YieldMax ETFs

Options for Your Income™

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Understanding Return of Capital in ETFs

Not All Income Is Created Equal

Income-focused Exchange Traded Funds (ETFs) have surged in popularity, offering investors a wide range of strategies to generate potential cash flow. However, not all income from ETFs is treated the same. This primer from YieldMax™ ETFs explores the concept of Return of Capital (ROC), a critical, yet frequently misunderstood component of ETF income.

What is Return of Capital (ROC)?

Distributions from ETFs may be classified in a few different ways. This classification determines the tax treatment of the distributions for the investor. Many income ETFs classify some distributions as **nondividend distributions**, also known as **Return of Capital (ROC)**. ROC distributions are often misunderstood, as ROC is a tax concept and not an economic concept. In other words, distributions classified as ROC inform investors as to how the distributions are treated from a tax perspective, but they do not offer any information regarding investment performance of the ETF.

ROC is a tax classification, **not** a reflection of economic loss or investment performance.

ROC distributions are cash payments to shareholders and are not treated as income, so they are not subject to current tax. Rather, they reduce the investment's cost basis by the amount of the distribution. If, after greater than a year °f ownership, an investor sells an ETF with ROC for a gain against that reduced cost basis, they will enjoy long-term capital gain tax treatment.

ROC in Practice: An Example

Here is an example of ROC in practice: an investor bought 100 shares of an ETF at $50 a share, for a total cost basis of $5,000. After the purchase, the ETF paid out $8 per share of distributions by the end of the year, or $800 total to the investor. Along with the rest of their annual tax documents from their broker, they receive a 1099-DIV that breaks down the dividend income into $300 from ordinary dividends and $500 from **nondividend distributions** or **ROC**. The investor would pay taxes on the $300, but the $500 from ROC would not be subject to tax. The cost basis would be adjusted down by the ROC, with the original $5,000 cost basis now $4,500.

Long-Term Effects and Zero Basis

An ETF that makes ROC distributions over a long period of time may eventually reduce the cost basis for the investor to zero. After that, all ROC distributions would simply be treated as capital gains.

Tax Reporting and Timing

When a distribution is announced for an ETF, the amount of ROC in that distribution is an **estimate**. These estimates should not be relied on for tax reporting purposes, as they are subject to change and finalization based on ETF activity for the entirety of a tax year. After the start of a new calendar year, fund companies send final 1099 information to brokers on behalf of shareholders, who then receive that 1099 from their broker. This finalized distribution information is used to file taxes.

Special Considerations

Step-Up in Basis (Inheritance)

If shares of an ETF with previous ROC distributions are inherited, the cost basis is typically "stepped up" to the market value on the date of death. This eliminates the impact of previous ROC distributions for heirs, potentially reducing future capital gains taxes.

Charitable Donations

When shares of an ETF are donated to a qualified charity, the investor may receive a charitable deduction based on fair market value, not cost basis. As a result, ROC impact is neutralized, making such donations potentially tax-efficient strategies.

Key Takeaways

- It may allow tax deferral, but at a reduced cost basis.
- Long-term or short-term capital gains treatment may apply upon sale, which can have significantly different tax consequences.
- ROC estimates throughout the year may change — only the 1099-DIV is final and used for tax purposes.
- Estate planning or charitable giving may neutralize the cost basis impact of ROC.

Disclosures

This material is for informational purposes only and does not constitute tax, legal, or investment advice. Investors should consult with their tax advisor regarding the specific tax implications of Return of Capital based on their individual circumstances.

Investment products, including YieldMax ETFs, are subject to risk including possible loss of principal. Past performance is not indicative of future results.