Spring 2017

Investment management

Highlights

- Global economic growth has continued to accelerate, while broadening out to Europe and Asia.
- Central banks are taking steps aimed at normalizing monetary policy, while keeping settings supportive for growth.
- Geopolitical uncertainty continues to rise amidst a trend of de-globalization.
- Equity valuations remain attractive versus fundamentals. Canada and international markets look increasingly attractive.
- Bonds will likely consolidate in Q2/17 following a sharp spike in Q4/16. Yields are likely to push higher as the FED sticks to its plans to hike two more time this year and probably reduce the size of its balance sheet.
- Commodities may see a pullback in Q2, based on a perceived delay in implementing President Trump's policy agenda and uncertainty about OPEC's output cut extension.
- The USD will likely see a short period of consolidation before resuming its upward trend if investors regain optimism over President Trump's pro-growth policies. The Euro and GBP will move in response to geo-political developments, while EM currencies may further strengthen as Emerging Market (EM) economies continue to recover.
- We're off to a strong start in 2017. Our portfolios are back ahead of benchmark and we are leaving our overweight equities/underweight fixed income asset mixes in place.

The global economic backdrop has continued to improve in recent months and rising consumer/business confidence, while still supporting fiscal and monetary policy settings, should maintain positive economic momentum. One of the biggest drags on overall economic growth continues to be the lack of business investment spending. Given a brightening economic outlook and signs of diminishing slack, central banks globally have begun to scale back ultra-easy monetary policy settings. The FED has raised its policy rate three times so far this cycle, and has signalled another two rate hikes this year, as well as have taken steps to begin a reduction in its balance sheet. While the outlook for growth appears on firm footing, geo-political tensions appear elevated- populism, trade tensions, and conflict flashpoints (i.e. Middle East, North Korea) are on the rise, while a general trend toward de-globalization is emerging.

We are remaining bullish on global equities over the coming year amidst an improving economic backdrop and rebounding profit growth; providing a constructive environment for equities as recession risks, for the year ahead, remain muted. We believe Canadian and International equity markets are increasingly attractive versus the U. S. based on- valuation, economic momentum, and easy monetary policy. Global infrastructure continues to be a longer-term strategic theme. Bond yields steadily climbed into year-end 2016, bolstered in large part by improving global economic growth data and the election of Donald Trump. However, since late last year, 10-year yields have traded in a wide range, as President Trump's pro-growth policies run into resistance. The Republican failure to pass a healthcare bill in late March has created uncertainty around the size and timing of tax reform and infrastructure spending. This has resulted in recent profit taking in equities and bolstering demand for fixed income. The FED's intent to raise its policy rate should have the effect of raising interest rates and a steepening of the yield curve. The European Central Bank's (ECB) quantitative easing (QE) tapering has now begun and may end outright by the end of this year. A rate hike in Canada is not foreseen this year; however, yields may get dragged higher by rising U. S. yields over the coming year. Our longer-term view remains that yields should continue to trend higher over the coming year. Within fixed-income, we continue to favour corporate bonds over government bonds.

With the Republican's failure to pass a healthcare bill in March, doubts are emerging over President Trump's fiscal stimulus agenda, putting downward pressure on commodity prices. Industrial metals are underperforming, while precious metals are outperforming on increased geo-political risk. Oil prices are likely to remain volatile as U. S. shale producers continue to ramp up production. There is no clear sign on whether OPEC will extend its output cut plans. The current round of production cuts end in June.

With investors having established large long positions in the USD since Donald Trump's win last November, it's not surprising to see them take profits. However, this round of consolidation may only be a short episode, conditional on President Trump's implementation of his pro-growth campaign promises. Oil prices and interest rate differentials between the U. S. and Canada will play a large role in the relative value of the CAD and USD. The possibility of a U. S. border tax is a risk to the Canadian dollar and Canadian companies. The Euro and GBP will likely move in response to geo-political developments, including the upcoming French Presidential election and Brexit.

While performance fell behind benchmark in the first half of 2016 as we failed to participate in the speculative bid in commodity (energy) prices and Canadian dollar, our investment management process is rewarding us with strong performance to start 2017 and we're back ahead of benchmark. We continue to be active in taking profits, managing risk, and searching for value. Our new momentum screen is helping us ride our winners longer, while our stop-losses are helping to minimize losses. If you have any questions about our investment management process, don't hesitate to ask. We'll be staring up our Friday Morning Coffee sessions again next month, and invitations will be going out shortly.

Gordon Bell
Portfolio Manager

U.S. Tax Exposure From Owning U.S. Rental Properties

Wealth Management Taxation, The Bank of Nova Scotia

Often, Canadian "snowbirds" purchase real estate in the United States ("U.S."), and rent it out in order to earn rental income. When a Canadian resident (regardless of U.S. citizenship) owns a U.S. rental property, there are U.S. tax implications from earning rental income, as well as exposure to U.S. estate tax when the Canadian passes away. This article outlines the U.S. tax implications with regards to a U.S. rental property owned by a Canadian resident.

Tax implications — rental income

A Canadian resident with a U.S. rental property will be subject to income taxes on the rental income in both the U.S. and Canada. Fortunately, Canada allows a foreign tax credit ("FTC") for the U.S. taxes paid in relation to the income that is also taxable in Canada. The FTC alleviates the problem of double-taxation. A Canadian resident is required to remit withholding taxes on the rental income earned from a U.S. property to the Internal Revenue Service ("IRS"), at a rate of 30% of the gross rental income. Alternatively, one can elect to pay tax on net rental income by filing a U.S. non-resident tax return reporting net rental income.

Tax implications — sale of the U.S. properties

A capital gain or loss arising as a result of selling a U.S. property is required to be reported on a U.S. Individual Income Tax Return. Capital gains in the U.S. are categorized as either short-term or long-term depending on the period of ownership of the asset being sold. The tax treatment differs for each category. For short-term capital gains, (period of ownership of the asset less than 12 months), the gain is taxed at the individual's progressive tax rate. Otherwise, a flat long-term capital gain tax rate of 20% will apply. The purchaser is required to withhold tax at 10% or 15% of the gross sales price of the property, depending on the date of disposition and type of property. One may apply to reduce the withholding tax rate to the actual U.S. tax liability by fi ling U.S. Form 8288B — "Application for Withholding Certificate
for Dispositions by Foreign Persons of U.S. Real Property Interests", by the closing date of the property.

Tax implications — U.S. estate taxes

The U.S. imposes estate tax on the death of an individual at graduated rates, based on the fair market value ("FMV") of the individual's taxable estate. In general, the U.S. taxable estate of a non-U.S. person is comprised of their U.S situs properties (e.g. U.S. real property, U.S. securities, U.S.mutual funds), net of certain debts and expenses. In the context of U.S. estate taxes, a U.S. person refers to a U.S. citizen or person domiciled in the U.S. The federal estate tax rate is progressive from 18% to 40% and there is a unified credit of USD $2,125,800 in 2016, which, for a U.S. person, effectively exempts USD $5,450,000 of assets from the estate tax.
Enriched Thinking™
Under U.S. domestic tax law, a Canadian resident is entitled to a unified credit of USD $13,000, exempting U.S. situs assets worth only $60,000. Fortunately, the Canada-U.S. Tax Convention (the "Treaty") allows Canadian residents to enhance their exemption entitlement to the same U.S. $5,450,000 exemption as a U.S. person. The unified credit is prorated based on the value of U.S situs assets in relation to the value of total worldwide assets, as follows:

$$\frac{\text{Gross value of U.S. situs property}}{\text{Gross value of worldwide assets}} \times \text{U.S. \$2,125,800 of 2016 unified credit}$$

Generally, if the value of the worldwide estate of a Canadian resident (non-U.S. person) is less than U.S. $5,450,000, they should not have a U.S. estate tax liability.

Where both spouses are U.S. citizens, and assets are passed to a surviving U.S. citizen spouse, one can defer the estate tax by claiming the "unlimited marital deduction". There is also the ability to transfer unused exemption amounts between U.S. citizen spouses. This allows the surviving spouse to take advantage of any unused portion of the spouse's estate exclusion amount. As a result, one may double the exemption, to $10,900,000. However, if the surviving spouse is not a U.S. citizen, the unlimited marital deduction is not available. Instead, assets must be transferred to a Qualified Domestic Trust ("QDOT"). Alternatively, a marital credit is available under the Treaty.

To claim the exemption under the Treaty, the Canadian resident must file U.S. Form 706-NA — "United States Estate Tax Return", along with a Form 8833 — "Treaty-Based Return Position Disclosure". The due date for estate tax returns is nine months following the date of death.

Finally, if a Canadian resident does pay any amount of U.S. estate tax, a foreign tax credit may be claimed in their Canadian income tax return, offsetting Canadian income tax paid on U.S. source income or capital gains on dispositions of U.S. assets.

Example

Below is an example of applying the unified and marital credits under the Treaty for Canadian residents.

Mr. A and Mrs. A are Canadian residents and own a Florida condominium for rental purpose.
In 2016, Mr. A passed away and the condominium is worth U.S. $2,000,000. They do not own any other U.S. situs assets and the total worldwide estate worth U.S. $6,000,000. 2016 estate tax rate is 40% for taxable estate value above U.S. $1,000,000 and the unified credit is $2,125,800

U.S. estate tax on $2,000,000	**Exemption with Canada-US Treaty**
Tax on the first $ 1,000.000:	$345,800
Tax on the balance ($2,000,000 - $1,000,000) at 40%	$400,000
Total U.S. estate tax before unified credit	$745,800
Less: Prorated credit ($2,000,000 / $6,000,000 X $2,125,800)	($708,600)
U.S. estate tax before marital credit	$37,200
Less: marital credit (limited to taxes payable)	($37,200)
U.S. estate tax after unified and marital credits	$0

Summary

There are many potential methods to minimize the U.S. estate tax liability. Common planning ideas include the following: setting up a "cross-border trust" to hold the U.S. real estate; financing the purchase of U.S. real estate with a "non-recourse mortgage", effectively reducing the net value of the total U.S. properties; and, reducing the value of the Canadian estate.

Owning a rental property in the U.S. can have significant U.S. income and estate tax implications. Speak with your cross-border tax advisor about your own tax situation, and before implementing any tax planning strategies.

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Important dates to remember: Monday, May 22nd - Victoria Day

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