Weekly Updates Issue # 647

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1. Weekly Markets Changes

[January 19, 2018]

S&P TSX	S&P 500	Dow Jones	NASDAQ	CAD/USD	Gold	WTI Crude
16,353.46 +45.28 +0.28%	2,810.30 +24.06 +0.86%	26,071.72 +268.5 +1.04%	7,336.38 +75.32 +1.04%	$0.8026 +0.29c +0.36%	$1,331.84 -5.79 -0.43%	$63.37 -0.93 -1.45%

2. What's more threatening: U.S. taxes or NAFTA talks?

[January 19, 2018] Business associations are warning that substantial tax changes in the U.S. could end up inflicting more damage on the Canadian economy than the possible termination of NAFTA.

Two of the country's biggest business lobby groups say much of their attention these days is focused on the negatives of the recent U.S. decision to slash corporate taxes to levels comparable to those in Canada.

The warning follows on the heels of the Bank of Canada's first public estimate on the impact of the U.S. tax changes on the economy north of the border.

The bank predicts NAFTA uncertainty and the tax reforms will encourage firms to divert more of their planned investments from Canada to the U.S., trimming half a percentage point off Canadian investment by the end of next year.

3. Manufacturing sales hit record high in November

[January 19, 2018] Statistics Canada says manufacturing sales rose 3.4% to a record high of $55.5 billion in November.

The agency says the gain was mainly due to higher sales in the transportation equipment, petroleum and coal product and chemical industries.

It says 12 of 21 industries, representing 81% of the manufacturing sector, gained ground in November.

Sales of transportation equipment increased 9.1% to $10.6 billion in November, following two consecutive monthly decreases.

The petroleum and coal product industry saw sales climb 6.1% to $6 billion, primarily due to higher prices.

Chemical industry sales rose 5.9% to $4.4 billion in November, after falling 2.7% in the previous month.

4. How to keep splitting income with family members in 2018 and beyond

[January 19, 2018] The new income sprinkling rules mean it no longer makes sense for incorporated professionals and many business owners to income split with their families. That's because dividends paid to a spouse or child will now be taxed at the top marginal rate unless the shareholder receiving the dividend can show specific labour or capital contributions to the business's operations.

Taxpayers will be responsible for demonstrating in their tax returns that a family member meaningfully contributes to the business. It's up to CRA to decide if the compensation is reasonable.

If only one shareholder is considered the legitimate owner of the business, he or she is only allowed to income split with:

- a spouse, once the owner turns 65;
- adults aged 25 or older who hold a 10% voting share in a non-professional corporation that earns less than 90% of its income from services; and
- adults aged 18 or older who have averaged 20 hours of work in the business per week during the year, or any of the five previous years.

Shareholders who do not fit perfectly into one of these categories won't know whether their 2018 dividend compensation will be taxed at the highest marginal rate (53.53% in Ontario) until mid-2019 when they receive their Notices of Assessment.

This is an unacceptable risk for most small business owners.

Consider a prescribed rate loan…

An alternative to paying dividends is to lend tax-paid personal capital to a spouse, child, or trust using a prescribed rate loan. This allows the passive income earned on the assets to provide an income for the borrower that avoids the tax on split income (TOSI) and kiddie tax rules that result in dividends being taxed at the top marginal rate.

For example, a $1.5-million loan to a trust at the current prescribed rate of 1% could earn a 4% cash yield after fees, equaling $60,000 of income. Out of that income, $15,000 would have to be paid back to the lender and would need to be declared as interest income. The remaining $45,000, however, could be distributed to the trust's beneficiaries at the trustees' discretion.

…but do it quickly

The loan option is attractive because, assuming interest is paid 30 days after year's end, the interest rate will always be the prescribed rate in effect when the loan was made, which is currently only 1%. This rate is set quarterly and will be announced again on March 15. Based on our analysis, the rate is likely to increase. Here's why.

The Income Tax Act contains a formula for determining the prescribed rate, which can be summarized as:

The average 90 Day T-Bill rate in the first 30 days of a quarter rounded up to the next whole percent and applicable the next quarter

In Q4 2017, the rate was 93 basis points, keeping the rate at 1% in Q1 2018. However, the T-Bill rate is already 1.17%% as of January 15, 2018. If it stays there, the Q2 rate will be 2%, or double the current rate.

Such a doubling would decrease the income-splitting potential of our above example by $15,000 (or 33%). Further, the 2018 federal budget will be released in March along with new passive investment rules for CCPCs. These new rules could easily limit trust loans or change the prescribed rate model.

Benefits of prescribed loans

Individuals can loan tax-paid capital to a trust at the prescribed rate. The trust can then distribute taxable income earned above that rate to the beneficiaries of the trust including a spouse, children or grandchildren.

Business owners can withdraw that tax-paid capital from their corporations (e.g., from their Capital Dividend Account or using shareholder loans) to achieve the above-noted strategy. The most obvious reason is to allow business owners to continue income splitting with their spouse before age 65 (the age at which income splitting is allowed).

Trust loans could also work for business owners who have been saving for their children's post-secondary education in their private corporations and were planning to pay their children dividends when they turned 18, but after these proposals are unable to do so. The disbursements that result from loaning money to a trust also avoid the kiddie tax, so the income could also be used to pay expenses for children and grandchildren under 18.

Ultimately, one family could use the trust for several purposes over time, as a trust is fully discretionary and has the longevity benefit of not requiring to be wound up upon the lender's death (note that unrealized gains on trust assets are subject to capital gains tax unless distributed every 21 years).

5. What happens if bonds become more appealing than stocks?

[January 18, 2018] Higher bond yields are finally here, and investors have to consider what, if any, changes to make to their portfolios.

Short-term yields haven't been this high for almost a decade, and long-term yields have also risen. Investors expect rates to keep going up as the economy improves and as the Federal Reserve continues to raises rates above their historically low levels. At the same time, the Fed is letting its huge bond portfolio shrink.

Low bond yields are one of the key reasons stocks have climbed higher and higher in recent years, and it's possible the increase in yields will break stocks out of their pattern of steady gains. Higher bond yields may tempt investors who want income, and they also tend to slow down economic growth by making it more expensive to borrow money, which could be bad for stocks.

Jack Ablin, chief investment officer for BMO Capital Markets, said higher bond yields have been a long time coming, so investors might not need to make big adjustments just yet. But if yields climb further, Ablin's prepared to make big changes. Bonds could even become more appealing than stocks, which have started to look expensive.

Answers have been edited for clarity.

Q: How should investors react to the rise in yields? High-dividend stocks have already lagged the market; so should investors avoid them now?

A: There are a lot of investors who are income-oriented, so income is a key part of what they're trying to do. I'm not sure we'd necessarily say avoid income. But for the most part we've positioned for higher rates and we just haven't gotten them. So I haven't necessarily changed anything big picture. This rise we expected last year appears to be coming through nowadays. This is probably the longest anticipated bond bear market in history. Now it appears that the Federal Reserve has curtailed its [easing] program, and many of the global central banks are doing the same.

Q: The rise in rates means the prices of many types of bonds are falling. Are any bonds doing well?

A: When Treasury yields rise, that tends to create a competition. You have to look at it asset class by asset class, but in general I would say more high-yield bonds should do well because they have higher coupons and shorter maturities. LIBOR-based floating-rate loans should do well.

And rates are going up for a couple of reasons, including less buying from the central banks of Europe and Japan. But what's driving the reduced buying from the foreign central banks is better growth. It's that growth that's fueling demand for oil and natural gas.

Q: Most experts expect market volatility to rise this year because it can't stay at historic lows forever. Will that limit the gains for bonds?

A: Treasury yields decline as volatility increases because volatility then increases uncertainty, and in periods of uncertainty, investors tend to clamour for quality. If we see rates rise and volatility pick up, that could attenuate that rate rise or the impact of higher rates.

Q: How high are yields likely to go?

A: I'm not an economist, so I couldn't say. But historically, the yield of the 10-year note has tracked the gross domestic product, and nominal GDP is about 4%. So fair value for the 10-year is about 4%. That's where it should be, but that's where it should have been a year ago.

Yields need to rise about 150 basis points across the board for that to be fair value. If that happens, it's going to create problems for equities because then we'll have some competition. For now, the equity market is the only game in town because the bond yields are so meagre. If the yield on the 10-year Treasury gets to 3.5%, then I'm selling equities. We have to be prepared for shifting our asset allocations around.

If rates rise enough, it's going to pull the rug out from under the stock market if the fundamentals don't improve enough.

Q: Since you're thinking about selling stocks and buying bonds if yields rise further, what do you expect stocks to do in the shorter term?

A: I think the stock market can be up high single digits or low double digits this year. While the tax plan may be priced in, I'm not sure the beneficial impact of those taxes is fully priced in. It's not just the repatriation of $2 trillion that could perhaps find its way into the equity market. We could see capital expenditures and business spending rise.

And countries including Germany and Japan view this tax rate as a shot across the bow. They're threatened by it. It's possible they could match our plans with similar plans and then we get a race to the bottom. The primary beneficiaries would be companies and shareholders.

6. BoC hikes interest rate to 1.25% on strong economic data

[January 17, 2018] The Bank of Canada (BoC) today raised its target for the overnight rate to 1.25%, an increase of a quarter of a percentage point. The bank rate is correspondingly 1.50%, and the deposit rate is 1.00%.

The change is expected to prompt Canada's large banks to raise their prime lending rates, a move that will drive up the cost of variable-rate mortgages and other variable-interest rate loans.

The economy's impressive run prompted the BoC to raise its trend-setting interest rate for the third time since last summer. In a press release, the central bank said recent data have been strong, inflation is close to target and the economy is operating at roughly capacity.

"Consumption and residential investment have been stronger than anticipated, reflecting strong employment growth," the release said. "Business investment has been increasing at a solid pace, and investment intentions remain positive."

Moving forward, the BoC predicts household spending and investment to gradually contribute less to economic growth, given higher interest rates and stricter mortgage rules. It predicted Canada's high levels of household debt would amplify the effects of higher interest rates on consumption.

NAFTA was cited as another economic risk, which the BoC says it has incorporated into its economic projection, with a negative judgment on business investment and trade.

Economic projections

The central bank said the global economy continues to strengthen, with growth expected to average 3.5% over 2017-2019, with growth in advanced economies stronger than in the bank's last monetary policy report (MPR)—particularly for the U.S., which will see growth boosted by recent tax changes.

For Canada in 2017, the BoC now predicts 3% growth in GDP, compared with its 3.1% prediction in October.

The bank slightly increased its predictions for Canadian GDP in 2018, up to 2.2% from 2.1%. It expects the economy to expand by 1.6% in 2019, up from its previous call of 1.5%.

The fourth quarter of 2017 and the first quarter of 2018 are each expected to see annualized growth of 2.5%.

The BoC also said governor Stephen Poloz's team is closely watching the economy's ability to grow without driving up inflation.

"In this respect, capital investment, firm creation, labour force participation and hours worked are all showing promising signs," the BoC said.

CPI inflation is estimated to have averaged 1.8% in the fourth quarter of 2017.

"Temporary factors, such as past electricity rebates, below-average food price inflation and exchange rate pass-through have contributed to keep inflation below target in recent quarters," says the bank in its MPR.

The BoC expects inflation to ease this month reflecting transitory effects of elevated gas prices a year earlier. Inflation is expected to rise later in the year, "as the temporary effects of past fluctuations in consumer energy and food prices fade." Overall, inflation is expected to remain close to 2%.

Compared with the last MPR in October, higher prices for crude oil are expected to lift the inflation profile in 2018, but other sources of inflationary pressures remain broadly similar. The inflation projection also incorporates the estimated effects of recent and scheduled increases in provincial minimum wages.

Again referring to NAFTA, the bank said the most important risk to its inflation outlook is the shift toward protectionist global trade policies.

Next rate decision

Heading into the decision Wednesday, Scotiabank Economics forecasted three hikes totalling 75 basis points throughout 2018 and three more in 2019. TD Economics expected a gradual pace of tightening over the next two years of about 25 basis points every six months.

The Bank of Canada stressed that it would remain data dependent when mulling future rate decisions. The next announcement is scheduled for March 7.

"Governing council will remain cautious in considering future policy adjustments, guided by incoming data in assessing the economy's sensitivity to interest rates, the evolution of economic capacity and the dynamics of both wage growth and inflation," the bank said.

In its MPR, the bank notes that financial conditions remain accommodative.

"Even with recent interest rate increases, the stance of monetary policy in Canada remains accommodative and continues to support the level of economic activity," says the report.

In an email to clients, CIBC chief economist Avery Shenfeld said that the BoC "put NAFTA uncertainties right up front in their statement, and also explained that monetary accommodation (i.e., rates at stimulative levels) will be needed to reach their growth and inflation forecasts, reasserting the need to be cautious in how fast they hike ahead."

He describes today's statement as dovish "relative to the minimum degree of optimism needed to justify a rate hike today, and could put some downward pressure on two-year yields and the value of the C$."

He forecasts one further hike this year, likely in Q3, and a further increase of 50 basis points in 2019.

BMO, CIBC, RBC, Scotiabank, TD and Desjardins today increased their prime lending rates by 25 basis points to 3.45% from 3.20%, effective January 18, 2018. The increased rate will affect the cost of variable-rate lending, including variable-rate mortgages.

7. Rising rates have Canadians worried about paying bills

[January 16, 2018] A new survey suggests one-third of Canadians can't pay their monthly bills, including debt repayments, against a backdrop of rising interest rates.

The quarterly MNP consumer debt index survey finds the number of Canadians who can't cover their fixed monthly expenses is up eight points since September.

It also finds Canadians who are making ends meet have less disposable income, with an average $631 left after paying bills and contributing to debt repayment. That's 15% less money left over than in the previous quarter.

The survey says Canadians worried more about their debt as the Bank of Canada raised its benchmark interest rate twice last year and is expected to continue the momentum in 2018.

Four-in-10 respondents say they fear financial trouble if interest rates rise much further, and one-in-three agree they're concerned rising rates could move them toward bankruptcy.

More than 70% of respondents say they'll be more careful with how they spend money as rates move up, and nearly half say they believe they'll have to take on more debt over the next year to cover expenses.

About the survey: Ipsos, which conducts the quarterly survey, interviewed 2,001 Canadians online between Dec. 8 and 13, 2017.

8. Lawsuit alleges Canadian banks manipulated benchmark rate

[January 16, 2018] A class-action lawsuit filed in a U.S. court alleges six Canadian banks and three others conspired to increase the profitability of their derivatives trading business by manipulating an interest rate benchmark for about seven years.

The Fire & Police Pension Association of Colorado filed the claim against BMO, Bank of Nova Scotia, CIBC, National Bank of Canada, Royal Bank of Canada, TD and three others at the United States District Court for the Southern District of New York on Friday.

The claim alleges the banks manipulated the Canadian dealer offered rate—which reflects what rate contributors are willing to lend to corporate clients using an instrument called a bankers' acceptance—from at least Aug. 9, 2007, to June 30, 2014.

The claim alleges the banks suppressed the rate by making artificially lower interest rate submissions to Thomson Reuters, which calculates the CDOR daily.

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The court filing also says that suppression increased their profits from CDOR-based derivative positions.

Scotiabank, RBC, National Bank of Canada and CIBC declined to comment, and none of the remaining big six banks immediately responded to a request for comment. None of the allegations have been proven in court.

The Investment Industry Regulatory Organization of Canada reviewed existing practices for the CDOR in 2012-13, and in 2014, the Office of the Superintendent of Financial Institutions announced it would supervise the CDOR submission processes.

9. Don't let a vacation property dream become a tax nightmare

[January 16, 2018] Have you ever caught yourself daydreaming about owning a pied-à-terre in an old-world metropolis, or a piece of tropical paradise? While international property ownership can be a pleasing fantasy, careful planning and understanding of the tax and estate concerns can prevent those reveries from becoming a nightmare. Here's what to think about before you buy in a foreign market.

Research local issues

International real estate should not be an impulse buy. Make sure you look into foreign property ownership restrictions and taxes, the political climate and the process for buying and selling real estate.

Currency can play a big role in these transactions. In addition to exchange rates, you should consider currency restrictions once they sell the property and try to bring the proceeds back to Canada. There may also be historical restrictions on a property that limit renovations and future development, and buyers will want to consider the costs of security, transportation and hooking up to utilities. One way to research such granular details is to spend time living in the country by renting property, rather than staying at a hotel or resort.

Tax implications

Purchasing property does not have immediate income tax implications in Canada. However, depending on the intended usage, you may be required to disclose the property on Form T1135. CRA identifies three possible scenarios for a foreign vacation property:

1. exclusive use as a vacation property;
2. renting out the property more than 50% of the time over the course of a year with a reasonable expectation of profit; and
3. renting the property part of the year with the intent of recovering associated ownership costs, rather than an expectation of profit.

Usage under scenarios #1 and #3 would not need to be reported on the T1135. In #2, the property is not considered personal use property since it is being rented out more than 50% of the time. Under these circumstances, if the adjusted cost base of this property and any other specified foreign property is $100,000 or more at any point in the year, it must be reported on the T1135. Don't forget other specified foreign property that might need to be included on the T1135 that could be indirectly related to property ownership (e.g., foreign bank and investment accounts). Currency fluctuations may also push your client above the threshold, making it necessary to report on the T1135 even if the cost amount is back under $100,000 by the end of the year.

In terms of foreign income, rental income would be taxable. You must report gross rental income and can deduct expenses related to that rental income, resulting in only the net rental income being taxable.

Since the rental income is earned in another country, it may be taxable there, too. Some governments require that tax be withheld at source on those rental payments. It will be important to review these requirements and any documentation or process that may allow clients to avoid such withholding tax. Foreign tax paid may be eligible for a credit against Canadian taxes owing on the same rental income.

When you sell property, any capital gain is taxable for Canadian tax purposes. It may also be taxable in the country where the property is domiciled. Not all countries tax capital gains in the same manner as Canada, but a foreign tax credit may be available to offset some or all of the Canadian taxes on the capital gain.

Canada's principal residence exemption (PRE) can be applied to real property located outside of Canada to protect the capital gains upon sale from Canadian taxation. Applying the PRE to foreign property would not allow the PRE to be applied to any other real property owned by the same person (and/or their spouse or common-law partner) for the same period. Further, the PRE is not available to trusts that own real estate except under specific conditions.

How to own the property?

Before you purchase vacation property, you should consider how you'll set up legal ownership.

1. Personal names (sole or joint): owning the property directly in your name alone or as joint tenants with rights of survivorship is the simplest form of ownership.
2. Canadian trust: owning the property within a trust may allow for additional estate planning benefits, but is costlier than the first option.

There may be additional legal ownership options available in the country where the real estate is purchased that provide tax and/or estate benefits. Such structures should be reviewed with extreme caution as the benefits may not be the same for Canadian tax purposes. This can lead to costly consequences such as double taxation with no eligibility for the foreign tax credit.

Estate planning

Foreign jurisdictions may have probate, estate or inheritance tax regimes that differ from Canada's (foreign real estate isn't subject to Canadian provincial probate). To address these items, consider the following:

1. Power of attorney. Having a valid power of attorney in the jurisdiction where the property is located could be valuable when the owners do not have the mental capacity to make decisions. It may also be useful when decisions related to the property must be made when the owners cannot provide signatures in person.
2. A will drafted where the property is located may be necessary to address the transition of the property to intended beneficiaries. With a will that is valid in the appropriate foreign jurisdiction, the executor would have the authority to manage the property, including its sale, and to take care of the necessary tax reporting and payments when the owners die.

After taking care of all the tax and estate implications associated with your dream vacation home, you'll be able to enjoy that beachside villa or Paris flat to the fullest. Or once you know the work involved, you'll decide to rent and let the owner deal with the tax and estate headaches.

Have a nice and fruitful week!

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