Wealth Matters - Spring 2006

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Tax Matters

As we are writing this newsletter, the tax return filing deadline is fast approaching. In past newsletters we've written about changes in tax rules and how they affect you as an investor. One thing that has not changed in many years is the fact that interest income on GICs and Bonds is fully taxable, while Dividends and Capital Gains are taxed at much lower rates. For this reason, how your portfolio is constructed can have a large impact on your total tax payable on investment income.

Table 1 Tax on Various Forms of Income

	Interest	Qualified Dividends	Capital Gains
Total Income	$100.00	$100.00	$100.00
Tax Rate	46.00%	29.78%	23.00%
Tax $ Paid	-$46.00	-$29.78	-$23.00
Net $ Income	$54.00	$70.22	$77.00

Table 1 compares the tax rates payable on various forms of investment income. Note that since 2006 there have been two different forms of Dividend Income, depending on whether the payor is a Small Business Corporation or a public company. Regardless of this difference, Capital Gains still enjoy the lowest tax rate, and Dividends are still taxed more than Capital Gains, but much less than Interest income.

Over the past few years, there have been several innovations in the design of investment products to help investors take advantage of the lower tax rates on Dividends and Capital Gains. As well, one set of tax rules that applies to corporations and trusts allows some portfolios to pay a tax-free 'Return of Capital' thereby deferring all tax until the investment is liquidated, and converting all of the deferred tax into lower-taxed Capital Gains.

Table 2 compares the taxation of 3 different investment structures, each of which is designed to produce annual income. In order to compare the tax effects, we've assumed that an investor in the top tax bracket of 46% has $100,000 to invest, the total return is 5% per year for all 3 options, and that all of this return is paid out as income to the investor each year, creating a $5000 per year income for any of the 3 options. The GIC/Bond portfolio generates fully taxable interest income, with an annual tax bill of $2300. The Balanced Portfolio is assumed to be 50% Bonds and 50% dividend-paying stocks. This structure reduces the annual tax payable by over $500 to $1771. The Return of Capital portfolio allows the investment return to be added back to the portfolio each year, while an equal amount of the original $100,000 of capital is returned to the investor each year. This means the investor pays no tax each year, but when the portfolio is later sold, or the investor dies, the total of capital returned over the years becomes a capital gain. Because capital gains have the lowest tax rate, this strategy:

1) reduces the amount of tax to be paid, and
2) defers payment of the tax until the disposition of the portfolio, when it can be paid out of the portfolio value.

Table 2 Comparison of Taxes on 3 Different Structures

Year	Annual Income	Annual Total Taxes Paid on Income		
		GICs or Bonds	Balanced Portfolio	Return of Capital
1	$5,000	$2,300	$1,771	$0
2	$5,000	$2,300	$1,771	$0
3	$5,000	$2,300	$1,771	$0
4	$5,000	$2,300	$1,771	$0
5	$5,000	$2,300	$1,771	$0
6	$5,000	$2,300	$1,771	$0
7	$5,000	$2,300	$1,771	$0
8	$5,000	$2,300	$1,771	$0
9	$5,000	$2,300	$1,771	$0
10	$5,000	$2,300	$1,771	$0
Total of Annual Taxes		$23,000	$17,705	$0
Tax on Disposition		$0	$0	$11,500
TOTAL TAX PAID		$23,000	$17,705	$11,500

Several excellent products are now available with the Return of Capital feature on a variety of asset allocations to meet a range of objectives. An efficient fixed income portfolio is currently yielding over 6% after-tax, much higher than GICs. Please let us know if you would like to discuss your situation and how we might help you reduce your taxes as well.

The strategies discussed in this newsletter are not for everyone. We would only recommend a particular strategy after fully understanding your unique situation, objectives, and values. We would be glad to offer a complimentary **'Initial Assessment and Evaluation'** meeting, and a written **'My Life – My Wealth'** report of the areas in which we believe we could help you achieve your financial goals. Please call us if you would like to discuss this opportunity.

The Family Cottage – A Case Study

We often find ourselves working with families that own a vacation property, or a family farm or business. Real Property and Business assets present a similar financial planning challenge when the family wishes the next generation to retain ownership of these assets after the deaths of the current owners. This case study highlights the problem and contrasts a number of solutions.

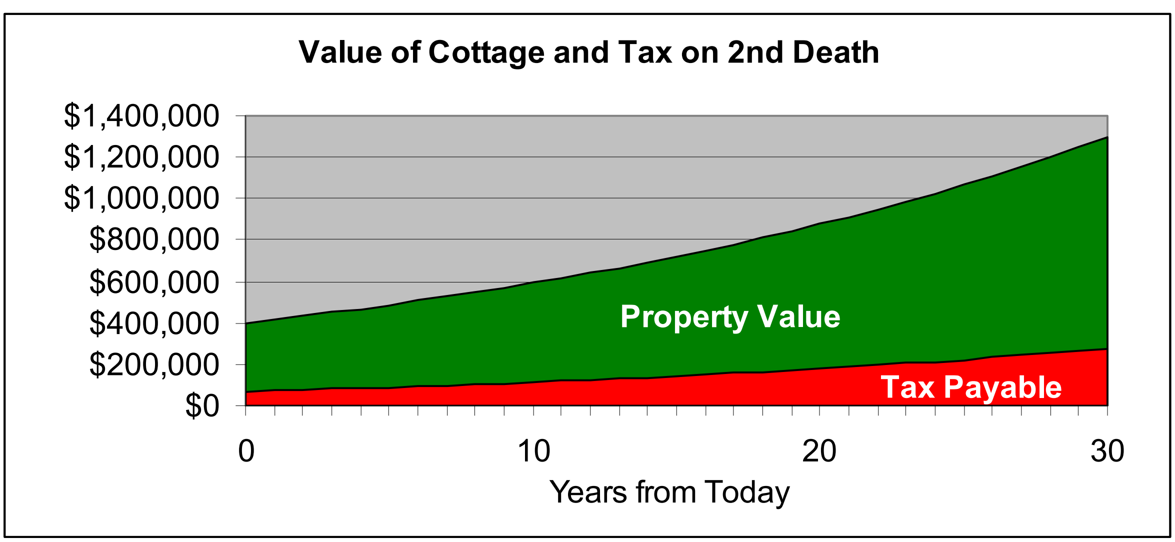
Bob and Judy are both 65 years old and own a cottage on Georgian Bay. Judy inherited the cottage in 1985 when her father passed away. At the time, it had a market value of $100,000, but its value has since grown to over $400,000.

Bob and Judy have two children, Matthew and Sarah, both in their 40's, married and with their own children. Over the years, Matthew and Sarah have enjoyed many summer weekends at the cottage with their parents and children. Bob and Judy have watched their grandchildren play and explore the lakeshore as they've grown, and would like to ensure that they can continue to benefit from these experiences in the future. In their Will, they have left all of their estate to Matthew and Sarah in equal shares.

Bob and Judy are financially independent – both have income from pension plans and RRIFs, and also have non-registered investments to provide income. Financial projections prepared by their financial advisors shows that these assets will support their planned lifestyle until age 95, with a small amount of investments left over.

The family home is in Richmond Hill, and is considered a 'Principal Residence' on which there is no tax payable on the sale of the home. The Cottage is a different story (as would be the family business or farm, or any other Real Estate). If the Cottage were sold, the difference between its starting value ($100,000) and the proceeds of sale ($400,000) is considered a Capital Gain. One-half of all Capital Gains is considered taxable in the year of sale, and this $150,000 taxable gain would push Judy into the highest marginal tax rate of 46%, plus would result in a reduction in her Old Age Security pension to $0. The tax bill alone is about $70,000 at present, but will grow larger over time as the value of the cottage rises. If Judy should die first, Bob could assume ownership without the tax consequences, but on the second death of Bob and Judy, the property is deemed to have been sold, and the tax is payable by the estate.

	Growing Tax Liability on Cottage at 4% Growth			
	Today	**In 10 Years**	**In 20 Years**	**In 30 Years**
Value of Cottage	$400,000	$592,000	$876,000	$1,297,000
Less Cost Basis	$100,000	$100,000	$100,000	$100,000
= Capital Gain	$300,000	$492,000	$776,000	$1,197,000
Tax Payable on Sale	**$ 69,000**	**$113,000**	**$179,000**	**$275,000**



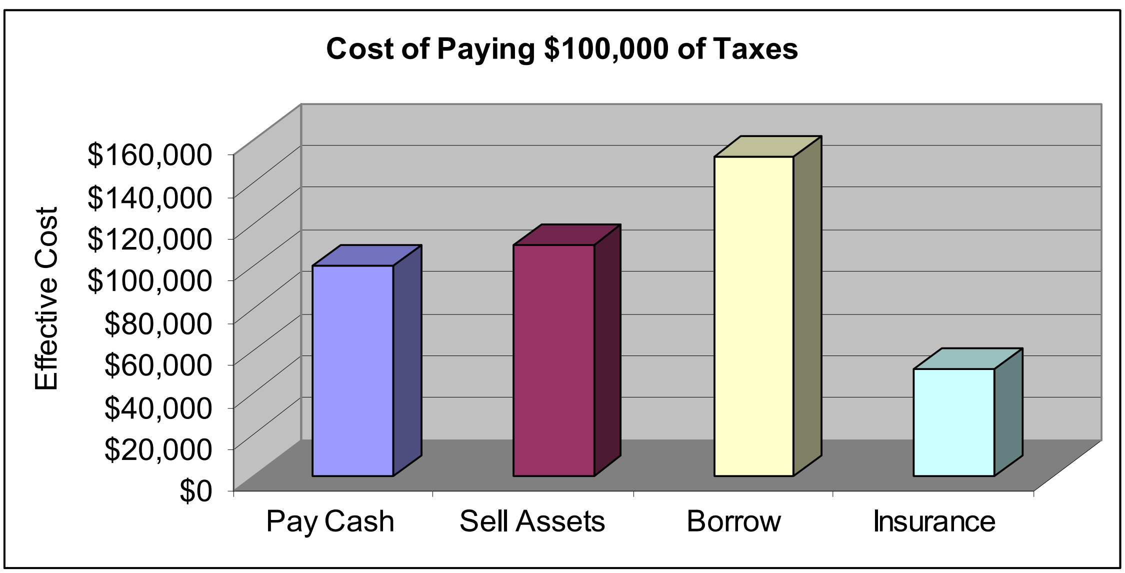
At present, the impact of this tax is purely financial. If Bob and Judy should both die while there is still a sizeable pool of investment assets, then the tax would be paid from these assets by their estate. If the second death occurs later in life when the investment assets have been depleted to provide them with income, then there may not be sufficient assets left to pay the tax. Especially since there will also be tax on all remaining RRSP or RRIF balances at the second death. This shortage of cash could force the sale of the Cottage – not what Bob and Judy (or Matthew and Sarah) intended.

Solutions: there are 4 solutions which could be used to pay the tax and preserve the cottage:

1) Pay cash – as noted above, there will eventually be insufficient cash in the estate to pay the tax. Matthew and Sarah could pay the tax in cash, if they have sufficient assets of their own.
2) Sell Assets – if the estate owns other assets (such as Bob and Judy's principal residence) it could sell those assets to create enough liquid cash to pay the taxes. A forced sale by the estate usually means the selling price is discounted, plus there would be real estate fees to complete the sale, so the total cost is more than the tax bill.
3) Borrow – Matthew and Sarah could take back a mortgage on the cottage to pay the tax bill or any portion of it that can't be paid by the estate. This increases the effective cost of the tax bill by the amount of the interest on the mortgage until it is repaid.
4) Life Insurance – if either one of Bob and Judy are reasonably healthy, they could buy a 'second to die' life insurance policy. The policy could be structured to provide a tax-free death benefit in a growing amount that would always be approximately equal to the rising tax liability of the cottage. The benefit would be payable on the second of their deaths, just at the time when the tax liability would need to be paid. The premium cost can be a fixed monthly or annual amount, and would be only pennies per year for each dollar of coverage ($100,000 of insurance is only $128 per month). Because the death benefit is tax-free, it will always be larger than the amount that could have been accumulated by investing an amount equal to the premiums.

The costs of these four strategies is compared in the table and graph below. Note that in 20 years time, the accumulated value of premiums for the insurance strategy is only about half the cost of paying the tax in cash.

	Cost of Various Solutions per $100,000 at Year 20			
	Pay Cash	**Sell Assets**	**Borrow**	**Insurance**
Fut. Val. Of Premiums	$ 0	$ 0	$ 0	$ 51,000
Cost At time of Death	$100,000	$100,000	$100,000	$ 0
Interest (next 15 yrs)	$ 0	$ 0	$ 51,894	$ 0
Cost of Asset Sale	$ 0	$ 10,000	$ 0	$ 0
TOTAL TAX COSTS	**$100,000**	**$110,000**	**$151,894**	**$ 51,000**



If you have a cottage, farm or business, or other property that your children would like to inherit (or that you would like to inherit from your parents) please call us to discuss your objectives. We would be glad to show you the alternatives for your particular situation.

Your Financial Plan

In our newsletters, we show examples of financial strategies which have helped many of our clients achieve their objectives. Because each person's situation is unique, some of these strategies may not be appropriate for some people even if they have similar objectives. At the same time, once we fully understand someone's situation and objectives, we are able to select and explain an appropriate set of strategies that will enhance our client's wealth. When we are able to agree on a set of strategies to be implemented, and assemble them into a written action plan, then our clients gain the peace of mind that comes from a more predictable financial future. The planning process answers such common questions as:

- How much income will we need during retirement?
- How much will we need to save each year, and for how long, to retire with that income?
- How can we achieve these objectives while also paying off our mortgage and funding our children's education?
- What is the best way to structure our investments to minimize taxes and balance expected return and risk?
- What impact would a disability or death of a breadwinner have on our ability to achieve these goals?
- For retirees or those approaching retirement:
    - Which pension plan options should we select?
    - How can we ensure that our income keeps pace with the rising cost of living?
    - How long will our investments and pensions support our desired lifestyle?
    - How can we ensure that our Estate Plan allows our assets to be transferred to our beneficiaries and preferred charities in a timely and tax-efficient manner?

Page and Associates has been providing strategic financial planning advice since 1982, long before the merger with Kenneth Brown Investment Services. Ken Brown, Bill Irwin and Lloyd Nelson have retired from the financial planning and investment management business, but are still doing tax returns for many of their former clients, and we still consult with them regularly. Even without counting Ken, Bill and Lloyd, our office has 9 advisors who collectively bring over 120 years of insurance, investment and tax and estate planning experience to the strategic planning we do for our clients. 76 of those years are with Page and Associates. Each advisor draws on the specific expertise and experience of his or her colleagues in developing customized strategies for each client.

Many of our clients had dealt with Kenneth Brown Investment Services primarily as a GIC Deposit Brokerage. Over time, we have had the pleasure of meeting with many of these clients to discover more about their specific circumstances and objectives, so that we could recommend strategies to better help them achieve their goals. We use a time-tested process, refined over the past 25 years, to assess our clients' situation and objectives, and we use sophisticated financial modeling and portfolio design tools to assess and explain the benefits of our recommendations and how they impact our clients' overall financial plans. Our process was selected as the basis for the Best Practices manual published by Advocis, the Financial Advisors Association of Canada, and has led to 5 separate finalist nominations for Advisor of the Year award from Rogers Media group.

Find Out More – With No Risk

Our process begins with an Initial Assessment and Evaluation meeting. We offer this initial consultation at <u>no charge or obligation</u>. The meeting normally lasts about one hour, at the end of which we provide you with a written report entitled 'My Life – My Wealth'. The report outlines the areas in which we see opportunities to improve your overall financial strategy, and outlines the ways in which we might work together to develop and implement a strategy for you. Even if you decide not to continue the process with us, the report alone will provide you with valuable insights into the opportunities.

If you would like to discuss your situation with us in confidence,
please call us to arrange your own Initial Assessment and Evaluation meeting.

Feedback

We hope you've enjoyed this newsletter. Your comments are important, and they are very valuable to us. Please let us know any ideas you may have for improving the newsletter, or topics you'd like to see in future issues!