Wealth Management
& Capital Markets Perspective

Wealth Management
Dominion Securities

For the clients of Cobban Grimes Handscomb Asset Management of RBC Dominion Securities | Spring 2018

Andrew Grimes, CIM
Vice-President
& Portfolio Manager
416-842-1008

Julie Handscomb, CIM
Investment Advisor
& Portfolio Manager
416-842-2502

Nancy F. Cobban, CIM, CFP, FCSI
Vice-President & Director,
Portfolio Manager
416-842-2500

Shelley Knox, CIM
Associate Portfolio Manager
416-842-2503

Michael Cochrane
Associate Investment Advisor
416-842-5596

Aurelia Imbrogno
Associate
416-842-2504

Laurie Christensen
Associate
416-842-1009

Karen Murphy
Administrative Assistant
416-842-2446

RBC Dominion Securities
Brookfield Place
Bay-Wellington Tower
181 Bay St., Suite 2350
Toronto, Ontario M5J 2T3
Fax: 416-842-2249
Toll-free: 1-855-889-1127

The song remains the same

Written by the Global Portfolio Advisory Committee, RBC Wealth Management

A lot of turbulent water has passed under the bridge over the past 90 days. We don't intend to enumerate all the market surges and plunges; data points, political shifts, and misinterpretation of facts; central bank press conferences; nor the severe weather events that have buffeted markets and investor psyches over the past few months.

However, when we check in on the factors that have mattered most in determining what the trajectory of the economy, corporate earnings, and share values is likely to be over the next year or two, remarkably little has changed. Central bank policies remain unusually accommodative, and banks are ready to lend. Employment and wages continue to grow, unemployment to fall. Consumers and businesses are confident. Meanwhile, fiscal policies range from mildly to wildly stimulative.

Reliable leading indicators suggest there is more of this to come. As long as that continues to be the case, we expect to counsel investors to give equities the benefit of the doubt.

That said, confidence in the sustainability of the economic and earnings expansion is no reason to cease being vigilant. One potential wild card – a sustained surge in inflation – that were it to occur would force a recalibration of most variables that drive the investment cycle, bringing the next recession and associated bear market for equities that much closer.

Being watchful of this and other potentially negative changes in the investment landscape is always appropriate. So far no factor has emerged that would change our constructive view.

Regional highlights

United States

- The U.S. equity market has been weak and wobbly so far this year due to the spike in Treasury yields, Federal Reserve policy uncertainty, inflation jitters, ongoing Washington chaos, and more recently, economic growth concerns and protectionism risks, including tariff threats between the U.S. and China. None of these risks are acute enough to knock us off of our constructive stance on U.S. equities.
- The U.S. and its trading partners have incentives to resolve their differences. As long as trade rhetoric and disputes don't put economic and corporate earnings growth at risk, the market should be able to navigate through this period. But there could be additional volatility and downside along the way.
- The economic and corporate foundation is sturdy. Almost all of the forward-looking economic indicators we track are signaling the expansion

Continued on page 2

The song remains the same
(continued from page 1)

will continue for the next 12 months, at least. The S&P 500 earnings outlook is strong, as RBC Capital Markets anticipates 17% y/y growth this year and the consensus forecast is even higher. The market is reasonably valued with a price-to-earnings ratio of 17.0x based on our $155 per share forecast for 2018. The consensus forward P/E ratio is 16.5x on slightly higher earnings estimates.

- As the correction plays out, we would look for opportunities because the multiyear bull market should ultimately resume its upward path.

Canada

- The S&P/TSX Composite trades at a discount relative to its historical valuation relationship with broad developed and emerging market equity indices. Moreover, it trades at a historically wide discount to the S&P 500. We believe these valuation discounts will persist until such time as investors have better visibility on the successful resolution of a number of domestic risks.
- Scenarios under which investor sentiment towards the Canadian equity market could improve include:

1) a positive resolution to NAFTA renegotiations and other trade policy uncertainty, 2) an improved energy outlook with tangible progress towards transportation solutions in Western Canada, and 3) wage growth that helps consumers adapt to higher interest rates. Of course, the converse also holds true. A perceived worsening of any of these issues could cause discounted valuations to persist and/or downward revisions to earnings forecasts.

- Looking beyond the consensus estimates for 2018 earnings growth when U.S. growth dominates in large part due to its aggressive corporate tax cuts, the consensus outlook for 2019 earnings growth looks broadly similar between the S&P/TSX Composite and S&P 500. Analysts are forecasting a little over 10% earnings growth for both benchmarks next year. Of note, earnings expectations for the S&P/ TSX are not skewed by the resource sectors as forecast growth for the non-resources sectors is roughly in line with the benchmark on an aggregate basis.

Passive investment income in a private corporation

(Please note that the following is a condensed version of a more detailed article on this topic. The original can be accessed at www.cobbangrimeshandscomb.com.)

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. One of the proposed changes targeted passive investments inside a corporation.

In October 2017, after a consultation period, the government announced that they were moving forward with the measures to limit the tax deferral benefits of holding passive investments within private corporations and that draft legislation for these measures would be included in the 2018 federal budget (the budget).

On February 27, 2018, the government released the budget. The government departed from their proposals originally outlined in the consultation paper and instead proposed two new measures to limit the tax deferral advantages:

1. Limiting access to the small business deduction (SBD) based on the amount of passive investment income earned in a corporation and any corporations associated with it.
2. Limiting access to a refund of high corporate taxes paid on passive investment income where dividends are paid from income taxed at lower corporate tax rates on active business income (ABI).

The details of the two new proposed measures are discussed in this article. These proposed measures do not directly impact taxes on passive investment income earned in a corporation. The tax rates applicable to investment income, refundable taxes and dividends remain unchanged.

Since, at the time of writing, the provinces have not yet announced whether they will apply the measure limiting access to the SBD for provincial tax purposes, the article primarily refers to federal tax rates.

Limiting access to the small business deduction

Currently, there is a tax deferral advantage for business owners

who retain after-tax income in their corporation. This is because corporate business income is generally taxed at lower rates than business income earned personally. If an individual is in the highest marginal tax bracket and earns business income, this income is subject to tax at a federal tax rate of 33%. Canadian corporations, on the other hand, are subject to a general federal corporate tax rate of 15% on its ABI. In addition, if a corporation is a Canadian Controlled Private Corporation (CCPC) throughout a tax year, it may benefit from the SBD which lowers the federal tax rate on the first $500,000 of ABI (known as the "business limit"). The government announced in October 2017, and confirmed in the budget, that it intends to decrease the small business rate (the rate applicable on the first $500,000 of ABI) from 10.5% to 10% effective January 1, 2018 and to 9% effective January 1, 2019.

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

As a result of the lower corporate tax rates for ABI, incorporated business owners may have more after-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 saving in a personal investment account can achieve. The longer the funds are left in the corporation, the higher the value of this "tax deferral advantage."

The government is concerned with this tax deferral advantage. As a result, the government is proposing to restrict access to the SBD for CCPCs that have significant income from passive investments. The government proposes to reduce the business limit on a straight-line basis where the CCPC and its associated corporations have between $50,000 and $150,000 of investment income in a 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 a CCPC, and its associated corporations, earn at least $150,000 of passive investment income in a year.

This proposed 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. The reduction in a corporation's business limit will be the greater of the reduction based on taxable capital employed in Canada and the reduction based on passive investment income.

Implications of proposed measure limiting access to SBD

The proposed measure will only impact CCPCs that earn ABI, seek to claim the SBD and have passive investment income over $50,000. Moreover, it will only impact CCPCs to the extent that their ABI exceeds the reduced business limit. If the reduced business limit is still greater than the ABI earned by a corporation, the ABI will continue to be taxed at the small business tax rate. For example, a CCPC that has ABI of $100,000 but their reduced business limit is $400,000 will not be affected by this proposal. Their ABI of $100,000 will still be taxed at the small business tax rate. The proposed measure will not impact a holding company earning only passive investment income.

Example of how the new SBD rules may impact business owners

Joe is a doctor. He is the sole shareholder of a medical professional corporation. Joe's corporation is not associated with any other corporations and the taxable capital employed in Canada does not exceed $10 million. The corporation earns $700,000 of ABI annually. Joe has also accumulated a $2-million portfolio of investments in his corporation, which generates a 6% investment return consisting of interest income and portfolio dividends ($120,000 of annual investment income).

Under the current tax rules, the first $500,000 of ABI earned in Joe's corporation would have been taxed at the federal small business tax rate of 9% resulting in $45,000 of federal taxes payable. Based on the proposed measure, beginning in 2019, the corporation's access to the SBD will be limited because of the passive investment income being generated in his corporation. For every dollar of passive investment income earned in excess of $50,000, the business limit will be reduced by $5. So if Joe's corporation earns $120,000 of passive investment income in the preceding tax year, the business limit for the current tax year will be reduced by $350,000 (reduction of business limit: ($120,000-$50,000) x $5 = $350,000). This means that only $150,000 of ABI will be taxed at the small business rate. The remaining ABI will be taxed at the general federal corporate tax rate of 15%. As a result, Joe's corporation will pay $21,000 more in federal taxes on the first $500,000 of ABI.

Based on the proposed measure, Joe will have less after-tax dollars to invest in his corporation. However, Joe may still decide to leave the profits of his business inside his corporation to be taxed at the general federal corporate tax rate of 15% versus taking it out as a salary or bonus to be taxed at 33%, assuming Joe is subject

Passive investment income
(continued from page 3)

to the highest federal personal tax rate. This is still a significant tax deferral. This also assumes that Joe does not need the funds personally now or in the near future.

Conclusion

In light of these proposed measures, you may want to review your corporation's investment portfolio with a qualified tax advisor. If you hold significant passive investments inside your CCPC, your investment strategy may change to one that has the least impact on the reduction to the SBD.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax, or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal, and/or insurance advisor before acting on any of the information in this article.

Administrative Corner

At tax time – and all year round – we can help you manage the information you need to provide to your accountant. We can also work together with you and your accountant to help identify tax-minimizing strategies that can potentially enhance your after-tax income.

With your authorization, we can establish your accountant as an Interested Party on your account(s), and provide duplicate copies of many of your investment-related tax documents directly, saving you the extra steps of copying and sending them yourself. There is no cost associated with this additional service, and only the information you authorize will be forwarded to your accountant.

If you would like to discuss setting up an Interested Party on your account, or have any questions regarding this service, please contact any one of our administrative team members.

Benchmarks

Equity market 12-month trailing return (for month ending March 31, 2018)	
S&P/TSX composite total return index	1.7%
S&P 500 total return (C$)	10.3%
S&P 500 total return (U$)	14.0%
DJIA total return (C$)	15.5%
DJIA total return (U$)	19.4%
Nasdaq composite price return (C$)	15.6%
Nasdaq composite price return (U$)	19.5%

RBC Capital Markets Canadian Bond Market indices 12-month trailing return (for month ending March 31, 2018)	
Short-term index	-0.4%
Intermediate term	-0.5%
Three-month T-Bill (C$)	0.7%
Three-month T-Bill (U$)	0.9%

Wealth Management
Dominion Securities

This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. This report is not and under no circumstances is to be construed as an offer to sell or the solicitation of an offer to buy any securities. This report is furnished on the basis and understanding that neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers is to be under any responsibility or liability whatsoever in respect thereof. The inventories of RBC Dominion Securities Inc. may from time to time include securities mentioned herein. Insurance products are offered through RBC Wealth Management Financial Services Inc. ("RBC WMFS"), a subsidiary of RBC Dominion Securities Inc.* RBC WMFS is licensed as a financial services firm in the province of Quebec. RBC Dominion Securities Inc., RBC WMFS and Royal Bank of Canada are separate corporate entities which are affiliated. *Member-Canadian Investor Protection Fund. RBC Dominion Securities Inc. and RBC WMFS are member companies of RBC Wealth Management, a business segment of Royal Bank of Canada. ® / ™ Trademark(s) of Royal Bank of Canada. Used under licence. ©2018 RBC Dominion Securities Inc. All rights reserved. 18_90441_KW7_002 (04/18)