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Here We Go Again

By John R. Ross, Chairman, Corporate Planning Associates

(Note: This article was written before September 11 but, upon reflection, we felt that the message was still appropriate.)

Every few years the markets correct causing much anguish for many of our clients. The ones who are affected the most, unfortunately, are those who have just moved into the equity markets. They were, of course, seduced by the fantastic returns realized over the past few years. The euphoria that watched Nortel rise to $120 has quickly been followed by disbelief and then horror as it has plunged to new lows on a seemingly daily basis.

In the spring of 1994 I wrote an article called "The Equity Markets: Myth, Reality and Common Sense" which can be reviewed on our website. This article centered around the various "bubbles" experienced over the centuries. It concluded with the following paragraph, "These phenomenon occur because emotions become caught up in the fad of the day, while objectivity and value take a back seat. It is little wonder that this happens, as the prime emotions that cause these phenomenal rises and falls are greed and fear, respectively. It is at times difficult to resist succumbing to the strength of these emotions. The most successful money managers of our time have been able to meet this challenge consistently by looking at the big picture and by investing in value, not passing fancies".

Then in November 1998, as we watched the markets tumble, I wrote "The Markets Go Up, The Markets Go Down". This article talked about focusing on the long term and pointed out that staying the course was by far the best strategy for a long-term investor. At that time we only had one client who moved to money market funds and this action cost him dearly. The markets immediately turned around and even today they are up 40% from the fall of 1998.

All investors get nervous when the markets are falling but the successful investors stay the course and wait for the good times to return. As they always will.

A review of the leading indexes between 1973 and 2001 shows that for any 10 and 20 years period the markets never produced a negative return:

- During any 10 or 20 year period, the TSE 300 index's lowest returns were 6.45% and 9.83% respectively.
- During any 10 or 20 year period, the S&P 500 index's lowest returns were 7.75% and 9.69% respectively.
- During any 10 or 20 year period, the MSCI World index's lowest returns were 9.20% and 14.53% respectively.

The biggest problem in worrying about the markets is if you bail out, what indicators are you going to use to go back in? If you wait until there is a clear indication that the markets have turned around you will surely miss the initial rise which could be substantial. Then, if the markets correct too quickly you will wonder if it is premature and run the risk of staying out even longer. Finally, having missed completely you will convince yourself that the market is due for another correction and stay out forever. Far-fetched? Not at all. We have some clients who are always pessimistic about the markets and have been waiting for years for the right correction but always miss the inevitable upside.

So what should you do? If you are already in the market, nothing. Read a good book, go on a vacation, and do anything but try to avoid the continual barrage of bad news. This too will end and you can amuse yourself by reading about all the experts who cashed out just before the downturn and then miraculously reentered the market at the lowest point. Interesting reading but probably not true.

If you have been sitting on the sidelines waiting for that positive sign, ease into the markets over the next few months. There may be some rocky roads along the way but once you're in you can stop worrying about when you should go in.

Nearly all of our clients are long term investors, many with a 20 to 30 year horizon. Don't worry about the short term, the long term will look after itself.

The RRSP Myth

Some investments may be better held outside of RRSP

By Michael McIntosh

Michael McIntosh is a Senior Vice President of Corporate Planning Associates' Calgary office

Life used to be so much easier to understand. Add to the list of complications the latest paradigm shift: The RRSP myth.

The RRSP myth – In times gone by, contributing investment dollars into the tax shelter of an RRSP was a mandatory event for those with the financial capacity to participate. So much so that many clients have amassed sizable accounts under the RRSP banner. For the most part this is a great parking place for investment dollars – a tax deduction in the year of contribution, tax-free compounding, and the possibility of a lesser tax rate at the time of withdrawal from the plan. The first two benefits are the most important, since only a few clients actually expect to be in a lower tax rate in the future. However, in some circumstances, such as the high (potential) growth investment, an investor could 'do better' buy investing via a non-RRSP account.

The high (potential) growth investments – A new or fast-growing business often requires capital, and it is usually family members and close friends of the founder(s) who are tapped first. Often such investments can be described as high risk, with the potential to either lose everything or enjoy a return sometimes many multiples higher than conventional equity or debt investments. These high potential growth investments are usually structured as shares and/or warrants, and they are often "eligible investments" as defined in the Income Tax Act, meaning an individual is permitted to use his RRSP funds for such investments.

The temptation to take the plunge into this type of investment using available capital within your RRSP should be kept in check until some hard thinking about pros and cons can be analyzed. Of primary concern is the new reduced capital gains tax rate for investments held outside one's RRSP. That is, if the investment is successful and results in a large capital gain, the tax paid by investing inside your RRSP could be much higher than if the gain was realized outside your RRSP. Gains within an RRSP do not enjoy the 50% inclusion rate, such that 100% of any gain is taxable when the funds are withdrawn from the RRSP account. For most clients this translates to tax at the top marginal rate: between 39% and about 48% (depending on your province of residence). On the other hand, gains in a non-RRSP account are taxed at between 19.5% to 24.5%.

If you are in your late 50's or early 60's you will be forced to commence withdrawals from your RRSP in the foreseeable future, starting at about 5% of the value of the account every year beyond your 69th birthday and escalating from there. Therefore, in many cases one's RRSP may not be the best entity from which to invest in high potential growth investments because the tax sheltering benefit is not long enough to outweigh the expected higher tax liability.

Other benefits of investing outside of your RRSP account for high potential growth investments include:

- The possible use of the $500,000 enhanced capital gains deduction for eventual sale of certain small business corporation shares.
- The opportunity to get a tax deduction against your regular income for your lost investment if the venture experiences a "dot-com-like" meltdown, i.e. accessing the Business Investment Loss rules.
- Gaining access to a capital loss that you can use to shelter other capital gains at your discretion.
- Escaping the forced income inclusion of a RRIF, which often increases a person's taxable income (typically post age 69) contrary to cash flow needs.
- No limitations on the type of investments you can hold – i.e. no foreign content concerns. Remember, if your friendly-high-growth-investment-founder moves to the U.S. (prior to any stock exchange listing of the company you invested in) you could face penalties within your RRSP account since your investment could become non-eligible. This can be especially awkward if there is no secondary market for your high growth investment shares.

What if it's too late? – If you have a substantial RRSP account and are nearing your 69th birthday, or you already have a substantial RRIF account, it is possible to reduce or shelter the required annual income inclusion.

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It is possible to set the annual withdrawal ratio applicable to a RRIF account based on the age of your spouse. This may be of benefit if your spouse is at least a few years younger than you. In some cases it may even be possible to change the person whose age has been used as the reference age for the RRIF account. On another note, by employing a strategy of borrowing to invest, usually in capital guaranteed investments such as segregated funds or newer-style financial products, an interest deduction can cancel out any undesired income inclusion – this strategy is not for everyone and should be fully explained by your financial advisor. Understanding all the options available, both RRSP and non-RRSP alike, is an important piece of each significant investment decision. The effects of taxation on investment returns are often overlooked and can be sizable. Having a skilled advisor on your team can make the heavy lifting of your investment strategy research a great deal easier, and typically more lucrative as well.

Lawyerly Thoughts

By David H. Sohmer, a lawyer with the Montreal law firm Speigel Sohmer

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Several months ago, I was asked to speak on recent developments in estate planning to a group of professionals and businesspeople. Under ordinary circumstances, I would have focused on three or four "hot" topics such as changes in U.S. estate tax and Alberta-resident trusts. I had, however, just turned sixty and I decided to use the occasion to attempt to impart some wisdom rather than mere information. The following are some excerpts from my speech which was entitled "Some thoughts from a lawyer who is now old enough to take his own will seriously."

1. THE GOLDEN RULE

Do not compel your children to be in business with each other. This will happen whenever you leave assets to them in joint ownership. Leaving shares of a business to children where some are employed in the business and some are not is a recipe for disaster for everyone but lawyers. Children who are not active in the business regard their shares as an investment on which they should receive a return. For children who are in the business, dividends are not a significant concern. Salary, power, status, and ensuring that the business will be a legacy for their own children are of paramount importance. If real estate is left to children jointly, each one will have the power to veto a sale, a mortgage, or even a lease. If an investment is required to improve or to repair a property, some may not wish to contribute. These differences are rarely resolved amicably. Leave shares to those who are active in the business and cash to children who are not. Give each child the option to receive cash instead of a joint interest in a property.

I had a client who left his business to his son and the cash equivalent to his daughter. Within two years after his death, the business was bankrupt. This may appear to be a planning failure, but I regard it as a success since the brother and sister are still on good terms. Imagine what would have happened if the estate was left to them jointly and the brother had pressured the sister to invest more in the business so it could be saved. When a client of mine in his 70s asked me how to structure the acquisition of a revenue-producing property, I asked him why he was buying it. He said it was a great deal and he was buying it for his children. I told him that if he is concerned about his children, he should concentrate his efforts on selling his real estate and not on acquiring new properties.

2. SHOULD INHERITING BE LIKE WINNING A LOTTERY?

The first time most children know how much they may inherit is when their father dies. The first time most children seriously consider how much they may inherit is probably ten or twenty years before their father's death. The failure to address the issue of inheritance on a timely basis can strain the relationship between parents and children. Parents may be reluctant to discuss their net worth with their children because they regard it as a private matter, or because they don't want their children to pressure them into making substantial gifts. Children may be reluctant to raise the issue because they do not want to appear greedy but they would like to know

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whether sending a child to Harvard or buying a more expensive house will threaten their ability to retire in comfort.

If parents are comfortable with their relationship with their children, I encourage them to discuss their wills and their estates with their children. For example, the children can be told that the mother and father have bequeathed all of their assets to each other and, in the event of a predecease, to the children equally. The children can be told that on the death of the survivor of the mother and father, they will probably inherit several hundred thousand dollars each. Other matters should be discussed, such as how to deal with a country house and who should get which items of jewelry, art, etc.

3. SECOND MARRIAGES: BALANCING ON THE HIGH WIRE

One of the most difficult dilemmas one can be faced with is how much to leave to a second spouse and how much to leave to children of a first marriage. Leaving your estate in trust with income to your second wife for life and capital on her death to your children may be tax effective but is probably the worst decision you can make. Because the relationship between your second wife and your children will probably be non-existent after your death, each will actively pursue their own self-interest. Your wife will want to maximize current income at the expense of capital appreciation and your children will want the opposite. Your wife will want to encroach on capital so that she can leave more to her own children and your children will want the opposite. If your wife is significantly younger than you, your children may be collecting their own pensions when they finally inherit. The best solution is to provide for your second wife with an insurance policy or a life annuity. You should take the initiative and discuss the matter with both her and your children.

4. THE "PROBLEM" CHILD

Unfortunately, not all of our kids are model children. Addiction to drugs or gambling is distressingly common. Kids can be lazy, spendthrifts or dangerously envious. An aging widow is rarely strong enough to cope with the problems such children present. I have seen case after case where a problem child has deprived his siblings of what should have been their inheritance. The child would pressure his mother into giving him money by pleading poverty or even threatening suicide. I have also seen cases where a child has forged his mother's signature on cheques knowing that she would never press charges. If you have a problem child, don't place the burden of saying no on your spouse. While you may give the power to your other children, it is not recommended. Your estate should be left in trust with income to your wife for life and capital to your children or to a trust for your children on her death. An independent third party trustee should have the power to veto any encroachment on capital. The third party should not be named as a trustee unless you know he or she will accept the appointment. The best way of ascertaining that he or she will do so is to have a full and frank discussion with the individual who you wish to appoint before you sign your will.

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