

An investor's adjusted cost base: a moving target

Investors who own non-registered investments in mutual funds or segregated fund contracts, will receive a capital gain (or capital loss), subject to tax, whenever a portion of the property is sold. The capital gain (or capital loss) is calculated as the difference between your sale price and your adjusted cost base (ACB).

Many investors believe their ACB is the amount they paid for their investment. However, there are other circumstances which will impact your ACB. In simple terms, though, the ACB is the amount of your investment that has already been taxed. The following will provide some common examples of adjustments that are made to your ACB.

PURCHASE PRICE

You may buy and sell the same investment at different points in time. For example, if you purchase shares from the same class of a particular corporation, or units of a particular mutual fund, you may purchase them over time, at different prices. If you invest in mutual funds and receive distributions, you may decide to reinvest these distributions to purchase additional units or shares of the fund. The price of these new units or shares is generally different because their values constantly fluctuate.

Each time more of the same investment (identical property) is purchased at a different price, an adjustment to the ACB of your total investment must be made. This is because the cost of all identical properties must be added together to come up with an average cost for each property you own.

The calculation of your average cost is as follows: Take the total cost of all identical properties you purchased, and divide this total by the total number of identical properties you own. The result is your new ACB per property unit or share.

Here's an example:

Here's an example of how multiple purchases of the same investment affect your ACB. Assume you made two purchases of the same investment, each at a different price.

	UNITS	COST PER UNIT (\$)	TOTAL COST (\$)
Purchase 1	800	10.00	8,000
Purchase 2	2,000	11.00	22,000
Total	2,800	10.71 (ACB per unit)	30,000 (ACB)

If later you decide to sell, your ACB will be used to calculate your capital gain. Your capital gain is calculated by subtracting your ACB per unit from the proceeds per unit on the sale of your investment, multiplied by the number of units sold.

UNITS SOLD	PROCEEDS PER UNIT (\$)	TOTAL PROCEEDS (\$)
100	15.00	1,500
Capital gain (\$15.00 – 10.71) X 100 units = \$429.00		



DISTRIBUTIONS AND ALLOCATIONS

It's common for mutual fund investors to receive distributions and a corresponding tax slip. For segregated fund contracts a distribution is called an allocation.

What's important to know is that if the mutual fund distribution is reinvested that amount is added to the ACB (or tax paid amount) of the investment.

If the amount is received as an allocation from a segregated fund, no further calculations are needed. This is because insurance companies selling segregated fund contracts track your ACB for you.

SPECIAL ELECTIONS

The *Income Tax Act* contains special provisions called "elections" and each of these elections has the potential to change your ACB. Some of the common elections that could affect the ACB of your investments include:

MUTUAL FUND FEE REBATES

Advisors sometimes offer clients a rebate of sales fees when they've decided to switch investments. Normally such a rebate is fully taxable to the investor. However, if the investor decides to reinvest the rebate to purchase more investments, the investor can file a special election so the rebate doesn't have to be reported as income. Instead, this election effectively reduces the ACB of the investor's (purchased) investments.

If you've filed such an election in the past, keep this information handy so you can properly calculate the capital gain when you ultimately sell your investment(s).

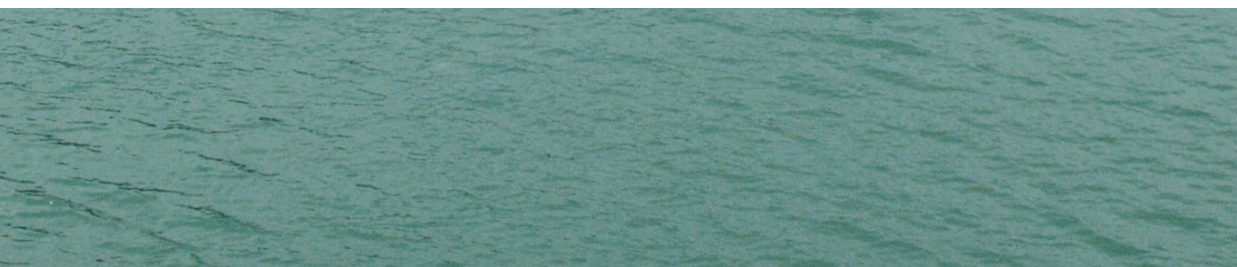
SPOUSAL TRANSFERS¹

When assets are transferred between spouses², the transfer takes place at the ACB for tax purposes. In other words, a transfer between spouses doesn't trigger tax if the asset being transferred has appreciated in value.

However, there are times when it's beneficial to trigger a capital gain, such as when the transferor spouse has unused capital losses. In such situations, it's possible to elect to transfer particular assets at fair market value instead of at the ACB.

¹ Such transfer may be affected by the attribution rules and an expert should be consulted before proceeding with such a transfer.

² The term spouse includes common-law partner as defined by the *Income Tax Act* (Canada).



It's very important for the spouse who now owns the assets to take this election into account if the investment is ever sold, or deemed to be sold, since this fair market value becomes that spouse's new ACB for tax purposes. This can help reduce tax when the spouse ultimately disposes of the asset. (See MK1381 — Capitalizing on capital losses for more details.)

1994 CAPITAL GAIN EXEMPTION

The government allowed investors to file a special election with their 1994 tax returns to “bump up” the ACB of their investments to take advantage of the \$100,000 capital gains exemption. For investments such as Mutual Funds and Segregated Fund contracts, this election created an “exempt capital gains balance”. If this balance wasn't used to offset capital gains from the sale of that portfolio by January 1, 2005, your ACB would have been increased.

SUPERFICIAL LOSSES³

Have you ever considered selling an investment for a loss to offset capital gains? Perhaps you still liked the investment and repurchased it shortly after that sale.

It may not come as a surprise that the tax collector frowns upon such transactions. In fact, there are a number of provisions in the *Income Tax Act* (Canada) that deal with these transactions, known as superficial losses. If caught under these rules, your loss is denied and instead is added to the ACB of the remaining units of that same investment you still hold.

These rules apply if you (or anyone affiliated with you, including your spouse or common-law partner, a corporation, partnership or trust) sell an asset for a loss, and you (or anyone affiliated with you) repurchase that asset within a certain time frame. That time frame is 30 days before and 30 days after the date of sale (a 61-day period in total).

It may be necessary to go back to your old tax returns to see if you had any superficial losses so that you can be sure to maximize the ACB on the ultimate sale of the assets.

³ See MK1381 — Capitalizing on capital losses for more details.



RETURN OF CAPITAL

Some investment products on the market today are paying distributions to investors that are partially a return of capital. The return of capital portion will reduce your ACB and will be reported on your tax slip. At the time you sell the investment, you will have a larger capital gain (or smaller capital loss) to report as a result of the reduced ACB.

In addition, some investors have set up systematic withdrawal plans (SWPs) with their investment account which also pays them some return of capital.

INHERITED OR GIFTED ASSETS

You may have directly inherited assets from a loved one, or you may have received the assets as a gift. In this case, the original purchase price may not reflect your true ACB. If you've inherited assets or received assets as a gift, the calculation of your ACB will depend largely upon who gave you the assets.

FROM YOUR SPOUSE:

If you received assets from your spouse, either on death, or during your spouse's lifetime⁴, you generally inherit your spouse's ACB. In other words, the ACB that would apply to your spouse will usually also apply to you.

There's an exception here. Where an election was made to transfer the assets from your spouse to you at fair market value (see "Special elections—Spousal transfers" discussed earlier), your ACB will be that fair market value instead.

FROM SOMEONE ELSE:

If you inherit assets, or are gifted assets, from a person other than your spouse, different tax rules exist to calculate your ACB.

Whenever a person transfers assets to someone other than a spouse on death or during his/her lifetime, he/she is deemed to have disposed of the assets for fair market value at that time. A capital gain or capital loss will result from the transfer and be taxed to the transferor. For you, the transferee, your ACB, is simply the fair market value on the date of transfer.

It's important that you keep records of the market value on the date you received the asset to properly calculate your ACB if and when you decide to sell the assets in the future.

⁴ Such transfer may be affected by the attribution rules and an expert should be consulted before proceeding with such a transfer.



SUMMARY

While it would be difficult to discuss every single provision in our tax law which impacts upon an investor's ACB, we've highlighted some of the more common ones related to investment products. Now you understand why our tax law calls your cost, for tax purposes, your adjusted cost base. Clearly, the calculation of an investor's ACB isn't as easy as many might think. There are many potential adjustments that can be made to arrive at your actual ACB.

Can a mutual fund company provide you with your ACB? Unfortunately not. While the fund company can certainly provide a transaction history, only you can know for certain whether there are adjustments to be made to your original purchase cost, and what those adjustments might be.

Fortunately, insurance companies selling segregated fund contracts are tracking it for you and calculate any capital gain or capital loss resulting from any allocations as well as any taxable transactions you made in the year.

Keep this in mind: If it's possible to increase your cost for tax purposes by making adjustments to your ACB, you'll manage to decrease a capital gain (or increase a capital loss) which, in turn, reduces the amount of tax you'll pay in the long-run. It's all part of good tax planning.

Finally, you should obtain the advice of a competent tax professional if you have any questions about the ACB of any asset you own, and to ensure that your ACB is calculated properly.

FOR MORE INFORMATION, PLEASE CONTACT YOUR ADVISOR OR VISIT MANULIFE.CA/INVESTMENTS



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