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This is the Private Wealth Podcast with Manulife Private Wealth.

CORPORATE PARTICIPANTS

Glen Brown
Managing Director, Head of Manulife Private Wealth

Frances Donald
Head of Macroeconomic Strategy, Manulife Asset Management

Hemal Balsara
Assistant Vice President, Tax & Estate Planning, Manulife Financial

PRESENTATION

Operator

Good afternoon, ladies and gentlemen. Welcome to the Year-End Tax Planning and Economic Outlook Conference Call.

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I would now like to turn the meeting over to Glen Brown, Managing Director and Head of Manulife Private Wealth. Please go ahead, Mr. Brown.

Glen Brown, Managing Director, Head of Manulife Private Wealth

Thanks very much. Hello everyone, and thank you for taking the time to join us today. As introduced, my name is Glen Brown, and I'm the Managing Director here at Manulife Private Wealth. On behalf of all of our team, welcome to the call.

At Manulife Private Wealth, we measure our success based on our ability to help clients reach their goals, not just against standard benchmarks. Achieving financial goals in today's environment requires accountable expertise, preparation, and solid foundations.

With that, many investors and business owners enter 2019 with questions about year-end tax planning, tax saving, and how the financial markets will react to the new year. Our November conference call featuring Frances Donald, Head of Macroeconomic Strategy and Hemal Balsara, AVP of Regional Tax at Manulife will explore these topics and how you can prepare for 2019.

We are recording this call, and a copy of the recording will be available to any participant upon request. If you have any requests or questions after the call, please contact one of our team at Manulife Private Wealth.

Today, we are joined by two amazing speakers to provide insight on what you can do to be prepared for the new year. Our first speaker, Frances Donald, has been featured in some of our award shows, and it is a pleasure to have her again today on our call.

Our first speaker, Frances Donald, has been featured in some of our roadshows, and it is a pleasure to have her again on our call today. Frances Donald is responsible for coordinating and generating global macroeconomic investment research and analyzing the potential opportunities and impacts on Manulife Asset Management's investments. She makes regular appearances on BNN and CBC, and is frequently quoted in the Wall Street Journal, Reuters, and Bloomberg. Frances will discuss what the markets may look like in the next quarter.

Frances, over to you.

Frances Donald, Head of Macroeconomic Strategy, Manulife Asset Management

Thanks, Glen. It's a real pleasure to be on this call, and what I like about it is the focus is a little bit more on the next three months. Instead of doing what I tend to do when I see clients and advisors, which is think really big picture, I wanted to highlight what's been on my team's mind over the last three months, what we're thinking about heading into 2019, and focus my comments on what our team is spending the most amount of time thinking about as we position in asset allocation and more broadly across the asset management and portfolio manager funds.

What I'm going to do is lay out the two big macro themes that we're thinking about, and then I'm going to dive a little bit deeper into how we're thinking about equities, how we're thinking about bonds, and then how we're thinking about currencies. Our perspective really is global, but of course, I'm here based in Toronto as well, so I can't help but throw in the Canadian implication behind those things as well.

The first big theme that's been on our minds, particularly over the last six months as we head into 2019, is actually what will turn out to be a 2020 theme that we're watching very closely. That's the possibility of a 2020, what I'll call a light recession in the United States around the 2020 time zone. When I talk about a light recession, I'm talking about a blip on the radar, two quarters of potentially negative back-to-back growth and what that potentially means for the economics and macro environment looking out over the period.

The first question I tend to get is, well, why would you possibly say that we could see a recession on that timeline? There's a couple reasons why 2020 is looking like a difficult year. The first one is that we have seen a significant amount of interest rate hikes from the Federal Reserve, from the Bank of Canada as well, and a series of other developed market central banks, in Europe for example.

Now, the interesting thing about monetary policy and when interest rates are hiked is that they tend to take about 18 months to two years before you really feel them permeate into the broad economy. What that means in the United States is that we're probably feeling interest rate hikes that happened a year and a half ago, and it's still going to take us another year and a half to feel the full effects of the subsequent five rate hikes.

The same story can be felt in Canada as well. We, as consumers, as business owners, have yet to feel the true brunt of the impact of higher rates. That puts 2020 in a little bit of a weaker environment. The second reason really comes from a U.S. story, and that is, over the course of 2018, many of you know that the United States economy and companies have benefited from a very large fiscal policy stimulus that came in the form of U.S. corporate tax cuts, personal tax cuts. That's provided a sizable lift to the U.S. economy in 2018, and by our estimates, an even larger increase in 2019.

The problem with the 2020 horizon, however, is that that fiscal stimulus drops to zero, and some forecasts even see that being a net drag on the economy by that time. By 2020, we're also expecting the drag of tariffs put in place over the course of 2018 to start to be felt in the broad economy.

Then lastly, we are seeing some evidence of late-cycle dynamics, very typical, very healthy in any type of boom-bust economy.

Those are some of the reasons why that horizon looks difficult to us. Now, I really do have to highlight, however, this to us is not a major crisis or a large recession. It looks nothing like 2008. Even in our own internal model when we play around with it, we actually don't even create a full recession, we simply are capable of generating two quarters of sub 1 percent growth. You might remember that the textbook definition of a recession is two quarters of negative growth. Numbers on my team, for example, sometimes talk about this not even being a full-blown recession but a soft patch, or something called a "profits recession".

That may sound a little bit dark and certainly not a fun way to start off a call, but I will tell you that there is a very silver lining in the meantime, and that is that, between now and 2020, the U.S. economy looks just fine. In fact, we don't see any evidence of any potential for any type of recession to occur before that mid-2020 horizon, and most of the economic data that we point at continues to suggest above-trend growth in the United States, as well as in Canada.

Now the reason that we're talking about 2020 now is we know, of course, that markets start to price in recessions about six months in advance of them actually happening, and our team we follow a lot of providers that will look at things like recession probability indicators, and those tend to work about a year out. We are expecting this concept of the end of the cycle after 10 years of an expansion to start to permeate more broadly into the psyche; and I think now that we're looking at about two-thirds of economists calling for a 2020 recession in the United States, and of course that has seeped through into the Canada story.

I will caveat this, however, and say that professional forecasters, i.e. economists, have actually only predicted one of the past seven recessions. The only recession they actually got completely correct was the 1980 recession. Typically, when economists are looking out, they tend to get the expected growth rates wrong in their forecast; the average error is about 4 percent. There is that particular caveat, that many of our forecasts, historically, have turned out to be a little bit of a margin of error.

That's the first big theme that frames our longer-term thinking and actually how we want to approach investing in the next 18 months. The other theme has come up quite a bit, and this may seem international but it has domestic risks, and that's what's happening in China. You may have seen a variety of data or headlines that said Chinese economy has slowed very considerably, and that's put a lot of pressure on emerging market performance, for example.

Now, it looks as though the Chinese government is trying to stave off some of that weakness. We've seen a variety of easing. That easing that's coming out of the Chinese government, both fiscal and monetary, and via the currency channels, has really been considered to be too piecemeal, too reactionary, and not enough. But once again, I will stress that when we see easing or tightening happening from the policy side, it does take about 18 months to hit the real economy.

In October, out of China, we saw some personal tax cuts that were pretty sizable, equal to about an increase of 5 percent of disposable income. There were various indications that the bank system would be increasing new loans towards infrastructure, and we did see a rate cut from China on October 15.

Why would I talk about China; and even if you don't have any assets directly tied there, our view is that this is becoming one of the most important determinants of global assets over the next three to 12 months. One of the reasons is that the Chinese currency is actually 22 percent of the U.S. dollar basket, so if the Chinese currency continues to weaken, which we expect it will, that actually puts a little bit more strength behind the U.S. dollar.

We also know that in this environment where it looks like the global economy in the United States will slow towards 2020, if we were to see a very sizable form of stimulus from China. If they were to get the gears going, that provides a lift to global growth in a way that is underappreciated, particularly because it doesn't look like the U.S. is going to come forward with an extension of personal and tax cuts after the midterm outlook. For those of you with international perspective, some form of sizable stimulus out of China to us would be an emerging market buy signal after that environment has been seriously weakened.

We're also—and this is a third theme for us as we look forward over the next three to 12 months; we have seen a failure of the rest of the world to reaccelerate, and this has been disappointing to us as we're hoping to see a rebound in European activity. Europe continues to be held down by a variety of geopolitical risk, Brexit in the news this week, certainly important, Italian budget woes coming to the forefront. It just keeps being, from our perspective, as others, just one more barrier towards an acceleration in every point.

We've noticed that European growth outlook continues to be cut, and the progression of GDP forecasts from economists in 2018 has just steadily moved lower. That's an area that continues to cause quite a bit of concern for us, but we can't quite seem to find anywhere else except the United States that is seeing some sizable growth.

On the Canada front, Canada I have stated, since about 2012, I've been quite bullish on the story. I've believed that Canada had the ability to reaccelerate even as it had heightened debt. What we are seeing in Canada is deceleration in credit growth, residential, consumer credit growth, but I think it's going to weigh on growth in the same way it will in the United States. Canada, to me, is going to follow this decelerating growth path, having probably seen the best of its growth in 2017.

That's the macro framework in which we're thinking about the world over the next three to 12 months and the main factors that come to mind as we come into work every morning. But what does that actually mean for the way that we think about assets?

Let's start with equities. Of course we've seen a pretty sizable pullback. We've seen a lot of volatility in stocks. But from our perspective, we certainly are still bullish over the next three months, and over the next 12 months. From our perspective, there are some reasons to still be interested in equities, in addition to technicals. We do believe that the correction has largely run its course; I'll tell you this example which I think is very telling.

Since 1990, when the United States has been in recessions, the average correction in the S&P 500 has been 31 percent and lasted one year. But if you are not in a recession, since 1991, the declines in the S&P 500 have averaged 15 percent and lasted 85 days. If you want to map the recent corrections over those non-recession declines, we're following that playbook to a T. To us, we continue to stress—and this is why I've been so clear that, while 2020 does look like that recession environment, right now it's not a recession, and that bodes well for us moving forward.

We've seen global valuations de-rated (phon) over the past period; that's good, and when you look at the MSCI All World Index, the forward PE is now down to 13.6 percent, that's 14 percent below long-term average. That doesn't necessarily mean that everything is cheap, but it does look better than it did a couple months ago. We are looking at peak growth in earnings, but not peak earnings.

I'll give you this which I find interesting: so the U.S. is looking to deliver a remarkable 23 percent earnings growth in 2018. One of the challenges for us is that tax reform in the United States has significantly distorted earnings visibility and muddled the waters of data that we look at. But I was looking at a study yesterday that showed if you strip out corporate tax cuts, earnings are still running around 15 percent and they're expected to run around 10.5 percent next year. That's a deceleration, but it certainly isn't peak earnings; it's just peak earnings growth.

Lastly, profit margins in the United States are at a record high: 11.8 percent. It's really a remarkable chart if you ever get a chance to look at it. A lot of margin expansion has come from a reduction in tax rates, but in our view, this isn't important, because at the same time that companies are facing higher tariffs and higher wages, it does look like they have the margins to absorb that moving forward, and that does make us more constructive on the space.

When we look at interest rates moving forward and what's happening in bond markets, our general view is that U.S. interest rates and Canadian interest rates will continue to grind higher. I am expecting the Bank of Canada to raise rates again in January and then potentially one more time in 2019, and the Federal Reserve as well two more times in 2019 with their next hike coming in December.

Our general perception, though, is that we have probably seen the bulk of the move that we're going to see in U.S. Treasuries. For those of you who like numbers, our view is that the 10 Year really only gets up to 3.4 percent, 3.5 percent, and we can't see that being a major game-changer at this point. We do believe that inflation largely piqued in July and August, and with oil prices tanking as some of you may have seen, that's certainly not conducive to higher inflation. While we will see wages and capacity utilization creep higher, we're really talking about a 2 percent inflation environment, that's a pretty healthy environment there.

Critically, one of the themes that we've been talking about on our teams is the idea that we should be expecting a lot more volatility in markets, both equity markets and fixed income markets, as we head in and over the next 18 months. That is very healthy; that's very typical of being late-cycle. We've gotten used to a low volatility world, particularly in treasuries with inflation being low, and economic growth in its second largest expansion in modern history; monetary policy has had a lot of forward guidance. But we're moving out of that paradigm into a new one, where we're going to see a lot less guidance from our central banks moving forward and we should expect more what we call "vol events" on my team, volatility in treasuries and equity markets.

The last thing that we think about a lot on our team is how to think about the broad U.S. dollar. I will say that we've spent a lot more time talking about individual crosses (phon) than we have broad U.S. dollar, recently, in large part because there's a lot of conflicting forces on the U.S. dollar. Now, on one hand there's a structural view that the U.S. dollar should be lower. It's running twin deficits that are pretty big, there's a lot of good news (phon) priced into the U.S. dollar, but we're still awaiting a sell signal there in order to get more negative and believe it's going to be range-bound.

I'm a little worried about the Canadian dollar, though not excessively so. I think we could probably see another 2 percent to 3 percent more weakness behind the Canadian dollar, but in general, I think we're probably a little bit more range-bound on currencies over the next three to 12 months.

One of the biggest risks from my point of view, however, is that we did continue to see a very strong U.S. dollar moving forward. That's a very difficult environment for multinational companies, for cyclical companies, and for emerging markets. To me that remains one of the biggest risks.

Looking forward over the next three months, there's a couple things we're watching very closely. The first one is what happens to oil prices; not particularly because we have or want to make a pure play on oil, but because, as goes oil, so does inflation; the consumer, as it benefits from lower gas prices; and also a little bit what happens in the credit environment. We're watching to see whether the U.S. does indeed move forward with higher tariffs on China in January. To us, that could be a turning point for a lot of important range-bound assets; of course, it is negative for global growth, it's probably supportive of the U.S. dollar because it's confirmed over that period.

We're also watching for more signs of business investment, both in Canada and the United States. This has been a concern for us. The theory tells us that there should be a lot of pent-up demand for business investment in these economies; we simply haven't seen it in the data yet, so that will be something that we're watching very closely from there, moving forward.

That's my time. I hope that gives you an overview or a snapshot of the way that we're thinking about things right now.

I'm going to pass it back over to Glen.

Glen Brown, Managing Director, Head of Manulife Private Wealth

Frances, thanks very much, that was great insight.

Our next speaker is a member of the Manulife Tax & Estate Planning team and works closely with Manulife Private Wealth to support our high net worth clients, delivering integrated insurance and tax planning solutions. Hemal Balsara has contributed to various Canadian publications including the Canadian Tax Highlights, PWC's Wealth and Tax Matters, and the Canadian Taxation of Life Insurance.

Thanks for joining us today, Hemal.

Hemal Balsara, Assistant Vice President, Tax & Estate Planning, Manulife Financial

Good afternoon and good morning, it's an absolute pleasure to chat with you today.

I'm going to take you through a discussion around three main topic areas: A, the small business tax changes around passive income and their impact on corporate tax rates; B, some tax planning strategies that can be considered around these rules before year-end; and C, some general tax saving ideas to consider before year-end.

As a background, on July 18, 2017, the government released a consultation paper, proposing changes that were intended to remove the perceived unfair tax advantages available to owners of private corporations. These involved three buckets of changes, the first bucket being income splitting using corporations, and these rules are now in place, effective January 1, 2018. Prior to these rule changes, there was the ability to split out income with family members by paying them dividends and benefiting from their graduated rate. Now, the standard is much higher, and certain requirements need to be met in order to benefit from the graduated rates. These are beyond the scope of the presentation.

The second area was the surplus stripping provision, and ultimately it was decided that these rule changes would not be implemented.

The last one was the taxation of investment income. When there were rule changes considered in this space, there was an initial thought that there would be a change in the way investment income was going to be taxed. These methodologies would have resulted in combined personal and corporate tax rates on investment income in excess of 74 percent in some cases. Where we ended up, ultimately, was a relatively simpler approach, but the result was a change in the way active business income was going to be taxed.

Currently, there is a tax deferral advantage for business owners who retain after-tax income in their corporation. This is because the corporate business income is generally taxed at lower rates than business income earned personally. If an individual is in the highest margin tax bracket and earns business income, this income is subject to tax at the combined Federal and Ontario rates at 53.53 percent. Please note that I'm using Ontario to demonstrate the concepts, but these ideas are equally applicable to all provinces and territories.

Canadian corporations, on the other hand, are subject to a combined 26.5 percent Federal and Ontario corporate tax rate on impacted business income. In addition, if a Canadian-controlled private corporation—if a corporation is a Canadian-controlled private corporation throughout a tax year, it may benefit from the small business deduction, which lowers the combined tax rate on the first $500,000 of active business income. This is known as the business limit in the tax world. This combined rate will be 13.5 percent in 2018, and it's going to be 12.5 percent in 2019.

The business limit must be allocated among all corporations that are associated. The concept of association is defined in the Income Tax Act, and also the business limit is reduced on a straight-line basis for a CCPC and its associated corporation where the group has taxable capital between $10 million and $15 million. The concept of taxable capital employed in Canada is beyond the scope of this presentation.

As a result of the lower corporate tax rates for active business income, incorporated owners may have more active tax money to invest inside their corporation. Due to the larger amount of starting capital to invest, a business owner may realize after-tax returns that exceed what an individual investor is saving in the personal investment environment can achieve.

The longer the funds are left in the corporation, the higher the value of the tax advantage. In other words, if $500,000 were to be earned personally, it would be taxed at 53.53 percent in Ontario, assuming that that $500,000 was taxed at the top marginal tax rate. This would create $267,250 of taxes, and ultimately leaves $232,350 after-tax. Meanwhile, if it was earned through a corporation at the small business rates, there would be $437,500 after-tax, and that's based on a 12.5 percent tax rate.

In other words, there is about a $205,000 tax deferral advantage in 2019, or about an 88 percent improvement compared to earning the income personally. This is absolutely enormous. The government was considering a tax deferral advantage. As a result, the government has introduced rules to restrict the small business deduction for Canadian-controlled private corporations that have significant income from passive investments. The government proposes to reduce the small business limit on a straight-line basis, where the CCPC and its associated corporation has between $50,000 and $150,000 of investment income in the year.

The proposed measure would reduce the business limit by $5 for every $1 of passive investment income above the $50,000 threshold. The business limit would be eliminated if the CCPC and its associated corporations earned at least $150,000 of passive investment income in the year. This reduction to the business limit will apply to taxation years that begin after 2018. It will operate alongside the existing rules related to taxable capital between $10 million and $15 million.

Ultimately, this reduction reduces deferral advantage, and ultimately, it results in $70,000 less of tax deferral. If the 26.5 percent rate applies, this is where the clawback would apply, we are looking at a deferral advantage of still $135,000 based on the $500,000 of active business income. This is ultimately where the clawback would apply.

For purposes of calculating the reduction to the small business limit, investment income earned by a corporation will be measured by a new concept known as adjusted aggregate investment income, or AAII. AAII would generally include net taxable capital gains, interest income, portfolio dividend, rental income, and income from savings in a life insurance policy that's not an exempt life insurance policy/

One thing I wanted to note with that last point is, Manulife hasn't sold our non-exempt policy for years. Generally speaking, most policies sold in Canada are considered exempt to life insurance policies, so this last point would be less applicable.

Adjusted aggregate investment income will exclude certain taxable capital gains or losses realized from the disposition of active business assets and shares of certain connected Canadian-controlled private corporations. Adjusted aggregate investment income also excludes net capital losses carried over from prior years and investment income that pertains to and is incidental to an active business. For example, interest on short-term deposits held for operational purposes such as payroll and inventory, that would be excluded. In addition to that, we would also have capital losses backed out that were carried forward from a previous year, for the purpose of the calculation.

The test for accessing the small business deduction is an annual test that is based on passive income earned by a Canadian-controlled private corporation and any associated corporation in the taxation year that ended in the preceding calendar year.

As a simple example, to determine a Canadian-controlled private corporation small business deduction for its taxation year ended December 31, 2019, the corporation's adjusted aggregate investment income for the 2018 year would need to be calculated. In other words, although we're not impacted by these rules in the current year, we're already indirectly in the rules as this year's passive income will impact next year's clawback.

As this is an annual test, it is possible that the corporation could regain access to the small business deduction if its passive investment income was high in one taxation year but lower in another taxation year. Let's look at an example: we have Steve. He's a doctor. He's a sole shareholder of his medical professional corporation. Steve's corporation is not associated with any other corporation and the taxable capital employed in Canada does not exceed $10 million. The corporation earns $750,000 of active business income and Steve has accumulated $4 million of portfolio investments in this corporation, which generates a 3 percent investment return, consisting of interest income and portfolio dividends. In other words, we have $120,000 of investment income.

Under the current rules, the first $500,000 of active business income earned as Steve's corporation would be taxed at the small business rate of 12.5 percent, resulting in $62,500 of taxes payable. Based on the proposed measure beginning in 2019, the corporation's access to a small business deduction will be limited because of the passive investment income generated in this corporation. For every dollar of passive income earned in excess of $50,000, the business limit will be reduced by $5. If Steve's corporation earns $120,000 of passive income in the preceding tax year, the business limit for the current year will be reduced by $350,000, which is basically $120,000 minus the $50,000, times $5, so $350,000.

This means that only $150,000 will be taxed at the small business rate; the remaining active business income, or $600,000, is taxed at the general rate, at 26.5 percent. As a result, Joe's (phon) corporation will pay $49,000 of taxes on the first $500,000 of active business income. Based on these new rules, Steve will have less after-tax dollars to invest in his corporation.

Now the question is, what can Steve, and indirectly you, do to minimize the impact of these tax rule changes? The first thing to look at with this is looking at strategies that would potentially reduce active business income, because ultimately, the less active business income you have, the less income you have that's exposed to this potential clawback.

If your current year's passive income can be reasonably forecasted, then so can your small business deduction. As a result, if your active business income is reduced, or below the anticipated small business deduction, then you could avoid the general higher corporate tax rate. Here are some ideas for doing so.

What we can do is we can revisit the compensation mix. Salaries and bonuses are employment income reported on a T4. They are also deducted from active business income. Receiving a bonus prior to year-end creates additional RRSP contribution room for 2019. If you have not reached your maximum 2019 RRSP limit, that might be something to consider. Furthermore, receiving a bonus prior to year-end may also allow for greater employee/employer pension contributions, and/or employee/employer profit-sharing planned contributions in 2019, as these contributions are based on your prior year's total compensation.

On the other hand, if you expect to be in a lower tax bracket next year, consider deferring the receipt of your bonus, if your employer permits, to early 2019. If the bonus was directly paid to you, there will be withholding taxes at the source on the bonus payment. However, if your employer permits, some or all of the withholding tax on the bonus may not have to be withheld if the bonus, or a portion of the bonus, is transferred directly to your RRSP. You must have adequate unused RRSP deduction room in the year of the transfer.

If your business is incorporated and you require income from your corporation, consider declaring a bonus before the end of your corporation tax year and pay the amount no later than 180 days after the corporation's year-end. Assuming that your corporation's year-end is December 31, if your corporation declares a bonus on December 31, 2018, it will get a tax deduction for 2018 and the tax you have to pay on the bonus will be deferred if you receive the bonus in the beginning of 2019.

Another idea is paying the salaries to the spouse and children. If the salary is reasonable for the job, this income splitting strategy is still viable. This can allow, ultimately, to take advantage of the family members' graduated rate. The key here is the amount has to be reasonable based on the work performed.

Another area to look at is also looking at strategies to reduce passive income. Directly reducing passive income or passive investment assets within the corporation can reduce the impact of the upcoming changes, and there are several ways to do this. One thing that we can look at is realizing capital losses in the current year. Capital loss carry-forward amounts will not help if any used amounts are added back as part of the adjusted aggregate investment income calculation for determining passive income levels.

That being said, capital losses realized in the current year can offset capital gains also realized in the current year. This can be beneficial if you're rebalancing current passive assets to reduce passive income in future years. In order to ensure that your capital loss can be claimed, you must be aware of the superficial loss rules.

A superficial loss will occur when a security is sold at a loss, and both of the following occur: during the period that begins 30 days before and ends 30 days after the settlement date of the disposition, you or a person affiliated with you, for example your spouse, the company controlled by you or a trust in which you or your spouse are a majority interest beneficiary, acquires the identical property that was sold at a loss. Two, at the end of a period, for example on the 30th day of the settlement date of the disposition, you or a person affiliated with you owns or has the right to acquire the identical property, we need to look at your holdings across all accounts when determining if superficial loss applies. Ultimately, these superficial losses ultimately deny the capital loss that you claim, so you've just got to be cognizant of these superficial loss rules.

The other piece of the puzzle here is looking at investing in low taxable income, low distribution assets. Investments that generate little or no taxable income, such as corporate class mutual funds, will result in less passive income now and possibly in future years. Some mutual fund trusts also allow for investment strategies that minimize taxable distributions.

The other part of the puzzle here is, don't forget expenses. Expenses incurred to generate passive income, such as interest expenses or investment counsel fees can be used to reduce passive income. A strategy involving leveraged investing, or the immediate finance arrangement which involves purchasing a life insurance policy and then leveraging amounts back, can help impact this.

For example, if you're doing leveraged investing, the interest cost can help offset against the passive income that's being generated. If you look at the immediate finance arrangement, which is basically a leveraged life insurance strategy which involves buying a policy and then borrowing the money back, it allows to create deductions for interest and a small portion of the premiums as well.

Another area to look at is repaying shareholder loans, so these are loans that are made through the company by the shareholder. One of the things that happens is, is we could use passive assets to repay the outstanding shareholder loans that can ultimately reduce the passive investment balance, which in turn can reduce the passive investment income in the corporation.

The other thing to look at is any dividends from the capital dividend account. The capital dividend account is one of the holy grails of all tax actions. What happens when we have a capital dividend account balance—and again, the capital dividend account is a notional tax account, you don't see it anywhere on the financial statements, you don't see it on the tax return. What happens is the capital dividend account—some of the things that create it include the non-taxable portion of capital gains.

For example, if you have a hundred dollar capital gain, one half is taxable, or $50 is taxable, and one half is non-taxable—so if you have $50 in non-taxable. What happens is that that $50 that's non-taxable can actually be cycled through the corporation, to the shareholder, on a tax-free basis.

One of the things to look at is, if there is a positive capital dividend account balance, what we can look at is funding capital dividends with funds from passive assets that could reduce the passive investment asset balance, which can ultimately, in turn, reduce the amount of passive income. Capital dividends can also be received tax-free by the shareholder, therefore not impacting the personal tax position. One of the things that I would recommend for any client on the phone is, maybe talk to their accountants about looking at what their capital dividend account balance is in the corporation.

Another thing to look at is maybe looking at purchasing a corporate-owned life insurance policy, and this is one of my favourite ones. Investments in a life insurance policy are generally tax-sheltered. Ultimately, what happens is, is this can reduce passive investment balances while addressing the planning need for you and your corporation. Corporate-owned life insurance can also build up investment amounts and can ultimately be leverage for the future to create retirement income in the future.

Another thing to look at is looking at a combination of both. Basically, reducing passive income and also reducing active business income. There may be opportunities to combine items from the list to lower the active business income and passive income. There's some options.

One of the things to look at here is just reviewing investment options outside of your corporation. Investment plans such as RRSPs, individual pension plans, and retirement compensation arrangements; that could create deductions against active business income for employer contributions.

One of the things to note is, we talked about IPPs in the past on MPW calls earlier this year. But basically, if such contributions came from passive assets, those passive assets will ultimately be reduced. If they're earmarked for future personal use, it may be beneficial to hold them outside your corporation, especially when your personal marginal tax rate is lower than your corporate tax rate on investments.

The other thing that we can look at is making a corporate donation. A corporate donation creates a deduction against income and may reduce passive investments as it's funded with corporate money. Another thing to note with this is further in-kind donations attract zero capital gains inclusions, therefore, they do not increase current year's passive income.

Finally, since one hundred percent of the capital gain is tax-free, the entire gain is added to the CDA, which could be paid to the shareholder tax-free. The moral of the story over here is if you're looking to make a donation corporately, maybe look at donating appreciated securities as there are several tax advantages, as we mentioned.

At the end of the day, the small business tax changes are another round in the game of tax change and adaptation. Rules change, new strategies emerge, and the process repeats.

Now where we're going to end off with is looking at some other year-end planning that a client can look at in terms of this. The first is your RRSP contributions. You have until March 1, 2019 to make an RRSP, or a spousal RRSP contribution in order to be able to deduct the amount in your 2018 tax return. However, if you have contribution room, contributing to your RRSP early, i.e. before December 31, 2018, helps to maximize the tax-deferred growth in your plan, which may increase your savings for retirement.

The other thing to look at is marginal tax rates vary significantly by province or territory. For example, combined with the Federal rate, the top marginal tax rate in Nunavut is 44.5 percent, and the top combined tax rate in Nova Scotia is 54 percent. Since you're generally subject to tax based on your province or territory of residence on December 31, if you are moving to a province or a territory with a lower tax rate, consider moving prior to year-end. If you're moving to a province or territory with a higher tax rate, consider delaying your move until early 2019. If you can handle the cold, Nunavut might be a great place to move.

Another idea is, if you intend on purchasing assets for your business, for example a computer, furniture, equipment, consider making the purchase before year-end. If the asset is available for use, this year-end purchase will allow your business to claim depreciation on the asset for tax purposes. This is referred to—will be called the half year. Basically, you get a half year amount of depreciation, regular allowable depreciation to be claimed for tax purposes for the first year of the purpose. Generally speaking, loading up on asset purchases towards the year-end can be beneficial from a tax perspective as well.

The other piece of the puzzle here is, if—another strategy to consider is, if you've set up a spousal loan or funded a family trust with the prescribed rate loan—and one of the things—I just wanted to pause here for a second just to explain the strategy a bit more clearly, is this strategy is ultimately used to create income splitting, and then you'll often hear it called as a prescribed rate loan strategy. This involves basically making a loan through a spouse at the prescribed rate. Historically, that number was about 1 percent, now we're up to 2 percent.

What happens is, with the prescribed rate loan, what we're able to do is, the person who received the loan, either a family trust or a spouse, ultimately gets the income tax in their hands at their marginal tax rate, but they have to pay the prescribed rate back to the person who made the loan. This is a great income-splitting strategy where you have family members in lower tax brackets. If it's just a husband and wife, for example, and the wife makes the husband a loan to take advantage of the graduated rate, that that loan can be made indirectly. But if there's kids involved, we could actually do it indirectly through a trust.

Ultimately, my whole point with all of this is, if you've got a prescribed rate loan in place, you have to remember to pay the interest by January 30, 2019. It's important, because otherwise the strategy will implode, and effectively, all of the income will be taxed in the individual statements. At the end of the day, where we make this interesting, is the borrower may be able to claim a deduction for the interest paid on their tax return, and the lender will have an income inclusion on their tax return. The timing of the income inclusion and the deduction depends on the year the interest relates to, and when the interest is paid, and the method, cash versus accrual you regularly follow in computing the income. At the end of the day, prescribed rate loans, we want to have that interest paid by January 30, 2019.

As you can appreciate, tax is a complex and ever-evolving area. You have a team of professionals at Manulife and Manulife Private Wealth that can help you navigate through uncertainty.

I wanted to thank you for your business and time today. I'm going to turn it back to Glen Brown. Glen, over to you.

Glen Brown, Managing Director, Head of Manulife Private Wealth

Thanks very much, Hemal, and thank you all for joining today's discussion. This will conclude our call. If you have any questions or would like to learn more about year-end tax-planning strategies, I'd welcome anyone to reach out to their regional Private Wealth consultant.

Thanks very much, and have a great day.

Follow the Private Wealth Podcast on www.manulifeprivatewealth.com or contact us via manulifeprivatwealth@manulife.com for more information.

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