

Phantom tax

Year-end phantom tax strategies

One of the tax factors that is often overlooked by investors when investing in ETFs is the year-end phantom tax. If not accounted for properly, phantom tax may result in the double taxation of income incurred from the ETF. This paper will describe what the phantom tax is and the steps that can be taken to prevent double taxation.

What is phantom tax?

When investing in ETFs, investors should be aware of and plan for phantom tax on distributions. To understand what this form of tax is, it is important to know how an ETF earns income. ETFs buy and sell securities throughout the year (just like mutual funds), incurring gains and losses on these investments. ETFs then make distributions periodically throughout the year of any net capital gain or loss that was realized from all of the transactions. Distributions from an ETF can also include interest, dividends or other forms of income paid in the form of cash.

There are certain situations where a distribution is made but no cash is received by the investor. In the books, the distribution has been paid to the fund holders, but in actuality, the income that would have been distributed to the investor is reinvested within the ETF. This is where phantom tax will apply to an ETF. Companies will decide to reinvest distributions as a way to help investors grow their contributions without additional commission being incurred. The phantom tax relates to these special distributions and it requires that the investor pay tax on the reinvested amount. This tax goes unnoticed by most individuals as it is not listed separately on the T3 tax slip. The effect of the phantom tax is similar to what would occur if the taxpayer contributed their own cash into the ETF, which means that the adjusted cost base of the ETF increases. Double Taxation can occur if the investor does not include the phantom tax when calculating the adjusted cost base and therefore pays more capital gains tax than would otherwise be required.

Next, we will discuss the steps that can be taken to eliminate the negative tax consequences of the phantom tax.

Steps to eliminate double taxation caused by phantom tax

- 1** Determine the amount of the distribution that was reinvested. Since the T3 does not state the amount of the investment that is contributed in the fund, the fund holder must check on the website of the ETF provider to determine the precise amount.
- 2** The amount of the reinvestment determined in step 1 should be added to the adjusted cost base (ACB) of the original investment.
- 3** The updated ACB will prevent the investor from incurring an unnecessarily large capital gain or smaller capital loss upon sale of the ETF.



Adjusted cost base and capital gains/(losses) for ETFs

To calculate your capital gains or capital losses, you first need to calculate the ACB of your units. The following tables describe, and walk you through, the ACB and capital gains calculations using a hypothetical example.



* including any sales commission paid at the time of purchase

The ACB is easier to calculate on a total investment basis rather than on a per unit/share basis. To obtain the ACB per unit/share, divide the total ACB by the number of units/shares held. For a partial redemption, the capital gain or loss is determined by multiplying the ACB per unit/share by the number of units/shares redeemed.

ACB example transaction

1 Purchase

During 2008 an investor purchased \$5,000 of Fund A, a Mutual Fund Trust at \$14.00 per unit for a total of 357.143 units (\$5,000 divided by \$14.00).

2 Purchase

Later during 2008, the investor made a second purchase of \$5,000 of Fund A at \$15.00 per unit for a total of 333.333 units (\$5,000 divided by \$15.00).

3 Distribution

On December 31, 2008, the fund paid a distribution of \$0.30 per unit.

This investor received a distribution of \$207.14 (690.476 units x \$0.30) which was reinvested in additional units at \$16.6701 per unit, the price at year end. 12.426 additional units were purchased (\$207.14 divided by \$16.6701).

The distribution also included a return of capital of \$0.0073 per unit, or \$5.04 in total (690.476 units x \$0.0073).

After the distribution, the ACB becomes \$14.5142 per unit (\$10,202.10 divided by 702.902 units).

4 Redemption

On June 30, 2009, the investor redeemed 300 units at \$18 per unit for gross redemption proceeds of \$5,400.00. The investor paid a 5.5% redemption fee at that time and therefore received net proceeds of \$5,103 in cash (5.5% x \$5,400 = \$297 redemption fee).

The ACB of the 300 units redeemed is \$4,354.26 (300 multiplied by the ACB per unit of \$14.5142). The total Adjusted Cost Base of the remaining units is reduced by \$4,354.26.

The new total ACB is \$5,847.84, the remaining number of units is 402.902 and the ACB per unit remains at \$14.5142.

The ACB per unit immediately after a partial redemption is the same as the ACB per unit immediately before the redemption.



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ACB Calculations

The ACB of your units, on a total investment basis is equal to the following:	The ACB would be calculated as follows:		
Transactions 1 & 2	Total Cost	Units	ACB Per Unit
The total of all amounts paid to purchase your units, including any commissions you paid at the time of purchase:	\$5,000.00	357.143	14.0000
	\$5,000.00	333.333	
	\$10,000.00	690.476	14.4828
		+	
Transactions 3			
The amount of any reinvested distributions	\$207.14	12.426	
		-	
The return of capital component of distributions (regardless of whether or not the distribution was paid in cash or reinvested in additional units)	(\$5.04)		
	\$10,202.10	702.902	14.5142
		-	
Transactions 4			
The Adjusted Cost Base of any units redeemed	(\$4,354.26)	(300.00)	14.5142
		=	
Adjusted Cost Base of units remaining	\$5,847.84	402.902	14.5142



The capital gain or loss from the example shown would then be calculated as follows:

Activity

Proceeds of disposition	\$5,400.00
<p>(the gross amount of the redemption which is equal to the net asset value per security “the price” on the date of the redemption multiplied by the number of units redeemed i.e., \$18 per unit x 300 units):</p>	
	—
The Adjusted Cost Base of the securities (see Adjusted Cost Base calculation in previous chart)	(\$4,354.26)
	—
Any expenses incurred on the redemption of the securities (such as redemption fees and administrative costs i.e., 5.5% redemption fee – \$5,400 x 5.5%)	(300.00)
	=
Capital gain (loss)	402.902

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