Brown Wealth Management Team Newsletter

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Kimberly Brown B.Comm, CFP®, CIM®
Investment Advisor
Portfolio Manager
250-953-8458
kimberly.brown@nbc.ca

Sylvia Yzenbrandt
Wealth Associate
250 657-2214
sylvia.yzenbrandt@nbc.ca

Sima Sepahi
Associate
250-953-8413
sima.sepahi@nbc.ca

Nicholas Friesen
Associate
250 953-8423
nicholas.friesen@nbc.ca

Looking Beyond Today's Challenges

Both equity and fixed income markets have seen significant volatility throughout 2022. Coming into this year, it was expected that central banks would normalize their policies post-pandemic by gradually increasing interest rates from artificially low levels and reducing balance sheets. Yet, it was also expected that inflationary pressures would ease—and they largely haven't. We've been confronted with new headwinds, including the Ukraine war and the spring COVID lockdowns in China. This has led to a more aggressive response by central banks, which some have worried will lead us into recession. The changing expectations have been a key driver of the volatility.

While it may be difficult to look beyond today, this period of market volatility and economic uncertainty will eventually pass. As wealth advisors, we have managed through these cycles before and have helped our clients navigate challenging times. Here are some thoughts:

Consider the Bigger Picture – Over shorter time periods, market performance is often unpredictable. By zooming out, this perspective changes; history has shown that the longer-term trend of equity markets is upward. Over time, economies and many businesses have continued to grow, which manifests in earnings growth and improved returns for equity investors. We continue to advocate that investors view the markets in the context of multiple years or even decades—not weeks or months.

Stop Checking Portfolios – Paying attention to the markets, or portfolio values, won't give you more control or change their outcome. Over time, they will experience both gains and declines. If the latter is a cause for concern, consider avoiding the temptation to check portfolio performance. Leave the day-to-day worries to those of us who are here to manage your assets.

Don't Make Unnecessary Changes – During market pullbacks, some investors may feel inclined to sell investments for fear of a greater loss. However, this can create two issues: selling at low prices and the inevitable need to re-enter the markets. Market timing is difficult, if not impossible, perhaps one of the most convincing reasons being that the biggest up and down days have historically tended to cluster together. Selling low to buy higher is the exact opposite of the desired outcome in investing.

There May Be Opportunity Amid Uncertainty – Rising equity valuations throughout 2021 made it difficult to find quality securities at attractive prices. Valuations have fallen since the start of the year, which may bring opportunity for those who have funds sitting on the sidelines. Consider that, to start the year, renowned investor Warren Buffett has added the largest amount of assets to his portfolio since 2008.

Without a doubt, there are challenges ahead. We have entered a period of slower growth globally and continue to face many uncertainties. Rate increases, rising bond yields and more moderate equity valuations have been expected as we embark on normalizing the economy. Periods of volatility can be anticipated as the current challenges are resolved. However, as the year progresses, inflation is expected to moderate. Labour markets continue to be robust and household balance sheets suggest consumer resilience as consumption patterns have shifted to the services industry. At home, our strength in commodities has helped us to be more resilient to the challenges of today. Consider that in the first quarter, Canada's GDP grew by over three percent, whereas U.S. GDP declined.

We understand the challenges that come from an uncertain near-term outlook. During periods such as these, investors should try to stay focused on longer-term goals. Keep your eyes on the horizon, stay invested and look beyond today as better times will eventually prevail.

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Federal Budget 2022 Recap: Few Significant Changes for Investors

This past spring, the federal government delivered its budget with few significant changes for investors: no changes to the capital gains inclusion rate or federal income tax rates. Many initiatives address the hot housing market. Here are some highlights:

Tax-Free First Home Savings Account (FHSA)

The federal government proposed a new account to help Canadians save for their first home. Expected to begin in 2023, the account will have a lifetime contribution limit of $40,000, with an annual limit of $8,000. Contributions will be tax-deductible, similar to the RRSP, and withdrawals will be tax-free, similar to the Tax-Free Savings Account (TFSA). When the FHSA was originally proposed in the 2021 election campaign, it came with an age limit. This was removed in the most recent budget. If this change stands, an article in the popular press suggests that tax-planning opportunities may be available to older Canadians by using the FHSA as a savings tool.[1] Stay tuned for updates as the rules are finalized and details become clearer.

Multigenerational Home Renovation Tax Credit

This proposed refundable tax credit offers up to $7,500 by allowing qualifying families to claim 15 percent of up to $50,000 in eligible renovation and construction costs incurred to construct a secondary suite for a senior or adult with a disability.

Residential Property Flipping Rule

Under proposed rules, property sold that is held for less than 12 months would be considered "flipping" and any profits would be subject to full taxation as business income (with certain exceptions). Where the new rule applies, the Principal Residence Exemption would not be available.

Small Business Deduction

Under current rules, access to the small business deduction is reduced when a Canadian-controlled private corporation has taxable capital greater than $10 million, reducing to nil with taxable capital of $15 million or more. The budget proposes to change the formula such that the small business

deduction will not be reduced to nil until the corporation has taxable capital of $50 million.

Minimum Tax for High Earners

The federal government announced an intention to revisit the current Alternative Minimum Tax regime with a view to ensuring high-income earning Canadians pay a minimum level of tax. Further details are expected in the 2022 fall economic update.

At the time of writing, these proposals have not been enacted into law. For greater detail, please see the Government of Canada website: https://budget.gc.ca/2022/home-accueil-en.html.

1. "Three ways to make the most of the new tax-free savings account for home buyers," Erica Alini, The Globe and Mail, April 30, 2022, B15.

Luxury Vehicles: Prices Are Set to Increase

The federal government quietly released revised draft proposals in the spring to introduce a luxury tax on certain vehicles. As of September 2022, this luxury tax is set to apply to cars and aircraft with a retail sales price over $100,000 and boats over $250,000.

The tax will be based on the retail sales value of the good and is proposed to be calculated as the lesser of:

a. 20 percent of the retail sales price that exceeds the thresholds: $100,000 for cars/aircraft, $250,000 for boats; or

b. 10 percent of the full value of the luxury car, boat or aircraft.

For more information, see the Government of Canada website: www.canada.ca/en/department-finance/news/2022/03/government-releases-draft-legislative-proposals-to-implement-luxury-tax.html.

You Asked: Transferring Family Property to the Next Generation

With the arrival of summer comes cottage and cabin season once again! Many family properties have been owned over generations and there is often a desire to keep them in the family for decades to come. Yet, many children do not have the funds needed to buy the property.

In working with clients, we are often asked questions about cottage/cabin succession planning. One question that is commonly asked is: Can I sell the cottage to my kids for $1, or a value substantially lower than its fair market value (FMV)? This is often to try and avoid the capital gains tax. When a cottage is not considered a principal residence, capital gains tax will generally be due on the difference between the FMV and adjusted cost base (ACB) of the property.

However, selling less than FMV is likely to lead to significant tax consequences. The child's ACB will be determined by the actual price paid, which may lead to the child paying tax on a gain already realized by the parent when the child eventually sells the property.

Take, for example, a cottage that is sold for $1 to a child. If the FMV is $1 million and the ACB to the parent was $400,000, the taxable capital gain to the parent would be 50 percent of $600,000 (or $300,000). For the child, a purchase at $1 results in the child's ACB being $1, rather than the property's FMV.

So, if the property is sold in the future for $2 million, the capital gain would be the full $2 million less $1. This results in double taxation as it includes the parents' earlier capital gain, as well as the original amount paid for the property. Instead, there may be better options, such as gifting the cottage. Although there will be a substantial tax liability to the parent at the time of gifting, the child's ACB will be equal to the FMV at the time and double taxation will be avoided.

As always, consult with legal and tax advisors familiar with cottage succession planning to help you understand the options available.

Your Estate Plan: Are There Ways to Better Protect Family Harmony?

An estate plan should consider more than just how you distribute your assets. It can also include strategies for preserving family values and relationships. This may be important; it isn't uncommon for even the most harmonious of families to undergo bitter disputes when dealing with the distribution of assets of an estate. As such, the time you invest in planning has the potential to leave a lasting legacy of family harmony. Here are some thoughts:

1. **Keep documents updated** — Consider reviewing your estate plan periodically to ensure it reflects your current thinking and to avoid future conflict. If you have a Will in place, how old is it? Perhaps this may be a good time for a thorough review of your estate planning documents, especially if circumstances have changed. Equally important: reviewing your designated beneficiaries, where applicable. Many investors fail to revisit these designations to account for major life changes, such as marriage, divorce or the birth of a child.

2. **Rely on professional support** — Improper documentation or vague instruction can lead to misunderstanding, conflict and even escalate to a costly court battle. While you are able to create estate planning documents on your own, such as by using an online Will service, even if the document is valid, do you fully understand the family and succession laws of your province, or income tax and investment rules? These can change over time and should be evaluated against your estate plan. With the rise in blended families, balancing competing interests from children, stepchildren and a new spouse may be challenging. The support of estate planning professionals can help ensure assets are distributed as intended.

3. **Communicate** — Sharing your intentions with beneficiaries can help manage expectations and prevent future conflict. While the topic of death is not always easily broached, consider communicating with loved ones while you are alive about your estate. In-depth details do not have to be provided, but high-level conversations can be beneficial to avoid future surprises. These conversations can also help you understand the wishes of loved ones for when you are gone, including for items of sentimental value, which can commonly become the centre of conflict.

4. **Understand the implications of joint ownership with children** — Joint ownership* is sometimes used to simplify the transfer of assets on death. In certain jurisdictions, it is used to minimize probate fees. Yet, it has the potential to lead to complications, often relating to estate equalization. It is a common cause of stressful lawsuits that will easily surpass the cost of probate—perhaps the exact situation you were trying to avoid in the first place! There may also be unintended consequences, such as tax implications or exposing assets to potential creditors.

5. **Consider the support of a professional executor** — It may be money well spent to consider a corporate executor. This can help to preserve impartiality if you have children you were considering appointing as executor. More important, it can help take the burden off of loved ones during what is often an emotionally difficult time.

Please seek the support of estate planning specialists for your situation.

*Not applicable in the province of Quebec.

Perspectives for Volatile Times: Reasons to Stay Invested

During periods of significant volatility, it may feel difficult to be invested in the equity markets. However, without risk there would be no returns, and equities continue to be one of the greatest generators of wealth of all asset classes. Maintaining discipline and patience throughout volatile times and staying invested is important.

Volatility is a reminder that portfolio growth does not occur at a steady rate. Yet, time reduces the volatility of returns. As history has shown, negative market performance smooths out as an investor's time horizon increases. Over the past 30 years, the likelihood of the S&P/TSX Composite Total Return Index experiencing a negative monthly return is 38 percent. This drops to 13 percent over a three-year rolling holding period, and 0 percent over seven-year rolling holding periods and beyond (chart 1).

Time in the markets also allows investors to participate in the best performing periods in the markets, which, as discussed in our cover story, can often cluster around the worst market declines. Missing these periods can be costly. The chart shows the impact of missing the best performing months of the S&P/TSX Composite Total Return Index over a 30-year period. By staying invested, a notional investment of $1,000 would have grown to $12,693. By missing the five best months, this would fall to $7,503 (chart 2).

These are just two reasons to continue to keep perspective and stay invested during volatile times.

Chart 1: S&P/TSX Composite Index % of Negative Returns Since 1991

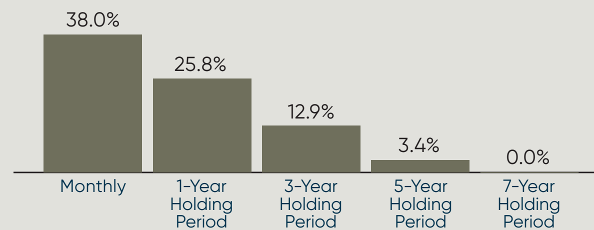
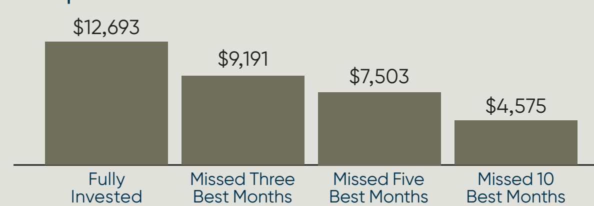


Chart 2: Return of $1,000 Invested in S&P/TSX Composite Since 1991



Source: S&P/TSX Composite Total Return Index from 12/31/91 to 12/31/21.

Estate Planning: Will You Join the Top One Percent of Taxpayers?

When we reach retirement, it is common for many individuals to have a marginal tax rate that is lower than during their prime working years. However, at death, this may change substantially. This is because our property is deemed to have been disposed of at fair market value at death and subject to taxation. In some cases, individuals will join the top one percent of taxpayers as the estate will be subject to a high marginal tax rate.

For couples, the taxes that are incurred on death may be deferred by using the spousal rollover, i.e., the transfer of certain registered funds (such as the Registered Retirement Savings Plan (RRSP) and Registered Retirement Income Fund (RRIF)) and/or capital property to the spouse (common-law partner) upon the death of the other. With this transfer, there will be no immediate tax consequences to the surviving spouse. However, once the surviving spouse passes away, the transfer of these assets may result in the estate being subject to the highest marginal tax rate, potentially leaving a tax bill that may significantly reduce the value of an estate.

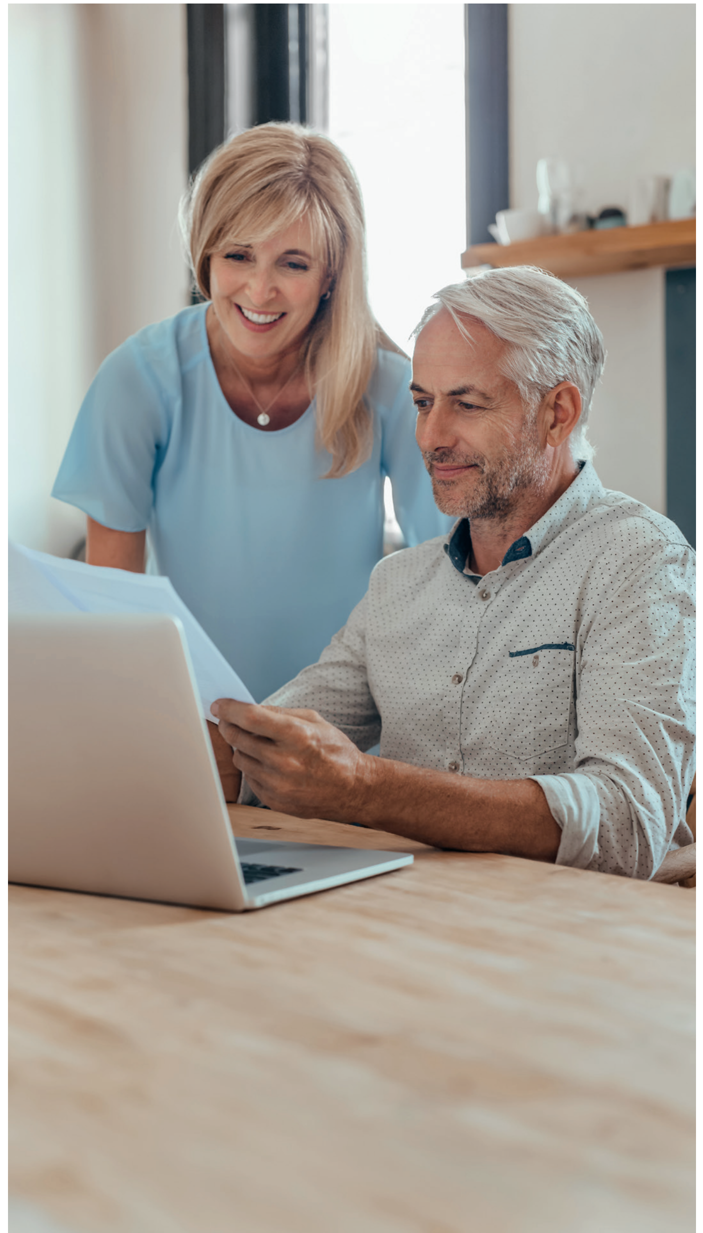
As many of us wish to pass along as much of our hard-earned wealth to our beneficiaries, are there ways to better plan for the eventual tax liability?

Here are three considerations that may require forward planning:

1. **The RRSP exit strategy.** While postponing withdrawals from the RRSP until retirement by using the RRIF takes advantage of the tax-deferral opportunities, waiting too long to draw down significant savings may have consequences. If you have other taxable income streams in retirement, you may be pushed into a higher marginal tax bracket. This may also result in a clawback of OAS benefits. As you approach retirement, and if you are in a lower marginal tax bracket, it may make sense to slowly draw down RRSP/RRIF funds. If you aren't in need of these funds, a potential opportunity may be to use these withdrawals to fund a Tax-Free Savings Account to benefit from the future growth opportunity of the investments, as well as their eventual tax-free withdrawal.

2. **Converting a portion of the RRSP to fund insurance.** Often, for high-net-worth investors who have contributed significantly to their RRSPs over their working years, there will still be funds available within the RRIF accounts at death. A partial drawdown to fund insurance can help to minimize the overall lifetime tax bill, especially when withdrawals occur in years in which the marginal tax rate is not at its highest. Funding a life insurance policy may be a way to provide an inheritance on a tax-free basis to the beneficiary(ies). Joint last-to-die life insurance is commonly used for this purpose by spouses, as insurance proceeds are paid out only upon the death of the surviving spouse.

3. **Electing to not use the spousal rollover.** There may be reasons to elect out of a spousal rollover for certain assets upon the death of the first spouse when there are opportunities to offset the potential tax liability. This can be done on a property-by-property basis. One common reason may be to use the deceased taxpayer's lifetime capital gains exemption (LCGE). It may also make sense when the deceased's marginal tax rate is low on the date-of-death return. Finally, the first spouse may have unused capital losses carried forward that can be used to offset the resulting capital gains. A tax professional can help explore the options.



Seek Assistance

These are just some of the potential tax-planning opportunities to consider as you plan ahead. Please seek the advice of a tax planning professional as it relates to your particular situation.

During Volatile Times: The Case for Goal-Based Investing

Goal-based investing differs from traditional investing programs that generally allocate assets and measure progress based on market benchmarks. Instead, it focuses on the investor by mapping savings and investments to unique goals, which may involve specific time horizons and risk profiles, while measuring progress towards achieving these goals.

With goal-based investing, there is a dedicated focus on the investor to create a wealth plan that meets their needs and works towards achieving their unique goals. It takes into account a detailed understanding of an individual's personal liabilities, as well as their stated objectives over their lifetime: What do you currently owe and how will this change in the future? What do you wish to accomplish? When do you want to retire and what type of lifestyle do you envision in retirement? It also helps to plan for the many milestones that will come along the way: Do you wish to save for and support a (grand)child's education? Are you planning on any large purchases, such as a car, home or vacation property?

A Focus on the Investor... Not Day-to-Day Market Performance

Goal-based investing shifts the focus away from the markets and back to the individual investor. For those who use this approach, the objective is not to generate superior returns or beat an index over the short term, but instead to manage investments to achieve measurable goals over the longer term. This doesn't mean directing all emphasis away from market or investment performance, but it does help individuals to look beyond what may be happening in the markets in the short term and instead consider a broader view over multiple time horizons.

It can also help to instill discipline and foster better investment decision making. For many investors, the biases that can influence poor investment decision-making more commonly emerge during periods of market uncertainty, such as during market pullbacks. With goal-based investing, investment decisions are instead focused on achieving certain goals alongside the individual's personal risk profile, rather than comparing performance to the markets at any particular time.

A goal-based approach also requires a deep understanding of the investor, which can help to foster better relationships between advisors and investors. As the investor, you are in the driver's seat and will be actively involved in the decision-making process, with your investment strategy aligned to your life goals. Over time, your progress will be carefully followed to help ensure that you are on track to achieve your set goals. There is no blanket strategy; the approach is tailored to your own personal roadmap. Your life goals are unique to you and your wealth strategy should take this into account.

Ultimately, the purpose of having a goal-based investing approach is to help individuals attain better outcomes for their financial independence. With clearly defined goals from the onset, you can track your wealth plan throughout time with a focus on meeting your life objectives.

We Are Here to Assist

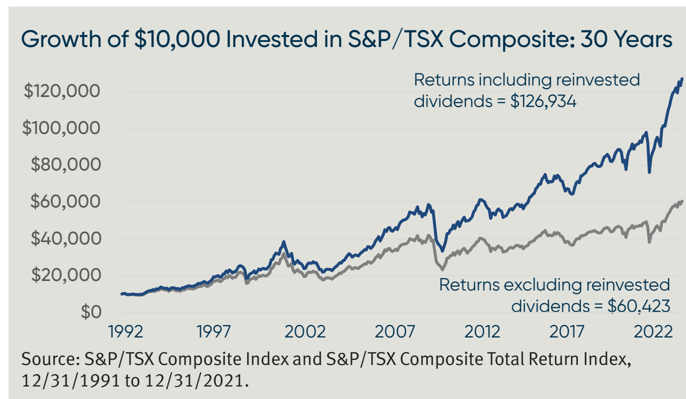
Portfolio construction and management should begin with the individual investor in mind. A goal-based investing program focuses on the investor first, helping to create a plan to achieve specific goals. If you have questions about this approach, or your own investing program, please get in touch.

1. worldpopulationreview.com/countries/countries-by-gdp; www.worldometers.info; 2. www.newswire.ca/news-releases/canada-is-the-no-1-country-in-the-world-according-to-the-2021-best-countries-report-867033906.html; 3. www150.statcan.gc.ca/n1/daily-quotidien/211101/dq211101a-eng.htm; www.statista.com/statistics/748223/leading-countries-based-on-natural-resource-value/; 4. www.bloomberg.com/news/articles/2022-04-29/canada-extends-growth-streak-as-first-quarter-tops-expectations; 5. www.cbc.ca/news/politics/census-2021-release-population-cities-1.6344179

During Volatile Times: The Continuing Case for Dividends

The long-term case for dividend-paying equities continues to be compelling. During volatile markets, such as the one we are experiencing today, dividends can play a role in reducing overall portfolio risk and volatility. Over the longer-term, increasing dividend payouts and the potential for compounded growth can make dividends an integral part of an investment portfolio. Here are some reasons to have confidence in the value of dividend-paying securities within your wealth management strategy:

An integral component of long-term returns. Dividend-paying companies represent a significant part of long-term returns within the equity market. Over a period of 30 years from 1992 to 2022, the compounding effect of dividends on the S&P/TSX Composite Index has been profound — with reinvested dividends providing around half of total returns. On this basis, a notional investment of $10,000 would have yielded around $60,423 today on the index alone, but around $126,934 if dividends were reinvested as based on the S&P/TSX Composite Total Return Index (chart below).[1]



Source: S&P/TSX Composite Index and S&P/TSX Composite Total Return Index, 12/31/1991 to 12/31/2021.

A potential source of cash flow that can be used for income or reinvested. In today's economic landscape of lower interest rates, slowing growth and a growing number of retiring baby boomers, finding income may be more challenging. Dividends can help to provide a steady stream of income to an investor or enhance income from other sources.

Historically have provided greater protection in bear markets. Companies that consistently pay dividends year after year are generally seen as having robust economic health because they have excess cash with which to pay shareholders. Unhealthy companies generally do not have the position to provide dividends to shareholders. The dividend yield of a stock can provide a degree of downside protection as it reduces the potential impact of a decline in share price during economic downturns. Studies have also shown that dividend-paying stocks are a useful buffer when investors experience high degrees of volatility.[2]

A tax-efficient means of investing. Remember that not all income sources are treated equally by the tax authorities. Eligible dividends are one of the lowest taxed sources of investment income in Canada, as compared to interest and regular income. This is due to the non-refundable tax credit applied to most "eligible dividends," generally dividends issued by Canadian companies. Consider that for each dollar of dividend income received, an Ontario resident taxed at the highest marginal tax rate would keep about 14 cents more on every dollar of fully taxable income, which isn't insignificant by any measure. (This assumes a 53.53 percent marginal tax rate and a 39.34 percent effective tax rate for eligible dividends.)

Potential for dividend growth. Don't overlook the potential impact of dividend growth. Well-established dividend-paying companies can typically increase their dividend payouts from year to year. As we have seen this year, despite the turbulent markets, a variety of Canadian financial and energy companies have announced dividend increases.

In short, we continue to advocate the benefits of quality dividend-paying stocks as part of your wealth management plan.

Sources: 1. S&P/TSX Composite Index and TR Index, 12/31/91 to 12/31/21; 2. Franklin Templeton Investments, "The Case for Dividend-Paying Equities in Today's Market".

Kimberly Brown B.Comm, CFP®, CIM®
Investment Advisor
Portfolio Manager
250-953-8458
kimberly.brown@nbc.ca

Sylvia Yzenbrandt
Wealth Associate
250 657-2214
sylvia.yzenbrandt@nbc.ca

Sima Sepahi
Associate
250-953-8413
sima.sepahi@nbc.ca

Nicholas Friesen
Associate
250 953-8423
nicholas.friesen@nbc.ca

www.kimbrown.ca

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National Bank Financial
700-737 Yates Street
Victoria BC V8W 1L6
Phone: 250-953-8400
Toll Free: 1-800-799-1175

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