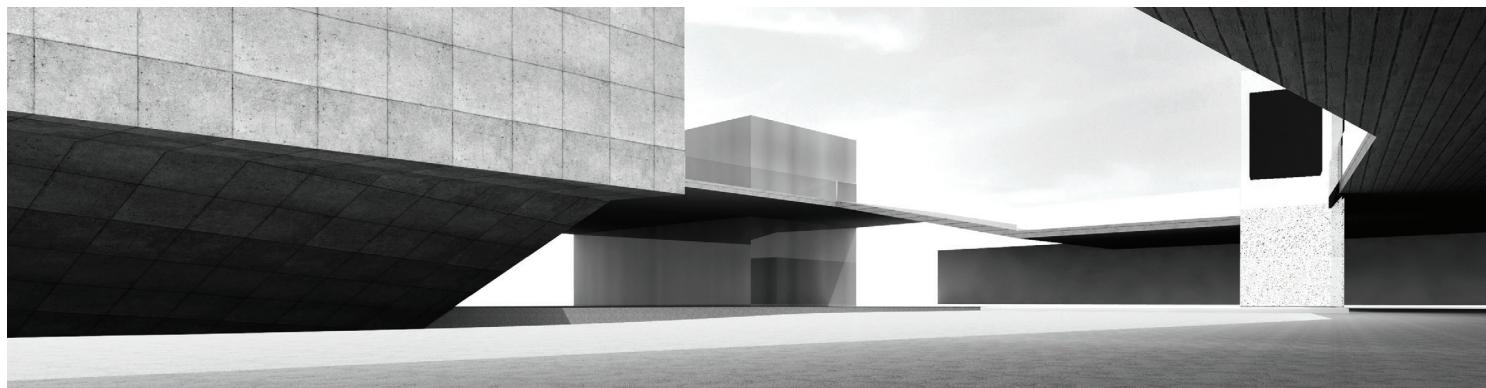


# Straight Forward



## U.S. estate tax

Wealth Advisory Services, TD Wealth

Campaigning for the upcoming U.S. presidential election is well underway as we draw close to the November 8<sup>th</sup> election date. While most Canadians follow American politics with a neighbourly interest, there are thousands who may be directly impacted by each candidate’s campaign promises more than they realize—and we’re not simply referring to the construction of walls.

A Canadian resident who is not a U.S. citizen, resident or green card holder may be subject to U.S. estate taxes on death if he or she holds U.S. situs assets, such as a U.S. vacation property or U.S. securities. The tax is applied to the fair market value of a person’s U.S. situs assets held at death (as opposed to accrued capital gains) with available credit(s) which can be applied to reduce the final U.S. estate tax that may be due. An estate of a Canadian resident decedent typically has access to an enhanced unified credit under the Canada-US Tax Convention (the “Treaty”) that pro-rates the lifetime exemption amount available for U.S. citizens through the following formula:

$$\text{Enhanced Credit under the Treaty} = \frac{\text{U.S. Situs Assets}}{\text{Worldwide Assets}} \times \text{US\$2,125,800}$$

The lifetime exemption in 2016 for U.S. citizens is currently set at US\$5.45 million and is indexed annually, which provides a maximum unified credit of US\$2,125,800; the equivalent of U.S. estate tax on an estate with worldwide assets of US\$5.45 million. Generally, as long as a Canadian resident’s worldwide assets are below US\$5.45 million at death, the enhanced unified credit under the Treaty would eliminate any U.S. estate taxes. If the assets pass to a surviving Canadian resident spouse, the Treaty also provides a marital credit that would essentially double the credit. Although U.S. estate

tax does not apply if a Canadian decedent has worldwide assets below US\$5.45 million at death, there is a U.S. federal estate filing requirement if the value of U.S. situs assets held by the decedent exceeds US\$60,000.

The U.S. estate tax regime has often been a subject of political debate and the changes proposed by each of the 2016 presidential nominees, Donald Trump and Hillary Clinton, illustrate the differing views of the political spectrum. The Trump tax plan proposes to abolish the U.S. federal estate tax while the Clinton tax plan proposes a move to a top estate tax rate of 45% (currently, 40%) and a lifetime exemption of US\$3.5 million (down from the current US\$5.45 million). The enhanced credit under the Treaty is directly linked to the exemption available for U.S. citizens under U.S. law and as such, any changes to the exemption limit would typically impact the credit available for Canadians.

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## TD Economics

## The Fed stands alone

Beata Caranci, Vice President and Chief Economist, TD Economics

Over the summer, a chorus of U.S. central bankers sang a tune for higher rates, including none other than the U.S. Federal Reserve's (Fed) Chair, Janet Yellen. They stand alone on this stage. Global peers have gone in the opposite direction with a crescendo of monetary stimulus. It's natural to wonder if this diverging policy path is sustainable. Conversely, with the test of time, will the Fed be criticized for having made a policy error?

A Nobel Laureate once said, prediction is very difficult, especially if it's about the future. Time will indeed tell, as history has criticised others, such as the prior Fed Chair, Alan Greenspan, for having left rates too low for too long.

The global landscape has arguably become more riddled with uncertainty than when the Fed raised rates last year. Britain's exit from the European Union (EU) remains unresolved and muddies the waters for businesses operating in those regions. In addition, Northern Ireland and Scotland may yet decide that their preference is to stay in the EU rather than the United Kingdom (UK). Geopolitical risks are as elevated as ever, marked by an intensification of terrorism activity in Europe and an attempted military coup in Turkey over the summer. The potential for these and other risks to rear up at any moment is ever-present, as well as their ability to undermine confidence and global economic growth prospects.

However, from the Fed's perspective, the longer we continue to see limited pass-through of global risks to the domestic data, the more likely their patience to remain on sidelines will be tested. After all, the Fed's mandate is to balance price stability against maximizing employment. This is why the Fed maintains that if the labour market continues to make steady progress, tightening conditions will eventually tilt the risks towards a feed-through to inflation. And, there are solid arguments underpinning this case.

First, the U.S. differs from its global peers on the inflation front (figure 1). While others push against disinflationary forces, the U.S. has steady underlying inflationary dynamics. This is indicative that corporate pricing power and capacity pressures differ between these regions. Consumer prices have also held steady in spite of a 15-20% appreciation in the trade-weighted U.S. dollar, which exerts downward pressure on prices through imports.

Second, the U.S. has a history of being far more resilient than its peers in the face of global turbulence, since it's a very domestically driven economy. And, the domestic fundamentals look pretty good. Discretionary spending by American consumers on the nice-to-haves, like TVs and ATVs, rivals the pattern seen during the pre-recession heydays. This is not only a measure of consumer confidence, but it's being made possible by solid employment and wage gains. There's always some healthy suspicion when it comes to U.S. labour

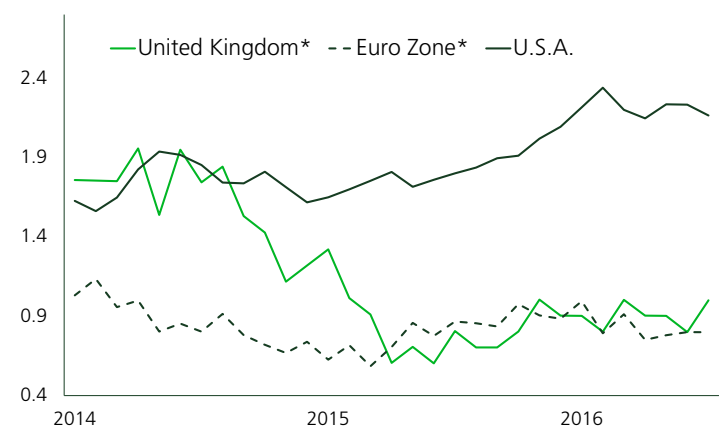
market metrics that a broad swath of workers remain underutilized. But, this measurement is back to 2004 levels and further improvement is likely given that firms have a record number of jobs available and layoffs have fallen to almost a two-decade low.

In a nutshell, domestic fundamentals argue that policy divergence can be sustained between the U.S. and its global peers, but it can be thought of as an elastic band that can only be stretched so far. We continue to expect the global environment to influence the Fed's pace, marked by a slow grind of no more than one or two hikes per year. Sensitivity to downside risks will dominate given that there is less scope for the Fed to adjust rates on the downside in the event of disappointment, relative to the upside if inflationary pressures heat up unexpectedly.

There will be ripple effects here in Canada, but the overall impact should be quite modest. Like many other central banks, the Bank of Canada is unlikely to follow the Fed's lead, as economic fundamentals are much weaker. The divergent path should cap the upside potential of the Canadian dollar, but at the same time, higher oil prices can exert an opposing force. Ultimately, a loonie in the US\$0.75-0.77 range is a reasonable expectation. Fortunately, the Canadian economy will also get a helping hand from increased fiscal stimulus. In fact, Canada is not alone in a greater push towards governments taking a more activist role to stimulate growth. Among major economies, Japan, the UK and Germany have also indicated fiscal stimulus is on the way. There is a growing appreciation that whistling the same tune with monetary policy loses its appeal with time.

Figure 1

Core Consumer Price Index (CPI), Year-over-year change



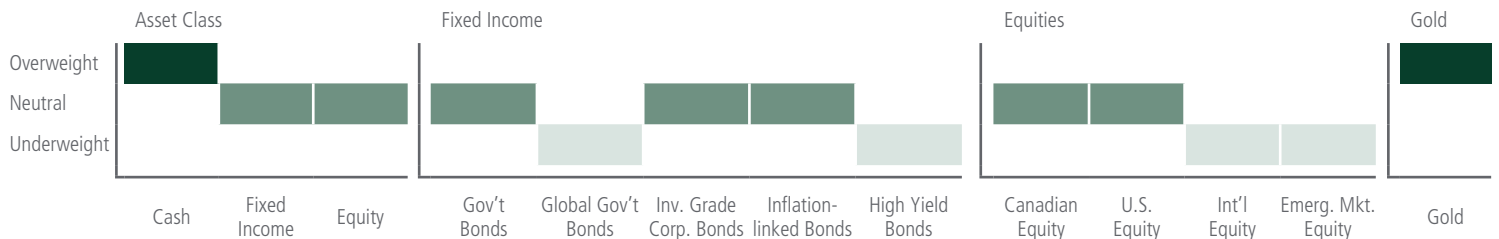
\*12-month moving average. Source: Haver Analytics, TD Economics.

## TD Wealth Asset Allocation Committee

## Market outlook

Bruce Cooper, Chief Investment Officer, TD Asset Management Inc. and Senior Vice President, TD Bank Group

## Asset Allocation Summary



Source: TD Wealth Asset Allocation Committee. For illustrative purposes only.

Following an exhausting few days surrounding the surprising Brexit vote toward the end of June, volatility took a much needed holiday and stayed muted for the remainder of the summer. While brief, the post-Brexit volatility was sharp, sending many investors scurrying for the relative safety of government bonds and leading 10-year government yields to hit record low levels in the U.S., U.K., Germany, Switzerland, France, Denmark and Sweden. However, markets recovered quickly as investors digested the news and continued to place their confidence in the support that central banks have been providing to financial markets.

And that support has been unprecedented. With the hope that low interest rates would stimulate economic growth, global central banks have decreased rates to historically low levels, engaged in massive asset purchase programs that infuse financial markets with hundreds of billions of dollar every month, and several have resorted to paying negative yields (i.e. charging for deposits). Yet the results have not reflected these monumental efforts. In fact, they've been lackluster at best, with economic data only showing modest improvement: economic growth is low, productivity is low, capital investment is low. The outlook doesn't look much rosier—over the summer, the International Monetary Fund downgraded its forecast for global growth in the wake of Brexit, and the Bank of Canada recently warned that domestic growth may be weaker than it earlier anticipated.

As the effectiveness of current measures appears to be waning, the TD Wealth Asset Allocation Committee ("we") believes the next round of stimulus will include aggressive fiscal spending. Fiscal spending has already increased substantially in China, we expect it to pick up in Canada and if Hillary Clinton wins the November election, we expect she will support additional fiscal spending in the U.S. Depending on the size of the programs, fiscal stimulus could spur growth, which in turn would be a tailwind to corporate revenues and earnings.

In spite of the current insipid economic backdrop, equities and fixed income continued to march higher over the summer, trading near all-time highs. Markets appear to be engaged in a tug-of-war between low growth and weak earnings, which are restraining gains, and stimulative central banks, which are spurring them.

Broadly, we believe that caution is warranted. While we expect assets to move modestly higher (we believe bonds will provide coupon-like returns and stocks will provide low- to mid-single digit returns), we also expect periods of elevated volatility.

In spite of a brief Brexit-related uptick in volatility during June, overall, volatility has been notably low over the past several years. For example, as of the end of August, the 5-year average level of the VIX Index, which measures implied volatility, was approximately 19% lower than the 20-year average,<sup>1</sup> and from late June to early September, the S&P 500 Index traded in a historically narrow range. In large part it's the actions of global central banks that are suppressing volatility, as their massive asset purchase programs are flooding markets with liquidity.

However, investors shouldn't become complacent; a number of catalysts could reignite volatility. In addition, during this lengthy period of relative calm investors have been moving further out the risk spectrum and leverage has increased, which could amplify volatility's negative effects when it returns. Risks we are monitoring closely include the upcoming U.S. election, stresses in Europe and increasing interest in protectionism in a number of regions, all of which may cause uncertainty. This uncertainty is likely to lead to choppy markets and episodes of volatility. It may also reduce confidence, which would weigh on investment and trade, ultimately restraining already sluggish global growth and increasing the risk of global recession.

Overall, there is potential for a wide range of possible economic and market outcomes. Therefore, we believe it is crucial to retain a long-term perspective and maximize diversification benefits within portfolios. As such, we maintain our preference for a diversified investment portfolio including high quality domestic and global dividend paying equities, government and investment grade corporate bonds, plus a modest allocation to cash and gold, where allowed by investment guidelines.

While we maintain our broad positioning, we did make one change to during the quarter: downgrading global government bonds from underweight to maximum underweight, as very low real and nominal yields coupled with increasing liquidity concerns make the current risk/reward dynamic unattractive.

<sup>1</sup> Source: TD Asset Management Inc. and Bloomberg Finance L.P.

## TD Wealth

**U.S. estate tax** (continued from page 1)

Wealth Advisory Services, TD Wealth

To illustrate the potential impact of U.S. estate tax based on current rates: Evan, a Canadian resident who is not a U.S. citizen, resident or green card holder, owns a vacation property in Florida worth US\$500,000 and an investment portfolio that includes US\$250,000 of U.S. securities. In the first scenario (Scenario 1), Evan's worldwide assets (including his U.S. situs assets) are worth US\$4 million. In our second scenario (Scenario 2) Evan's worldwide assets (including his U.S. situs assets) will be worth US\$8 million. Evan's U.S. estate tax exposure on death is illustrated below:

	Scenario 1	Scenario 2
Value of U.S. situs assets	US\$750,000	US\$750,000
Value of worldwide assets	US\$4 million	US\$8 million
U.S. estate tax on U.S. situs assets	US\$248,300	US\$248,300
Less: enhanced unified credit	US\$398,588	US\$199,294
Estate Taxes Payable	Nil	US\$49,006

Note that once Evan's worldwide assets exceed the lifetime exemption for U.S. citizens, his estate would be liable for U.S. estate taxes. If Evan was survived by a Canadian resident spouse and his assets passed to his spouse, then his entire estate would likely be sheltered from U.S. estate tax on his death as the marital credit would eliminate the remainder of his U.S. estate tax liability. In order to claim the enhanced unified credit (and marital credit) under the Treaty, a U.S. estate tax return would need to be filed on behalf of Evan's estate.

There are several planning opportunities to mitigate U.S. estate tax exposure on death. The following are a few examples.

**U.S. Securities**

Personal ownership is appropriate for U.S. securities if the U.S. estate tax liability can be eliminated by the previously noted credits. However, if the credits are insufficient, consider holding Canadian domiciled mutual funds with similar investment objectives. Canadian mutual funds that hold U.S. securities are not considered U.S. situs assets. Investing in U.S. securities through a Canadian holding company may achieve similar results, although there may be compliance and legal fees to consider if using a holding company.

If a generational transfer of wealth is an objective, gifting U.S. securities prior to death would remove the assets from an individual's taxable estate for U.S. purposes and effectively reduce an individual's U.S. estate tax exposure. Please note that gifting U.S. securities may have Canadian tax implications which should be considered.

**U.S. Real Property**

For U.S. real estate, ownership structuring is ideally considered before the purchase of the property. Subsequent changes in ownership may result in a taxable transaction for both Canadian and U.S. purposes. As noted above, personal ownership may be desirable if available credits would eliminate the U.S. estate tax liability. In particular, with appropriate will planning, ownership by the spouse with fewer assets may be sufficient.

Joint ownership with right of survivorship is often used to structure real estate properties for couples, however this may not be ideal for U.S. estate tax planning. Practitioners tend to agree that tenants-in-common is a preferable joint ownership option, as appropriate will planning can be undertaken for each spouse's share of the property.

Another option may be ownership through a family trust, which could be structured to mitigate the U.S. property from U.S. estate tax exposure. Alternatively, if the property is held personally, a non-recourse mortgage may also be considered to reduce the value of the property for purposes of U.S. estate tax. However, it may be difficult to obtain a non-recourse mortgage for more than 50% of the value of a property.

While the outcome of the U.S. election is uncertain, consider whether you need to speak with your advisor with regard to your overall estate plan and possible planning steps to manage your U.S. estate tax exposure.



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