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Tax Treatment of Mutual Funds for Individuals

This information sheet contains general information on the tax treatment of income received from Canadian mutual funds. It will help you understand what a mutual fund is, how to report income, and how to report the sale of mutual fund units or shares. We have included an example to show how to report these activities.

Note
This information sheet does not apply to certain investments in mutual fund trusts that are acquired through a securities option agreement, or mutual fund investments that are held in tax-deferred plans. For more information, see guide T4040, *RRSPs and Other Registered Plans for Retirement*, and RC4092, *Registered Education Savings Plans (RESPs)*.

You can find forms and publications and more information on capital gains on our Website at **www.cra.gc.ca**.

What is a mutual fund?

A mutual fund is an arrangement under which shares or units are sold to raise capital. Investors purchase units if the mutual fund is a trust or purchase shares if the fund is a corporation. When you invest in a mutual fund, your money is pooled with the money of other investors and invested on your behalf by the fund manager.

Mutual fund trusts and corporations are also known as flow-through entities. For tax purposes, a flow-through entity treats the taxable income earned inside the entity as if you held the investments directly, instead of through the fund. The income that is distributed, or flowed out to you, keeps its identity. For example, dividend income remains dividend income, and capital gains remain capital gains when they are flowed out (or distributed) to investors.

How is income from mutual funds taxed?

In most situations, income from mutual funds is taxed in two ways:

- While you **own** the shares or units, you are taxed on the distributions that are flowed out to you. If you own units of a mutual fund trust, the trust will give you a T3 slip, *Statement of Trust Income Allocations and Designations*. If you own shares of a mutual fund corporation, the corporation will give you a T5 slip, *Statement of Investment Income*. This income can be capital gains, capital gains dividends, dividends, foreign income, interest, other income, return of capital, or a combination of these amounts.
- When you **redeem** (or **cash in**) the units or shares, you are taxed on the capital gain, if any. This is because your mutual fund investment is considered capital property for tax purposes. You will receive a T5008 slip, *Statement of Securities Transactions*, or an account statement from the mutual fund.

How do you report income from information slips?

The back of the information slip explains where to report the income shown in each box and it refers you to the appropriate section of the *General Income Tax and Benefit Guide* when necessary. See page 4 for instructions on how to report the most common types of income.

If you choose to reinvest any distributions by buying more units or shares, you may not actually receive the income shown on your information slips. However, you must still report on your return the amounts shown on your slips. This is because we consider you to have received these amounts before reinvesting them.

How do you calculate and report capital gains when you redeem units or shares?

When you redeem your mutual fund units or shares, you may have a capital gain or a capital loss. Generally, 50% (1/2) of your capital gain or capital loss becomes the taxable capital gain or allowable capital loss.

Use lines 131 and 132 of Schedule 3, *Capital Gains (or Losses)*, to calculate and report all your capital gains and capital losses from your mutual fund units and shares. List the information for each mutual fund separately. Group more than one redemption from the same fund together.

To calculate your capital gain or your capital loss, you need to know the following three amounts:

- the **proceeds of disposition**, which is the amount you received or will receive for your units or shares;
- the **adjusted cost base (ACB)**, which is the cost of your units or shares, plus any expenses you incurred to acquire them, such as commissions and legal fees; and
- the **outlays** and **expenses** you incurred when selling your units or shares, such as redemption fees and commissions.

Calculating capital gains and capital losses

To calculate your capital gain or capital loss, subtract the total of your property's ACB, and any outlays and expenses you incurred, from the proceeds of disposition.

How do you calculate your ACB?

Mutual fund units or shares are identical properties because each property in the group is the same as all the others. You may buy and sell several identical properties at different prices over a period of time. This occurs, for example, when you immediately reinvest your distributions in the mutual fund.

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To calculate your capital gain from the units or shares you redeem, you first have to calculate your ACB. To calculate the ACB of the units or shares redeemed, multiply the average cost per unit of all units or shares held immediately before the redemption by the number of units or shares redeemed (see Chart 1 on page 3).

The average cost per unit or share of your total investment increases or decreases when you purchase new units or shares, or reinvest your distributions, depending on the price when the transaction occurred. Every time you purchase additional units or shares, or reinvest your distributions, you should recalculate the average cost per unit or share. Do this for each of your mutual funds.

If you receive a T3 slip with an amount in **box 42** – **Amount resulting in cost base adjustment**, the ACB of that mutual fund trust identified on the slip will change. If Box 42 contains a negative amount, add this amount to the ACB of the units of the trust. If Box 42 contains a positive amount, subtract this amount from the ACB of the units of the trust. See the example below.

If the ACB of the trust units is reduced below zero during the taxation year, the negative amount is deemed to be a capital gain in the year. Enter the amount of the capital gain on line 132 of your Schedule 3. Place a zero on line 131 since there is no actual sale of units. The new ACB of the trust units is deemed to be zero.

For example, Richard purchased MNO Mutual Fund Trust units for $1,000 in 2000 and received a $200 return of capital in each of the 2000, 2001, 2002, 2003 and 2004 tax years. The total return of capital by the end of 2004 is $1,000. In 2005, he received an additional return of capital in the amount of $200. On his 2005 tax return, Richard will report a capital gain of $200. The ACB of his units will be reset to zero.

How to calculate the proceeds of disposition

The second step for determining your capital gain, is to calculate the proceeds of disposition. Do this by multiplying the number of redeemed units or shares by the redemption price. Report the capital gain (or loss) on lines 131 and 132 of Schedule 3.

You should also report capital gains from information slips on Schedule 3. Capital gains from a T3 slip are reported at line 176 while capital gains from all other information slips (for example, a T5 slip) are reported at line 174.

What do you do if you have a capital loss?

If you have a capital loss, you can use it to reduce any capital gains you had in the year. If your allowable capital loss is more than your taxable capital gain, you may have a net capital loss. You cannot use this loss to reduce other income. However, you can use a net capital loss to reduce taxable capital gains in any of the three previous years, or in any future year. For information on capital losses, see Chapter 5 of guide T4037, *Capital Gains*.

Can you claim a capital gains deduction?

You cannot claim a capital gains deduction for capital gains from mutual funds. However, if you filed Form T664 or T664 (Seniors), *Election to Report a Capital Gain on Property Owned at the End of February 22, 1994*, for any of your units or shares, the unused balance of your exempt capital gains balance (ECGB) that expired after 2004 may be added to the ACB of your units and shares. For more information, see guide T4037, *Capital Gains,* or visit our Website at **www.cra.gc.ca**.

Example

Kate has mutual fund investments in XYZ Mutual Fund Trust and STU Mutual Fund Corporation. Over the years, she purchased units in XYZ Mutual Fund Trust, and she reinvested her distributions from the trust to buy more units.

On June 30, 2005, Kate redeemed 200 units from XYZ Mutual Fund Trust at a price of $17.42 per unit, for a total of $3,484. Her redemption fees were $70. Kate records her redemption and her reinvested distributions, and she recalculates her adjusted cost base (ACB) for XYZ Mutual Fund Trust as shown in Chart 1 on page 3.

For the 2005 tax year, Kate received the following information slips:

- a T3 slip from XYZ Mutual Fund Trust showing capital gains of $750 in box 21 and a return of capital of $500 in box 42;
- a T5 slip from STU Mutual Fund Corporation showing capital gains dividends of $330 in box 18 and interest of $200 in box 13.

Step 1 – Capital gains resulting from the redemption

The first step Kate takes is to calculate her ACB. Chart 1 on page 3 shows how she does this.

The average cost of the units at the time of redemption is $15.20 per unit. She calculates the ACB for the redeemed units by multiplying the number of units redeemed by the average cost per unit (200 × $15.20 = $3,040).

To calculate her proceeds of disposition, Kate multiplies the number of redeemed units by the redemption price (200 × $17.42 = $3,484).

Step 2 – Completing Schedule 3

When she completes her 2005 income tax return, Kate records her ACB ($3,040), her proceeds of disposition ($3,484), and her redemption fee of $70 on Schedule 3, under the heading "Mutual fund units, deferral of eligible small business corporation shares, and other shares including publicly traded shares." To determine her capital gain (or loss) on this transaction, she subtracts the ACB and redemption fee from the proceeds of disposition [$3,484 – ($3,040 + $70)]. In this example, her gain is $374.

Kate also reports the capital gain of $750 from the T3 slip on line 176 of Schedule 3 and the capital gains dividend of $330 from her T5 slip on line 174 of Schedule 3. Kate does not report the amount of $500 from box 42 of the T3 slip on Schedule 3 or as income on her return. This box 42 amount does result in an adjustment to her ACB as shown in Chart 1 below.

Kate's total capital gains on line 197 are $1,454 ($374 + $750 + $330). To calculate her total taxable capital gains, she multiplies this amount by 50%, for a result of $727. This is the amount she will enter on line 199 of Schedule 3 and line 127 of her return.

We have reproduced the appropriate areas of Schedule 3, below, as Kate would have completed them. Kate records her redemption and any future purchases or reinvested distributions, and she recalculates her ACB as shown in Chart 1 below.

If, instead of a capital gain, Kate had a capital loss of $1,454 on line 197, 50%, or $727, would be her net capital loss. Kate would file Schedule 3 with her return to register her loss. She can use this net capital loss to reduce taxable capital gains in any of the three previous years or in any future year.

Step 3 – Completing Schedule 4

Kate completes part II of Schedule 4, *Statement of Investment Income*, and includes the interest of $200 from box 13 of the T5 slip on line 121 of her return.

Chart 1 – Recalculation of Adjusted Cost Base (ACB)

Date	Description	Total Cost in $ (A)	Number of units (B)	Average cost per unit (A÷B)
March 12, 1999	purchase at $14.75 per unit	20,000.00	1,355.9322	$14.75
December 31, 1999	reinvested distribution at $16.40 per unit	+ 1,427.82	+ 87.0622	$16.40
	new cost	21,427.82	1,442.9944	$14.85
April 15, 2000	purchase at $17.29 per unit	+ 5,000.00	+ 289.1845	$17.29
	new cost	26,427.82	1,732.1789	$15.26
December 31, 2001	reinvested distribution at $13.77 per unit	+ 962.11	+ 69.8700	$13.77
	new cost	27,389.93	1,802.0489	$15.20
	Balance in the fund on December 31, 2000	**27,389.93**	**1,802.0489**	**$15.20**
June 30, 2005	redemption of 200 units at $17.42 per unit[1]	- 3,040.00	- 200.0000	$15.20
	Balance in the fund on June 30, 2005	**24,349.93**	**1,602.0489**	**$15.20**
December 31, 2005	return of capital of $500 reported in box 42 of T3 slip[2]	- 500.00		
	Balance in the fund on December 31, 2005	**23,849.93**	**1,602.0489**	**$14.89**

[1] Kate bases her proceeds of disposition on the selling price of $17.42 per unit. To calculate her ACB on June 30, 2005, when she redeemed her units, Kate multiplies the average cost per unit of all units held immediately before the redemption ($15.20) by the number of units redeemed (200). This gives Kate an ACB of $3,040 ($15.20 × 200).

[2] As a result of the return of capital reported in box 42 of her T3 slip from XYZ Mutual Fund Trust, she reduces her total cost by $500 and recalculates her ACB on December 31, 2005, to be $14.89 per unit.

Reproduction of Schedule 3

Note: If you have a business investment loss, see line 217 in the General guide.	(1) Year of acquisition	(2) Proceeds of disposition	(3) Adjusted cost base	(4) Outlays and expenses (from dispositions)	(5) Gain (or loss) (column 2 minus columns 3 and 4)

3. Mutual fund units, deferral of eligible small business corporation shares, and other shares including publicly traded shares (report capital gains and losses shown on an information slip on line 174 or 176)

Number	Name of fund/corp. and class of shares	(1)	(2)	(3)	(4)	(5)
200	XYZ Mutual Fund Trust of Canada	1999	3,484 00	3,040 00	70 00	374 00
		Total 131	3,484 00		Gain (or loss) 132	374 00

Information slips – Capital gains (or losses) from all your T5, T5013, and T4PS slips	174	+	330 00
Information slip – Capital gains (or losses) from all your T3 slips	176	+	750 00
Total of all gains (or losses) in column 5 before reserves and gifts	191	=	1,454 00
Total capital gains (or losses)	197	=	1,454 00
Taxable capital gains (or net capital loss) in 2005: Multiply the amount on line 197 by 50%. Enter the taxable capital gains on line 127 of your return. If it is a net capital loss, see line 127 in the guide.	199		727 00

Reporting instructions for T3 slips and T5 slips

Capital gains

Capital gains	T3 slip	Box 21	Subtract any amount in box 30 from the amount in box 21. Include the difference on line 176 of Schedule 3. All or part of this amount may be foreign non-business income, which will be footnoted. Include this type of footnoted amount on line 433 of Schedule 1.
Capital gains dividends	T5 slip	Box 18	Include this amount on line 174 of Schedule 3.

Dividends

Taxable amount of dividends	T3 slip	Box 32	Include these amounts in part I of Schedule 4 or on line 120 of your income tax return if you do not have a Schedule 4. See note 1 below.
	T5 slip	Box 11	
Federal dividend tax credit	T3 slip	Box 39	Include these amounts on line 425 of Schedule 1. See note 2 below.
	T5 slip	Box 12	
Actual amount of dividends	T3 slip	Box 23	Do not report these amounts.
	T5 slip	Box 10	

Interest income

Interest from Canadian sources	T5 slip	Box 13	Include these amounts in part II of Schedule 4 or on line 121 of your income tax return if you do not have a Schedule 4. See note 1 below.
Other income from Canadian sources	T5 slip	Box 14	

Foreign income

Foreign non-business income	T3 slip	Box 25	Include these amounts in part II of Schedule 4 and on line 433 of Schedule 1.
Foreign income	T5 slip	Box 15	
Foreign non-business income tax paid	T3 slip	Box 34	Include these amounts on line 431 of Schedule 1. See note 2 below.
Foreign tax paid	T5 slip	Box 16	

Notes

1. If you received a T1 Special or T1S-A income tax package in the mail, you will not have a Schedule 4 to complete. Enter your dividend or interest income as instructed above.
2. If you qualify for the federal dividend tax credit or federal foreign tax credit, you may also qualify for similar provincial or territorial credits. For more information, read the Forms Book included in your tax package.