strategy shares

Return of Capital (ROC) Distributions Explained: How Investors Can Leverage Constructive ROC Distributions

Return of capital (ROC) or nondividend distributions are among the least understood type of distribution that investors receive. This is largely because an ROC distribution is a tax concept and not an economic concept, meaning that it tells an investor little about whether the distribution was earned but rather how the IRS will classify this distribution.

Put simply, ROC distributions are cash payments to shareholders that represent a return of invested capital that are not subject to current tax. ROC distributions can be either constructive or destructive depending on whether they are supported by total returns. However, this is not unique to ROC distributions as dividend and capital gains distributions may also be earned or unearned.

Earned ROC distributions that have a high likelihood of remaining earned into the future can offer investors significant benefits from a tax perspective.

What is a Return of Capital (ROC) distribution?

- » A distribution resulting from a return of invested capital.
- » Decreases the investment's cost by the payment amount.
- » Represents a tax concept and not an economic concept.
- » Can be earned or unearned, just like dividends and capital gains.

What are the potential tax advantages?

- » Reduces the tax rate to a long-term capital gains rate.
- » Defers the taxation until the year of sale.
- » Offers inheritance benefits. The initial investment will be "stepped-up" to the current value of the investment upon inheritance, eliminating the capital gains generated from the ROC distributions.

Look at the change in a fund's NAV to understand the economic impact of the ROC distribution.

- » Did the fund's NAV rise over the long-term and is it likely to do so in the future?
- » Yes: earned distribution that is constructive and positive for the investor.
- » No: the fund did not earn its distribution, which can be destructive and ultimately dilutive for the investor.

Example of Potential Tax Benefits

From a tax perspective, funds that return capital to shareholders are simply returning a portion of the investor's original investment. The return of capital itself is nontaxable, but the distribution does impact taxes paid on future capital gains. The example below shows a breakdown of the benefits of a return of capital distribution compared to traditional dividend payouts. Starting with the same cost basis and looking over a 5-year time horizon until the investment is sold, the cumulative net after-tax returns are higher for return of capital as a result of the tax advantages associated with the distributions.

Hypothetical Example: ETF Comparison Analysis with a 7% Distribution

	Traditional Dividend	Return of Capital
Initial Cost Basis	$500.00	$500.00
Year 1		
ETF Value	$700.00	$700.00
After-Tax Distribution	$15.68	$49.00
Year 2		
ETF Value	$900.00	$900.00
After-Tax Distribution	$20.16	$63.00
Year 3		
ETF Value	$1,100.00	$1,100.00
After-Tax Distribution	$24.64	$77.00
Year 4		
ETF Value	$1,300.00	$1,300.00
After-Tax Distribution	$29.12	$91.00
Year 5		
ETF Value	$1,500.00	$1,500.00
After-Tax Distribution	$33.60	$105.00
Taxes on Distribution	$123.20	$0
Net After-Tax Cash Flow[1]	$261.80	$385.00
Investment Sold After 5 Years		
Sale Price	$1,500.00	$1,500.00
Remaining Cost Basis	$500.00	$115.00
Return on Investment	$1,000.00	$1,385.00
Long-Term Capital Gains Tax[2]	$200.00	$277.00
Total Taxes	$323.20	$277.00
Cumulative Net After-Tax Returns	$676.80	$1,108.00

[1] 32% Tax Rate [2] 20% Tax Rate

Other Potential Benefits

Investments that distribute return of capital typically appeal to those seeking regular cash flows from their portfolio. A predictable cash flow stream allows for easier planning of long-term financial goals. This may be particularly appealing for investors that rely on cash flows from their investments to support their day-to-day expenses, such as retirees.

An additional potential benefit for retirees is that it allows the transfer of the assets to heirs with typically unmatched tax benefits to both the retiree and the heirs. The cost basis of property transferred at death receives a "step-up" in basis to its fair market value. This eliminates the heir's capital gains tax liability on appreciation in the property's value that occurred during the decedent's lifetime. The same concept applies to the long-term capital gains generated by return of capital distributions. The beneficiary inherits the current value of the estate upon inheritance, eliminating all long-term capital gains.

Investors Should Avoid Destructive ROC Distributions

For some funds that look to make fixed monthly distributions to shareholders, using ROC distributions can be an effective strategy to ensure consistent payouts. If a fund is unable to generate enough income and gains to support a full monthly payment, a ROC distribution may be made to make up any shortfall. For example, some closed-end funds use return of capital distributions while experiencing declining NAVs and issuing new shares in after-market programs. This type of dilutive behavior is typically disadvantageous to the investor because the total cash flows may ultimately decline (either naturally or at the discretion of the fund) if the fund cannot sustainably support that level of cash flow. This is a major reason why ROC distributions are sometimes not held in the same regard as traditional dividend distributions. However, when a fund is consistently earning its distribution, the benefits of return of capital are fully realized.

Outside of managed payout funds (i.e., ETFs), REITs and MLPs most frequently make return of capital distributions. These types of investment vehicles may return capital to shareholders to account for depreciation and drawdown of assets. Because depreciation is a non-cash expense that only affects net income and not cash, the return of capital distribution could be made to level out this imbalance.

Important Risk Disclosures

Any tax or legal information provided is merely a summary of our understanding and interpretation of some of the current income tax regulations and it is not exhaustive. Investors must consult their tax advisor or legal counsel for advice and information concerning their particular situation.

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