Investment Insights

Lessons of the Past: Higher for Longer

Summer 2024

"What's past is prologue." — William Shakespeare, *The Tempest*

With expectations for multiple interest rate cuts to start the year, why have the central banks been slow to move? On June 5, the Bank of Canada became the first Group of Seven central bank to reduce its policy rate, by a quarter-percentage point. However, the central banks have been proceeding cautiously with their monetary policy decisions. Let's not forget that they faced significant criticism in 2021 for not acting swiftly to contain rising inflation, suggesting it was transient. Additionally, their caution has been influenced by the looming spectre of the 1970s.

Just how severe was inflation in the 70s? In an era of bell bottoms and a Beatles' breakup, it was a decade marred by persistently high inflation, high unemployment and low growth, or stagflation. During this time, Canada grappled with an average inflation rate of around 8 percent, with inflation peaking two times: 11 percent in 1974 and almost 13 percent in 1981. In the U.S., inflation would hit 14 percent by 1980. It was only when then-Fed Chair Paul Volcker aggressively raised the federal funds rate to 20 percent by 1981 that inflation would be contained, but this pushed the U.S. into severe recession. Canada followed suit by hiking rates to a whopping 21 percent. At that time, five-year fixed mortgage rates reached a high of 21.5 percent; a stark contrast to today's rates of around 6 percent.

Central bankers are keen to avoid a repeat of the 1970s. Some suggest that the underlying drivers of inflation back in the 70s share similarities to today. Oil price shocks and energy supply shortages played a major role back then, compounded by the expansive fiscal and monetary policies of the 1960s and early 70s aimed at boosting employment. When inflation peaked in 2022, many attributed it to pandemic-induced supply chain disruptions, along with overly expansionary fiscal and monetary policies in response to the pandemic. Whether or not we agree on the drivers, one thing is certain: a slow response in the 70s led to higher interest rates and a more pronounced economic slowdown.

Today, labour markets remain resilient amid easing inflation, a comforting development. Traditionally, inflation and unemployment exhibit an inverse relationship, observed by the economic theory known as the "Phillips curve." Instances of significant central bank-induced disinflation often coincide with elevated unemployment rates and recession.[1] While the psychological toll of inflation is undeniable — most of us have felt the pain with the rising costs of essentials like groceries — the impact of increased unemployment may be more profound. Multiple studies have shown that higher unemployment depresses our well-being more than inflation; with one study suggesting nearly double the impact and another proposing up to five times as much.[2]

Achieving a "soft landing" that maintains both labour and price stability is, therefore, enviable — and still appears attainable. However, the central banks remain cautious in their rate adjustments, mindful of the past. Just as with many aspects of investing, patience may continue to be needed as we navigate the ongoing battle against inflation.

1. https://www.reuters.com/business/retail-consumer/fed-needs-recession-win-inflation-fight-study-shows-2023-02-24; 2. https://www.wsj.com/articles/inflation-and-unemployment-both-make-you-miserable-but-maybe-not-equally-11668744274

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To Our Clients:

Despite positive equity market strides including robust market breadth, opinions on the near-term outlook remain varied. One market observer recently noted that we find ourselves in a 'liminal space' — a transition zone where economic conditions are neither terrible nor great. It's a fair observation and one that may explain why financial market narratives appear to keep shifting. With summer's arrival, it's an opportune time to take a break from the headlines. Short-term uncertainties will always be with us; yet, most of us are investing for the longer term and not based on what tomorrow may or may not bring.

One of our roles is to simplify your financial life, tending to your wealth management so you can step back from the noise. Don't hesitate to call if we can be of assistance with any investment matters, but know that we are here taking care of things for you. Enjoy the summer.

Matt, J.D., Aimée & Emma

Timing CPP/QPP Benefits: Three Things You May Not Know

Here are three things that may impact the timing decision.

Lately, there's been considerable media attention advocating for the delay of Canada/Quebec Pension Plan (CPP/QPP) benefits, likely because the vast majority take benefits early. Actuarial studies continue to show that many are better off delaying since the break-even age* falls below our average life expectancy. Living beyond this age means that waiting will yield a larger total lifetime payment. Recall that starting CPP/QPP before age 65 (as early as age 60) decreases payments by 0.6 percent per month;** yet, delaying beyond 65 increases payments by 0.7 percent per month, up to 42 percent (age 70) for CPP and, now, 58.8 percent (age 72) for QPP.

If you've yet to make the decision, here are three things you may not know:

1. Retiring early — or late — can impact the benefit amount. Consider the situation in which an individual works past age 65 and also delays the benefit. This can lead to a potentially greater benefit. For both CPP and QPP, since lower-earning years tend to be at younger ages when first starting a career, by extending your working years past age 65, you may add higher-earning years to the calculation and increase the benefit. For the CPP, benefits are generally calculated using the best 40 years of income, usually between ages 18 and 65, but you may be able to use those earnings to replace any periods of low earnings before age 65. The good news? It doesn't work the other way: Low-earning years past age 65 will have no effect on the CPP benefit calculation. However, for both CPP and QPP, if you retire before 65 and wait to take benefits, the zero-earnings years have the potential to negatively impact the benefit (i.e., retiring at age 60 and waiting to collect CPP/QPP at age 65 can potentially add five zero-earning years to the calculation of the benefit).

2. Survivor benefits may be less than anticipated. CPP/QPP survivor benefits are often misunderstood. Many assume they are more generous than they actually are, which can leave a retirement income/cash flow shortfall for a surviving spouse. Consider a situation in which both spouses collect maximum CPP benefits, collectively providing almost $33,000 in annual retirement, based on a monthly CPP of $1,364.60 (2024). If one spouse passes away, annual benefits of over $16,000 will be lost. This is because the most that can be paid to a surviving spouse eligible for both CPP and survivor benefits is the maximum retirement pension. If the spouse was the only one eligible for CPP and dies after taking their CPP at age 65, the surviving spouse may be eligible for up to 60 percent of the deceased's benefits. How much is received depends on a number of factors, including their age and whether they're taking their benefits before or after age 65.

3. You can change your mind, within limits. If you start benefits and change your mind, you can cancel CPP within 12 months of its start, or 6 months for QPP. The cancellation must be in writing to Service Canada/ Retraite Québec and you must pay back the benefits received.

*The age at which total benefits received by delaying payments exceed total benefits received by starting payments earlier. **Or 0.5 percent for some small QPP amounts.

CPP Timing Tool: If you have yet to take benefits, this tool may help you frame the timing decision: https://www.theglobeandmail.com/investing/personal-finance/tools/cpp-benefits/

In Brief: Budget 2024 — Key Changes Impacting Investors

In the spring, the Federal government released its budget. There were no changes to personal or corporate income tax rates, but here are five notable changes for investors.*

1. Capital gains inclusion rate — The budget proposes* to increase the capital gains inclusion rate from 50 percent to 66.67 percent for corporations and trusts and on the portion of capital gains realized that exceeds a threshold of $250,000 per year for individuals, for capital gains realized on or after June 25, 2024.

2. Lifetime capital gains exemption (LCGE) — The budget proposes to increase the LCGE from $1,016,836 to $1,250,000 for dispositions on or after June 25, 2024, with this indexed to inflation beginning in 2026.

3. Canadian entrepreneur's incentive — This new incentive proposes to reduce the prevailing capital gains inclusion rate by 50 percent on the disposition of qualifying shares by an eligible individual on up to $2 million of lifetime capital gains, subject to conditions. The limit will be phased in by $200,000 per year, beginning in 2025 and reaching $2 million by 2034.

4. Alternative minimum tax (AMT) — The AMT is a "parallel tax" calculation that prevents high-income earners and some trusts from paying little or no tax as a result of certain tax deductions and credits. The budget further amends the AMT rules, notably those relating to donations to now allow individuals to claim 80 percent of the charitable donation tax credit when calculating the AMT, instead of the previously proposed 50 percent. Employee ownership trusts would be fully exempt from the AMT.

5. Employee ownership trusts (EOT) — An EOT is a trust that holds shares of qualifying businesses for the benefit of employees to support succession planning and promote employee ownership of small businesses. The budget further clarifies the conditions required to meet the $10 million capital gains exemption on the sale of shares to an EOT. Most notably, the exemption can be shared among multiple individuals and the exemption applies to qualifying dispositions of shares that occur between January 1, 2024, and December 31, 2026.

For more information, please see: https://budget.canada.ca/
At the time of writing, budget legislation has not been enacted.

Reducing the Bite: An Increasing Capital Gains Inclusion Rate

With an increase to the capital gains inclusion rate, are there ways to manage a potentially greater tax bite?*

Since late 2000, 50 percent (1/2) of realized capital gains have been subject to tax. As of June 25, 2024, the inclusion rate will increase* to 66.67 percent (2/3) for corporations and trusts, and on the portion of capital gains realized in the year that exceed $250,000 for individuals. The table shows the impact on a capital gain of $500,000 for an individual with no other gains. Are there ways to manage the potential tax bite? Here are a handful of ideas:

Weigh the benefits of a lower inclusion rate — Tax deferral is commonly viewed as a way to create greater future returns since funds that might otherwise go to paying tax can remain invested for longer-term growth. However, individuals should evaluate the possibility of accelerated taxation at a lower rate versus deferred taxation at higher rates: A higher inclusion rate applies to gains over $250,000. As an example, based on a capital gain of $100,000 and a marginal tax rate of 48 percent, an investor would save $8,000 in taxes by realizing a gain at the lower inclusion rate. Yet, this comes at the cost of "pre-paying" $24,000 in capital gains taxes today. If this amount was invested with a return of 6 percent per year, it would take seven years of tax-deferred growth, based on a 2/3 inclusion rate, to beat the $8,000 in tax savings.

Spread gains over multiple years — If possible, consider realizing gains over multiple years to take advantage of a lower inclusion rate under the $250,000 threshold versus a larger realized gain in a single year.

Crystallize gains — Deliberately selling and rebuying stocks to trigger a capital gain ("crystallizing") can decrease book value over time. This strategy, often used in years when an investor is in a lower tax bracket, may help to capitalize on the lower inclusion rate each year.

Plan to cover increased tax liabilities — Plan ahead for an increased tax liability. The use of insurance or other planning techniques may be considered to cover the eventual higher tax liability, such as for the transfer of a family property.

Donate securities — Assuming the new rules apply to the deemed disposition of assets at death,* for estate planning if you are considering donating to a registered Canadian charity, consider the use of publicly-listed securities as any accrued capital gain is excluded from taxable income and a donation receipt equal to the value of the donated securities is received.**

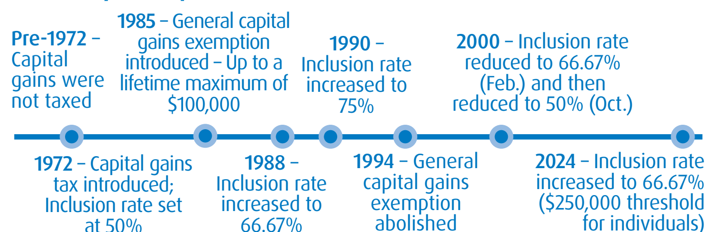
Business owners — Evaluate whether certain assets should be held in the corporation or owned personally. For corporations, there is no $250,000 threshold; realized capital gains are taxable at the 2/3 inclusion rate. The use of corporate-owned insurance or an Individual Pension Plan may be considerations for a business' tax strategy. Plan ahead to use deductions, such as the lifetime capital gains exemption proposed to increase to $1.25M, to reduce the taxes payable on the disposition of qualified shares.

As always, please seek advice from a tax expert regarding your situation.

*At the time of writing, legislation has not been enacted.

**If managing over a lifetime, this applies to individuals not affected by the AMT.

A History of Capital Gains Tax in Canada



Source: "A Primer on Capital Gains Taxes in Canada," CBC, 10/18/2000.

How Much More Tax On a $500,000 Gain?

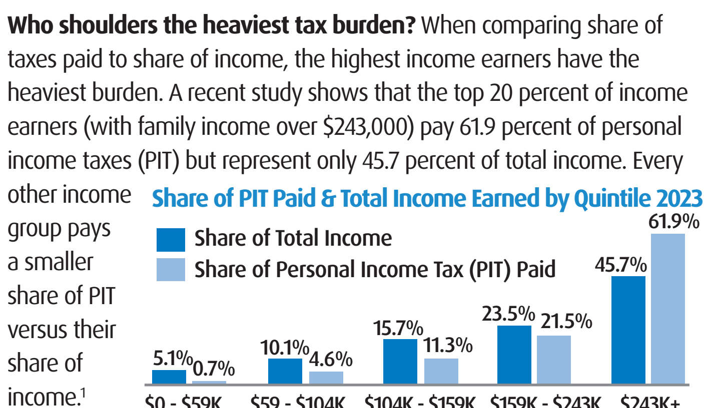
Province	Tax Rate on Capital Gain*		Additional Tax
	1/2 Inclusion	2/3 Inclusion	
BC	26.75%	35.67%	$22,292
AB	24.00%	32.00%	$20,000
SK	23.75%	31.67%	$19,792
MB	25.20%	33.60%	$21,000
ON	26.76%	35.69%	$22,304
QC	26.66%	35.54%	$22,213
NB	26.25%	35.00%	$21,875
NS	27.00%	36.00%	$22,500
PEI	25.88%	34.50%	$21,563
NL/LB	27.40%	36.53%	$22,833

*For individuals based on top marginal tax rates, 01/01/24.

Two Graphics: Perspectives on the Taxes We Pay

If it feels like you're paying more tax, you may not be mistaken. Here are two graphics that provide insight on the taxes we pay.

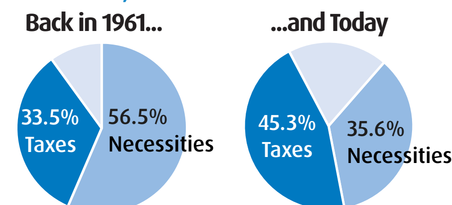
Who shoulders the heaviest tax burden? When comparing share of taxes paid to share of income, the highest income earners have the heaviest burden. A recent study shows that the top 20 percent of income earners (with family income over $243,000) pay 61.9 percent of personal income taxes (PIT) but represent only 45.7 percent of total income. Every other income group pays a smaller share of PIT versus their share of income.[1]



How has our tax burden changed over time? According to the *Canadian Consumer Tax Index*, around 45.3 percent of family income goes to pay taxes today. Since 1961, this has increased by 2,778 percent, outpacing the 863 percent rise in the Consumer Price Index.[2] Despite recent inflationary pressures, it may be surprising to note that over the past six decades, the portion of income allocated to necessities — housing, clothing and food — has decreased by over 20 percentage points. This has resulted in greater disposable income despite a higher tax burden.

1. https://www.fraserinstitute.org/studies/measuring-progressivity-in-canadas-tax-system-2023; 2. https://www.fraserinstitute.org/studies/taxes-versus-necessities-of-life-canadian-consumer-tax-index-2023-edition

Average Canadian Family's Tax Burden vs. Necessities, 1961 and 2022



The Increasing Capital Gains Inclusion Rate: Two Ways Insurance Can Help

Insurance continues to be a compelling tool in wealth planning. With an increasing inclusion rate, here are two situations that may impact you and how insurance can provide support.

While the recent increase to the capital gains inclusion rate (page 3) was targeted to impact only the most wealthy Canadians, a greater number of individuals may be impacted. Here are two situations in which many Canadians may find themselves with higher tax obligations — and how insurance can help:

The Transfer of a Family Vacation Property: One of the most common issues in keeping a vacation property in the family relates to covering a potentially large capital gains tax liability triggered upon its transfer if it isn't considered a principal residence. With real estate prices soaring, a cottage or cabin with a $500,000 cost base can now easily be valued at $2.0 million or more in many markets. Before the recent tax changes, only one-half of the $1,500,000 capital gain was subject to tax. Now, for gains over $250,000, two-thirds will be subject to tax. At a top marginal tax rate of 53.53 percent (using ON as an example), this change could result in an additional $111,000 tax liability (assuming no other realized gains), with a total tax bill of over $512,000. This is certainly not insignificant by any means.

Insurance has traditionally served as a solution to cover such tax liabilities at death and should continue to be a consideration. This involves purchasing a policy with the death benefit equal to the expected tax bill. The proceeds will typically be paid tax free and may avoid probate fees (in provinces where applicable), allowing beneficiaries to cover the tax liability and keep the property in the family. You might even arrange it so that the annual premium cost is paid by the eventual beneficiaries.

Small Business Owners: Investing Inside the Corporation: Many professionals — doctors, dentists, accountants — have incorporated their practices and may need to evaluate whether holding capital assets within the corporation remains the best longer-term tax strategy. Under new rules, corporations do not receive the same tax break as individuals on the first $250,000 of annual realized gains — there is no threshold. As such, every dollar of capital gain is now subject to the two-thirds inclusion rate. This means that the effective Federal tax rate on capital gains has increased from 19.33 percent (38.67% X 50% inclusion) to 25.78 percent (38.67% X 66.67% inclusion) before factoring in provincial tax.*

Corporate-owned life insurance may present a tax-efficient alternative to investing surplus cash, especially when considering future distributions for estate planning. The cost to fund policy premiums will be lower if paid by the corporation rather than personally (assuming the corporation's tax rate is lower than the personal tax rate). Holding an exempt permanent life insurance policy until disposition within a corporate structure allows for tax-deferred growth of the cash value of investments. Proceeds over the policy's cost base can be credited to the capital dividend account (CDA) and can be distributed as a tax-free dividend to shareholders. Most notably, the investment rate of return, especially after factoring in tax savings, commonly exceeds a comparable fixed-income portfolio — this can be estimated through an insurance illustration based on premium costs and expected age at death.

Plan Ahead: The rising capital gains inclusion rate may be one reason to consider insurance as a wealth planning tool. If you'd like to learn more about these or other ways insurance can provide support, please contact the office.

*Investment income (other than most dividends) of CCPCs is subject to the Federal rate of 28%, in addition to a refundable Federal tax of 10.67%, for a total Federal tax rate of 38.67%.

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