund are generally not taxable events.

Q: Will cost or book value amounts reported on T5008/RL-18 tax slips include return of capital adjustments, or will investors have to make ROC adjustments when calculating their ACB?

CI will calculate cost or book value amounts (including return of capital adjustments), on a best effort basis and this information will appear on T5008/RL-18 tax slips issued by CI. Clients, however, are advised to calculate and keep track of their own cost and ACB amounts as certain transactions (e.g., the transfer of assets to/from certain corporations or trusts, immigration or emigration from Canada, the death of an investor or holding the same fund in multiple accounts or at different institutions) can occur without sufficient documentation or the financial institution's knowledge which can impact ACB calculations.

Not all financial institutions have the ability to appropriately calculate cost/ACB amounts, so investors may wish to contact their account administrator(s) to confirm how this information is reported on their respective tax slips.

Q: How are outlays and expenses (if any) reported on the T5008/RL-18 slips?

Outlays and expenses (amounts incurred when selling units or shares), are not reported on T5008/RL-18 tax slips. These amounts can often be found in the transaction details reported on client statements.

Note, for T5008/RL-18 tax slips issued by CI Investments, box 21, proceeds of disposition, is reported net of any deferred sales charges (DSC). Where these charges were incurred to sell CI funds, these charges have already been subtracted from proceeds of disposition on CI T5008/RL-18 tax slips for purposes of calculating capital gains/losses. Where this is the case, capital gains/losses can normally be calculated as follows: Capital gains/losses = Proceeds of disposition – ACB.

Working with financial and tax advisors can help to ensure income is reported correctly for tax purposes. This, in turn, can reduce the potential for audits, penalties and/or related interest charges.

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