Wealth Management
& Capital Markets Perspective

Wealth Management
Dominion Securities

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The road to normal

By Jim Allworth

Markets and the economy have both come a very long way in a short time. The year began with complacent expectations that 2020 would be another year of decent growth in GDP, corporate earnings and share prices. COVID-19 was thought to be a big problem for China but unlikely to produce a direct hit to North America and Europe.

Before February ended, the world had turned upside down: share prices had fallen massively, economies were shutting down and borders closing. Simultaneously, policy-makers undertook unbelievably huge monetary and fiscal stimulus efforts to head off a credit crunch and bridge finance the consumer and industrial economy.

By April, the number of new daily COVID-19 cases had peaked or was peaking and heading lower throughout the developed world. By May/June, the process of reopening many economies was under way.

Still a wildcard

Things are likely to go on changing quickly for some time yet. The virus itself could throw curveballs, any one of which might either reignite a surge in new cases or further stimulate the pace of economic recovery. Among the negative concerns:

- Reopening of regional economies might reverse the downward trend in infections and send the number of new cases sharply higher once again. To some extent, that appears to have happened in places like Florida and Arizona, although so far the number of new deaths has not followed suit. If this proves a big enough threat, then closures and/or restrictions could be re-imposed, a blow to already-tentative consumer and business confidence.

- On the science front, the eagerly awaited vaccine candidates already in trials might prove to be ineffective, dashing hopes for an early remedy. There are at least 135 vaccine candidates in development,

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of which seven are in Phase 1 trials, seven in Phase 2, and one in Phase 3. Phase 2 trials are where most vaccine candidates founder. By one estimate, there is only a 30% chance that a prospective vaccine that makes it to Stage 2 will go on to be an approved, effective therapy.

There are also possibilities for COVID-19 virus developments to deliver upside volatility:

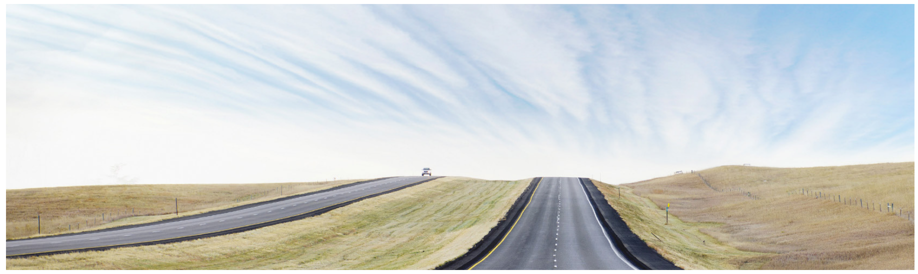
- A vaccine or anti-viral therapy shown to kill the virus, and/or confer immunity, would likely deliver a big boost to equity prices.
- The virus could weaken of its own accord. Health authorities first in Italy then more recently in New York City (both epicenters of huge outbreaks, since tamed) have recently reported that, in a matter of a few weeks, the virus in their locales has changed dramatically for the better. They report that many fewer infections require hospitalization, while a significantly smaller proportion of those hospitalized require ventilation or intensive care.

A big drop in the death rate could induce a meaningful decline in an individual's assessment of their personal health risk or the liability risk facing a business. This, in turn, would boost consumer and business confidence and open the door to further normalisation of conditions.

There are many, largely unpredictable, potential outcomes, directly and indirectly flowing from the course of the pandemic that could either make the stock market surge higher or lurch lower from here.

Beyond the crisis

In an environment where such volatility is clearly possible, maybe even widely expected, it makes it difficult for investors to focus on



long-term values. We think it's worth repeating a point we made back in April:

"The 'value' of the market [or of an individual business] is the present value of ***all future earnings***. Looked at that way, even big unexpected changes in the near-term earnings outlook shouldn't have a large impact on the market value of corporations. But they usually do because, for a while, investors come to believe that the performance of the economy and market today are pointing to an altered trajectory for economic and earnings growth in the future.

"Looking back at a century of pandemics, wars, nuclear disasters and more, that sort of conclusion has not been useful. Within a year or two the forces of global population growth and rising prosperity would reassert themselves and before that stock markets would go back to capitalising future earnings appropriately."

Arguably that is what has been happening since stock markets bottomed and turned higher in late March. Investors have stopped focusing on what appeared in March to be open-ended downside for the economy and the stock market, and have begun to value businesses on their prospects beyond the pandemic – when the trajectory of the economy and earnings is likely to be positive and not too dissimilar to what it was in the years leading up to this crisis.

Focusing solely on the crisis-driven downside at the bottom in March, while ignoring the compelling market values then available and the prospects for a return to economic growth post-crisis, was the wrong thing for a portfolio investor to do. By the same token today, ignoring the considerable scope for nearer-term volatility and disappointment, at a point when share values are much fuller and no longer mouthwateringly compelling, would seem to be repeating the same mistake in the opposite direction.

One foot in

In our view, the goal of a portfolio investor should be to own for as long as possible the high-quality businesses most likely to thrive and grow in the future, thereby allowing their usually high internal rates of return to compound on behalf of shareholders. At the same time, we think it's advisable to lean against risks that arise in the economic and business environment when they become higher than normal.

We would reconcile those behaviours today by being invested in equities but not "with both feet." We think a balanced portfolio should be somewhat shy of its long-term target exposure to equities. That will add to staying power if more downside volatility were to materialise in the fall, and leave a buying reserve should more attractive prices become available. The cost of this approach if markets were to go on appreciating would be the extra returns forgone on the buying reserve.

Planning for a possible increase to the capital gains inclusion rate

By RBC Wealth Management

Increased government spending has been essential in response to the COVID-19 pandemic. However, this may mean that governments will need to find a way to boost revenues. They can indirectly raise revenues by boosting economic activity, income, and wealth. They can also directly raise revenues by increasing tax rates, reducing tax breaks, expanding the tax base, improving tax enforcement and levying new taxes. Increasing the capital gain inclusion rate may be one tax change the Canadian government could consider in order to boost tax revenues. This has Canada speculating, again, if a hike to the capital gains inclusion rate may occur in the next federal budget.

If a change to the capital gain inclusion rate is announced in the upcoming budget, it is not known whether it would be effective immediately, be retroactive, or start at a future date. If you would like to plan for a potential increase in the inclusion rate, the following article details some planning items (not necessarily exhaustive) you may wish to consider along with your qualified tax advisor. It is important that you consult with your qualified tax advisor to assist you in assessing the costs and benefits of implementing any planning strategies.

History of the capital gains inclusion rate

The capital gains inclusion rate is the percentage that is applied to a capital gain you realize. The result, known as a taxable capital gain, is included as your taxable income. The taxable capital gain is subject to tax at your marginal tax rates. Since tax on capital gains was introduced in 1972, this inclusion rate has changed four times as shown below:

Time Period	Inclusion Rate
1972 to 1987	50%
1988 to 1989	66 $^2/_3$%
1990 to February 27, 2000	75%
February 28 to October 17, 2000	66 $^2/_3$%
After October 17, 2000	50%

Source: Federal legislation

Planning ideas

You and your qualified tax advisor may want to consider the following strategies (not necessarily exhaustive) assuming there is an increase to the capital gains inclusion rate for transactions on or after the budget date.

Consider the timing for rebalancing your portfolio

If in your regular review of your portfolio, you determine that a rebalancing is appropriate, and there are large unrealized capital gains, consider whether to implement the rebalancing before the federal budget date. Keep in mind that the trades would need to settle before the budget date. This way, any capital gains triggered from the rebalancing would be subject to the current 50% inclusion rate. Although this rebalancing may be appropriate from an investment standpoint, it does result in a pre-payment of tax (albeit at a potentially lower tax rate) and loss of tax deferral. Furthermore, triggering capital gains tax in 2020 may result in increased instalment payment reminders from the CRA.

If you have securities in a capital loss position, you may wish to defer rebalancing these securities until after the budget date to benefit from any potential increased inclusion rate.

Transfer appreciated securities to a spouse or common-law partner

If an unrealized capital gain has accrued in one spouse's name alone, a planning strategy to transfer the appreciated securities to the other spouse could be considered.

Let's assume a situation where you transfer appreciated securities to your spouse. Transfers between you and your spouse (where both legal and beneficial ownership are transferred) are generally not taxable for income tax purposes. The default option is that your spouse will receive the property at your ACB. However, you and your spouse have the option of electing to report the transfer at FMV. If the assets are in an accrued gain position and the election is made, you will need to report the capital gain on your income tax return. The deadline to file the election (there is no prescribed form) is the income tax return deadline for the taxation year in which the transfer occurred, generally April 30th. The ACB of the property for

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your spouse will be the FMV of the assets on the date of the transfer.

If there is a change in the inclusion rate introduced in the budget, you may be able to elect to trigger the unrealized gain and be subject to the 50% inclusion rate. If there is no change to the inclusion rate, you would not make an election and the security would transfer at cost.

As a general rule, when your spouse earns investment income (loss) and capital gains (losses) from the securities you transferred to them, the income or loss and capital gains or capital losses will attribute back to you. However, there will be no attribution on future investment income if you elect to report the transfer at FMV, trigger gains and also receive FMV consideration from your spouse. FMV consideration could be in the form of cash received from your spouse or even a loan receivable at the CRA prescribed interest rate.

Before implementing this strategy you should seek professional legal advice regarding the potential application of family law and whether this planning strategy would have any effect on your current estate plan. In addition, you should consult with your qualified tax advisor to determine the tax consequences for a potential transfer, including whether there are any U.S. gift tax or estate planning considerations.

Donate securities in-kind

If the above strategies are not appropriate or you are unable to trigger a capital gain before the capital gains inclusion rate increases, then you could consider the tax savings from charitable giving. To encourage individuals to increase their charitable giving, there is a tax incentive for those who donate publicly traded securities. These securities include shares, debt obligations or rights listed on a designated stock exchange, mutual funds, interests in related segregated funds and Government of Canada or provincial government bonds donated to charitable organizations, public or private foundations. The capital gains triggered upon the donation of these securities may be eliminated. As such, if you have appreciated securities that may be subject to a higher inclusion rate if sold, you may wish to consider donating these securities directly to charity instead.

Table 1 compares donating publicly traded shares directly to selling the shares and donating the cash proceeds for a resident in the province of Ontario who has taxable income over approximately $210,000 (indexed annually).

The table illustrates that if you donate the security directly to the charity, the after-tax cost of donation will be the same regardless of the capital gain inclusion rate.

Be sure to consult with your qualified tax advisor before making a gift of securities as charitable tax credits vary by province/territory. Further, before making a donation in-kind, contact the charity and verify that they can accept in-kind donations.

Takeaway

Given the current economic climate, Canadians are wondering what changes lie ahead. There are speculations as to what may or may not be included as tax changes in the upcoming federal budget, but as always, we will only know for certain on budget day. Speak with your qualified tax advisor to explore any opportunities or strategies that may mitigate effects of any potentially adverse tax changes to the capital gains inclusion rate.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.

Table 1

	Sell shares and donate cash		Donate shares directly	
	50% inclusion	75% inclusion	50% inclusion	75% inclusion
FMV of donation (a)	$50,000	$50,000	$50,000	$50,000
ACB	$10,000	$10,000	$10,000	$10,000
Capital gain	$40,000	$40,000	$40,000	$40,000
Taxable capital gain	$20,000	$30,000	$0	$0
Tax on capital gain @ 53.53% (b)	$10,706	$16,059	$0	$0
Tax savings from 50.41% donation tax credit (c)	$25,205	$25,205	$25,205	$25,205
Total cost of donation = (a) + (b) – (c)	$35,501	$40,854	$24,795	$24,795

Administrative corner

Introducing *eSign*

eSign is a digital signature solution that enables you to sign eligible documentation electronically through our approved, fully secure *eSign* application.

What are the benefits of using *eSign*?

Time Savings – *eSign* accelerates our ability to obtain your consent on eligible forms and documents;

Improved Experience – *eSign* is a seamless digitized experience; you no longer need to print, scan, or mail-in eligible forms and documents;

COVID Safe – using *eSign* means less mail handling for all parties involved.

For further information on how to use *eSign*, please contact one of our team members who can provide you with step-by-step instructions.

Introducing Aurelia Imbrogno

Aurelia, a member of the group since 1995, prides herself on the care, consideration and service she provides to clients. Her responsibilities bridge two mandates: wealth management and client service. Her extensive experience and superior analytical and communication skills are invaluable in creating and delivering the team's client service program. She also provides integral support to the group's Portfolio Managers in the day-to-day management of clients' portfolios and affairs.

When not in the office, Aurelia enjoys gardening, cooking and spending time with her family. Family traditions are very important – each fall all family members participate in making sauce from locally sourced tomatoes. If you should be so lucky, you may find a jar on your desk!

Benchmarks

RBC CM Canadian bond market indices 12-month trailing return (for month ending June 30, 2020)	
Short-term index	4.5%
Intermediate-term	8.1%
Three-month T-Bill (C$)	1.5%
Three-month T-Bill (U$)	1.6%

Equity market 12-month trailing return (for month ending June 30, 2020)	
S&P/TSX composite total return index	-2.2%
S&P 500 total return (C$)	11.5%
S&P 500 total return (U$)	7.5%
DJIA total return (C$)	3.1%
DJIA total return (U$)	-0.5%
Nasdaq composite price return (C$)	30.3%
Nasdaq composite price return (U$)	25.6%

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