

HOUSEHOLD DEBT LOADS

MARKET COMMENTARY

By Richard J. Wylie, CFA, Vice-President, Investment Strategy, Assante Wealth Management

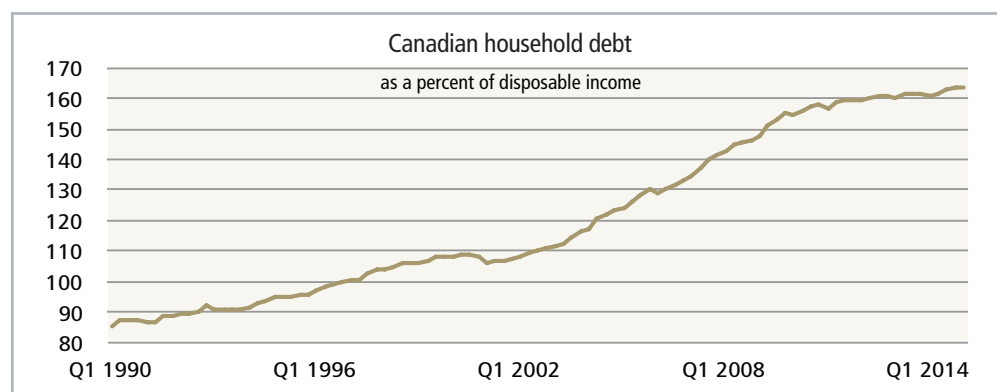
Much ink has been spilled over the past several years regarding the extent of the debt burden on Canadian households. The Bank of Canada has made it clear that household debt is a growing problem. In a largely overlooked report, Statistics Canada announced on June 12, 2015 that Canada's household debt level had actually declined during the first quarter of 2015. The reversal was nominal, but it raises questions about the future direction of accumulated household debt and its economic implications. While debt is a financial tool used by many Canadians, seeking professional financial advice can help reduce the risks associated with taking on debt.

While the ratio of credit market debt to disposable income moved lower in the first quarter, it did so from an all-time high. This figure stood at 163.6% in the final quarter

of 2014 and edged down to 163.3% in the first quarter of this year. When the fourth quarter statistics were released, some analysts pointed out that the figures were higher than a similar ratio reported in the U.S. immediately preceding the Great Recession of 2008-09. Other analysts pointed out that, like many other statistics, the figures published by Statistics Canada were calculated differently than their U.S. counterparts. Regardless of the actual debt level, Canadians typically have a greater equity stake in their home compared to Americans. In the end, all analysts agree that the ratio has increased beyond historic levels during the ongoing period of extremely low interest rates.

A key implication of the low interest rate environment has been the commensurate reduction in the cost of servicing debt. Even as the ratio of debt to disposable

income has increased, the debt service ratio (interest cost as a percentage of disposable income) has fallen. In the first quarter of 2015, this ratio stood at 6.4%, the lowest level since these statistics were first recorded in 1990. This implies that even though the debt burden is higher, it is more "affordable." Although the Bank of Canada has been vocal about its own concerns over household debt, the bank cut interest rates again on July 15, 2015. This was the second downward adjustment of 2015 and took interest rates back to the level previously established on March 3, 2009 during the financial crisis. The press release that accompanied the announcement underscored the bank's concerns about domestic economic growth rather than worries that it would inadvertently foster additional debt accumulation. In either case, the weak economic environment is unlikely to result in a material change in inflation over the near term and the risk of a dramatic upward shift in interest rates seems remote. Nevertheless, interest rates in the U.S. will likely move higher before they do in Canada, although eventually they will rise here as well. Even if an individual's debt load is not a concern, it would be prudent for all borrowers to examine the implications for their own finances before these events unfold. Taking advantage of professional financial advice can help to alleviate concerns over the impact of rising interest rates. ■



Source: Statistics Canada

CHARITABLE GIFTS IN YOUR WILL – IS IT TIME TO UPDATE YOUR DONATION PLANNING?

By Jamie Dunlop, LLB, LLM, TEP, Wealth Planning Group

The inclusion of a charitable gift in your will can be an effective and meaningful way to achieve your philanthropic objectives. It can also generate tax relief by providing an opportunity to offset taxes that are otherwise payable on death.

Recent amendments to the Income Tax Act, effective January 1, 2016, have significantly changed the way in which donations on death will be treated for tax purposes. If you have included a charitable gift in your will or you intend to do so, you should review your planning in light of these amendments to ensure that your objectives will continue to be met in the most tax-effective way.

Prior to the implementation of these amendments, when a donation was made by will, it was deemed to have been made immediately before death and a tax receipt was issued for the value of the donated property at that time. A donation credit was available to offset taxes owing in the deceased's terminal tax return. Any donations not claimed in the terminal return could be carried back to the immediately preceding year. However, any remaining credits could not be carried forward to be claimed by the deceased's estate.

The new legislation deems the donation to be made when the property is actually

transferred to the charity and a donation receipt will be issued for the value of the donated property at that time. If the estate qualifies as a Graduated Rate Estate (GRE) at the time the gift is made, the new rules provide greater flexibility by allowing the donation to be applied to offset the taxes owing in the terminal return, the return for the immediately preceding year, the taxation year of the estate in which the donation was made or a prior taxation year of the estate. An estate will qualify as a GRE if, among other things, no more than 36 months have passed since the date of death and the estate is a testamentary trust. If the estate makes the gift after its first 36 months or if the estate loses its GRE status during the year the gift is made, the gift may only be claimed by the estate in the year that the gift is made or in any of the five subsequent tax years of the estate.

To realize the full benefit of the flexibility included in these tax changes, your executor will have to ensure that your estate qualifies as a GRE when the gift is made. If you anticipate this may pose a challenge to your executor, given the nature of your estate, you may want to plan the gift as a cash bequest so that it can be made as soon as possible following your death or make the gift by means of a direct designation of a retirement plan,

TFSA or life insurance policy which will also be eligible for the donation credit.

The new rules will have a profound effect on the tax treatment of charitable gifts made in your will. You should review your donation planning to ensure that it maximizes the available tax benefits while continuing to meet your charitable giving objectives. ■

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FINDING VALUE IN EMERGING MARKET EQUITIES



We spoke to Matthew Strauss, Vice-President and Portfolio Manager at Signature Global Asset Management, to get his insights on the opportunities his team is uncovering for the emerging market equity mandate.

Q: Where are the opportunities and risks in emerging markets?

Matthew Strauss: As the world economy is slowly weaned off of monetary policy stimulus in the form of quantitative easing, we hope that underlying economic fundamentals will once again become the driving force of equity performance. Early signs of this are starting to show with emerging markets holding their own against developed markets during the first six months of 2015 as investors contemplated the first interest rate hike by the U.S. Federal Reserve. Within emerging market economies, investors are clearly distinguishing between economies with strong macro support and economies that are struggling from a cyclical or structural perspective. This is a welcoming departure from the "incoming tide lifts all boats" mentality during the first few years after the 2008-09 financial crisis when global developments dominated emerging and developed market equity returns.

Q: How is your outlook affecting your positioning of the emerging market equity mandate?

Matthew Strauss: Given the unique risks within emerging markets, we believe that a successful approach to emerging market investments must fully incorporate the complex policy and political environment, as well as fundamental bottom-up company analysis. Some emerging economies are struggling with internal political issues and/or softer economic conditions and against this background, we continue to focus more on the Asian emerging markets. We see generally better investment opportunities in Asia than in Latin America or Eastern Europe. In Asia, countries like India, the Philippines and China are still recording over 5% growth. A key component in our outlook is the view that the Chinese authorities will be able to stabilize not only the financial markets but also the domestic economy despite a number of structural issues.

Q: What are three of your favourite emerging market holdings?

Matthew Strauss: The Philippine conglomerate, **Ayala Corporation**, is a perfect example of fundamental company analysis and macro strategy coming together. Ayala Corp. stands out among its peers on issues such as corporate governance and strong management, and with business interest in real estate, financial services, telecommunications, water

infrastructure, power generation and retail health care, it is an ideal way to benefit from one of the fastest growing economies in Asia.

With the recent volatility in Chinese stock markets, one could easily overlook sound local companies with decent visibility around their earnings potential. **Shanghai Airport** is a case in point. Not only is passenger traffic increasing by double digits as the Chinese government continues to raise the monetary limit on Chinese tourists visiting countries abroad, but Shanghai Airport is still the fastest growing listed airport company in China in terms of both aircraft and traffic volumes.

Tencent has morphed into one of the largest global Internet companies with monthly active user accounts of more than 500 million for its messaging services and more than 800 million for its QQ value-added service. Tencent continues to enhance and expand its services in an effort to continue to capture the imagination (and business) of the growing and increasingly tech-savvy middle class in China. ■

AVOIDING A TAX HIT ON YOUR TRUST'S 21ST BIRTHDAY

By Camille Jordaan, B.A., J.D., Wealth Planning Group

Trusts are a common and effective planning tool when it comes to wealth management and succession planning. However, there are a number of Canadian tax rules that must be considered when one is used. One of these rules – known as the “21-year rule” – prevents the indefinite deferral of capital gains taxes through the use of a trust.

The 21-year rule deems trusts (subject to some exceptions, such as spousal trusts and RRSP and mutual fund trusts) to dispose of their capital property at fair market value every 21 years. This “deemed disposition” effectively forces trusts that are subject to the 21-year rule to pay tax on any accrued capital gains every 21 years as if they had sold all of their capital property for fair market value. Where the value of assets held by a trust subject to the 21-year rule has appreciated significantly while the assets were held by the trust, the tax burden can be considerable.

Fortunately, with planning, the potential tax problems presented by the 21-year rule can be prevented. The most common strategy for dealing with the 21-year rule involves distributing a trust's capital property to a Canadian-resident beneficiary

on a tax-deferred, or “rollover” basis. With this strategy, the trust would transfer the capital property to the beneficiary at cost. Capital gains tax will then only apply with respect to the former trust property when it is subsequently disposed of by the beneficiary.

“With planning, the potential tax problems presented by the 21-year rule can be prevented.”

While this “rollover” strategy sounds simple enough, it comes with one crucial caveat – there are certain ways in which a trust was set up or funded that will prevent it from using the beneficiary rollover strategy to avoid the 21-year rule. More specifically, if a trust is “revocable” for tax purposes, it will be disqualified from rolling out capital property to a beneficiary. Very generally, a trust may be considered revocable when a capital beneficiary of the trust has also contributed property to

the trust, or, under certain circumstances, when a contributor to the trust is also a trustee. Unfortunately, once a trust has one of these features, it is considered to be “tainted” and the beneficiary rollover strategy will be unavailable even if subsequent changes to the trust are made.

If a trust has features that make it revocable, the sooner the issue is recognized, the better, as it may be possible to mitigate, if not completely avoid, negative tax consequences. For example, planning can be done to fund the 21-year rule tax liability in a tax-efficient manner, or an estate freeze involving a new trust can be done to cap the value of shares held by a tainted trust.

If you have a trust, or are considering using one, speak to your advisor as awareness of the 21-year rule is critical if your trust is to avoid an unpleasant 21st birthday surprise. ■

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