

# Phantom Distributions: Don't Pay Taxes Twice!

## *The Impact on the Adjusted Cost Base of Canadian ETFs*



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**Investors have gravitated to the over \$180 billion Canadian Exchange Traded Fund (ETF) market seeking lower fees. While most ETFs make distributions, many investors do not fully grasp the tax implications of payments received over the time they hold their positions. Consequently, they may be inadvertently paying tax twice on the same distribution. In recent years, many Canadian trusts have paid non-cash or "phantom" distributions. Failure of the investor to accurately keep track of these payments will, unfortunately, result in an overpayment of taxes.**

Each year, funds or trusts such as ETFs, must distribute their earned income to unit-holders to avoid paying tax within the trust. Cash distributions received may be a combination of fully taxable income, or a return of capital that reduces the **adjusted cost base (ACB)** of the investment which is factored in upon disposition.

While most funds pay their distributions in cash, a fund may elect to declare distributions in the form of additional units, then concurrently complete a unit consolidation. These are referred to as

phantom distributions. The investor incurs a tax liability in the year of record and will receive a T3 tax information slip for the value of the phantom payment. However, note that the investor has not received any cash (hence the term "phantom" distribution) with which to pay the tax liability.

Phantom distributions increase the ACB of the holding, thus reducing the capital gain liability (or increasing the capital loss) upon the ultimate disposition of the position. Failure by the investor to increase the ACB at the time of disposition will result in the payment of taxes twice on all phantom distributions received over the holding period – once upon receipt of the T3 when the fund originally paid the phantom, and again if the ACB is not increased when the position is sold.

The number of phantom distributions made by ETFs is increasing, in line with the increase in the size and number of ETFs now outstanding. Furthermore, as portfolios are rebalanced and gains realized, more and more funds are making phantom payments. From their inception through 2018, the ACB Tracking data base shows that Canadian listed trusts have made over 1,700 phantom distributions, ranging anywhere from a few cents to several dollars per unit. Over 80% of those 1,700 phantom payments have been made by ETFs. In 2018 alone, over

300 phantom distributions were paid by ETFs.

For long-term investors who buy and hold positions for an extended period, phantom distributions can add up. For example, from 2006 through 2018, the widely held iShares Core S&P 500 Index ETF CAD-hedged (XSP) with assets exceeding \$4.7 billion, has made six phantom distributions totaling just under \$5.00 per unit. For an original investor in this ETF, failure to increase the ACB of the units upon their sale would result in the payment of tax twice on \$5.00 per unit held. An even more extreme example is the iShares S&P/TSX Global Gold Index ETF (XGD), that has made phantom distribu-

tions in excess of \$16.00 per unit since its inception.

Unfortunately, not all investment dealers have accurately factored in all adjustments to the cost base of trust positions held. Consequently, investors should not rely upon the "book value" shown on statements as being accurate for tax purposes. Specifically, book values may be understated if all phantom distributions have not been accounted for.

ETFs have proven to be excellent investment vehicles for diversified portfolios. **ACB Tracking** can ensure that investors accurately calculate the ACB for positions held, thus avoiding the possibility of accidentally overpaying taxes.

### **So how can an investor (or investment advisor, or accountant) keep track of all return of capital payments and phantom distributions?**

In 2007, **ACB Tracking Inc.** ([www.acbtracking.ca](http://www.acbtracking.ca)) launched a unique web-based ACB calculator. The user simply inputs the settlement amounts and dates of the purchase and sale, and the ACB Tracking website calculates the ACB of the position sold as well as the ACB of any unsold balance. The calculator captures not only return of capital and phantom distributions, but it automatically factors in unit splits, consolidations, name changes and tax-deferred mergers. A detailed summary of calculations performed may be saved by the user in a PDF format. There is no software to buy and install and calculations purchased do not expire, and thus can be carried forward for future use. The ACB Tracking data base currently contains over 80,000 distributions made by 2,000+ active or predecessor Canadian trusts and funds, including Canadian ETFs. This is the only service of its kind in Canada, as the ACB Tracking data base contains all the required information to complete the calculation. Note that all data has been meticulously entered and double checked by the principals of the company to ensure accuracy.

ACB Tracking Inc. is co-owned by individuals who have extensive experience in the financial services industry. Mike Wooding, Managing Director of Western Operations based in Victoria B.C., was an investment advisor with CIBC Wood Gundy for 30 years prior to his retirement in 2006. Kathy Hill, Managing Director of Eastern Operations, spent over a decade on Bay Street in a variety of fixed income roles while Lea Hill, President of ACB Tracking, was the only analyst covering closed-end funds in Canada for the 10 years prior to his retirement in 2011 after 38 years with CIBC Wood Gundy.