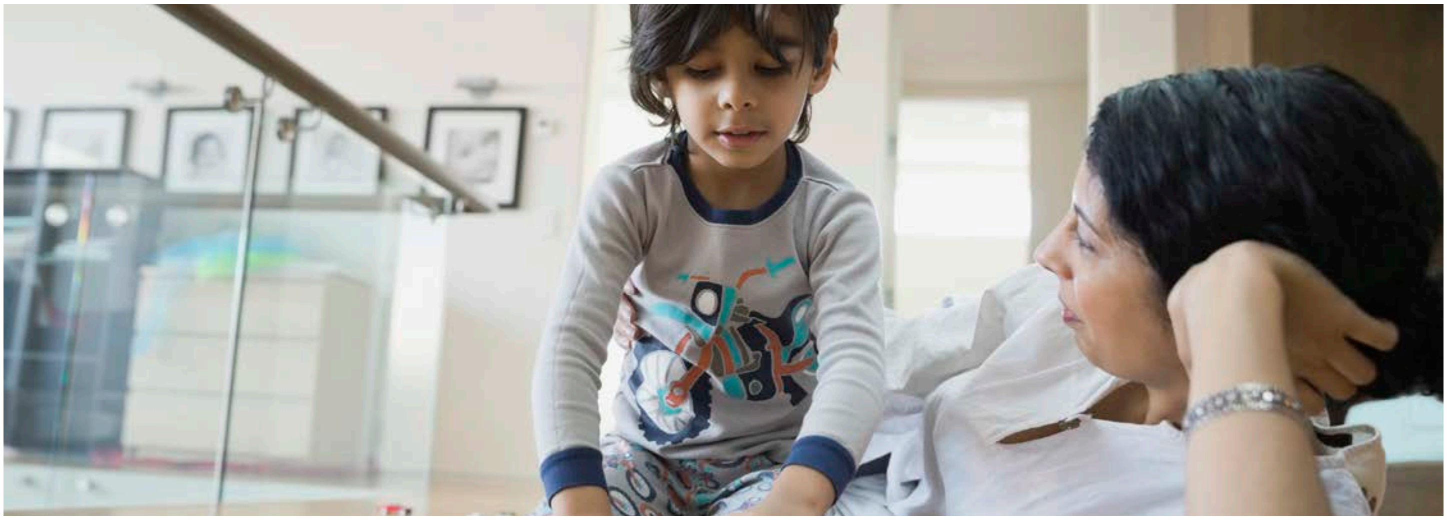
Tax planning in a volatile market

Stock market volatility may cause investors to worry about their investments and to make matters worse, the taxable amounts reported at year end may not relate to the value of their portfolio.

Portfolio managers (also called fund managers) who actively trade may trigger gains which are reported as taxable income and investing just prior to the allocation date* may result in allocation of income earned prior to the purchase.

There are generally two reasons why you could receive a tax slip even though the value of your investment has dropped.

* Most Manulife segregated funds allocate fund income and capital gains/losses annually on December 31. Manulife PensionBuilder® allocates fund income and capital gains/losses quarterly on March 31, June 30, September 30, and December 31, each year. For the Manulife Money Fund and Manulife Dollar-Cost Averaging Advantage Fund, allocations of fund income is determined on a daily basis.



1. INCOME (DIVIDENDS AND INTEREST)

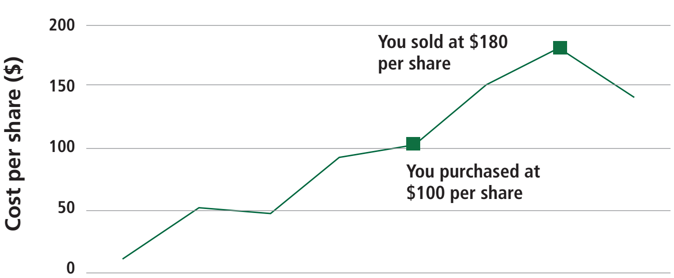
This can be described using a rental property analogy. Receiving taxable income in a down market is similar to when, for example, you own an apartment building. The value of the building may be less than when you purchased it, but you will still have to include any rent you collect as income. Mutual funds and segregated funds will also report to you any dividends or interest that the fund receives from the investments they hold.

2. CAPITAL GAINS

There may be unrealized gains in the fund or growth in the fund prior to your purchase which has not been taxed yet. This is probably the most difficult to understand — the following three examples may help you to understand this concept.

EXAMPLE #1

If you hold a share directly, you only pay tax when you sell.



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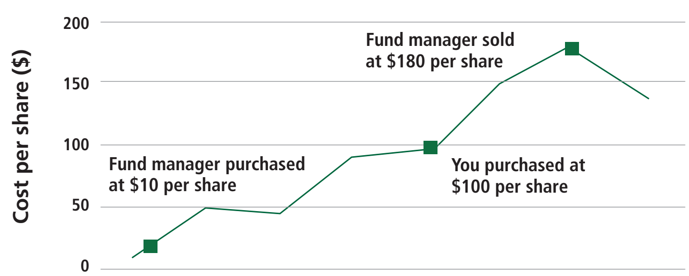
A mutual or segregated fund is made up of a variety of stocks and securities with many investors. To keep the example simple, let's assume that the fund only has one stock and you are the only investor.

If you purchase the stock (unit) at a price of $100 and sell it later for $180 you will receive a tax slip showing a capital gain of $80. When you sell a stock at a profit, you recognize a capital gain — the difference between your purchase price (cost) and the value you received at the time of sale ($180-100). In our example:

- Gain = Proceeds less cost
- Gain = $180 - 100 = $80

EXAMPLE #2

You may have a gain even if you don't sell!



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The fund is also taxed on its trading activity. So even though you may have bought into the fund at $100, the fund manager may have purchased this particular stock many years earlier for $10. The $100 you paid represented the value of that stock on that particular day. If the fund manager sells the stock for $180, the fund has realized a gain of $170. By law, this gain must be flowed through to the investors. If you were the only investor you would receive capital gains of $170 even though you have only seen an increase in your holdings of $80 since purchase.

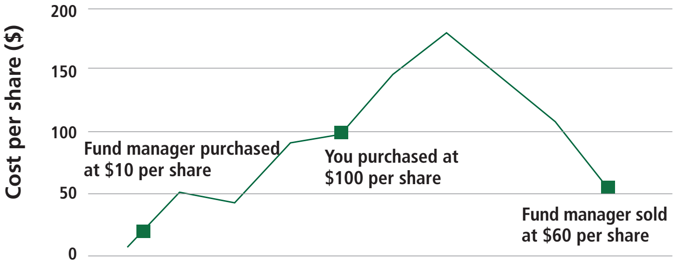
It is important to keep in mind that not only will you be taxed when you sell your stock (as shown in the previous example) but you will also be taxed on gains realized if the fund manager sells the underlying securities. This gain is allocated to all fund holders at distribution date.

If the fund manager sells at $180, then the gain is $170. In our example:

- Gain = Proceeds less cost
- Gain = $180 - 10 = $170

EXAMPLE #3

You may receive a tax bill even if your investment drops.



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Let's take this example one step further. Suppose the fund dropped in value after you bought in. If you recall, your purchase price was $100 and the fund manager's purchase price was $10. After you buy in, the value drops to $60. If you sold at this time, you would receive a capital loss of $40. The difference between your purchase price (cost) and the value you received ($100 - 60).

However, if the fund manager decides to sell at this point the taxable amount reported will be a capital gain of $50 — the difference between their purchase price of $10 and the sale price of $60.

In this situation, it is possible for an investor to receive taxable amounts reported to them even though their investment has dropped in value. It is also important to note that an investor never pays tax on more than they actually make in profit. If you pay tax on $50, your cost is increased by that amount and taken into account when you sell the stock yourself.

For example, if you sold the stock after receiving the

$50 gain, your new cost would be $150. If the stock was still trading at $60 when you sold, you would now have a capital loss of $90. The difference between the amount of money you already paid tax on (cost) $150, and the value you received when you sold, $60.

If the fund manager sells at $60, then the gain is $50 even though you are at a loss if you sold.

In our example:

- Gain = Proceeds less cost
- Gain = $60 - 10 = $50

If you sell (or switch) after receiving the tax slip, your loss will be:

- Loss = Proceeds less cost
- Loss = $60 - 150* = ($90)

* Your original cost of $100 plus the $50 reported to you.

CAUTION! LATE YEAR INVESTING

Before investing into a fund, consider the impact of allocations. If there will be significant year end allocations, consider investing in the Manulife Dollar-Cost Averaging Advantage Fund* to avoid the tax impact.

IDEAL CANDIDATES

Investors who:

- Are in a loss position but received a taxable amount
- Are making late year deposits

TAKE ACTION:

If you do have a gain reported… Consider one of the following strategies:

1. Fund switch to realize capital losses to offset gains
Switch to another fund to trigger the capital loss and recoup taxes already paid on gains. If the loss is more than the current year gain, you can carry back to previous years to offset other gains.

2. Transfer capital losses between spouses
If you haven't incurred any capital gains this year or in the previous three years, but your spouse (or common-law partner) has, it is possible to transfer capital losses to your spouse using something called "superficial loss rules."

Here is an example of how this works:

John purchased 100 shares in ABC Co. for $30,000. Later he sells those shares for $10,000, realizing a loss of $20,000. If Jane, his wife, purchases 100 shares in ABC Co. within 30 days of John selling them, John's loss is denied under the superficial loss rules and is transferred to Jane (for tax purposes), because she is "affiliated" with John.

Jane then waits a minimum of 31 days and sells those 100 shares for $10,000 incurring a capital loss for tax purposes of $20,000, but no actual monetary loss for her. This allows her to claim John's $20,000 loss against her taxable capital gains.

See Tax Managed Strategy #1, Capitalizing on capital losses for more details.

* The Manulife Dollar-Cost Averaging Advantage Fund may not be available in all segregated fund contracts, including Manulife PensionBuilder. However, as Manulife PensionBuilder allocates on a quarterly basis, if you are making an investment just before year end those funds will not receive a full year's allocation, but instead will only receive that quarter's allocation.

INVESTMENT OPTIONS WITH MANULIFE

Manulife and its subsidiaries provide a range of investments and services including:

Mutual Funds from Manulife Investments can help meet your specific financial needs, throughout your life. Whether you are just starting out, accumulating wealth or are nearing in retirement, mutual funds offered by Manulife Investments, can provide you with solutions to help build a portfolio that meets your needs. Manulife utilizes four principal asset management firms to oversee its extensive fund family. Each firm is recognized for its strength and depth of experience in various asset classes and investment styles. Manulife is committed to providing superior investment products and services so you can enjoy life and worry less.

Manulife Segregated Fund Contracts combine the growth potential offered by a broad range of investment funds, with the unique wealth protection features of an insurance contract. Through Manulife segregated fund contracts, investors can help minimize their exposure to risk through income, death and maturity guarantees, potential creditor protection features, and estate planning benefits — all from a single product or insurance contract.

For more information, please contact your advisor or visit manulife.ca/investments

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