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SMART MONEY

Adviser likens taking care of your wealth to life on the links.

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KANE

MONEYLINE

Managing money and golf: It's how you get to the green

With just five days left to file a return for 1996, let's forget about paying taxes and play golf instead.

At the end of the game we should be able to keep more money for ourselves and our heirs in 1997 and beyond.

Today's course professional is Malcolm Ross, a financial adviser who likens the different stages of wealth management to life on the links. In short, you go from school to the tee-box of life, the fairway is your career and the green your retirement.

Your game should change at each stage. At the tee, you swing as hard as you can with little regard for risk. Your focus is distance and direction.

When you are midway through your career, you start looking toward the green and become much more aware of traps and hazards and their impact on your final score.

Ross, 39, says if you play golf the way he plays, the decisions you make at the green will impact on your score as much, if not more, than the decisions you made on the fairway.

To keep your game up to par (the three fundamentals of financial security are protection, accumulation and retirement) you must address the impact of taxes.

"Tax is an obvious place to focus when we start looking at wealth management because tax is the average Canadian's largest ongoing expense and their most predictable investment risk," says Ross, president of Vancouver's Invest-A-Flex Financial Strategies.

Ross is an insurance specialist with a background in accounting and taxation from his native Zimbabwe. He moved to Canada seven years ago.

With help from financial planners, lawyers and accountants, he seeks to shift client assets and income from fully taxable status to tax deferred, through tax preferred and, preferably, to tax exempt.

That does not mean the average wage earner should pour all of their income into lottery tickets, a principal residence or insurance death benefits, three asset classes that are tax exempt.

But a balanced approach to asset shifting can increase after-tax disposable income by anywhere from 15 to 30 per cent and increase after-tax distributable estate by anywhere from 30 per cent to 100 per cent, Ross says.

At the same time it is possible to provide security while remaining flexible enough to meet changing circumstances.

Invest-A-Flex clients tend to have a net worth of $300,000 and up, but even if you can't afford green fees, tax planning can still be effective.

To illustrate the potential rewards, Ross outlined a client's case history, changing her name to Ann Investor.

She was 65 when she came to the firm two years ago, had been remarried for eight years, and had a pre-nuptial agreement to preserve assets for the children of the previous marriage.

On remarriage, her new spouse sold his house and invested in guaranteed investment certificates to generate income. He then moved into her house which subsequently climbed in value from about $150,000 to $250,000.

Under the Family Relations Act, that increase in value is attributable to the marriage and he may be entitled to 50 per cent of the gain, regardless of the pre-nuptial agreement.

"While he, as a gentleman, would honor their agreement, if he were incapable the public trustee would step in to enforce that division on his behalf," Ross says.

"Another problem is B.C.'s Wills Variation Act under which the client must make adequate provision for her spouse and her children. If she leaves everything to her children, she is not making adequate provision for her spouse."

In addition to the house, Ann Investor had $30,000 in RRSPs, non-registered savings of about $300,000, and government pensions paying about $14,000 a year. With investment earnings, her annual income was about $32,000 and she was paying $12,000 in tax.

To address her estate planning concerns, her advisers arranged for the home to be set up as a life estate, allowing the husband to remain in the property as long as he lives but ensuring it eventually goes to her children.

Tax classification of assets and income

Tax exempt
(No tax payable)
- Lottery winnings
- Principal residence
- Family farm roll overs
- Insurance death benefits
- Capital dividends (private companies)
- Small business capital gains exemption

Tax preferred
(Lower tax rates)
- Dividends
- Capital gains
- Prescribed annuities
- Qualifying offshore investments

Tax deferred
(Tax-sheltered accruals)
- RRSPs/RRIFs
- Life income annuities
- Income from life policies

Tax afflicted
(Fully taxable)
- Salaries and bonuses
- Pensions and benefits
- Interest and management fees

Source: Invest-A-Flex Strategies

Ross then arranged for the RRSPs to be converted into a registered retirement income fund, generating $2,000 a year to cover property taxes, with her husband named as successor, should she die first.

As a result, the husband has life use of the home which will eventually go the children free of capital gains tax.

Ross then set aside $80,000 of Ann Investor's $300,000 in savings to pre-fund a universal life insurance policy. When she dies, her heirs and beneficiaries will receive the insurance proceeds tax-free. Ross anticipates about $300,000. The final amount will depend on the investment return.

Another $100,000 went into a prescribed annuity to generate about $8,000 each year, of which only $3,200 is taxable. The balance of the payment is viewed by Revenue Canada as a non-taxable return of capital.

The annuity has a 20-year guarantee with payments going to the estate if Ann Investor dies prematurely. Payments continue until death if she outlives the guarantee.

After paying for the life insurance and the annuity, the savings balance of $120,000 was invested in segregated funds — mutual funds administered by an insurance company — with a projected eight-per-cent return.

Ross then started systematic monthly withdrawals from the segregated funds, totalling $9,000 annually, of which only about $900 is taxable initially.

Subsequent withdrawals are indexed to absorb a rising tax bite on dividends and capital gains, so that Ann Investor can count on a steady after-tax income stream.

The assumption is that the fund unit values will continue to rise, preserving the original capital. If they drop, fixed withdrawals could eat into the capital.

Unlike mutual funds, segregated funds come with a mortality guarantee. In Ann Investor's case, the insurance company will pay out at least 90 per cent of their original value, less withdrawals, to her children.

Like the insurance and annuity proceeds, the funds will bypass the estate and are not open to challenge under the Wills Variation Act.

So let's check the scorecard. Ann Investor's annual income, including $14,000 in pensions, now totals $31,000, of which about $18,000 is taxable at the start of the program for an actual tax bill of about $6,000. Her after-tax income has jumped from $20,000 to $25,000.

At the same time, legal hurdles that could have diverted funds from her children have been overcome. Her estate value is always going to be higher than if she had been drawing down $300,000 invested in GICs.

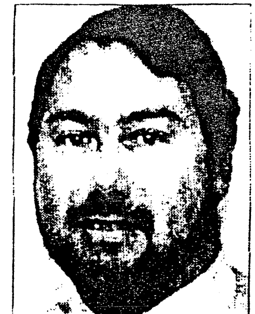
If she dies today, there is an increase of about 70 per cent in the estate value, Ross says.

About two-thirds of Ann Investor's funds are liquid because she can borrow against the cash values in the insurance policy and the segregated funds can be converted to fixed-return investments if interest rates rebound.

Invest-A-Flex Strategies is associated with Independent Brokerage Group, the largest insurance agency in B.C.

Ross, who is also a shareholder and director of Independent Wealth Management, a mutual fund dealership, says most clients are referred to his firm by their financial advisers.

He suggests anybody considering the tactics outlined here should first consult a financial professional who will give full weight to their personal objectives, age, wealth and tolerance for risk.



MALCOLM ROSS: Balanced approach can increase after-tax income