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# Perspective

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## Cautious Optimism

There are plenty of things to worry about in the global economy and many of them have surfaced in the past quarter. Sovereign credit risk in the U.K. and the Eurozone dominated much of the news in the past quarter and mounting calls for fiscal restraint run the risk of derailing the nascent recovery—that is, if the U.S. were to respond this year. Instead, however, the U.S. is more likely to maintain its current degree of monetary stimulus, taking more time than other central banks to raise interest rates. The U.S. fiscal position, though still in deficit, is improving as the economy has picked up and corporate tax revenues have increased faster than expected. Political pressure is mounting in principle in the U.S. for deficit-reduction measures, but any substantive moves in that direction likely await a convincing sustained expansion. Labour markets are improving, but not as fast as most people would like and the exogenous shocks to the economy, be it from the BP oil spill or the fiscal tightening in Europe, can't help but depress overall confidence.

Businesses and households have deleveraged; in fact, even though government borrowing has risen, total credit outstanding in the U.S. is falling. Banks are reducing their balance sheets in response to likely financial reform measures, businesses are holding a record proportion of cash, and consumer spending is restrained. Overall, however, we are forecasting roughly 3% growth in the U.S. this year.

Growth will be even stronger in Canada. While many of the same factors have plagued our stock market of late, Canada's domestic economy and fiscal position is fundamentally stronger than in the U.S. as evidenced by the Bank of Canada's rate hike this month. Inflation pressures are rising a bit contrary to the decline in core inflation stateside to less than 1% year-over-year. But the slowdown in the global economy in recent months has taken commodity prices down (other than gold), negatively impacting the Canadian economy. Volatility will continue for some time yet, but despite the many pessimists out there, we continue to believe that the risks of a double-dip in the economy are low.

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# BMO Nesbitt Burns Tax Survey

## Reveals Canadians Unsure of their Tax Situation

BMO Nesbitt Burns commissioned a survey which received significant media attention during the past tax season, as it examined Canadian's attitudes and behaviours towards tax planning. Conducted by Leger Marketing in late March of 2010, the survey found that the majority of Canadians are not thinking about tax implications every time they are making investment decisions, and as a result may be paying too much in taxes or not reaping the full benefits from their investments. Specifically, the survey revealed that:

- More than three-quarters (76 per cent) of Canadians do not take tax implications into consideration every time they make an investment decision;
- Almost 40 per cent (37 per cent) are not confident they are taking advantage of all tax incentives available to them; and
- Almost 9 in 10 Canadians (89 per cent) are not certain how recent changes in federal budgets impact their personal tax situation.

The survey also examined Canadian's intended uses for their tax refunds this year and found that most people will focus on paying down credit card debt and bills over travel, home renovations and mortgages.

Specifically, the survey revealed that:

- Twenty-one per cent of Canadians are planning to invest their refunds in RRSPs and TFSAs;
- Fifteen per cent are planning on using their refunds for home renovations or household expenses;
- Twelve per cent will be using their refunds for travel and/or leisure items; and
- Only four per cent of Canadians plan to use their refunds to pay down their mortgage.

While considering overall investment objectives and factors such as risk tolerance and expected return should be top of mind for investors, Canadians should keep in mind personal tax implications when planning their investment strategy.

Please contact your BMO Nesbitt Burns Investment Advisor to help you understand the basics of investment taxation and ensure you are making sound investment decisions that fit within your personal financial plan.

# Make the most of your RRSPs/RRIFs

As Canadians live longer and healthier lives, the need to ensure that one's retirement savings will be adequate to sustain a long retirement period becomes ever more important.

The BMO Retirement Institute recently released a report *Proposals to Improve the Flexibility of RRSPs & RRIFs*, in which it recommended changes to the rules relating to RRSPs and RRIFs to help Canadians save more for retirement. The recommendations are to (i) remove age restrictions for RRSP contributions, (ii) provide more favourable tax treatment of investment income earned inside an RRSP, (iii) permit tax-free rollover of RRSP and RRIF assets on death to the next generation, (iv) lower the mandatory RRIF withdrawal rates, and (v) increase the maximum RRSP contribution amounts. The Institute has also appeared before the Senate Committee on Banking, Trade and Commerce as well as the House of Commons Standing Committee on Finance to discuss and present these issues.

> As Canadians live longer, retirement savings will need to be adequate to sustain a long retirement period

Until such time that some or all of these changes have been validated and / or implemented, there are some strategies that you can consider to make the most out of your retirement assets:

**Maximize your RRSP savings**

- Contribute early in the year, and contribute the maximum amount allowed.
- You are required to convert your RRSP to a RRIF by the end of the year you turn 71. If you still have earned income (and hence RRSP contribution room), and you have a younger spouse, consider making spousal RRSP contributions so long as your spouse is under age 71.
- Also, at the end of the year you turn 71, if you still have earned income, consider making an over-contribution to your RRSP at year-end, in anticipation of the contribution room that you will have the following year. This will result in a tax penalty for a month, but you will benefit from a tax deduction for the following year, as well a larger RRSP asset base.

**Keep your retirement assets inside a tax-deferred environment as long as possible**

If you do not need the RRIF income, you can:

- Convert your RRSP into a RRIF at the latest possible moment (i.e. at the end of the year in which you turn 71),
- Postpone taking your first RRIF withdrawal until the very last moment (i.e. the end of the calendar year following the year your RRIF is established), and
- Elect to calculate the mandatory minimum withdrawal amount of your RRIF based on your younger spouse's age.

**Ensure optimal tax planning**

Although you are not required to convert your RRSP to a RRIF until you reach age 71, you may wish to start taking RRIF income earlier.

- RRIF income qualifies for the $2,000 pension income tax credit if you are 65 years or older, so if you do not have other income sources that qualify, you may wish to take out $2,000 from your RRIF every year to take advantage of the tax credit.
- In addition, tax rules permit individuals who are 65 years or older to elect (for tax purposes) to split up to 50% of their RRIF income with their spouse. If your spouse is in a lower income tax bracket, this may result in lower overall household tax burden for you. If your spouse is also 65 years or older, this will also qualify him/her for the $2,000 pension income tax credit.

**Transfer your retirement assets to a tax-free environment**

Consider taking out RRSP / RRIF funds during years of low income, and use those funds to contribute to a TFSA. For example, if you retire at age 55, you may be at a lower tax bracket since your CPP and OAS payments have not yet commenced. It may make sense to start taking your RRSP / RRIF income earlier instead of waiting until after age 65, when your taxable income will be boosted by CPP and OAS payments. The funds invested into a TFSA can be withdrawn tax-free in later years to supplement your retirement income or, if you do not need the income, be used to create a tax-free legacy for your heirs.

To discuss these strategies further, contact your BMO Nesbitt Burns Investment Advisor.

# Tax Planning for an Inheritance

Having a Will, keeping it up-to-date and minimizing taxes payable by your estate are all important aspects of estate planning. Understanding the possible tax benefits of a testamentary trust requires the skill of a professional who specializes in estate planning. If you are looking to take your estate planning that "extra mile," your BMO Nesbitt Burns Investment Advisor can help introduce you to an estate planning professional, who can discuss opportunities for your spouse, children or grandchildren, to save taxes in the future through the use of testamentary trusts.

The inclusion of trusts in your Will can give your beneficiaries a greater after-tax return on the investment income earned from their inheritance. If you are expecting an inheritance from your parents, this might be an option worth considering in their Wills to reduce your family's tax bill in the future.

*Testamentary trusts* are trusts created on death (usually in your Will) that have one unique tax characteristic: they are taxed as a separate individual and have the same graduated tax rates. Income earned in the trust and paid to beneficiaries can be taxed at the lower marginal tax rates of the trust, even if the beneficiaries are taxed at the higher marginal rates.

Depending on the province and the income of the trust, the tax saving on the trust's lower rates can be up to approximately $13,000 every year. The maximum tax saving applies primarily to the first $30,000 of income; the approximate level where the income is taxed is at the lowest marginal rates. Even more savings can be generated where multiple trusts for separate beneficiaries are set up, or where the trust permits income to be paid, or *sprinkled* on a discretionary basis to other family members who themselves may be taxed at lower rates. These can include the child's spouse, children and grandchildren. An advantage of a family trust is that the distributions from the trust can be made at the discretion of the trustee, providing maximum flexibility and tax savings.

This could be a useful strategy if you expect that the inheritance you leave might be more than your children or family members will (or should) spend on debt reduction and lifestyle changes – e.g. if the inheritance will be invested. To determine this, you need to estimate the approximate value of your estate, and anticipate the financial position of your children or other beneficiaries at the time they will inherit.

Remember, by the time your children receive their inheritance, their income may already be at or close to the highest marginal tax rate threshold. Additional investment income will be taxed at the highest rate. If this income first passes through a testamentary trust you have set up in your Will, the tax rate can be reduced and your child can still receive the income. If your beneficiaries receive the inheritance directly, they cannot create the trust themselves to access this tax saving; it must be done in your Will.

There are many technical details involved when considering the use of testamentary trusts to reduce income tax for surviving beneficiaries. For example, unless the trust is for a spouse, unrealized capital gains will be taxed every 21 years in the trust. For this reason, many of these trusts have an option to terminate and distribute all property before the 21-year deadline. The final distribution of the trust property can be set out in your Will, or the trustee, such as your child, can be given the right to determine the final capital beneficiaries, either during the child's lifetime, or in the child's Will.

Your BMO Nesbitt Burns Investment Advisor can introduce you to an estate planning professional who can review with you the possible benefits of using a testamentary trust in your personal estate plan.

## Harmonized Sales Tax (HST) in Ontario and BC

Ontario and British Columbia will harmonize their provincial sales tax with the federal goods and services tax. Effective July 1, 2010, Ontario will have a federally administered 13% tax, British Columbia will have a 12% tax and the existing 13% HST rate in Nova Scotia will increase to 15%. The HST will follow the same basic operating rules as the Goods and Services Tax (GST). Generally speaking, goods and services that are taxable under the GST will be taxable under HST. Likewise, goods and services that are currently exempt from GST will not be subject to HST.

# Making sure your money lasts

Like many Canadians, you may have spent your working years building up your savings to buy a home, send your children to college or university, or perhaps fund other priorities while still managing to put aside some savings for the future. But as retirement draws nearer, you may also be uncertain if you have enough saved, how much income your savings will provide, and how long that income will last.

"Living off your retirement savings is very different than saving for retirement," says Tina Di Vito, Head, BMO Retirement Institute. "And while a lot of focus and energy may have previously been directed on accumulating savings, Canadian boomers who are approaching retirement now need to shift their focus to managing their income and withdrawals throughout retirement." Having a retirement income strategy will help you understand how much income you will receive from your pensions and other savings and identify any potential income gaps you may have.

> Living off your retirement savings is very different than saving for retirement

Make sure your retirement income strategy addresses the following key factors that will impact how long your savings will last:

1. **Withdrawal period –** A longer retirement means a longer amount of time that your current savings will need to last. One way to help decrease the amount you'll need to withdraw from your savings is to work part-time during the first few years of your retirement.
2. **Inflation –** Canadians are living longer, so your retirement could potentially last 30 years or more; and although inflation has been relatively low in recent years, this might not be the case for the next 30 years. Even a seemingly low annual inflation rate can significantly erode your spending power during your retirement years.
3. **Spending patterns –** Everyone has a different idea of what their desired retirement lifestyle might look like. Retirees who spend more during the earlier, active years of their retirement will find that their savings will deplete faster than a more steady withdrawal pattern.

> A fundamental element to successful financial management is to ensure that strategies are aligned properly with current life stages

4. **Taxation –** Make sure you consider how the various sources of retirement income are taxed. The source and amount of income may affect your tax rate, your eligibility for the federal income tax age credit, your ability to split your pension income with a spouse or partner, and whether you'll be subject to Old Age Security (OAS) clawback.

A recent BMO Retirement Institute study indicated that only 48% of Canadians are planning to discuss or have already discussed their post-retirement income strategies with a financial advisor.

"A fundamental element to successful financial management is to ensure that strategies are aligned properly with current life stages," says Ms. Di Vito. "Those in the 55-65 age range need to develop a retirement income strategy which may include restructuring their investments and developing a plan to deal with unforeseen expenses such as health care costs. It's critical that they speak with a financial advisor in order to determine what needs to be done to ensure a successful transition."

Speak to your BMO Nesbitt Burns Investment Advisor to update your retirement income planning strategy.

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