Understanding return of capital

A flexible consideration for cash flow distributions

Federated Hermes

What is return of capital?

Return of capital (ROC) is a type of distribution payment that returns part of an investor's original investment. It's treated differently from a tax perspective compared to dividend income or capital gains and commonly results from investment strategies, like ETFs, that seek to provide steady cash flow. Because ROC is not considered taxable income, it does not incur immediate tax liability for a shareholder. Instead, it reduces the investor's cost basis in the investment, which may result in a larger capital gains liability when the investment is eventually sold.[1]

Key features

- ROC is a tax classification and typically is not taxed when received. Rather, it reduces the cost basis of an investment.
- It can be misunderstood as dividend or coupon income by investors and does not reflect income or gains of an investment.

Understanding cost basis

Cost basis is the price paid for an investment for tax purposes. When ROC is received, it reduces the cost basis of the investment. A lower cost basis means potentially larger capital gains or reduced capital losses when the investment is sold. If the investment is inherited, the cost basis can be adjusted on a step-up basis to the market value of the investment at the time of inheritance.

Hypothetical ROC distribution example

Consider a hypothetical ETF that pays both dividend and ROC distributions. This example illustrates how ROC impacts cost basis over time and how market movements may affect the investor's tax position.

Initial investment: $100,000 for 1,000 shares

Initial cost basis: $100 per share

Annual distribution: $8,000

- $4,000 from qualified dividends (taxable at long-term capital gains rate)[2]
- $4,000 classified as ROC (not taxed when received)

Scenario A: share price remains at $100

Impact on cost basis

- ROC reduces cost basis to $96 per share
- Unrealized gain: $100 - $96 = $4 per share

Potential taxable income or gain

- **From dividend income:** $4,000 from qualified dividends in the year received, taxable at long-term capital gains rate
- **From ROC**
  - **If ETF is held:** $0 (ROC is not taxed until sale[1])
  - **If ETF is sold:** $4,000 capital gain after ROC cost basis adjustment

Scenario B: share price rises to $110

Impact on cost basis

- ROC reduces cost basis to $96 per share
- Unrealized gain: $110 - $96 = $14 per share

Potential taxable income or gain

- **From dividend income:** $4,000 from qualified dividends in the year received, taxable at long-term capital gains rate
- **From ROC**
  - **If ETF is held:** $0 (ROC is not taxed until sale[1])
  - **If ETF is sold:** $14,000 capital gain after ROC cost basis adjustment

Scenario C: share price falls to $90

Impact on cost basis

- ROC reduces cost basis to $96 per share
- Unrealized loss: $90 - $96 = -$6 per share

Potential taxable income or gain

- **From dividend income:** $4,000 from qualified dividends in the year received, taxable at long-term capital gains rate
- **From ROC**
  - **If ETF is held:** $0 (ROC is not taxed until sale[1])
  - **If ETF is sold:** $6,000 capital loss after ROC cost basis adjustment

Key takeaways from example

- **Dividends:** Always taxed in the year received.
- **ROC:** Typically not taxed immediately, but lowers cost basis, which affects future gains/losses.[1]
- **Price movement:** Determines whether the investor has a gain or loss when selling.
- **Tax timing:**
  - Dividends = immediate tax
  - ROC = deferred tax[1]

Capital gain/loss calculations above reflect share price movement and cost basis adjustment only. Dividend distributions and ROC distributions are treated separately from a tax perspective: qualified dividends are taxed in the year received, while ROC is typically not taxed until shares are sold (or until cost basis reaches zero). These scenarios are hypothetical and for illustrative purposes only to demonstrate how ROC distributions differ from qualified dividend distributions.

Understanding return of capital

Reasons to consider an investment that may deliver ROC distributions

- **Tax deferral:** ROC does not incur a capital gain when received, only when an investment's shares are sold.[1]
- **Cash flow management:** Provides distribution payments without selling an investment's shares.
- **Estate planning:** Cost basis can be adjusted on a step-up basis upon inheritance, potentially eliminating capital gains tax otherwise resulting from ROC distributions.
- **Charitable giving:** Gifting shares can avoid tax impact otherwise arising from ROC distributions.
- **Supports long-term income strategies:** Helps maintain steady distributions.

Discuss which of Federated Hermes' investment approaches best fits your income-focused goals. Reach out to 1-888-400-7838 to learn more.

[1] If the cost basis of an investment is reduced to zero through cumulative ROC distributions and the investor continues to hold the investment, any additional ROC distributions will generally be treated as taxable. This scenario typically occurs over an extended period, especially when ROC represents a small portion of the overall distribution. ROC distributions do not reflect any positive income or performance gain by an investment. Investors should consult their tax advisor for guidance on how this scenario may affect their tax position.

[2] Other types of fund dividends are taxable at higher rates applicable to ordinary income.

Fund shares are bought and sold on an exchange at market price (not NAV) and are not individually redeemed from the fund. However, shares may be redeemed at NAV directly by certain authorized broker-dealers (Authorized Participants) in very large creation/redemption units. Shares may trade at a premium or discount to their NAV in the secondary market. Brokerage commissions will reduce returns. Market price returns are based on the official closing price of an ETF share or, if the official closing price isn't available, the midpoint between the national best bid and national best offer ("NBBO") as of the time the ETF calculates the current NAV per share. NAVs are calculated using prices as of the end of regular trading on the New York Stock Exchange (normally 4:00 PM Eastern Time). Recent information, including information about the fund's NAV, market price, premiums and discounts, and bid-ask spreads, is included on the fund's website.

Definitions

Return of capital (ROC): A distribution that returns part of the investor's original investment. It is not taxed when received, but it reduces the cost basis of the investment. When the investment is sold, the lower cost basis may result in higher capital gains.

Cost basis: The original value of an investment for tax purposes. It is used to determine capital gains or losses when the investment is sold.

Qualified dividends: Dividends paid by US corporations or qualified foreign corporations that meet IRS holding period and other criteria. These are taxed at the lower long-term capital gains rate.

Ordinary dividends: Dividends that do not meet IRS criteria to be considered qualified. These are taxed at the investor's regular income tax rate.

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