TD Wealth

Wealth Insights

TD Wealth Private Investment Advice

Winter 2018

Skipping Prediction Season

The beginning of a new year is a period rife with predictions. But why not skip prediction season altogether? For one, consider that predictions have a tendency to be wrong. At the start of 2016, the Bank of Scotland warned investors of a "cataclysmic year", predicting stock markets would fall by 20 percent and advising clients to sell "everything except high quality bonds". Of course, it was a dangerous message that never came to pass.

Quantitative researchers would argue that we can fool ourselves by transforming data into predictions. Two decades ago, an exercise illustrated this point by correlating non-financial data with equity market performance. Over a 10-year period, it determined that three variables could account for 99 percent of the S&P 500 index's performance: Bangladeshi butter production, U.S. cheese production and the sheep population in both countries.[1] The absurdity of this complex regression analysis continues to be referenced today as evidence that if you examine enough data, you can eventually come up with associations. It is a good reminder of the dangers of using predictors to gauge future market performance.

Nobody can predict the course of near-term markets, except to say that fluctuations in both directions should always be expected. Today's worries are different than those of the past — some investors have been asking when a market correction will take place. Eight years of a bull market run can do that! While we shouldn't ignore the work of analysts or economists, we should be careful about making long-term decisions based on short-term news. Our focus has always been on the longer term.

There are many positive economic signs for the year ahead. Our economy continues to grow despite lower resource prices, oil prices have shown modest increases and corporate earnings have been healthy. The federal government has reversed some of its small business tax initiatives and continues to spend to stimulate the economy. But there are challenges. It is uncertain how NAFTA negotiations will impact Canadian business competitiveness. Growth is also expected to slow this year.

Regardless of the path forward, investors will be prudent to remember that guidelines have been built into your portfolio to manage risk. This may include rebalancing to a certain asset mix, limiting the size of any one holding, maintaining quality criteria for assets, and others. For each investor, portfolio guidelines depend on many factors such as investment objectives, personal needs, stage of life and risk tolerance. Having a long-term view requires you to own the right mix of assets for your goals, not for the market of the moment.

So let's skip prediction season and continue to have a longer-term view. May the new year bring happiness and prosperity to you and your loved ones.

Source: 1. "Stupid Data Miner Tricks: Overfitting the S&P 500", David Leinweber, 1995.

Anderssen Wealth Management

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"Helping clients make better decisions."

In This Issue

The Mortgage Stress Test Has Changed (Again)

Providing Support for a Home Purchase?

As of January 1, 2018, a new mortgage stress test is in effect for homebuyers with large down payments who do not require Canada Mortgage and Housing Corporation (CMHC) mortgage default insurance. For new mortgages, uninsured home buyers now need to qualify at a rate that is two percentage points higher than the actual rate on their contract or at the posted five-year Bank of Canada rate, whichever is higher.

Over the years, the mortgage lending rules have become increasingly tight. In addition to skyrocketing housing prices, this means that many first-time home buyers are able to purchase "less house" with their current incomes. As a result, more parents and grandparents may be helping children with this purchase.

If you are thinking about providing support, the way in which you structure the arrangement today can have different future tax and ownership implications. For example, if parents purchase a child's property in their own name but also own another property, this may impact the parents' use of the principal residence exemption (PRE). Since they may allocate the exemption to only one of the two properties per year, they may therefore be subject to income tax on capital gains realized upon the sale of one of the properties. Or, consider the situation in which a child is married/common-law. What will happen to the property if the couple splits? Family law varies by province, but depending on how the transaction is structured, the property may or may not be protected.

Financial support can come in many forms: gifting cash, lending funds, purchasing the property in your own name, or using a trust to purchase a home. Each option may have differing tax or ownership implications. These are just two issues to consider and professional advice from a tax and/or family law expert is recommended for your particular situation.

Estate Planning & Taxes

Plan Ahead for Capital Gains

As the saying goes: "nothing is certain but death and taxes." But as much as we may gripe about high personal income taxes in Canada, there is one area in which our tax law is comparatively favourable. Unlike certain countries, Canada doesn't have a formal estate tax. Consider that Japan's estate tax has rates of up to 55 percent! (Certain countries provide tax relief via exemptions.)

Select Countries with Top Estate or Inheritance Tax Rates			
Japan	55%	United Kingdom	40%
South Korea	50%	United States	40%
Germany	50%	Spain	34%
France	45%	Chile	25%

Source: "Worldwide Estate & Inheritance Tax 2017", Ernst & Young.

Although Canada does not have an estate tax, taxes are still likely to be due upon the death of an individual. At the time of death, the Canada Revenue Agency deems the deceased to have disposed of all capital property immediately prior to death. As such, any resulting capital gains may be subject to tax. But planning ahead may help to minimize these taxes and maximize the future transfer of wealth.

Transfer to a spouse. Assets transferred to a spouse/common-law partner (CLP) (or to a trust for the spouse/CLP's benefit during their lifetime) are considered to be transferred at cost, deferring the capital gains tax on the assets until the spouse/CLP either sells them or passes away. If the deceased has unused losses, tax deductions or credits available in their final tax return, it may be beneficial to use these by excluding some assets from the transfer (rollover) to recognize capital gains.

Principal residence exemption. Capital gains on a principal residence may be exempt from tax using the PRE. Remember that for the purposes of the PRE, both spouses/CLPs must designate the same residence in any given tax year. Thus, if more than one property is owned, it is advisable to plan which property should be designated as the principal residence to maximize the PRE.

Lifetime capital gains exemption. Qualified small business corporation (QSBC) shares may be eligible for a capital gains exemption of $835,714 (for the 2017 tax year, with the amount indexed annually to inflation; qualifying farming/fishing properties have a $1,000,000 exemption). Planning ahead is important as certain conditions must be met years in advance of the intended sale/disposition.

Donations to charity. Making gifts of securities to a charity may provide tax advantages, compared to other forms of donations such as cash. When publicly-listed securities are donated to a registered Canadian charity, any associated capital gain is excluded from taxable income and the donor receives a donation receipt equal to the value of the donated securities.

These are some ideas to potentially minimize the impact of the capital gains tax. Consult with an estate planning specialist and tax or legal advisors to construct your estate plan in the best way.

Don't Forget: RSP Season is Here!

RSPs: Never Too Early to Get a Head Start

Do you have teenage children or grandchildren who hold a part-time job? Don't overlook the value of an early start with the registered Retirement Savings Plan (RSP).

Report income. If income earned from a part-time job is less than the basic personal amount for tax purposes, it may be easier not to file an income tax return since there are no taxes owing. However, if this earned income is not reported, the child loses out on the potential RSP contribution room.

Carry forward for future benefits. If the child reports income but decides not to contribute to the RSP in the current year, the unused RSP contribution room carries forward. This may be beneficial as it can be used to make contributions in future years to reduce taxes when the individual is in a higher tax bracket.

Building an RSP balance when children are young may provide additional benefits. In the future, they could access up to $25,000 from the RSP under the Home Buyers' Plan to aid in purchasing a home, or use RSP savings to help finance training or education under the Lifelong Learning Plan. As long as withdrawn amounts are deposited back to the RSP within specified time frames, the amounts will not be included in income.

RSP Deadline: March 1, 2018

Remember that RSP contributions for the 2017 tax year must be made by **March 1, 2018**. Contribution limits are based on 18 percent of your previous year's earned income, to a maximum of $26,010 for 2017, less any pension adjustment or past service pension adjustment plus any pension adjustment reversal and unused contribution room carried forward. For the 2018 tax year, the RSP contribution limit increases to $26,230.

Tax Changes Are Coming

Small Business Tax Proposals: Pared Down

Last summer, the federal government released a consultation paper targeting the tax planning strategies of private corporations that were perceived as unfairly reducing the personal taxes of high-income earners. This involved three areas: income splitting through income sprinkling, holding passive investment portfolios within a corporation and converting regular income into capital gains.

In the fall of 2017, after a consultation period that saw over 21,000 submissions, the government announced that it would pare down the original proposals as follows:

Income splitting: The government had originally intended to target owners of private corporations who were lowering taxes by sprinkling income to family members. It now intends to focus only on income sprinkling for family members who do not meaningfully contribute to the business. At the time of writing, draft legislation is pending, with changes expected to be effective for 2018 and subsequent tax years.

Proposed measures to limit access to the Lifetime Capital Gains Exemption have been abandoned.

Holding passive investment portfolios: The government has pared down this controversial tax proposal. The revised proposal will allow for an annual amount of up to $50,000 of passive income to be earned in a corporation without being subject to proposed higher tax rates. (According to the Finance Minister, this is equivalent to $1 million in savings, based on a nominal 5 percent rate of return.) This is meant to ensure flexibility in retirement or a financial cushion of savings for business owners.

Existing passive investments and related income will not be affected. Draft legislation, including a technical description of how the threshold will be applied, is expected in Budget 2018.

Converting income into capital gains: The government has abandoned this proposed tax reform that would have restricted the conversion of income into capital gains, acknowledging that it would have created difficulties for farmers/fishers in passing along their businesses to their children.

Reduction in the Small Business Tax Rate

In addition to these changes, the government announced a reduction in the small business tax rate. It has been proposed to be lowered to 10 percent (from 10.5 percent) as of January 1, 2018. It will be further reduced to 9 percent as of January 1, 2019. (The tax rate for non-eligible dividends will be adjusted to maintain integration of corporate and personal taxes.)

At the time of writing, these tax measures are still in proposal stage and have not been enacted into law. For more details, please see the Government of Canada website: fin.gc.ca

Keep Perspective on Returns

What kind of average return should you expect on your investments over the long term? If you were to look solely at the performance of U.S. equity markets over the last 12 months, you might have an inflated view of expected returns. As the stock markets have achieved new highs, the gains often highlighted by the media are not likely to be sustainable.

What drives asset returns over the long term? Economic growth is one of the key influencers, impacting corporate earnings, interest rates and other factors that affect asset returns. Over the next decade, global growth may be challenged by various factors including an aging population and therefore lower labour productivity, peaking globalization and increasing protectionism (such as the potential impact of ongoing NAFTA renegotiations).

Innovation and technology, which were the key drivers of growth in previous decades, may continue to contribute to growth. However, these factors are expected to be less significant in influencing developed nations' growth, whereas developing markets may benefit from them by playing "catch up".

Recent projections developed by actuarial professionals for the Financial Planning Standards Council suggest that Canadian equities are expected to return around 6.5 percent over the long term. After factoring in a portfolio that includes fixed income investments, they believe that conservative investors should expect a 3.25 percent return over the long term.[1] This figure is far from the double digit average equity returns that some investors may recall during the 1980s and 1990s. Remember, though, that inflation was much more significant during this period (see chart), so the real return was much lower. According to one financial publication, since the start of 1900, the average annual real return of Canadian equities is only around 5.7 percent after factoring in inflation.[2]

Keep in mind that a real return of around five percent is still an excellent one — well beyond the returns on many bonds and money-market instruments. For perspective, consider that with 2 percent inflation, the nominal value of a portfolio would double at around 10 years at that rate.

While there is no consensus on the future prospects for equity markets, investors should remain realistic about long-term returns. The alternatives could be increased risk and lower quality than you'd like to see within your portfolio. At the same time, remember that while returns will vary, equities are expected to continue to be one of the best performing asset classes over the long run.

Performance of the S&P/TSX Composite Total Return Index (Dividends Reinvested) — By Decade[3]

Decade	Average Annual Nominal Return for Period	Average Decade Inflation Rate[4]
1970s	10.4%	9.4%
1980s	12.2%	5.9%
1990s	10.5%	2.1%
2000s	5.6%	2.1%
2010s	6.8%	1.6%

Sources: 1. http://fpsc.ca/docs/default-source/FPSC/news-publications/2017-projection-assumption-guidelines.pdf; "conservative" portfolio based on 25% equities, 70% fixed income; 2. https://publications.credit-suisse.com/tasks/render/file/?fileID=B8FDD84D-A4CD-D983-12840F52F61BA0B4; 3. S&P/TSX Composite Total Index Return data from 31/12/1969 to 9/29/2017. 4. Calculated using the average of annual Canada CPI (Consumer Price Index) figures at December 31st.

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