



The Tax You Didn't See Coming: Phantom Income Explained

Background

For direct investments such as stocks and bonds, interest and dividends are taxed in the year in which they are received, and capital gains are taxed in the year in which they are triggered (sold). This results in a straightforward tax effect whereby the investor receives investment income and pays the appropriate amount of tax on a portion of the proceeds. With indirect ownership of securities, for example where an investor owns stocks indirectly through a mutual fund or an ETF, the tax situation may not be as simple.

Income vs. Distribution

We must first understand what fund distributions are, and how they are different from income. A mutual fund or an ETF can generally be described as a basket of securities. The unit holder purchases shares or units of this fund rather than the individual underlying securities, and the fund could earn different types of income. For example, an underlying stock or bond could make a dividend or interest payment. The fund may also trade securities resulting in potential capital gains or losses within the fund. Additionally, there could be taxable events from corporate actions such as reorganizations. A familiar example is the privatization of Twitter, now X, by Elon Musk in 2022. **These types of income are taxable to the end investor.**

Distributions can broadly be described as returning cash to the unitholders. Income and distributions usually go hand-in-hand, as funds often "distribute" income to investors (hence, the name). However, that does not mean they are synonymous, even though it is not uncommon to see these words (incorrectly) used interchangeably.

For example, an ETF may sell a holding throughout the year that triggers a capital gain. However, the ETF may use some or all the cash proceeds to buy another stock within the ETF, rather than pay it out as an income distribution to the

investor. The investor is responsible for paying the taxes on the capital gain regardless of what the fund did with the proceeds. Alternatively, a fund may make a distribution that is larger than the income earned by the fund. For example, the fund may have only earned 4% in combined interest and dividends, but may pay a 6% distribution. In this case, the 2% distribution in excess the income earned in the fund would be considered return of capital (ROC). Essentially, it is the fund returning part of the investor's original investment – not just the income – back to them. This is more common with funds that are focused on producing consistent cash flow for their investors, often designed for retirees who require monthly cash flow from their investments.

What is Phantom Income?

Income can be reinvested into the fund in two ways. Many investors may be familiar with a **DRIP** (dividend re-investment plan), whereby the income distributions are automatically reinvested into the fund by purchasing additional units of the fund. In this scenario, the number of units held by the investor increases, and the Net Asset Value (NAV) per unit of the fund decreases by the corresponding amount. That is, money leaves the fund resulting in a decrease in NAV, and that money is used to immediately purchase additional units of the fund. There is no net change in the total market value of the investment. This is more common with mutual funds.

The other mechanism, referred to as **notional distributions**, is more common with ETFs. This is because ETFs trade on the stock exchange and cannot have partial units. With this method, a notional distribution is made to purchase additional securities that are immediately consolidated so that the total number of shares owned by the investor remain the same as before the distribution, and there is no change in NAV per share. The investor receives a tax slip for the income, but they did not receive cash flow in the form of a distribution. They are left scratching their heads wondering where this "phantom" income for which they received a tax slip, went.

As demonstrated in the example below, the end result is the same under both scenarios. The investor has the same tax bill, and the same market value of investments. With the first method, the investor owns more shares but at lower NAV; under the second method, the investor owns the same shares with the same NAV. In other words, NAV multiplied by the number of units will be the same under both methods.

What are the Consequences of Phantom Distributions?

1. Mismatch in cash flow: A mismatch occurs when income is reinvested, and therefore distributions are lower than income, or nil. Ordinarily, investment income produces a cash inflow that could in turn be used to pay the taxes. But when the cash proceeds are already reinvested, the investor is left to come up with the liquidity to pay the tax liability. While this can create meaningful short-term cash-flow pressure, it is typically an issue of liquidity and timing rather than a permanent erosion of value, as the investor may pay the tax from other sources or liquidate a portion of their holdings to raise the required cash.

2. Double-taxation: The second issue is a bit more sinister and demands more careful time and attention from the investor. Notional distributions affect a fund's Adjusted Cost Base (ACB). Unless the investor correctly keeps track of their ACB, they may pay tax again on the gains when the investment is ultimately sold, resulting in double taxation – once on the capital gains when the holdings within the ETF are sold by the ETF, and again on the sale of the shares of the ETF itself. With notional distributions, the investor should adjust their ACB upwards by the amount of the notional income. Failing to do so could lead to the investor having a larger capital gain or a smaller capital loss when they sell units of the fund. The opposite could happen where a distribution is made in the form of ROC, whereby the ACB should be reduced, and taxes would be under-reported.

How to Handle the Taxes on Notional Distributions

Investors generally buy/redeem mutual funds directly from the fund provider, meaning the mutual fund provider has records of fund owners and sends tax slips to end investors. ETFs, on the other hand, are traded on the secondary market (stock exchanges where investors buy and sell shares from each other). Therefore, the ETF issuer does not have a record of end investors. They provide the fund's tax information through their transfer agent and Clearing and Depository Services Inc. (CDS). The information is then used by the investor's brokerage to prepare tax slips for the investor through the brokerage's back office.

It is the investor's responsibility to understand the distributions of their funds and make sure the ACBs have been adjusted correctly. It is important to distinguish between the types of income and distributions received, as they affect the ACB differently. The formula below demonstrates how ACBs should be adjusted for notional distributions.

ACB = Total paid to purchase units or shares (including commission) + reinvested distributions – ROC – ACB of previously sold units or shares.

Example:

* Note that under the traditional method, the investor holds partial units post-distribution, which is generally possible under a mutual fund structure, but not with ETFs.

Event	Traditional Distribution				Notional Distribution			
	NAV per Unit	Number of Units	Total ACB	FMV	NAV per Unit	Number of Units	Total ACB	FMV
100 Units purchased at \$100/unit	\$100.00	100	\$10,000	\$10,000	\$100.00	100	\$10,000	\$10,000
Fund grows by 10% (all capital appreciation)	\$110.00	100	\$10,000	\$11,000	\$110.00	100	\$10,000	\$11,000
Fund triggers an \$6 capital gain and reinvests it	\$104.00	105.77	\$10,600	\$11,000	\$110.00	100	\$10,600	\$11,000
Capital gains triggered (and taxable) this year	\$600.00				\$600.00			
Unrealized capital gains per unit	\$3.78				\$4.00			
Unrealized total capital gains	\$400.00				\$400.00			

* FMV=Fair Market Value

**If you own ETFs, notional distributions may be impacting your taxes.
Reach out to your Wellington-Altus advisor to review your holdings and protect your after-tax returns.**

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