**Case Study #1**
**Dealing With Aging**

**James and Elizabeth Wakefield**

## Background Information

Jim and Betty are an elderly couple with 3 grown children, and 7 grandchildren. They live in a pleasant, quiet neighbourhood where the houses are modest but well-looked after. Each neighbour takes pride in their gardens and landscaping. When I first met them, Jim was 82 and Betty was 78. Their previous advisor was more transaction oriented, and unable to provide detailed financial planning. In our first meeting I met with Jim only because Betty was suffering from a health problem that made it difficult for her to leave the home. Jim explained that he was concerned that lately he'd begun to forget things, and he was thinking that he might be needing help in managing his affairs. He was particularly concerned that his wife Betty would always be taken care of. I asked him who made the financial decisions in their family, and he stated that he did, but that he always consulted with Betty first.

Jim had an interesting background. He had had three distinct careers, all different but connected. All involved substantial travel, and Jim and Betty had enjoyed a wonderful life and had been almost everywhere in the world. From Jim's first two careers he ended up with two separate but sizable pensions, one of which was indexed. In addition, Jim had been very clever in buying annuities when rates were high in the early 1980's, giving him an additional guaranteed income stream. Meanwhile, Betty had been busy raising 3 boys. Eventually all 3 boys became successful in their careers, and all were in the upper tax brackets. The eldest boy lives out west, the next youngest lives about 200 kilometres to the east while the youngest lives nearby. Jim and Betty had made the youngest, John, the executor in their wills because he lived nearby. The problem was that John had a marked aversion to discussing the reality of his parents' ultimate passing.

In planning the family's affairs, Jim had eventually recognized that he was going to have a much higher income than Betty, with resultant high taxes, but by the time he realized this, it was mostly too late. They began to arrange things so that Betty started to accumulate investment assets in her own name, and they were somewhat successful at doing this. However, despite their best efforts, by the time I met them, Jim's total income was $128,000 while Betty's was $47,000. All of Jim's OAS was being clawed back. Both Jim and Betty were concerned by the high level of taxes they were paying (about $52,000 in total for the 2001 tax year).

Their net worth was considerable. In addition to an attractive mortgage free house, they had $1,050,000 of registered and non-registered mutual funds, $122,000 of GICs, $460,000 of blue-chip stocks and about $80,000 in cash, giving them a total net worth of just under $2.0 million. Their cash flow needs were very modest because unfortunately their travelling days were pretty much ended, and their lifestyle was now very simple. Jim estimated that their after tax lifestyle was only $21,700. It was obvious to me that they had considerable surplus capital. Their mutual fund portfolio did not appear to be properly allocated between the right asset classes.

In our first meeting Jim raised a number of issues. He wanted to:

1. Preserve what he had.
2. Leave what was left to the 3 boys equally.
3. Get a decent return (he mentioned 8%).
4. Lower his tax bill.
5. Gradually relinquish control of his investments.

In subsequent meetings with Jim and Betty, I found that Betty's thinking was very close to Jim's and that their objectives were identical. I discovered another issue for them, and that was the extreme complexity of their affairs. For example, their stock portfolio was accumulated slowly over a 30 year time period using Dividend Reinvestment Investment Plans (DRIP). Although an excellent way to build assets, with 13 different plans, each issuing a report each quarter, the paper work was overwhelming them. And unfortunately, unlike mutual funds, DRIP plans do not keep track of Adjusted Cost Base (ACB). Jim had no idea what his ACB was for the stocks, but he did recognize that there was probably a very significant capital gain. Furthermore, all of the stocks were in certificate form, which made physical security a real concern for them. Jim complained that he was having trouble keeping track of things, and was particularly concerned about leaving a mess for his son, John. One of the things I have found in dealing with older folks is that they sometimes have conflicting desires. They are comfortable in being able to touch and feel their stock certificates, interest and dividend cheques and bank passbooks, but yet they are concerned about losing track of things. I had to give them so compelling reasons to change from their old habits.

At my firm, one of our key processes is to go through the Initial Assessment and Evaluation process for ever potential planning client to identify objectives and planning opportunities. We prepare a Client Planning Assessment report which provides our clients with a brief summary of their situation, a quote for our fees, and what benefits they can expect in engaging us. I prepared this report and presented it to them both. The report, along with my verbal presentation, emphasized the benefits of simplifying and organizing their affairs, calculating ACBs and capital gains (this would also help when it came time to settle their estate), reducing both current and estate taxes, and maximizing their investment returns for a given risk through better asset allocation. At the end of our meeting I sensed that they were still a little hesitant. I could understand that two bright, capable and independent people would have some difficulty letting go. I assured them that they did not need to totally abdicate responsibility and input, and that we could carry out this process in a slow, measured way. Eventually they agreed to become fee paying comprehensive financial planning clients. I prepared an engagement agreement which we all signed in due course. Now I was ready to get started.

My next step was to complete a detailed fact finder. There were no surprises here, but I discovered a few more issues. They were both concerned about the financial impact if one or both of them had to go to a nursing home. They were quite keen to gift some of their capital to the boys, but not keen to simply give money to grandchildren because as Jim said: “I don’t want them to fritter away the money at a young age”. They were also concerned by the possibility of hidden fees or costs in anything we would do. I reassured them that all costs would be fully disclosed to the best of my ability. What this revealed to me was that their ultimate objective was to see that the legacy they had built over a lifetime was passed on safely to the next generation, without it being eroded by excessive taxes, fees or hidden costs.

With help from my teammates I prepared the comprehensive financial plan.

**<u>Jim and Betty’s Final List of Objectives/Needs</u>**

Based on my many notes and the fact finder, I developed the following list of objectives for Jim and Betty:

1. Create peace of mind by simplifying and organizing their affairs.
2. Preserve their estate from taxes and unnecessary costs and ensure that each son got the same share.
3. Reduce current taxes.
4. Simplify the work for their executor.
5. Reduce portfolio risk.
6. Provide an after-tax annual lifestyle of $21,700 in today’s dollars plus a contingency of $10,000, for a total of $31,700, with an assumption for inflation of 3%.
7. Pass on some of their estate while they were alive so that they would feel good about it.

**<u>Challenges in Developing an Effective Plan</u>**

As I developed the financial plan, I made a list of the challenges I was facing. If I couldn’t overcome most or all of these, any plan I developed would be useless. Here’s my list:

1. How to create a process that allowed the Wakefield’s to gradually relinquish responsibility, without giving them the feeling that they were totally losing control, or were committed for life. They needed to have a trusted advisor to guide them.
2. How to deal with the thousands of transactions over 30 years that made up their ACB. My concern was that a lawyer or executor would simply assume that the

ACB was equal to the original purchase price. This would dramatically overstate the capital gain, leading to unnecessary taxation.
3. How to deal with the large disparity in income between Jim and Betty, resulting in a much higher tax burden, given that I couldn't just move assets around without triggering income attribution rules. Jim had the majority of the registered investment assets with \$540,000 versus Betty's \$127,000.
4. How to deal with what was obviously going to be a large capital surplus. Plainly Jim and Betty could live on just one of Jim's pensions after tax.
5. How to involve the sons, particularly given that two of them were geographically removed, and the one nearby (and also my client) had a problem dealing the thought of his parents' passing.
6. How to simplify their portfolio and decrease the risk, and make it tax effective.
7. How to deal with the large capital gain in their portfolio, particularly given that I would want to reposition their portfolio to improve the asset allocation.

## Proposed Solutions

After considering the objectives, and the challenges I had detailed, I completed the plan and discussed it with the Wakefields. My approach was to go slow, with no pressure to implement anything until they were fully comfortable with it. In order to help the Wakefields understand what I was proposing, I developed a schematic diagram showing the flows of assets and income that would take place during the repositioning process. Jim commented that he found this diagram particularly useful.

The following outlines the solutions I came up. I will show how each recommendation overcame the challenge and achieved the Wakefield's objectives:

1. **Discontinue the DRIP plans.** After getting the Wakefield's agreement, I had letters of direction prepared from the Wakefield's for each DRIP plan, asking the transfer agent to stop the dividend reinvestments and to send share certificates to the client (partial shares resulted in a cash payment). This immediately reduced the paperwork they were receiving and put an end to having to account for each dividend when calculating ACBs, achieving the objective of simplifying their affairs, and their estate.

2. **Open up brokerage accounts for all share certificates.** Using the asset management service that I recommended, the Wakefield's opened three non-managed brokerage accounts (one for each of them plus a joint account). All of the share certificates, once they had been delivered from the DRIP plans, were deposited into these accounts. Now all dividends would flow into these accounts, where they could be swept out periodically and re-invested. All transactions would be properly tracked and reported. This facilitated a slow and easy transition, because the Wakefields still had the stocks, but they could manage them more easily.

3. **Calculate ACBs and capital gains.** I obtained the Wakefield's files for each stock they owned. I developed a spreadsheet to track original purchase cost, all reinvested dividends, and any additional purchases or sales. Luckily I had access to the 1994 tax return, where some of their capital gains had been crystallized. I incorporated the ACB increase from crystallization into my spreadsheets, and then created a summary spreadsheet showing number of shares, current value, ACB, capital gain or loss, and a provision for tracking future sales. Their estate liability for capital gains was now clearly documented and we were now in a position to make further decisions on how to deal with the capital gains.

4. **Reallocate existing mutual funds and GICs to a private money manager.** Here the first objective was to create the optimal asset allocation for a given risk tolerance. Using a risk tolerance questionnaire, I determined that they had a moderate to high tolerance for risk. This was fairly consistent with the portfolio they had though their current portfolio was inefficiently allocated, leading to higher than necessary risk. In addition, there was no system to automatically rebalance, which is another effective risk reduction strategy. My recommended money manager created an Investment Policy Statement, showing an improved asset allocation, and I went over this with Jim and Betty and got their concurrence. The investment return was projected to be the same as they would expect from their old allocation, but the risk was reduced by about 1% at one standard deviation. More importantly, the tax effectiveness of the portfolio was greatly improved by allocating the fixed income to the registered portfolio and the equity to the non-registered portfolio. This allowed the Wakefield's to enjoy the tax benefits of capital gains and dividends. Furthermore, the management expenses for the non-registered portion are charged to Jim directly, allowing him a sizable tax deduction. Our objective of simplifying things was also achieved because now Jim and Betty get one statement each quarter for their entire portfolio (excluding the agency accounts) instead of the 18 sets of statements they were getting before.

5. **Determine estate surplus and redeploy it to reduce tax.** In order to give the Wakefields a sense of what sort of estate they could expect to leave, our financial plan included a life goals analysis. This is a fundamental part of any financial plan. Our analysis projected that the Wakefield's would leave an estate at Jim's age 99 of over $2.0 million in today's dollars using our projected returns. This confirmed the obvious: that they had sizable surplus assets. I reassured them at this point that there would be no financial problem if one or both had to go to a nursing home – they had more than enough income and capital to cover this. The problem was that these surplus assets were causing their current taxation to be very high, including having Jim's OAS clawed back 100%. I recommended that we apply for a Joint 2$^{nd}$ to Die Universal Life (UL) insurance policy funded with deposits of $500,000 spread over 5 years to reduce the amount of capital exposed to tax. Since they would never need this capital (but would have access to it and control over it) the $500,000 plus growth would eventually pass tax free to the sons. This is an effective way of

reducing current taxation. The deposits to the policy would be invested using the same basic allocation as their non-insurance portfolio (to the extent possible). Using the selected insurance company's illustration, and even taking into account the higher management expense ratio (MER) for investments within an insurance policy, the insurance portfolio consistently outperformed the alternative investment by a huge amount initially, and by a considerable margin at their joint life expectancy.

The difficulty here was in funding the policy. Selling non-registered assets would trigger capital gains tax. I will describe how we overcame the problem below. Before I could get to that, I had to determine if this solution was feasible. I selected two insurance companies that I knew had the best solutions for people their age and had the Wakefields complete applications for both. By making the policy last to die, I made their insurance age equivalent to a single male non-smoker male of 70. The actuarial tables suggested that at least one of them would be around 15 years later. Once I got the quotes back from the insurance companies, I prepared new projections and analyzed them. I suggested to the Wakefields that it would be a good idea to involve their sons in the decision making process. They suggested that I prepare an executive summary for the sons, which I did. This report analyzed the offers from each insurance company and the reasons for recommending one of the companies. The best results came from keeping the death benefit equal to the base insurance plus the investment account value. The Wakefields consulted with their sons, who endorsed the proposal. At the same time, I answered the Wakefields many questions. Because the Wakefield's were unfamiliar with this kind of insurance, I described the features, benefits, and even a few negatives, until they were completely satisfied.

After many questions, and several meetings, Jim and Betty finally agreed to implement my recommendation.

6. **Funding the UL policy by gradually reducing the stock portfolio.** To overcome the capital gains problem, and using the summary spreadsheet described above, I recommended funding the UL policy by first of all selling stocks with negative or very low capital gains. All stock sale decisions were made by the Wakefields. I simply showed them the gains or losses for each stock. We also used their RRIF payments, which totalled about $50,000 per year. Together these were enough to fund the first year's planned premium. The following year, the Wakefields sold the stocks with higher capital gains that were in Betty's name. Because of her much lower tax bracket, this had little effect on her taxes (less than $3,800), but it helped reduce the large capital gains tax overhanging the estate. Using this strategy, we will gradually sell Betty's portfolio first, which will be taxed at her lower marginal rates. This ultimately saves them tax because if we sold all at once, or if there was a deemed disposition by way of her passing, she would be taxed at the top marginal tax rate. By doing this, I was able to even out the income between Jim and Betty, and ultimately reduce the final tax on their estate.

7. **Gifting to their sons.** A simple but effective strategy for reducing surplus assets is to gift them to those you love. I encouraged the Wakefield's to gift money to their sons, with the knowledge that they had a large capital surplus and could easily afford it. Gifting while alive gives many clients a strong feeling of satisfaction.

8. **Will and power of attorney review.** I reviewed their wills and found them to be straight-forward, with each leaving to the other, and when they are both gone, to the three sons equally. I reviewed their powers of attorney and found them to be satisfactory.

## Overview of the Results

It has now been 3 years since we started the planning process. I will summarize the results in relation to the final list of objectives.

**Create peace of mind by simplifying and organizing their affairs.** Here is where I think I had the most positive effect on the Wakefields' lives. I reduced their mutual fund portfolio from 18 separate mutual fund companies to one, dramatically reducing the paperwork they receive. Their stock portfolio was reduced from 19 stocks to 9 and will be reduced further. Instead of getting 19 different dividend payments each quarter and related T5 tax slips, their dividends are all accumulated in brokerage accounts and accounted for automatically. Now they get only 3 T5 tax slips. And the Wakefield's can easily determine their financial situation by reviewing their quarterly statements. Since making these changes, I have noticed that Jims has become increasingly more reliant on my judgements.

**Preserve their estate from taxes and unnecessary costs.** During this 3 year period, Jim and Betty's projected estate, including life insurance, has grown by $741,000. The improved asset allocation allowed them to weather the bear market and positioned them to enjoy the dramatically improved equity markets in 2003. Their investment portfolio has not quite achieved the projected returns yet, but despite the poor market conditions from 2000 to 2002, the Wakefields increased their portfolio by $190,000. Their returns fell within the range predicted by our Investment Policy Statement, which was reassuring to both them and me. By gradually repositioning the stock portfolio, we have realized the $85,000 of capital gains in their portfolio at a lower tax rate, which will decrease future estate taxes.

**Reduce current taxes.** The Wakefield's 2003 combined tax bill was $48,000, a reduction of $4,000 from 2001. The reduction would have been even greater but we have $3,800 in tax arising from the capital gains in Betty's name from repositioning the stock portfolio, which reduces future tax (her marginal tax rate is 31% now versus 46% in her estate). We will continue to take capital gains in Betty's name until her stock portfolio has been entirely repositioned. This reduction was achieved because of the deductible management fees, higher portfolio tax efficiency, and tax sheltering of their portfolio within the UL policy.

**Simplify the work for their executor.** Their estate is much better organized because we are tracking the on-going capital gains position. This information will be available to their executor whenever it is needed. And neither they, nor their executor, have to worry about the physical security of stock certificates.

**Reduce portfolio risk.** We reduced portfolio risk by 1% at one standard deviation through better asset allocation and automatic rebalancing. This allowed the Wakefields to weather the worst bear market in 50 years, despite having a relatively aggressive portfolio for an elderly couple.

**Provide an after-tax annual lifestyle of $31,700 ($34,600 in 2004 dollars).** With Jim's tremendous pension and RRIF income this was easy to achieve.

**Pass on some of their estate while still alive.** I encouraged them to do gift some of their capital to their son's, which they did. They reported that it felt good to be able to do this knowing that they were in no danger of running out of capital.

My biggest satisfaction in creating and implementing this plan was to become the Wakefields' trusted advisor. None of the results by themselves were dramatic, but I feel I have truly helped them to achieve peace of mind knowing that their affairs are well looked after. As their capacity to deal with their affairs is diminished each year, I now have things managed in such a way that it will be easy for me to work with their executor or power of attorney when the need arises. The most important thing for the Wakefields is knowing that, through this process, they can be assured that their wishes will be carried out.