TD Wealth

Straight Forward

Autumn 2019

Cottage Succession Planning

Wealth Advisory Services, TD Wealth

The cottage occupies a special place in the hearts of many Canadians, many cottage owners are eager to preserve the cottage for future generations to enjoy. There are many considerations associated with cottage succession planning.

When you sell or are deemed to have sold capital property in Canada, this gives rise to capital gains tax. The capital gain is calculated by subtracting your Adjusted Cost Base (ACB) from the proceeds or Fair Market Value (FMV). The Adjusted Cost Base is usually the cost of a property plus any expenses to acquire it, such as commissions and legal fees. The ACB also includes capital expenditures, such as the cost of additions and improvements to the property. However, you cannot add current expenses, such as maintenance and repair costs, to the cost base of a property. The difference between the ACB and the proceeds or FMV is the capital gain, and the taxable capital gain is 50% of this amount. This amount will be included on your tax return and taxed at your Marginal Tax Rate. For property that has realized significant growth, this can result in a substantial tax liability.

Possible Strategies to Deal with the Tax Liability

Use the principal residence exemption (PRE)

The PRE is an income tax benefit that generally provides you an exemption from tax on the capital gain realized when you sell the property that is your principal residence. A cottage may be designated as a principal residence if you ordinarily inhabit it. However, it is important to note that only one property can be designated as a principal residence for each calendar year when you own multiple properties for personal use. Therefore, the designation of one property as a principal residence may subject any other property to capital gains tax when it is sold or deemed to have been sold. A key element to this strategy is to determine which property has the higher annualized capital gains and to designate that property as the principal residence. As this calculation could be complex, particularly for properties held prior to 1982, it may be necessary to consult with a tax professional.

(Note: prior to December 31, 1981, it was possible for each family member to designate a separate principal residence for capital gains purposes. Since 1982, however, the rules were changed to restrict the principal residence designation to one principal residence per family unit per year.)

Use life insurance

With multiple properties, there will likely be capital gains tax owing at death. If you wish to ensure that there will be sufficient funds in the estate to pay the capital gains tax (and other taxes arising on death), you may consider life insurance to fund this liability. Insurance proceeds received are typically tax-free and provide the estate with liquid funds to pay the tax liability so that other assets do not have to be sold. The main consideration with this approach is the insurance premiums and insurability. There may also be questions around who should pay for the premiums since the policy would be put in place for the benefit of the estate beneficiaries.

Deal with the capital gains tax liability now

Another option for managing future taxes is to "freeze" the value of the cottage now and deal with the tax liability on the current gains on the cottage. The merit of this approach is that the tax liability becomes more predictable. After all, if the cottagecontinues to grow in value, the capital gains tax associated with the property could be compounded.

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In this issue

TD Economics

It was all yellow

Beata Caranci, SVP & Chief Economist, TD Economics

This title isn't a reference to Coldplay's hit song, but rather the observation that struck when we updated our U.S. Leading Economic Index. Six of our eight indicators flashed yellow. The last few months have brought a seismic shift in several areas:

1. Our global economic outlook has been downgraded to 2.9%, marking the thinnest cushion in a decade to absorb political and economic shocks.
2. Small green shoots that materialized on global trade over the spring were stepped on during the summer. And, further trade escalation in August will not help matters.
3. Longer term yields have shifted down in parallel with falling expectations for economic growth. This has reinforced yield-inversion dynamics in countries like the U.S. and Canada, while others have seen a large tranche of yields move into negative territory.

Against this backdrop, it's not surprising that recession talk is top of mind among our clients. A deep dive shows that there is no evidence in the hard data that the U.S. is headed for a recession, but some warning flags indicate higher odds over the next 12-24 months.

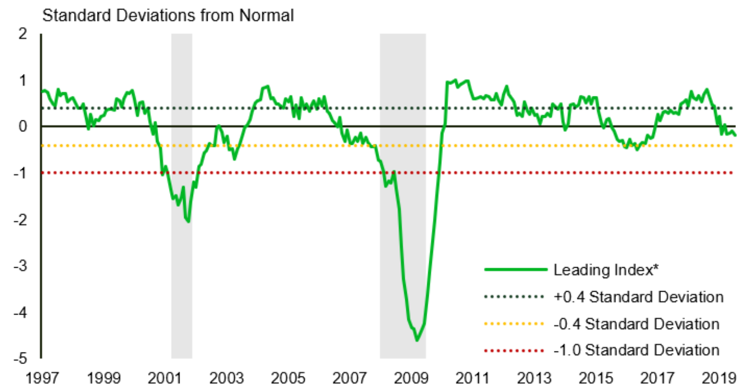
Dynamics at Play

The incidence of 'recession talk' shot up over the summer to higher levels than prior periods of market angst (i.e. stock market correction in December 2018 and the Chinese revaluation episode in 2015). A catalyst was the inversion of the U.S. yield curve.

Any recession probability model that contains the yield curve as an explanatory variable will show high odds of a recession, typically within the 50-60% range. Yield inversion is unquestionably a good signal of a recession. But, its record is not perfect, and these days the signal may be distorted by a host of other factors that depress yields, including unconventional central bank policies in other parts of the world and changes to banking regulations. In any event, models where the yield curve is the primary focus will always predict high odds once inversion occurs.

The more important piece of the puzzle comes into play when the focus of recession probability models is switched to economic indicators. Doing so causes recession odds to fall measurably within the 20-30% range. What accounts for the difference? Timing. The signal from yield curve inversion has a long lead time of 12-24 months, while those driven by economic indicators offer small windows of typically only a few months. Herein lies a key piece of information. All our predictive models are telling us that a period of slower growth is on deck for 2020, particularly as the weight of tariff hikes come to fully bear on production and consumer costs. But, the signal has not yet arrived that negative financial market sentiment has bled through the economic data. Nothing is written in stone: a recession may be in our future, but that risk is not imminent.

TD Economic Leading Index Flashing Yellow



* Index is comprised of eight leading economic indicators. Readings of 0 are consistent with historical average (1997-present) points in the business cycle. Readings of -0.4 are typically associated with a "warning" signal, whereas readings of -1.0 are consistent with a recessionary environment.
Source: TD Economics, as of July 2019

Within the economic data, our Leading Economic Index (see Chart) shows six of eight indicators flashing a cautionary yellow. This is not a surprise for those indicators capturing business sentiment and output, which have been well telegraphed in the data for months. What caught our eye over the summer was the deceleration in hours-worked. Is this a sign that businesses are responding to uncertainty by pursuing more cautionary hiring? Time will tell if the trend deepens. If so, it would be harder for the mighty U.S. consumer to stand strong in the face of a compromised job market.

In fact, the timing of the trade escalation couldn't have been worse. We have been perpetual optimists that the U.S. consumer has strong underpinnings and present a key source of upside risk to our forecast. However, as the full force of the tariffs comes to bear on production and market sentiment, we will be more cautious on our U.S. outlook for 2020. And, the near-term data on consumer spending may not be the best guide for next year.

Consumers are likely to front-load purchases this fall to get ahead of tariff-related price hikes on some of their favorite items. This may leave our Leading Economic Index prone to a false signal, requiring more emphasis to be placed on what hours and job conditions are telling us. Don't forget, we have likely not seen the peak in trade tensions, as the U.S. administration will be releasing a ruling on whether European and Japanese auto imports should be subject to a higher tariff. Europe is a larger U.S. trading partner than China.

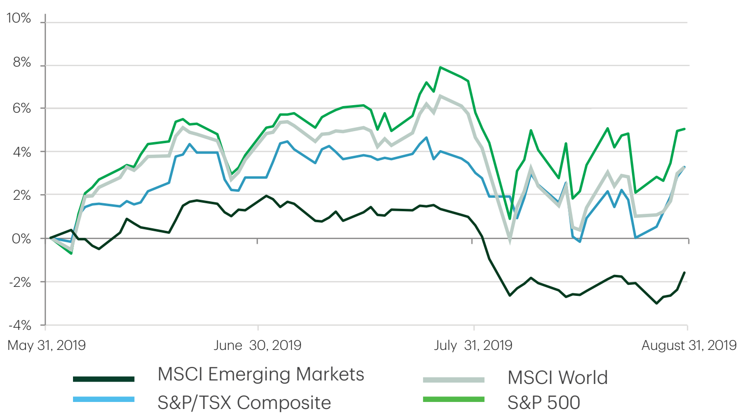
The economics community needs to be humble during this period of extreme political uncertainty. Economic models are not designed for political shocks, which create more complex outcomes that require significantly more forecast judgement. And, with the U.S. being the source of political uncertainty, it may result in stronger feedback loops between countries than predicted by pure model dynamics. In this context, it is completely reasonable for central banks to err on the side of caution on any evidence of fault lines forming in the economic data. □

TD Wealth Asset Allocation Committee

What to Do If You Encounter a Bear

Bryan Lee, Vice President & Director, PIC Portfolio Strategist, TD Asset Management

This has been a year of uncertainty and negativity, yet at the time of this writing, global financial markets continued to defy expectations and are higher than last year. Great news, but investors have been skittish. Take for example, back on August 14th stock markets took a tumble and headlines exploded with recession predictions because the yield curve inverted intra-day. Yield curves are typically upward sloping with longer term bond yields higher than shorter term bonds. But, when the 2-year/10-year relationship inverts, it has typically been followed by a recession because it signifies restrictive short-term lending conditions. Borrowing is more expensive, which in turn causes the economy to slow. So, on August 14, the yield of the 10-year U.S. Treasury Bond was 1.9 basis points lower than the 2-year U.S. Treasury Bond. In other words, short term rates were 0.0019% higher than long term rates for just minutes before correcting later that day. While an inverted yield curve is a significant data point to monitor, it did not invert for a long enough period to be considered a restrictive signal - yet investors still panicked. That hyper reaction was like seeing a solitary snowflake in August and expecting to see a snowstorm the next day.



Source: Bloomberg Finance L.P. as of August 31, 2019; total/gross returns in CAD.

As this economic expansion continues, I expect that recession predictions will grow more frequent. Regardless of the predictions, our hunch remains that equity markets will end higher this year - but this market advance will be interrupted with intermittent periods of market turmoil. At some point in the future, we may be confronted with a market correction of greater than 20% decline otherwise known as a bear market, which in turn may be followed by a recession. But no one knows when the next one will occur.

It is during these periods of volatility and uncertainty when the temptation to abandon your long-term strategy may be high. But as Auguste Rodin once remarked patience is a form of action. Unfortunately, doing nothing is hard to do because of our behavioral biases, particularly the inclination to take action, or what psychologists call the action bias. We are wired to think that doing something is better than doing nothing. But the evidence is clear that no one can time the market reliably and consistently.

Jumping in and out of the markets is a dangerous strategy considering that missing just one percent of the best trading days, which typically occur within days after the worst day, can significantly erode your performance. Between January 1, 1999 and December 31, 2018 there were 5,250 trading days. If you had invested $100,000 and stayed invested, your portfolio would be worth $355,937 by December 2018. Missing just one percent of the best days (i.e. 52 days) your portfolio would be worth $46,133. That is why our investment philosophy is centered on diversifying across multiple asset classes and tilting portfolios to take advantage of periods when investors are not rationale.

Despite the inability to accurately predict the next bear market, the long-term data still shows that patient investors have been handsomely rewarded over time by sticking to their long-term plan even in the face of a bear market. Patience allows you to take advantage of the fact that bear markets are short lived, generally lasting on average less than a year. The Ontario Ministry of Natural Resources give us some of the best advice when encountering a bear - do not run, do not panic and most importantly, remain calm.

Canada

Canadian companies continue to report mostly solid results and the Canadian economy continues to record positive growth. Canada's core inflation measure came in at around 2% in June, which is within the Bank of Canada's ideal range. Despite these positive factors, we still maintain a preference for U.S. stocks due to the challenges in the energy sector and the over leveraged Canadian consumer.

The United States

U.S. companies also continue to report solid growth and the earnings recession that everyone expected in both the first and second quarter of this year has not yet materialized. U.S. stocks are not as cheap as they were at the beginning of the year, but we feel U.S. equity valuations remain reasonable considering historically low fixed income returns and strong corporate health. We believe the quality of corporate earnings to be high and as companies continue to generate substantial free cash flow, we expect them to continue boosting dividends and share buy backs.

International

We continue to prefer North American equities over International due to Brexit uncertainty, and weak overall European growth expectations. The good news is that both the European Central Bank and Bank of Japan have both stated a commitment to providing further stimulus if warranted.

We expect trade frictions between the U.S./China to persist for some time, but do not anticipate a total collapse in the relationship. In the short term the dispute will likely create volatility, however continued strength in the U.S. economy and labour markets, combined with low interest rates, should minimize downside risk.

Stay Calm

Market commentators have called for a recession going back as far as 2012 when the U.S. fiscal cliff was expected to cause the U.S. to head back into a recession. Over the past seven years market commentators have continued to be wrong – perhaps one day they will get it right, but today is likely not that day. □

TD Wealth

Cottage Succession Planning (continued from page 1)

The downside with this strategy is that the capital gains tax becomes immediately payable, requiring resources to pay the tax bill right away. Additional downsides include loss of control of the property, and exposure to potential creditor/family law claims of the children.

Possible Strategies to Deal with the Tax Liability

Addressing the tax liability resulting from a transfer in ownership of a family cottage often garners much attention when it comes to succession planning. However, the question of how best to structure the future ownership of the property is arguably as important.

Cottage Co-ownership Agreement
An alternative to having the children own the cottage outright as joint tenants with right of survivorship (JTWORS), may be the use of a joint use and ownership agreement. With this approach, matters related to decision-making and dispute resolution procedures are documented in advance. In addition, for family members who wish to retain a life interest in the cottage, a co-ownership agreement will clearly define the roles, rules, and responsibilities of each co-owner.

Cottage Trust
If the intention is to "keep the cottage in the family", an alternative for ownership is a trust. When considering a trust, you can create an inter-vivos trust during your lifetime or a testamentary trust in your will to pass the cottage to the children when you pass away. Typically, when establishing a trust that holds real property such as a cottage, property like cash and/or investments are also added to the trust. The additional liquid assets can then be used exclusively for cottage purposes. With this structure, all maintenance, taxes and repairs can be paid for out of the trust.

A key to this strategy is that the trust be flexible and agreeable to those involved which may help lower the chances of any future disputes or litigation.

One of the pitfalls of trusts is that there is typically a deemed disposition every 21 years. This may cause potential tax issues each time the trust is deemed to dispose and reacquire the property within the trust. Furthermore, there are costs associated with creating and maintaining the trust on an ongoing basis. These costs should be considered when exploring the merits of using a trust arrangement for cottage succession planning.

Other considerations

Cottages located in the U.S. & potential cross-border tax issues
For Canadian citizens who reside in Canada (i.e., "non-resident aliens" for U.S. tax purposes), succession planning for real property located in the U.S. presents additional challenges. Owning real property in the U.S. may expose Canadians to the U.S. gift and estate tax regime. Without proper planning, this could lead to additional costs upon death. In some instances, appropriate planning needs to be implemented prior to purchasing the property.

Non-financial elements
One non-financial consideration for cottage succession planning is the level of interest of a child or children. If one or more children are not interested or able to use the cottage, consideration should be given to equalization measures to provide some balance as part of broader estate planning by parents or grandparents. This may involve leaving the non-cottage owning child(ren) more of the other estate assets or using life insurance to balance the overall distribution of the estate.

Irrespective of the potential planning strategies noted earlier, Cottage Succession Planning should be discussed amongst the family members to determine if the next generation is prepared to share the cottage and agree with the arrangements that their parents have in mind. The next step may involve engaging appropriate professional advisors to discuss and potentially execute the agreed upon strategy.

This article is presented for information purposes only. Clients should seek qualified professional accounting, tax or legal advice before proceeding on any course of action. □

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