Newsletter

Summer 2023

In this edition

Winning the Longevity Lottery

"Plan on Living Past Your Life Expectancy" — this is the headline of a recent article in the popular press that suggests many of us will live longer than we expect.[1] In fact, many of us systematically understate our chances of living to age 75 by 10 percentage points or more.[2] Yet, according to longevity researchers, those of us alive today have won a longevity lottery. We have been handed an extra 30 years of life compared to just 100 years ago.

In 1921, the average life expectancy was 57 years; today it is around 84. Reaching the esteemed 100-year milestone is no longer a rarity. As many as half of those born today can expect to become centenarians. The good news is that we are living longer and healthier lives. The not-so-good news is that some may realize too late that they have claimed government benefits too early, passed up the opportunity to buy insurance or annuities or have simply undersaved for these additional years.

What is the possibility that your life might last much longer than you believe — will it change your perspectives on the present moment? Of course, this means a whole new set of issues — notably, those relating to our wealth planning to ensure a good quality of life over an extended period. As advisors, we make retirement planning and beyond a key focus in the wealth planning process. Whatever your plans, you should have the necessary financial means to enable you to make choices freely.

Some will not have that choice. With the increasing cost of living, coupled with greater longevity, some retirees will need to consider work in some form. A recent survey suggests that over two-thirds of those who retired during the pandemic have considered returning to work, with more than half citing financial need as their main motivation. We may be on the verge of what has been referred to as the "Great Unretirement."[3] Yet, there may be a "silver" lining. The growing population of contributing seniors may spur a demographic dividend, accelerating growth per capita, driving economic expansion and enhancing social development. This "longevity economy," in which the anticipated economic contributions from older adults will be higher, is expected to benefit everyone. Yet, it's not just those who need to work to support themselves. Others are challenging the traditional notion of retirement: No longer is it a time for rest, and some will choose to reinvest themselves in different roles to share their wisdom or to enjoy income-generating hobbies.

What about you? What is your vision for retirement and beyond? Regardless of your aspirations, make sure to give your wealth plan the attention it deserves today. Even small contributions can build wealth down the road. Consider that an extra $250 per month invested at a rate of return of 6 percent would yield over $250,000 in 30 years — not an insignificant amount, by any means, for those "extra" three decades we've been granted. By recognizing the current opportunities, even in more challenging times, and committing to them, investors can share in the growth that lies ahead to make that vision a reality. Continue to invest and plan for tomorrow to build your flexibility. And, above all, continue to look forward with confidence.

1. "Plan on Living Past Your Life Expectancy," Josh Zumbrun, Wall Street Journal, Feb. 11, 2023
2. www.wsj.com/articles/death-finances-and-how-many-of-us-get-our-money-needs-wrong-51a660a2
3. https://weforum.org/agenda/2022/10/great-unretirement-older-people-working-longer/

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The Principal Residence Exemption: Your Questions Answered

Summer is often one of the busiest seasons for residential home sales. With many investors owning multiple properties, thinking ahead to their eventual disposition may be worthwhile.

As a reminder, when you sell your home and a capital gain is realized,* the resulting tax may be eliminated/reduced if the property is designated as a "principal residence" by claiming the Principal Residence Exemption (PRE). As of 2016, you must report the sale of a principal residence on your income tax return and claim the PRE. If you own multiple properties and sell one, you will need to decide which one to designate as the principal residence for each of the years it was owned: only one can be named each year.[1] Generally, you should consider designating the property with the largest average capital gain per year to reduce the overall tax liability. Yet, the decision is rarely straightforward and may involve multiple factors, such as predictions about the future value of the remaining residence(s).

Here are six common questions relating to the PRE:

1. **To qualify, do I have to live in the unit most of the time?** A principal residence generally refers to a housing unit that is "ordinarily inhabited." This doesn't mean that the taxpayer needs to live there the majority of the time. The property may qualify if the taxpayer or member of the family unit lived in it at some point during the year.
2. **Can a cottage/cabin qualify?** Yes, seasonal residences, even those outside of Canada, may be designated as a "principal residence."
3. **What if I forget to report the sale on my income tax return?** The Canada Revenue Agency (CRA) may charge a late-filing penalty of $100 per month, up to a maximum of $8,000. As well, the PRE may be denied at a further date.
4. **Can I use my property for rental/business income?** If a property is predominantly used to produce income, it will not be eligible for the PRE. If part of a principal residence is used for rental/business purposes, you may be able to claim the PRE for the portion used as a residence. If you change the use of a property, if it was a principal residence prior to the change, the PRE may be claimed for those years. Note: a "change in use" may result in additional tax implications.[2]
5. **What if I leave Canada for extended periods?** If you weren't a resident of Canada for the entire time you owned a designated property, the period of non-residence may reduce/eliminate the PRE.
6. **What if I move into a care home?** The PRE is only available if the unit is ordinarily inhabited, so a property may not qualify during the time an owner lived in a seniors' facility. As you plan ahead to use the PRE, one option may be to have an adult child occupy the home during this time.

*Or a deemed sale for tax purposes
1. Per family unit. For years before 1982, each spouse can designate a different property
2. www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-income/line-12700-capital-gains/principal-residence-other-real-estate/changes-use.html

A Reminder: The TFSA is a Valuable Tool For Every Stage of Life

By now, you have likely received your CRA Notice of Assessment for your 2022 taxes. Do you have available TFSA contribution room? Many of us are not fully maximizing tax-advantaged accounts — even the wealthiest Canadians are overlooking the opportunity. At last count, only 30 percent of taxpayers earning $250,000 or more had fully contributed.[1] Beyond the significance of growing funds on a tax-free basis, here are some reminders of how the TFSA can be a valuable tool:

Transferring Wealth While Alive — The TFSA may help to gradually transfer wealth to beneficiaries while you are alive. Gifted funds can be used by adult children to contribute to their own TFSA to grow over time, keeping in mind the loss of control of funds. This can also simplify an estate and potentially minimize taxes upon death.

Approaching Retirement: RRSP/RRIF Meltdown Strategy — There may be benefit in gradually drawing down RRSP/RRIF funds as you approach retirement. One significant reason is if you are in a lower tax bracket than you will be in the future. A strategy may be to use RRSP/RRIF withdrawals to fund TFSA contributions. As the TFSA grows, this tax-free income can augment or replace RRIF withdrawals later. At death, these funds can pass entirely to heirs; residual RRSP/RRIF income could potentially be subject to the highest marginal tax rates.

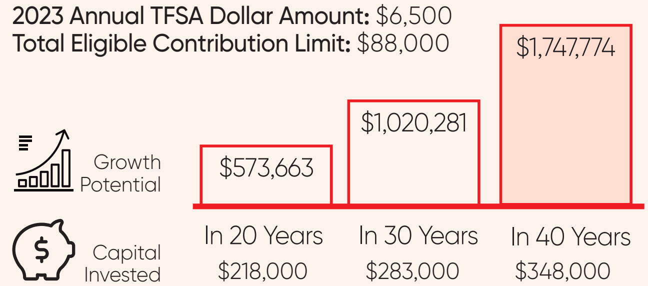
Funding Retirement — The TFSA can help optimize retirement income and cash-flow streams. TFSA withdrawals are not taxable and won't affect income-tested benefits such as Old Age Security. A TFSA may also help with tax planning. For example, if generating RRIF income will put you in a higher marginal tax bracket, you may be able to minimize tax by withdrawing only the required RRIF amount and using TFSA withdrawals to supplement income. On the other hand, if your marginal tax rate is lower than you expect in the future or at death, funds in excess of the RRIF minimum requirement can be withdrawn and put into a TFSA where they can continue to grow. This can reduce an overall lifetime tax bill. The TFSA can also supplement cash flow if a retiree chooses to defer Canada Pension Plan benefits.

Your Estate — The TFSA can be an excellent way to pass along assets on a tax-free basis. Consider the way you have designated beneficiaries: a named "beneficiary" will receive proceeds upon death tax free. However, if a spouse/partner is named as "successor holder," they can continue operating the account "as is" going forward. Please contact the office if you require an update to beneficiary designations.

The bottom line? Ensure you have fully contributed to your TFSA!

The Extra $1.7 Million: Don't Overlook the Opportunity

2023 Annual TFSA Dollar Amount: $6,500
Total Eligible Contribution Limit: $88,000



This assumes full contributions since 2009 and ongoing $6,500 annual contributions compounded at a rate of 5 percent annually.

1. https://www.canada.ca/content/dam/cra-arc/prog-policy/stats/tfsa-celi/2019/table1c-en.pdf

The FHSA: The High-Net-Worth (HNW) Investor Opportunity

Beyond its benefits in supporting the purchase of a first home, the First Home Savings Account (FHSA) offers a compelling opportunity for investors to transfer wealth to the next generation or potentially increase their retirement nest egg — but planning ahead is important.

What is the FHSA? The FHSA is a tax-advantaged registered account intended for the purchase of a first home. Eligible Canadian residents ages 18 or older who are first-time home buyers can contribute up to $8,000 per year, to a lifetime maximum of $40,000, and grow these funds. Contributions are tax deductible, similar to the Registered Retirement Savings Plan (RRSP), and withdrawals are tax free, similar to the Tax-Free Savings Account (TFSA), if used for the purchase of a first home. The FHSA must generally be closed after 15 years or the year after the first qualifying withdrawal is made or the holder reaches age 71.

The High-Net-Worth Investor Opportunity: Beyond the prospect of supporting young folks to purchase a first home, the FHSA may also provide opportunities for HNW investors:

- A potential intergenerational wealth transfer tool;
- For those who haven't owned a home over the past four years, a potential tax-advantaged way to supplement retirement savings.

Many parents and grandparents choose to gift funds to future generations to help cover large expenses such as an education or a first home purchase. Some HNW investors support a child's education through the RESP but stop contributions around age 17 when the Canada Education Savings Grants cease. The opportunity to then gift funds to a child to contribute to their own FHSA, which can begin at age 18, may be compelling (keeping in mind the loss of control with gifted funds). If the FHSA was opened at age 18, it would need to be closed in the calendar year after the child turns 33. By some accounts, this is the average age of a first-time home buyer.[1]

For HNW renters, the FHSA provides an opportunity for tax-deductible contributions and tax-deferred growth. While the account would need to be closed by age 71 (if the 15-year limit isn't reached), the holder could transfer any amounts to their RRSP/RRIF without affecting any existing contribution room.

The Importance of Planning Ahead: Since the FHSA can remain active for a maximum of 15 years once it is opened, here are some ways to potentially maximize the growth opportunity:

- **Start early** — If the holder intends to purchase a first home, keep in mind that the FHSA must be closed in the year after making the first qualifying withdrawal, so the account's life may be shortened. As such, helping a child to open it closer to age 18 may be beneficial to allow for compounded growth over the longest period possible.
- **Maximize contributions from the onset** — Consider making full contributions at the start of each year to maximize the growth potential. Although unused portions of the annual contribution limit carry forward, the carryforward is limited to $8,000 each year.
- **Consider the way that funds are invested** — The FHSA offers a substantial tax-advantaged opportunity to grow funds. As such, we believe that investing funds in quality securities has the potential to provide meaningful growth and return potential.

The Compelling Outcome: By maximizing contributions from the onset, assuming a five percent annual rate of return, the account could grow to over $75,000 by the end of 15 years, and this doesn't include the tax benefit from the initial contributions!

- **A substantial down payment** — If both first-time buyers, a couple could each access the FHSA alongside the Home Buyers' Plan (HBP). The HBP allows first-time buyers to withdraw up to $35,000 from the RRSP, subject to repayment in 15 years and other conditions. Together, this could provide a substantial down payment — using the example above, over $220,000.
- **Increase retirement savings** — If the holder decides not to purchase a home, the FHSA can be transferred to the holder's RRSP/RRIF without affecting the available contribution room.
- **Defer the tax benefit** — Generally, contribution amounts not claimed as a deduction on an income tax return in the year made can be claimed in a future year — even beyond the FHSA's closure! If saved for future years, this may provide a substantial tax benefit when the holder's marginal tax rate may be significantly higher.

To learn more about the FHSA, please call the office.

1. cdn.nar.realtor/sites/default/files/documents/2021-highlights-from-the-profile-of-home-buyers-and-sellers-11-11-2021.pdf

Are We Nearing the End of the Rate Cycle?

Talk of interest rate increases has seemed unending: we are living through one of the most aggressive tightening cycles in 40 years. Back in May, the U.S. Federal Reserve raised rates for the 10th consecutive time in its pursuit to bring down inflation. In less than 14 months, the federal funds rate has risen by a total of 5 percentage points (500 bps) to 5.25 percent from where it stood at 0.25 percent in March 2022. The Bank of Canada has similarly increased interest rates, raising the overnight rate by 0.25 percent to 4.75 percent at the start of June. (*At the time of writing. Note: this newsletter was written before the Fed's June 14 rate announcement*.)

However, in its latest rate announcement, the Fed indicated it would be "determining the extent to which additional policy firming may be appropriate." This prompted the question: Are we nearing the end of the rate cycle?

Until recently, the effects of the rapid rate hikes have appeared relatively benign. One market strategist suggested that if you were to tell investors two years ago that we would be entering one of the most aggressive rate increase cycles in history, alongside inflation that would reach 9 percent in the U.S. (and 8 percent in Canada), you would think that there would be greater effects on the stock market.[1] In fact, in May 2023, both the S&P 500 and the S&P/TSX Composite hovered around similar levels to those of May 2021.

Glass Half-Empty or Half-Full: Are We Headed to Recession?

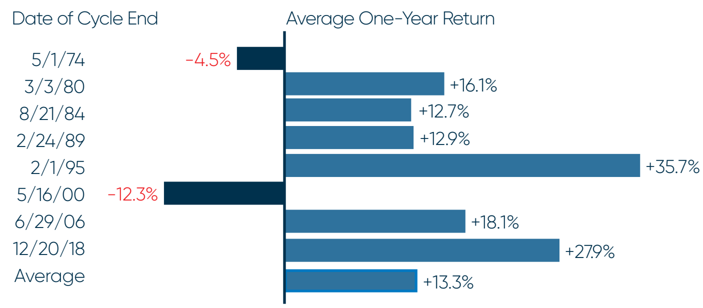
The regional banking sector fallout in the U.S. in the spring was a reminder that there were likely to be follow-on effects from the unprecedented speed and magnitude of the hikes. After all, these actions were intended to slow the economy. As part of the normal course in every business cycle, some businesses will collapse, making room for others to grow. Yet, it is somewhat confounding that unemployment levels remain at lows and consumer spending has been relatively strong. Despite the expectation for slower growth, the latest earnings season has been positive. For many months, market pundits have suggested an imminent recession, but these factors may suggest otherwise.

Equity Markets: What Happens at the End of the Rate Cycle?

If we are nearing the end of the cycle, if history is any indicator, it may be good news for the equity markets. A look back at past tightening cycles shows that equity markets have historically performed well in the year after the final rate increase. Similarly, analyses show that the markets have rallied in the months after a pause.[2]

Chart: What Happens to Equity Markets After the Last Rate Hike?

S&P 500 Average Return One Year After the Final Rate Hike in the Fed Tightening Cycle



However, in the near term, a resilient labour market and more sticky inflation, recently driven by service sector growth and housing costs, could contribute to keeping interest rates elevated — all of which are carefully being watched and likely to influence future rate decisions.

Of course, from our perspective as we manage assets for the long term, the challenge for investors is ignoring the day-to-day noise and continuing to position assets for when we will eventually need to access our capital — sometimes a decade or two into the future, or more, depending on your timeline. For many investors, longer-term returns are the only ones that matter. Though we may all appreciate some respite from the volatility of the past two years, consider also that buying when prices are lower is one of the best ways to improve longer-term results. Keep perspective and continue looking forward.

1. https://ritholtz.com/2023/05/half-empty/
   For historical rate hike cycles, please refer to: https://www.cnbc.com/2015/09/15/when-the-fed-raises-rates-heres-what-happens.html
2. https://ritholtz.com/2023/05/10-wednesday-am-reads-330/
   https://www.bloomberg.com/news/articles/2023-05-06/wall-street-is-in-no-mood-to-celebrate-the-fed-s-last-rate-hike

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