Return of Capital (ROC) Distributions Explained

How Investors Can Use Constructive ROC Distributions

Return of capital (ROC), or a nondividend distribution, is among the least understood types of distribution an investor can receive. That is largely because ROC is a tax concept, not an economic one: it tells an investor how the IRS will classify the cash, not whether the fund earned it.

Put simply, an ROC distribution is a cash payment to shareholders that is treated as a return of invested capital and is not taxed when received. Instead, it reduces the investor's cost basis in the shares. ROC distributions can be constructive or destructive depending on whether they are supported by total return. That is not unique to ROC: dividend and capital gain distributions can also be earned or unearned.

When a fund's distributions are earned and are likely to remain earned, ROC treatment can offer investors meaningful benefits from a tax perspective: a lower rate on the cash received, and deferral of that tax until the shares are sold.

ROC at a Glance

What is a return of capital distribution?

- A distribution that is classified as a return of the investor's invested capital rather than as income or gain.
- It reduces the investor's cost basis by the amount of the payment. Once basis reaches zero, further ROC is taxed as capital gain.
- It is a tax concept, not an economic concept.
- It can be earned or unearned, just like dividends and capital gains.

What are the potential tax advantages?

- No tax is due in the year the ROC distribution is received.
- The tax is deferred until the shares are sold, and the gain from the basis reduction is taxed at long-term capital gains rates (if held more than one year) rather than ordinary income rates.
- Potential estate benefit: shares passed to heirs at death generally receive a step-up in basis to fair market value, which can eliminate the deferred gain created by ROC distributions.

How to tell constructive from destructive ROC: look at the NAV.

- Did the fund's NAV hold or rise over the long term, net of distributions, and is it likely to continue?
- Yes: the distribution was earned. That is constructive and positive for the investor.
- No: the fund did not earn its distribution. That is destructive and dilutive, because the investor is being paid back with their own money.

Hypothetical Example: 12% Distribution Over 5 Years

On a $10,000 investment paying a 12% distribution ($1,200 per year) for five years, ROC treatment leaves the investor with $1,020 more after tax than the same cash taxed as ordinary income, and no tax is due until the shares are sold.

Assumptions: $10,000 initial investment; 12% annual distribution on the initial investment ($1,200 per year); fund value rises $200 per year after distributions (the distribution is fully earned); shares held for more than one year and sold at the end of Year 5 for $11,000; a 37% top federal ordinary income rate and a 20% top federal long-term capital gains rate. State taxes and the 3.8% net investment income tax are excluded; both would apply equally in either column.

	Ordinary income distribution	Return of capital distribution
Initial cost basis	$10,000	$10,000
Annual distribution (Years 1 to 5)	$1,200	$1,200
Tax on each distribution (37%)	$444	$0
After-tax cash received each year	$756	$1,200
Total distributions received (5 years)	$6,000	$6,000
Taxes paid on distributions	$2,220	$0
Net after-tax cash flow from distributions	$3,780	$6,000
Investment sold after 5 years		
Sale price	$11,000	$11,000
Remaining cost basis	$10,000	$4,000
Taxable long-term capital gain	$1,000	$7,000
Long-term capital gains tax (20%)	$200	$1,400
Total taxes paid	$2,420	$1,400
Total pre-tax return (distributions + gain)	$7,000	$7,000
Cumulative net after-tax return	**$4,580**	**$5,600**
Effective tax rate on total return	34.6%	20.0%

The pre-tax return is identical in both columns. What ROC changes is when the tax is paid and at what rate: the $6,000 of distributions is taxed at 20% on sale instead of 37% as received, a $1,020 difference, and the investor keeps the use of $444 per year of deferred tax for the life of the position. Tax rates are the 2026 top federal rates per IRS Revenue Procedure 2025-32 (37% ordinary) and IRS Topic No. 409, Capital Gains and Losses (20% long-term capital gains).

Other Potential Benefits

Investments that distribute return of capital typically appeal to investors seeking regular cash flow from their portfolio. A predictable cash flow stream makes long-term financial planning easier, which can be particularly valuable for investors who rely on portfolio income to support day-to-day expenses, such as retirees.

A further potential benefit is at death. Under current law, the cost basis of property transferred at death is generally stepped up to its fair market value, which eliminates the heir's capital gains liability on appreciation during the decedent's lifetime. The same rule applies to the gain created by ROC distributions: because ROC lowers basis rather than creating current income, the deferred gain can be eliminated entirely if the shares are held until death and the basis is stepped up.

Investors Should Avoid Destructive ROC Distributions

For funds that target a fixed distribution rate, ROC can be an effective way to keep payouts consistent. If a fund does not generate enough income and gains in a period to cover a full payment, an ROC distribution can make up the shortfall. The question is whether the shortfall is temporary or structural.

When a fund's NAV declines steadily while it continues to pay a high fixed distribution, the fund is paying investors back with their own capital. That is dilutive: the income base shrinks, and the distribution either falls over time or becomes harder to sustain. This pattern, seen in some closed-end funds that pair ROC distributions with declining NAVs, is the main reason ROC is sometimes viewed with suspicion.

The classification alone does not tell an investor which case they are in. The test is total return: if the fund's NAV has held or grown over the long term after paying its distributions, the distribution was earned and the ROC treatment is a tax advantage rather than a warning sign.

Outside managed-payout funds and ETFs, REITs and MLPs are the most common sources of ROC distributions. Those investment vehicles return capital to shareholders because depreciation, a non-cash expense, reduces taxable income without reducing cash available to distribute.

Important Disclosures

The example above is hypothetical and for illustrative purposes only. It does not represent the performance of any VegaShares ETF or any actual investment, and it assumes the fund fully earns its distribution each year, which is not guaranteed. Actual results will vary. Tax rates shown are the top federal marginal rates for the 2026 tax year, sourced from IRS Revenue Procedure 2025-32 and IRS Topic No. 409, and exclude state and local taxes and the 3.8% net investment income tax. The tax character of a fund's distributions is determined at year end and reported on Form 1099-DIV; estimates provided during the year are subject to change.

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

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Investors cannot invest directly in an index.

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