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This is the Private Wealth Podcast with Manulife Private Wealth.

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Presentation

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Hello, everybody. Welcome, and thank you for taking the time to join us for Manulife Private Wealth's Fall Webinar. Today, I'm pleased to welcome the speakers for our specialized segment on Cottage Succession Planning. First up, we have Frances Donald, Manulife Investment Management's Chief Economist, who will provide a macroeconomic outlook and outline the key trends she believes will shape the economy in the months to come. Frances is followed by John Natale, Head of Tax, Retirement and Estate Planning Services, who will focus an in-depth look on cottage succession with a focus on tax implications and strategies for wealth transfer.

For those interested in a replay or in sharing the contents of this call with others, we are recording the segment and a copy of the recording will be available to participants on our web site at manulifeprivatewealth.ca. If you have questions or any requests after this call, please feel free to contact a member of the Manulife Private Wealth team.

The volatility in the Dow Jones Index and the S&P 500 since February of this year have left many of us of a certain age reminiscent of the topsy-turvy world of Mr. Toad's Wild Ride at Disneyworld, with its quick turns, about-faces and near misses. As you will no doubt recall, the key stock indices fell sharply in February, and then from April through to June, reversed course and accelerated upwards, propelled by the shares of certain technology companies.

Not all shares moved in tandem, however, and shares tied to the broader economy have for the most part lagged the indices' spectacular recovery. A recent article in the Wall Street Journal points to five reasons for the sharp rebound in the market. One, Central Bank and government stimulus programs. Two, optimistic expectations of a strong recovery. Three, the dominance of the tech giants. Four, heightened trading by retail investors. And five, momentum trading.

As we head into Fall, we're seeing increased cases of COVID infections, the expiry of government stimulus programs, and overall investor optimism beginning to waver. Have we entered that macroeconomic phase that Frances Donald has called The Stall-out?

Many of you know our first speaker, Frances Donald. Frances is the Chief Economist and Head of Macroeconomic strategy at Manulife Investment Management. She's responsible for coordinating and generating global macroeconomic investment research and analyzing potential opportunities and impacts on Manulife Investment Management's investments. Frances also coordinates macro research to assist Manulife's Global Asset Allocation team in the development of their asset class forecasts. Frances, over to you.

Frances Donald, Chief Economist and Head of Macroeconomic Strategy, Manulife Investment Management

Wow, thank you, Leslie. And I'm so happy that you've internalized the idea of The Stall-out. Way back when we conceptualized this three-phase framework in March and April, I would have been so excited to hear that by the time we got to the Fall, that three-phase framework would become something that we could all be referencing.

Now, indeed, what I want to do today is walk us through this three-phase framework. If you've heard it before, we're going to give you an update on where we are in our current thinking. If you haven't heard it before, I'm going to introduce it to you and hopefully give you a roadmap to think about how this economy has recovered so far and where it's going next.

Now, typically, when you do a presentation like this you start with a joke. I usually use one at the expense of my husband. But I have migrated lately away from jokes to motivation quotes. It's a new paradigm for me. And there's a quote that keeps coming up in my mind every morning when I sit down to come to work. And the quote is: "We are called to be the architects of our future, not its victims." I love this messaging because it really hits home that amidst this incredible chaos and catastrophe and real genuine heartbreak, there is some opportunity for us.

In my world, really seizing that opportunity is based on recognizing that the way of thinking about the economy and financial markets that helped gear us over the past several decades is shifting. And what will separate the winners from the laggards, in my view, are those that

recognize this is a new circuit break; this is a paradigm shift. We maybe need to come at things a little bit differently than we would in the past.

Why? Three reasons. One, the economic data that we used to use to guide us into what was happen next, whether it was retail sales or job reports, well, it's too slow. It tells us where the economy was a month or two ago, not where it is now. This crisis is fast-moving, and worse, it's getting heavily distorted by new particularities of this recession. For example, California is no longer, over the next two weeks, going to be accepting initial jobless claims data. We won't know how many people newly became unemployed in a huge segment of the US market. That's one example.

The second reason: this time is more challenging for anybody watching markets is that this is effectively a situation without comparison. Most economic and financial analysis is going to use past precedent to help us figure out the future. In the past, if X occurred, then most of the time Y occurred as well. But this pandemic in this type of economy has not happened before so we are effectively flying blind.

And the last reason that this is a more challenging environment and why we need to really push away some of the past recessions in comparison is that much of the outlook will, of course, depend on medical advancements, of which I am not an expert. I can put a Paw Patrol band-aid on my son's knee, and that's about the end of it. So we are really reliant on an entirely different field that has very rarely been incorporated into economic and financial analysis in the past.

Now, that said, over this period we have developed what we feel is a useless way of – useful, certainly not useless, that's a poor choice of word – useful way to think about where we're heading next, and we call this our Three-Phase Framework. This framework is available to you on the Manulife Private Wealth web site; it is there, we write about it frequently. You can follow me on Twitter; I'll update you about it as frequently as I can.

This Three-Phase Framework begins with what we call Phase 1: The Rapid Rebound. Now, this period was really defined as of beginning in mid-April. We can even pinpoint it, April 15th to April 18th, by analyzing all of the high-frequency data. And we expected that period to run until about August. Now, in the Phase 1: Rapid Rebound, our call has been that the economies in Canada and the US and most of the developed world would recoup 60 to 70% of the lost economic output between March and April. That's pretty expansive. But key to this view has been the view that economists would vastly underappreciate the re-acceleration that we would see in the economy. But as much as we could say, and it was true, that this would be the worst economic crisis in modern history, our view has been that the rebound would be vastly underappreciated between that period.

Why? Well, it came down to one factor. And yes, Leslie is right to note that, you know, there are Wall Street Journal articles that will tell you there are five different reasons, but to me the most important one is the extent of the historically large government transfers and government stimulus that landed in this system. This is without compare. It has also been difficult to measure because we're using new lows of distributing, things like CERB in Canada or unemployment insurance top-ups in the United States, new programs like Pandemic Unemployment Assistance in the US, data points for which we don't have a history.

Critically, over this period our view was expectations will be so low they'll be easy to surmount. Now, I'll give you an example of this idea. It might seem initially a bit awkward, but it really comes down to the idea that markets do not care if data is good or bad; markets care if data is better or worse than expected.

The other day I heard my husband talking to his friend who just got married, a nice socially-distanced wedding out in the countryside, probably around a lot of cottages. John Natale will talk about that with you. And he said to his friend on the phone, I overheard this, I'm sure I wasn't meant to: "You know, the key to a happy marriage is really to just set expectations so low. Lie on the couch, do almost nothing. Every once in a while, change a lightbulb or take out the garbage, your wife will be so happy with you she won't know the difference."

So my husband is not in markets, he's an artist, but I tell you, he could probably play markets really well because he understands this key differentiator. It is not about good or bad; it's about better or worse than expectations. And over this Phase 1 period, what did we see? Extraordinarily low expectations and then the largest upside surprise in data's history when it came to the wedge between what economists' expectations are and how data really came in.

Now, it's odd to talk about what happened in the past. That's not how we make money. Telling you about Phase 1 does not help you necessarily make investments when we head into Phase 2, except it carried with it two extraordinarily important lessons. Number one is that expectations started very, very low for this recovery and the economy has outperformed even though it has been very weak. Now we are a pivotal moment where the bar has been raised.

My husband, who fancies himself a marriage counsellor, would say, "Buddy, you've done too much. You've set expectations too high, now she's always going to think you're going to take the garbage out. That's a problem.

Number two, the fiscal stimulus that was in this pipeline was so powerful that in April, in the US, for example, personal incomes were up 14% year-over-year. Imagine, the worst recession in our history and personal income is rising because of the transfers from the government.

Now, as we enter Phase 2: The Stall-out, not only have expectations been raised, but almost all of those major fiscal transfers have expired or are being wound down.

And that brings us to Phase 2, what we call The Stall-out, which I dramatically named intentionally. And because Leslie has noted here that it stuck, I feel like I made the great creative choice on this one. Why did we call it The Stall-out? Well, we called Phase 2 The Stall-out because we did not want to imply that the economy worsens from this point forward, but only that it becomes much more challenging for the momentum we've seen thus far to continue.

Now, in Phase 2: The Stall-out, our view is that the remaining 30% of growth stagnates, that it becomes very challenging for us to recoup that last 30%. Part of that is because of the end of government transfers or the waning down of them. But the second one is actually a very simplistic idea, but also incredibly detrimental, and that is that we are still asking primarily services and businesses to operate with social distancing in effect.

Now, I could show you a bunch of charts and tables and talk you through the models of this, but I will tell you, I had a singular experience that made this incredibly clear to me. So I don't know what you did after the economy started to reopen and we had news that shops were opening again. I called my hairdresser because the world was dangerously close to discovering I am not at all a blond, but a dark brunet. This was a big problem for me. So I called my hairdresser and I said, "When can you see me?" And he sounded actually very distressed on the phone. He said, "Frances, it's going to be six weeks to two months." And I thought, "Why? I'm a VIP, shouldn't I be in right away?" And he said, "Listen, I can only bring in one client at a time. I can't have two chairs running at the same time next to each other. In addition to that, I have to schedule 30-minute breaks in between for a complete disinfection of my salon. And I can't even offer all the services that I typically did. You're going to be leaving here with wet hair because I'm not allowed to blow dry it."

Then he tells me, "In order to make ends meet, in order to make sure that I can meet payroll for the rest of the people in the salon, I'm going to be raising prices." Now, in that one experience, my hairdresser has actually described exactly what happens in Phase 2. That once everything is opened up again, we are still operating with social distancing in effect. It means that companies cannot bring in all of the clients and all of the revenue that they would want to or even that there might be demand for. And in addition to that, because as economist would say we are dealing with a supply side shock, prices are rising. That's very important. It means that unlike in past recessions which were deflationary, there's no demand for things, you're getting coupons to buy things from the Gap for 60% off, they just want to get rid of the inventory, now we're in an environment where the supply side is falling, they have no choice but to raise prices. That would be called bad inflation by economists; it's problematic.

So as we enter Phase 2, you will see that there will be more companies that actually have to close permanently. There will be more companies that have no choice but to cut payroll, not continue hiring. And all that momentum that we saw, in my view, will stall out over that period.

So there are other things that will happen over the stall-out period that make this a more challenging environment for markets. In Phase 1, my team and the Asset Allocation team advocated being overweight risk assets that worked with our strategy, a weaker US dollar. As we enter Phase 2, we know that markets are more likely to be range-bound or suffer down days or down periods just like we're experiencing right now, and that markets are going to have to pay a little bit more attention to this idea of bad inflation that's problematic.

Other things to monitor in Phase 2. Of course, the US election. When we talk about the US election, I am far less concerned about who wins the presidency and far more concerned about the composition of government. Who wins the senate, for example? It is the composition of senate that will determine, and the government as a whole that will determine which policies are passed and which ones actually stay on the sidelines. We also need to watch for uncertainty around who potentially is the winner of this election. Is it declared on November 3rd? Are we all sitting there on our couches at 11:00 at night? Or does it take a couple of weeks for us to know the answer? These are issues that are far more important in the next six months than any of the underlying policies.

Now, I also think we need to watch employment data. Many of us have noticed that there has been a significant improvement in hiring. Now, we need to differentiate between two employment forces that are happening here. In the beginning of the crisis, 80% of those that were laid off were laid off "temporarily." They checked this box. They were, for example, the Starbucks baristas who knew that the Starbucks would eventually reopen and they would be rehired. Or, I have a cousin who is a tattoo artist, and she had to close her shop, she could not do any tattoos and she knew apparently people really like tattoos, I don't have any, but she said, "Listen, eventually people will come back and they will want to have forever drawings on themselves." Everyone can do what they want with themselves. And she knew she would be hired back so she was a temporary layoff.

Now what we're witnessing is all those temporary layoffs are being rehired in droves. But underneath the surface is a more problematic development, which is that we are seeing more and more companies that are choosing to close their doors on a permanent basis. Last week, my sister, an architect in downtown Toronto, was told that actually her firm would be closing. So this is a little bit more of a permanent type of job loss, right? So we need to differentiate between the tattoo artists and the

architects. That is the differentiator that's happening under the surface. In many ways, I am more concerned about the job market now than I was the job market in March and April, even though the headlines numbers make it appear that it's better right now.

Now, I want to talk a little bit about Phase 3. Phase 3 is what we call The New Normal. And I'm had this sort of obsession in my head about when we transfer out of The Stall-out to The New Normal, Phase 3. And in the past, I would have told you I think it's based on a vaccine. The vaccine must be the thing that makes people feel comfortable going out to the museum again. Or mixed governments say we don't need to be incorporating social distance. My hairdresser does not have to disinfect his entire shop in between clients.

However, I no longer believe that it's just vaccine or bust, and all the epidemiologists and medical experts that we speak to suggest that we may actually be able to arrive to Phase 3 with a drop in mortality rates, a drop in hospitalization rates, and it might not be so simple as Phase 2, direct transition to Phase 3. So timing this is really challenging.

But what I think is important about the framework that we've set up is the themes that I feel are relevant in Phase 3 are investable now. Even if we see a lot of volatility in the near term, if you are a long-term investor, if you have more interest in investing, setting up a well-defined portfolio and letting it move or breathe for that five-year period or multi-year period, then you can already focus on Phase 3.

Now, in The New Normal, I get asked all the time: What do you think about corporate real estate? What do you think about Zoom? What do you think about work from home? But I want to emphasize some powerful trends that I think are more dominant forces in the way we think about the economic and financial system.

First and foremost, no matter who wins the election, the pandemic was another deglobalization shock. US and China will continue to decouple and we will continue to see regionalization of trading blocks and an ongoing movement of Asia trading with Asia, Europe trading with Europe, and North America trading within itself. That is true regardless of who wins the election, regardless of what Phase 2 happens, we know that deglobalization is a trend that will persist.

Number two. This one is a very hot topic, particularly with the Canadian Throne Speech coming up, and that is the idea that we are going to see extraordinarily large government spending. This there is no doubt. Canada is likely to go back to the debt-to-GDP ratios that were so problematic for it in the 1990's. The US will hit it's highest debt-to-GDP ratio ever measured since the 1800's. Now in the past, I would have told you this means taxes are going to go up. But actually, this is more complicated and game-changing than initially seems.

For one, interest rates are extraordinarily low and likely to stay low, in my mind, for at least five years and possibly longer. And if that's the case, then the cost of servicing government debt, the debt servicing cost, may stay the same or even decline. In fact, next year in Canada we will pay less for debt servicing costs than we did last year.

Number two reason, but this is not as problematic as it has been in the past, is that central banks are buying up massive amounts of the issuance from governments. In the past what we worried about is that people would say, "Sheesh, you know, Canada or the US is running huge deficits, huge levels of debt, we should maybe be worried that they could repay us in the long-term, we're going to ask for a higher interest rate." But the Bank of Canada has bought 83% of the Government of Canada's issuance since March. We don't need to attract global investors; we have a captive investor from the Bank of Canada. This is a bit of a game-changer.

What it does imply, however, is that we are going to see governments that are issuing a lot of bonds, particularly at the long end. And this is why I think that yield curve does start to seep in. And if you're an investment that benefits from that, that is good news for you.

The last point I want to make before I turn it over to John Natale is that we are going to be in an extraordinarily low interest rate environment. I have talked with so many of you about this before, but now because of the pandemic, it is certainly exacerbated. What do I mean by this? I mean that global government bonds are going to continue to give you a very low return. In fact, in Canadian dollar terms, over the next five years, I actually have the global government bond complex giving me a negative return over a five-year period.

Now, if you're a massive institutional investor, a pension fund, and you're trying to generate 6-7% nominal, you have no choice but to move out of global government bonds and into other assets that can generate a return for you. That means you have to be further up the risk curve, so you're going to be heading more into equities. It means you're going to be thinking about alternative types of funds, things like infrastructure, agriculture or hard assets, or real assets, these types of things that maybe were not on our docket beforehand. It means we're going to be thinking internationally. Emerging market debt is a complex that I like for a lot of reasons, this as well. But the game-changing development here is that we went from a period where we thought interest rates would be normalized higher, and in fact they are back at zero and likely stay that way.

So as you progress through all of the information that comes in the next couple of weeks, months and years, do your best to categorize it into what qualifies part of that end of the Phase 1? What is really going to be about the next six to eighteen months? What helps me decide when we're moving from Phase 2 to Phase 3? But most importantly, what are the long-term investment trends

that I can focus on now in the midst of this volatility that make sense no matter what this uncertainty produces for me?

So I am here because I'm so thrilled to pass over back to one of my favourite speakers in the company, a treasure for Manulife, which is John Natale. Thank you for your attention today. Thank you for dialling into this call. And if you need more information, check out what we're writing about. Talk to your Manulife Private Wealth support; we're here to help you.

Leslie Brophy, AVP, Head of Investments and Sales, Manulife Private Wealth

Thanks, Frances. Definitely a lot to think about, especially given the uncertain conditions we're seeing today in the market, but definitely long-term. Stay invested.

As the wealth of family increases, families tend to acquire additional assets, which sometimes carry an emotional attachment and can make asset transfer planning for high net-worth families complicated. For many families, the cottage comes with a high or very high level of emotional attachment. And in succession planning, families can make it their highest priority for the cottage to stay in the family for the enjoyment of successive generations. When one of the owners of the cottage passes away, this asset may be transferred to the surviving spouse tax-free. But a transfer to your children or other heirs may trigger capital gains tax, which must be paid before ownership is transferred. Those families planning to pass on the cottage to their children may not realize the potential tax bomb that awaits. In fact, many cottages have increased significantly in value over their purchase price, and 50% of this increase could be taxable at death. If not properly planned for, your estate may ultimately be forced to sell the family cottage to raise the money necessary to pay the capital gains tax.

Our next speaker, John Natale, is the Head of Tax, Retirement and Estate Planning Services Wealth Team at Manulife. He and his team provide case-level support on tax, retirement and estate planning matters to advisors across the country. He's a frequent speaker at industry conferences and seminars, and has appeared as a guest expert on industry podcasts and BNN Bloomberg TV. John has published numerous articles on tax and estate planning, and is co-editor of Canadian Taxation of Life Insurance.

John is going to provide us with tips on cottage succession planning and keeping the family cottage in the family, by taking a look at the issues, discussing possible wealth transfer strategies, and outlining some of the other considerations you may want to look into. John, over to you.

John Natale, Head of Tax, Retirement & Estate Planning Services, Manulife Investment Management

It's my pleasure to be here today, one day before the Throne Speech, like Frances mentioned. Who knows what's in store tomorrow?

So, keeping the family cottage in the family. This is a very, very significant issue. Just changing my view. There we go. I've listened to a lot of presentations on this, did a lot of reading, obviously, to prepare for this presentation. And I can tell you, actually, I thought some of the best speaking points on this was I heard lawyers comment that family cottages, they found to be very similar to family businesses. And the reason being is lots of value, but highly illiquid, and with an emotional overlay, which results in very problematic estate planning.

And it's actually funny, but this lawyer she was actually living it and she was saying, "Do as I say; don't do as I do," because she was having all sort of issues with cottage succession planning. So this is a very, very sensitive topic for many people. Obviously, there's the emotional attachment, there's the memories and so forth. This is very fact specific. I know that sounds like a bit of a lawyer cliché, but I would say it particularly applies in this situation. There is no silver bullet, there's no panacea. Every situation is unique.

I would also say that, you know, in the interest of time, I'll speak to things at a high level. I will at the end touch very briefly on foreign properties, specifically US property, you know, like that property in Florida, Arizona or California, wherever that may be. But again, this is something that your clients need to speak with their tax legal advisor to confirm the best strategy for them.

So, I think Leslie you did a fantastic job with the segue. I think the dilemma that many people are facing, whether they realize it or not, is they have cottages that have been in the family for many, many years. They bought the cottage years ago at a significantly reduced price and now the cottage has appreciated in value tremendously. And just so you know, when I say cottage, it could be a cabin, it could be a chalet, it could be a condo, per se. But hopefully you guys all know what I mean by that. And so now they have this incredibly large pregnant or inherent capital gain. And the dilemma that they have is, you know, if you take the example here, and I have an example on the slide.

Someone has bought a cottage let's say, 15 or 20 years go. The purchase price at the time was $100,000, and it is now worth half a million dollars. And again, this is just for illustration purposes. You may have clients – I'm sure you have clients whose numbers vary from this, but you'll get the point. So let's say they're 65 today. They're 65, they want to keep the cottage in the family because of its sentimental value. The grandkids love going to the cottage. In fact, I've heard many people say, well, the

parents don't want to take on the cottage, they know the potential headache, but the grandkids love it so much that they want to keep the cottage in the family.

And the grandparent who owns the cottage is saying, "Okay, well, I have a $400,000 gain today. If I was to sell that cottage today or if I were to pass away, because when you pass away there's a deemed disposition, I would trigger a $400,000 capital gain. Fifty percent of that would be taxable, so $200,000. If I assume a tax rate of 45%, the tax liability today would be $90,000." So not an insignificant amount. However, a 65-year-old quite possibly could live another 20 years. So if they live to age 85, assuming a 6% rate of growth, which I'll let you guys debate whether that's appropriate or not, but again I think you'll get the point. The fair market value would increase to approximately $1.6 million. Assuming that the cost base stays the same at $100,000, you're now talking about a $1.5 million capital gain, and assuming 50% inclusion rate, which may or may not change, and a 45% marginal tax rate, you're talking now a tax liability in 20 years of almost $340,000.

If this individual 20 years down the road doesn't have the liquidity in the estate to pay the tax for that disposition at death – and again, you know, eventually you can transfer a cottage to your spouse on a tax deferred basis, but eventually it's going to go to somebody else – if they don't have the liquidity in their estate to pay for that tax, then worst case scenario, the estate may be required to sell the cottage to provide the liquidity to pay the tax and therefore their estate plan and their intention of maintaining that cottage in the family has been frustrated, which is not their intent.

So how do you deal with that? So I call this a ticking tax time-bomb, and it is very significant. So there are many, many different options. You can deal with cottage succession planning and I'll go through a few just quickly. The first two are kind of my favourite, and I'll spend a little bit more time with them. But each of them kind of has their pros and cons.

And so the first one is, think about selling the cottage to your intended beneficiary – so in this example, let's say your children – now, as opposed to waiting until you pass away. Now, the benefit of that, obviously, is you know who it's going to, you can set the terms of the sale. An obvious downside is you're triggering the tax liability now. So you're triggering that $90,000 tax liability now and anybody who knows anything about taxes says, you know, a dollar of tax deferred is always better than a dollar tax paid now. That is true. However, I think there are some other benefits that may overcome that initial disadvantage.

By transferring the cottage to your – or selling the cottage to your next generation, your kids, now, the asset has left your estate. So you don't have to worry about that asset flowing your estate, being subject to probate, potentially fees, estate administration fees for the value of the asset that flows through your estate, any delays in terms of the administration of your estate. Any assets that flow through your estate and are dealt with under probate are also a matter of public record; anybody can go down to the court house and take a look at a copy of your will. You also cap your tax liability. You don't have to worry about that $340,000 down the road, now you just have to worry about the $90,000 now because the asset flows today as opposed to through your estate, you don't have to worry about estate creditors, etcetera. So there are a lot of benefits from that perspective.

Now, the other thing you can do is, if you take back a promissory note or a mortgage and the payments are deferred over at least five years, then what you can do is you can actually spread that tax liability over five years. So again, in our example the initial tax liability would be $90,000. Well, if the parent takes back a mortgage or a promissory note, and no more than 20% is paid each year, then they can actually spread the capital gain over five years. So instead of $90,000 in a year of sale, they can have $18,000, so $90,000 divided by five, $18,000 of capital tax payable each year. So a much more manageable amount. Much more significant. So it's important for people to realize that significant tax advantage.

The other thing to keep in mind as well too, is if your child – if you like this idea and your child doesn't have the financial wherewithal to perhaps buy the cottage now, that's okay. You don't actually have to force them to make the payments. You can forgive the payments or you can give them the money to make the payments. That's not the issue. In order to spread the capital gains over five years, all that matters is the payments at least contractually. You have no right to them over more than 20% per year. So that's very important. Furthermore, you can also forgive the debt in your will, for example, or after the five years, it doesn't really matter. So you don't actually need the transfer of assets from your child to you, but as long as you take a demand promissory note or a mortgage, you can spread that capital gain.

The other nice thing with documenting or papering the loan agreement, is that if for whatever reason the child you transfer ownership to has credit protection issues or they go through a marriage breakdown, by having that mortgage, for example, it gives you priority in terms of creditor protection and helps you preserve the value of those assets.

Now, what some people try and do, sometimes people overthink this, and this is a very common mistake and it's very problematic, so a big red flag here. They say, "Well, John, you know what I'll do, is I will transfer the cottage to my child for a nominal dollar amount. So instead of transferring the cottage at fair market value at $500,000 to my child, and triggering a $400,000 capital gain, I'll transfer it for $100,000, for example. No capital gain."

That's a big no-no, because regardless of what price you charge, if it's less than the fair market value, for tax purposes, the CRA will deem the proceeds or the disposition to be at fair market value. So if you paper the sale at $100,000 at your cost base thinking you're not trigger the capital gain, CRA says, "No, no, no, no. We're going to apply fair market value, which is half a million dollars, so you're still going to trigger that $400,000 capital gain. Furthermore" – and this where the whammy comes in – "furthermore, the cost base for your child instead of being $500,000 going forward, is actually what you use for your transaction of $100,000." So you actually have double tax, so that's a big red flag, a big potential trap for people to fall in. So be very, very wary about this, okay?

The second one that I think is one of my two favourites, is life insurance. I think it's pretty self-explanatory, pretty simple. If people have life insurance in place or are able to get life insurance on a cost-effective basis, this is a great strategy. It provides liquidity for your estate to manage the tax liability. And there's nothing like an injection of liquidity to carry out your estate plans.

Obviously, the big caveat here is do you have life insurance or can you get reasonable life insurance? If you don't have life insurance, that can be an issue, especially as your clients get older. What I have heard some people say is if the cost of life insurance is a discouragement or an impediment to getting life insurance, maybe have the beneficiaries contribute or pay for some of the life insurance premiums. So that can be one way to overcome that cost. So life insurance is another great way to deal with the tax liability at death.

I'll deal with the other ones kind of quickly as well. You could, there's nothing stopping you from gifting the cottage to a next generation now, okay. And when you gift the cottage to the child now, you're deemed to have disposed of it at fair market value, so you are going to trigger that capital gain. Okay, so you trigger that capital gain, you can't avoid it. The downside in addition to that is you can't spread it out over five years like you could if you do a sale and you take back a mortgage or a promissory note. So that's, I think, a very significant downside. Your child will inherit your ACB at the fair market value, but that is a potential strategy. As well, by gifting that asset to the child now, you do expose the asset to your child's creditors and you don't have a claim to protect against that or if they go through a marriage breakdown or something like that.

And the one other thing I want to mention that is very important with a sale now or a gift now, is that there is an element of loss of control. So one thing that people recommend is as a parent if you're either going to sell it now to your child or gift it to them now, if you want to retain some type of access to the property, then it's very important to draw up some type of residual or life interest in the terms of the sale or the potential gift. And you can do that with the help of a lawyer to allow you to have access or still use the cottage, for example.

Another strategy that people use that is a little bit complicated, but has significant pros, is a trust. You can transfer the asset to a trust either at death or while you are alive. The trust rules have changed significantly over the last couple of years. So previously what people used to call in layman's terms is a cottage trust. You transfer the cottage to a trust. It's just basically a regular old trust. The downside was that when you transfer the cottage to the trust, it's a taxable event when it goes to the trust. And as well, there was a 21-year deemed disposition, so after 21 years, the trust is deemed to have sold the cottage unless they flow it out to a beneficiary. But the benefit was that it flows outside of your estate so you avoid probate and all of those other things, that's a nice benefit. You can also add features in the trust or terms of the trust of how the cottage is supposed to be administered, how it's supposed to be distributed, and so forth. And again, you cap your tax liability and then any future tax liability is going to be in the hands of the trust. And that trust could in previous years potentially claim the principal residence exemption if you otherwise qualified.

Now, they have narrowed down the rules in terms of which trusts can qualify for the principal residence exemptions. The only ones that can qualify generally speaking are an alter ego trust, or a joint partner trust, or a qualified disability trust, or certain very specific trusts for minor children where their parents passed away. So if you're going to use one of those trusts anyway, you could still potentially use the principal residence exemption, but that kind of vanilla trust from a cottage planning perspective can no longer claim the principal residence exemption if that's what you were hoping to do. The nice things with an alter ego trust or joint partner trust or even a spousal trust, is the asset can roll into the trust on a tax deferred basis so you get that nice tax deferral and, again, you still maintain your principal residence exemption. The downside with trusts, obviously, is the cost, the initial setup, you have to find trustees. And starting next year – a lot of people don't realize this – starting next year, even if your trust has no income to report, they still have to file a tax return and there's significant documentation required by your tax preparer in terms of who the seller of the trust was, who the trustees are, who the beneficiaries are, including all of the beneficiaries, and all sorts of personal identification required amongst all those potential people. So that's actually an increasing burden when you're dealing with a trust strategy, so keep that in mind as well. But trusts can work.

Joint ownership is another strategy you can use. You could name an adult child as joint owner on your cottage. Keep in mind though, with that, there is a taxable event. When you name your child as joint owner, you are disposing of part of your asset at that time. And then when you pass away, assuming that you pass away first,

and your remainder interest goes to your child at your death, that's another taxable disposition at that point in time as well. By adding an adult child as a joint owner, you do expose that asset to their creditors as well if they have a marriage breakdown. As well, you've lost an element of control now with that asset, which is very, very important. And if you're dealing with a US property, joint ownership, my understanding is joint ownerships is very much discouraged, it's not recommended at all if you're dealing with a foreign cottage, so you want to think twice about using joint ownership.

And lastly, this was kind of our default provision, is you could just deal with the cottage in your will. But you deal with the cottage in your will, so hopefully you planned for that tax liability, that $340,000 tax liability we talked about in this example. In many provinces, that asset will flow through probate and be subject to probate fees or estate administration fees. In some provinces, including Ontario, if you use a multiple will strategy and a bare trust, so you transfer ownership of the cottage to a bare trust and you deal with that in a second will, then you can avoid probate, so there is that benefit there potentially. But again, the key there is make sure you have liquidity in your estate to pay for the taxes, and that's where life insurance and dealing with it through your will can actually be very, very effective.

So again, very high level, definitely should be talking to your tax or legal advisors to determine which one is best for you. There are pros and cons with each one. Like I said, there's no silver bullet. So that slide was really talking about or dealing with the assumption that the principal residence exemption is not applicable, right. And so you say, "Well, John, can you give me a little bit of background about the principal residence exemption? Why would it potentially not be applicable to the cottage?"

Well, just keep in mind now that they changed the rules. In 1981, they changed the rules so that there's only one principal residence exemption allowed per family unit. And the family unit is considered yourself, your spouse or common-law partner, and your minor child. Sorry, in 1982 they changed the rules. So before 1982, if you had two properties, no problem. You could claim the principal residence exemption on one and your spouse could claim the principal residence exemption on the other. That all changed in 1982. So now you can only have one principal residence going forward from 1982 and onward.

So then you think about, well, which property do I want to use the principal residence exemption on? And to me that becomes a bit of a quantitative or mathematical analysis. I would look at it and say, which property, if you're comparing two properties, let's say your city home and your cottage, which property – in the years that you had ownership in the same years – which property realized the greatest growth? Whichever property realized the greatest growth in market value, that would be the property I would generally use for the principal residence exemption.

So we initially assume they used the principal residence exemption on their city property, but you don't have to.

So just to take a step back here, what happened was in 1972, before 1972 there was no capital gains. In 1972 the government introduced capital gains, so that's the first time when you sell a property you would trigger capital gains. In 1981, starting 1982, you could only have one principal residence exemption per family unit. In 1994, you were entitled to a $100,000 one-time capital gains exemption. So a lot of people used that $100,000 capital gain exemption and added it to the cost base of their property. So that's some of the background. In order to qualify as a principal residence, it must be something that you own, okay, and you must ordinarily inhabit it.

What does ordinarily inhabit mean? Well, there's all sorts of case law on it. I mean, if you stay in your cottage three, four weeks a year, a month or two a year, I would say ordinarily inhabited. If you stay in your cottage one day a year, is that ordinarily inhabited? Technically you might get away with it, but I think it's really a stretch. And I heard other commentators say that they think that might not be sufficient. But you must ordinarily inhabit it or a family member must ordinarily inhabit it. You must own it and it can't be an income property, it must be capital. So you can't be in the business of flipping properties. And as well, you're entitled to up to half a hectare, which is 1.2 acres. I had to look that up. Half a hectare, which is 1.2 acres, and they basically allow you to own that land around your residence and then qualify for the principal residence exemption.

Any land in excess of half a hectare, or 1.2 acres, the starting presumption is that you do not need that for the use and enjoyment of your residence, so therefore will not qualified for the principal residence exemption. But if you can make an argument that you require it, for example, you have a full hectare and the sub-division rules don't allow you to sub-divide your property less than one hectare, well then that would be an adequate argument that has being successful in court in the past. So those are some of the things to kind of keep in mind with the principal residence rules and its history.

When it comes to foreign property, a foreign cottage, like a US property, can qualify for the principal residence exemption assuming you meet all the other tests. But I will tell you that most practitioners do not use the principal residence exemption on a foreign property because when you sell that foreign property, you're going to pay tax usually in that foreign jurisdiction either on the sale or as estate tax. Like, for example, US estate tax. But then that tax that you pay in the foreign jurisdiction, you can claim as a tax credit in Canada on your Canadian taxes. If, however, you claim the principal residence exemption on your Canadian taxes, then you can't make use of the foreign tax credit. So effectively, you've wasted your principal residence exemption. In that example you'd be better off to use your principal residence exemption on your other property. So keep that in mind.

Now, a couple of things specifically with respect to US property that I do want to mention, is even if – and I'm only going – I'm really getting into an area where I'm less and less comfortable – so again, even more impetus or requirement that you guys speak to a tax advisor. I'm going to focus on individuals who are not US citizens. So for example, someone who is a Canadian citizen, resident in Canada and owns a property in the US. If you're a US citizen, the rules get even more complicated. So a non-US citizen living in Canada with a US property. A lot of people are surprised you could still be subject to US estate tax, because that US property is considered US situs property. Okay, so be very, very careful about that. You could still be subject to US estate tax.

A lot of people are surprised. But as well, when you sell it, it may be subject to US estate tax if it's on your death, or a capital gains tax in the States. But as well, you're going to be taxed on a capital gain in Canada. And when you calculate your capital gain in Canada, you have to convert the US dollars to Canadian dollars. So if I bought a US vacation property for $200,000 US and I sold it two years later for $210,000 US, you think, well, my capital gain is only $10,000 US. But you need to convert that to Canadian dollars. So when I bought that property for $200,000 US, if the dollar was at par, that's $200,000 Canadian. If I sold it at $210,000 when the US dollar is worth $1.50, well, now my proceeds of disposition are $315,000, right. So now I actually triggered $115,000 capital gain. A lot of people forget about the foreign exchange.

The other thing to keep in mind too is when you sell your property, if it's at a loss in the States, you don't get the benefit of the loss. So think about your US estate tax, think about your Canadian capital gains with the foreign exchange. For US estate tax, I have heard different strategies. Some people have talked about using – I have heard about using a single-purpose corporation, but I've heard that the attractiveness of that is significantly diminished because they changed some tax rules lately, so be very careful with that.

A more popular strategy I've used is using a Canadian Resident Trust to avoid or eliminate US estate tax. Another strategy you can use is to reduce the value of your US property. So how do you reduce the value of your US property for US estate tax purposes? You use what's called a non-recourse debt. That's a debt that’s specific to that property whereby it reduces the value of that specific property. Or as well, set up ownership tenants in common instead of joint ownership. By doing that, you reduce the value of that property for US estate tax purposes. Or you can use a tax deferral strategy. And there's a strategy out there called using a QDOT, a qualified domestic trust. It's a specific type of US trust and you can combine it with what's considered a Canadian spousal trust, and you get an element of tax deferral when it transfers over to your spouse. So there's a lot there, especially with the US property. Be very, very careful, but there are some strategies to mitigate or reduce your US estate tax.

And the very last point I have for you, just to really talk about tomorrow and the Throne Speech. There's been a lot of talk there about the potential change to the principal residence exemption. If you had asked me three months ago, I would have said 95% chance it's not going to change. I have to admit that I think the chance of that changing has improved slightly just because a lot of people are talking about it. They're comparing us to the US where the US they have a type of principal residence exemption but you only get up to about $250,000 per person and you must also live on the property for two of the last five years. So maybe there's something there that I should be – I might actually do sometime – I really consider this kind of sacred, that people would never touch the principal residence exemption, it would be political suicide, but people are talking about like it's a real possibility.

The other thing that people are talking about there is the capital gains inclusion rate. I think that this is much more likely. It's low-hanging fruit. People have been talking about it for many years and the government is desperate for tax revenue, so I think that is very likely. And again, that will obviously impact the situation where you're selling a property and you're not using the principal residence exemption.

That being said, be careful. If you try to be proactive with any tax planning, there's all sort of crazy tax strategies out there. One specifically people are talking about transferring your cottage to your corporation, triggering the principal residence exemption. I can tell you, speaking to many tax advisors, that's a huge no-no. Big red flag. Don't do that. Or at the very least, talk to your tax advisor, because transferring your cottage to your corporation, very, very significant adverse tax consequences and you lose your principal residence exemption. So very wary.

And my very final point is, it's not all about taxes. Even though I'm a tax guy, it's not all about taxes. Both my personal experiences and talking with other lawyers, sometimes other factors are more important. You know, that sentimental or emotional value or just keeping your family together and not having it breaking down in terms of all sort of petty arguments. So think about the terms of how the cottage is going to be transferred to your next generation. Think about the rules. A common thing people ask are ask what ifs. What if one child dies before another child? What if one child doesn't want the property? What if one child wants to sell out? What if one child is not carrying the load and paying their fair share of the expenses or taking care of their share of the responsibilities? Have rules in place that kind of manage that or reduce the likelihood or possibility of some type of family dispute.

Anyway, that's a whole whirlwind. I hope that we left you with some tips and things to consider and thank you very much for your time.

Leslie Brophy, AVP, Head of Investments and Sales, Manulife Private Wealth

Thanks, John. There's a wealth of information there for all of us on cottage ownership, cottage succession planning and just essentially the pitfalls and the benefits of transferring the cottage with planning involved. So thank you so much. On behalf of Private Wealth, we appreciate that high net-worth investors have a broad range of wealth management needs which call for specialized skills to help manage their complex financial situations. That said, clients of Manulife Private Wealth enjoy access to the professionals at Manulife for help with their private banking and wealth and estate planning needs, not to mention the advantages of MPW's investment management expertise to help them along the way to meeting their financial goals.

We hope today's comments were insightful for you as we head into the latter part of 2020. To learn more about Manulife Private Wealth's investment platform or how to access the specialized expertise of the team working with Manulife Private Wealth, please reach out to a member of the Manulife Private Wealth team.

On behalf of the team, thank you for joining. We look forward to hosting you at our next session on October 15, where we will discuss business strategies for small- and mid-size business in this New Normal business environment. Thank you very much, and good afternoon.

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