# 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.

## In This Issue


Timing CPP/QPP Benefits ... 2
Increasing Capital Gains Inclusion Rate ... 3
Two Graphics: Perspectives on Taxes ... 3
A Home Isn't a Retirement Plan ... 4


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# 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:

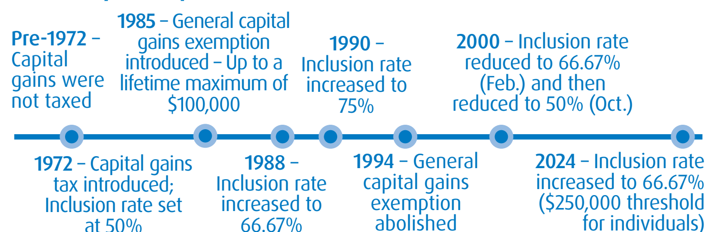
**Weigh the benefits of a lower inclusion rate** — Tax deferral is commonly viewed as a way to create greater future returns since funds that might otherwise go to paying tax can remain invested for longer-term growth. However, individuals should evaluate the possibility of accelerated taxation at a 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.

### 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.

**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.

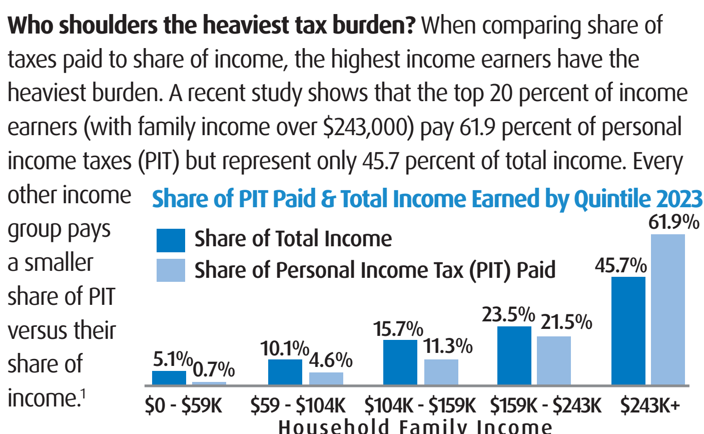
As always, please seek advice from a tax expert regarding your situation.

*At the time of writing, legislation has not been enacted.
**If managing over a lifetime, this applies to individuals not affected by the AMT.

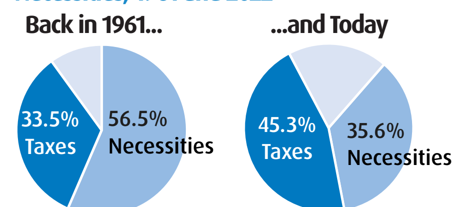
# Two Graphics: Perspectives on the Taxes We Pay

## 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

# Now More Than Ever:
# A Home Isn't a Retirement Plan

Summer is the season for home sales. With real estate prices rising substantially over the past decade, it may be tempting to see your home's value as a potential source of retirement income.

When supporting clients in planning for retirement, it's generally not recommended to consider a home's value as a primary part of that plan. Some homeowners opt to downsize as a way of unlocking retirement funds, while others may look to borrow against their homes. However, there may be significant reasons to exercise caution in relying on home equity to fund retirement, especially in light of prevailing market conditions:

**Fewer seniors are moving** — What if you eventually decide not to sell your home? According to a recent CMHC report, seniors are now less likely to sell their homes before the age of 85. In fact, the sell rate among those aged 75 and older has been trending downward since the early 1990s, falling to 36 percent between 2016 and 2021, down from 41.6 percent between 1991 and 1996.[1] This may not be surprising. For some, selling a lifelong home may be more emotionally difficult than anticipated. Many seniors remain in their dwellings to stay close to family, friends or their community and to maintain their sense of independence. Some have instead chosen to "downsize from the inside" — using only a portion of their homes, such as the ground floor, to reduce costs such as heating.

**Low housing supply** — Even if you do plan on downsizing or renting, will you be able to find suitable accommodation? While selling a home in this market may not be difficult, finding an appropriate alternative may be challenging given the constrained housing supply and tight rental market.

**Moving can be expensive** — Consider that the costs associated with moving homes may be higher than many anticipate: real estate fees, lawyers' fees, land transfer tax, staging and other expenses can add up to be significant. There may also be other unanticipated expenses that come with a new dwelling such as maintenance, renovations and, if you end up in a condominium unit, monthly management fees. All of these costs can erode the net financial gain by downsizing.

**Higher interest rates** — Recent reports suggest that about 25 percent of retirees still carry mortgages as individual wealth has shifted to real estate.[2] Many mortgage holders have seen their mortgage interest rates reset at higher rates over recent times, leading to lower disposable income, especially for those on fixed incomes. While it is possible to access home equity for retirement, consider that with rising interest rates this has become much more costly. Reverse mortgages, which are not common in Canada, may allow you to borrow against your home equity (usually up to 55 percent) with minimal proof of income. However, reverse lenders can charge substantially high interest rates, and there are few large providers. More commonly, a home equity line of credit (HELOC), which is often best secured prior to retirement when income is high enough, allows you to draw on the line as needed and pay interest only on what you borrow.

These are just a handful of reasons to exercise caution when considering home equity for retirement. For a deeper discussion on this, or any other aspects of retirement planning, we would be happy to assist.

1. "Canadian seniors not downsizing, partly owing to lack of options," S. Peesker, Globe & Mail, Feb. 12, 2024; 2. "Wealth tied up in real estate can hurt your retirement," R. Carrick, Globe & Mail, Nov. 30, 2024, p. B10.

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