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It's all about Asset Allocation

By Jamie Purves, Senior Vice President, Corporate Planning Associates

At CPA we sit on the same side of the table as our clients. Our role is to understand their needs and to formulate strategies that provide solutions.

We have always believed in establishing and adhering to a straightforward investment plan. Value biased by tradition, our approach hasn't always been exciting. So it was with interest that we watched the 'irrational exuberance' of the dotcom era, a growth-driven frenzy where investment success had more to do with the amount invested than what you were invested in. The ensuing correction provided a much needed rear view mirror to consider what went wrong and how to avoid it in the future.

One thing was clear, people had forgotten about risk. Many investors put all their eggs in one basket and didn't bat an eye. Rebalancing one's portfolio was just as likely to mean strapping on more margin as it was taking profit. Everything was going-up and return seemed the only investment objective. What a painful lesson that was.

On the back side of the boom, another area that came under intense investor scrutiny was fees. No one seems concerned about fees in an up market but the protracted pullback, with 20%-30%

portfolio declines, made them a bitter pill to swallow. The US mutual fund industry was the first to mollify investors by improving efficiencies to reduce the management expenses ratios on their offerings. Also feeling a shift was the traditional commission-based 'stock-broker' as fee-based accounts provided better transparency and a declining fee schedule for larger portfolios.

Against this backdrop CPA set out in 2004 to develop a highly sophisticated investment option for our clients while providing a more competitive fee structure. We had an advantage in starting from scratch, the freedom to respond to our clients needs with the most up-to-date tools. Consider the WestJet experience to that of Air Canada. New planes with state-of-the art entertainment consoles versus an aging fleet with one small screen for twenty passengers.

The 'GoldLeaf Investment Process' is an open architecture platform offering best of breed investment management across the traditional asset classes. The 'open architecture' allows us to access investment acumen, whether a passive index, actively managed mutual fund or one of our third-party, pension style, money managers. Our due diligence manager

goes to extremes to measure and monitor investment talent, negotiating access for CPA clients with a select few. But having the right investment managers is only part of the process.

Studies have shown that more than 90% of a portfolio's long-term return characteristics and risk profile are determined by asset allocation. Asset allocation is the blending of different asset classes, namely; bonds, stocks, real estate and more recently, hedge funds and private equity. More times than not a Canadian investment portfolio holds a mix of bonds and Canadian equity with some US and International equity exposure. This is understandable given that most investment advisors are confident in their researching of Canadian names but less so globally. Until the past few years investors were also hampered by the 30% foreign content limit in our registered investment accounts. Why is that a problem? Failing to include US and International equities actually increases the overall risk of one's portfolio. Also, US and International equities have traditionally outperformed Canadian equities in the long-term, so the average Canadian investment portfolio is also giving up potential returns.

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Joint Pain

Documenting intentions is essential to avoid ownership issues

By **Jamie Golombek, CA, CPA, CFP, CLU, TEP**, Vice-President, Taxation & Estate Planning

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Although summertime traditionally is a slower period (to wit, this combined July/August FORUM), it need not be unproductive. During these months, as Canadian families vacation together or just spend warm summer days lazing by the lake, the talk often turns to estate planning.

To this end, numerous articles have been written on how to transfer the vacation property to the next generation while paying minimal income tax or, in some provinces, avoiding the probate tax. One such strategy, discussed in my feature article last year, “How Not to Avoid Probate” (FORUM May 2006), involves putting the property into joint names.

While I’ve always argued against this idea for a number of reasons, the two recent decisions of the Supreme Court of Canada in *Pecore v. Pecore* (2007 SCC 17) and *Madsen Estate v. Saylor* (2007 SCC 18), whose judgments were released simultaneously on May 3, 2007, should serve as ample warning about the biggest danger of holding assets – whether the cottage or the investment account – in “joint ownership with rights of survivorship” or JTWROS.

What was at issue in both cases was the meaning of “joint ownership” of investment accounts and the true intentions of the original owners when the joint accounts were established.

Joint ownership is a common way to hold investment assets and is most often used to avoid provincial probate taxes. It’s also often used for convenience purposes so that any joint owner can deal with the account during their lifetimes and the assets pass immediately upon death of one of the owners to the survivor, with minimal administrative delay.

But, when monies are put into JTWROS, what is really happening? Has a gift been made at the moment another account holder is added to the account? Or are the funds merely being held in a resulting trust for the benefit of the original owner, to be dealt with upon death as part of the original owner’s estate? These questions (and more) were addressed in these two cases.

In the first case, Edwin Hughes, father of Paula Pecore, put nearly \$1 million of mutual funds into joint ownership with his daughter Paula. Upon Mr. Hughes’ death, the assets in the joint account were transferred into Paula’s name. Two years later, Paula and her husband, Michael Pecore, separated and, in the course of the divorce, Michael tried to go after the assets in the joint account since he was a beneficiary under his ex-father-in-law’s will. His argument was that the transfer of the joint account into Paula’s name was not a true gift since it was done “for probate purposes only.” Both lower courts disagreed and found that Paula legitimately inherited the account through JTWROS.

The second, very similar case, involved Michael Madsen who named only one of his three children, Patricia Brooks, as the joint owner of his investment accounts. After Michael’s death, Patricia’s brother and sister sued and claimed that their late father only named Patricia on the account “for convenience purposes” and thus no true gift was made. As a result, the monies in the joint accounts should be distributed in accordance with the will, with both siblings receiving a portion of the funds. Both lower courts agreed.

The Supreme Court of Canada (SCC) saw no reason to reverse either of these lower courts’ decisions. The court found that due to the presumption of resulting trust, the onus falls on the surviving joint account holder to prove that the transferor intended to make a gift of any remaining balance in the account.

Factors that should be considered to determine the transferor’s intent include: wording in any financial document used to open the account, control and use of the funds while the transferor was alive, whether a power of attorney was granted, who paid the tax on the account and any other evidence the court finds necessary to establish intent.

So, what lessons can we take away from these two decisions? Perhaps the most important one will be that if clients still insist on making an account JTWROS, they should be sure to document their intent.

One way to do so is by signing a “Declaration of Intention” for joint assets. While anyone presumably could make their own such declaration, Ontario wills and estates lawyer Les Kotzer has prepared a “Joint Asset Planning Kit” that includes all the forms needed to declare your intentions regarding all of your joint assets.

The kit includes special language that reflects the SCC’s decisions and even has a “special clause” that promises to protect the joint asset from your ex-son-in-law or ex-daughter-in-law in the case of a child’s separation or divorce.

(To find out more information about the kit or to order, visit Mr. Kotzer’s website at www.familyfight.com.)

Charitable Foundation?

Why not?

By John R. Ross, *Chairman, Corporate Planning Associates*

In the past, it was possible to donate appreciated assets to a public charity and not pay tax on the accrued capital gain. The recently passed budget extends that favourable tax treatment to gifts made to private foundations. As a result, establishing a “Family Charitable Foundation” has never been a more attractive option. Private foundations have many advantages and few, if any, disadvantages.

Many Canadian taxpayers believe that a Charitable Foundation is only beneficial for very wealthy individuals who are able to set aside millions of dollars. I believe that establishing a Foundation with a nominal amount creates the opportunity to add funds as circumstances permit.

Let’s visit the reasons for establishing a Foundation. It’s true that there are significant tax advantages but this is no different from contributing directly to any qualified charity. I would submit that the real reason for establishing a Foundation is to create a method whereby you can support your favorite charities... forever!

Suppose that you are in the habit of contributing \$10,000 a year to one or more charities and you expect to continue this contribution as long as you are able. It may end at your death and the charities will no longer benefit. Now let’s assume that you had an opportunity to commute your next ten years and contribute \$100,000 into a newly established Charitable Foundation and you earmark this contribution as a “10 year gift”. A 10 year gift is essentially an endowment which means that your Foundation can now contribute the same \$10,000 on your behalf every year. The Foundation doesn’t pay income tax if it earns 10% a year and the contributions will continue indefinitely.

Maybe you are lucky enough to have some appreciated asset such as BCE stock. Assume that you have \$100,000 of stock with an accrued gain of \$80,000. If you simply sell the stock and pay tax you will net \$81,440. If you contribute the stock to your Foundation you will get a tax refund of about \$46,400 (in Ontario). In other words, to establish a \$100,000 endowment you forsake only \$35,000!

You’ve also created a flexible vehicle for future planning. Here are some examples:

- 1. You can contribute matured stock options and avoid paying tax. A stock option gain of \$100,000 would have netted you about \$77,000; if you contribute it to your foundation you will receive the tax credit of \$46,400. Net cost, less than \$31,000.***
- 2. You’ve accumulated a lot of DSU’s and now you have to bring them into income. If you contribute them to your foundation you’ll forsake 53.6% but your Foundation has another significant amount added to its endowment.***
- 3. Let’s look long term. Over the years you’ve contributed to your RRSP’s and now have accumulated \$1,000,000. At the death of you or your spouse, the RRSP’s will be taxed at the top rates, but if you leave it directly to your Foundation there will be no taxable income and your estate will benefit from the tax credit.***

There are many other examples but I’m sure you see the point. Even though you start small you could build the entity into a substantial amount to create a legacy that will go on benefiting society indefinitely.

In my case I started a foundation five years ago with a \$300,000 contribution. I plan on adding to this amount and expect that it will eventually have more than \$1,000,000 available to support worthy causes. Currently my wife and I are the primary trustees but I am getting my children involved so that they will carry on after we’re gone. Hopefully this responsibility will pass through the generations but if not, I have arranged for a public trustee to take over.

The bottom line; governments will not and cannot afford to support the myriad of charities that are desperate for funds. Those of us who have prospered in this society owe a debt to that society and this is one way of repaying that debt.

Highlights of the 2007 Federal Budget

RRSP Age Limit to 71 – The age limit at which RRSPs, RPPs and DPSPs must be converted either into an RRIF or an annuity has been increased to 71 from 69.

RESP Changes – Annual RESP contribution limit of \$4,000 has been eliminated, and the lifetime contribution limit of \$42,000 has been increased to \$50,000.

The Canadian Education Savings Grant (CESG) has been increased to \$2,500 from \$2,000, however the \$7,200 lifetime CESG limit is unaffected.

New Child Tax Credit – A new non-refundable child tax credit for parents of \$2,000 for each child under age 18. The credit is non income-tested.

Registered Disability Savings Plan – this new plan will come into force in 2008. The lifetime RDSP contribution limit will be \$200,000 and there is no annual contribution limit. Rules governing the plan will be similar to those of the RESP.

Donations to private foundations – Donations of publicly traded securities to private foundations will now be exempt from capital gains tax.

Elementary and secondary school scholarships – Scholarships and bursaries provided to students attending elementary and secondary schools are fully exempted from tax.

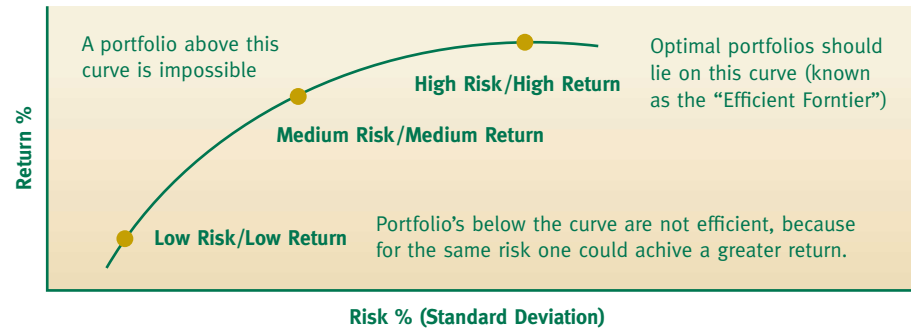
Spousal amounts – The spousal amount is increased to \$8,929, the same level as basic personal amount, and eliminates the threshold above which a dependant's net income must be taken into account.

Capital gains exemption – Lifetime capital gains exemption increases to \$750,000 from \$500,000 for capital gains realized on sale of qualifying small business shares and qualifying farm or fishing property.

It's all about Asset Allocation

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Understanding the importance of asset allocation CPA sought out and is happy to provide a methodology to balance our clients need for investment returns while managing risk. CPA GoldLeaf Mix is a tool that draws on 50 years of scientific data to derive an optimal asset allocation model based on a client's unique risk profile, illustrated by the efficient frontier below.



As this chart illustrates, portfolios to the right of the efficient frontier can be optimized by maintaining the same risk with higher return (moving vertically to the efficient frontier) or the same return with less risk (moving left horizontally to the efficient frontier). We believe that identifying your specific risk profile is the most important consideration. The returns that come from that allocation are not in our control.

It's not enough that the GoldLeaf Process identifies a manager for his/her acumen. We go further in trying to reduce investment risk by considering the low correlation between investment styles namely, growth and value. Since the market rarely rewards both styles at the same time prudence suggests you have exposure to both. Our due diligence manager will therefore identify both a growth and value manager who on a risk adjusted basis outperforms his peers. This strategy to reduce portfolio risk extends further to consider that large cap and small cap equities don't always move in sync either.

The second consideration was with respect to fees. Could we deliver a high quality investment solution and be competitive? We researched other offerings and found that we were not only competitive but could drive savings to our clients. As mentioned earlier we understand that

too few investors really know what their returns are let alone what they pay for them. For that reason transparency is a further cornerstone of our investment offering. Through the consolidated quarterly report or internet access, you can be as connected to your investments as you like.

CPA has in a few short years, woven an investment approach that focuses on asset allocation, the most critical determinant for investment success and provides it on a highly competitive fee schedule. Before joining CPA I was a commission-based investment advisor, I had fits of irrational exuberance and dejection; today I appreciate the value of diversification and understanding my own risk profile.

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