

*Retirement Income
Strategies- Winter
2009*

Chris Ball, CFP, CIM, FCSI



Be well-advised.

The objective of this report is simple; to provide you with information to assess your existing income plan. The recent volatility of the markets has made the selection of the right investment vehicles even more important, a miscalculated decision can have a devastating, long term effect.

This report outlines the various strategies and techniques that can be used to create income. I am by no means advocating one strategy over another. This requires personalized planning and consultation. I do think it is valuable that my clients understand all of their income options; this helps them come to grips with the question “is there something better available?”

This report will likely leave you with more questions than answers. Feel free to call or email me to ask questions that you may have. A proper income plan should be done in concert with a comprehensive financial plan. When working with clients, this is mandatory. Imagine driving in a strange land with no map. We see the marketplace of investing as the strange land; a comprehensive plan provides direction in uncertain times.

Sincerely,

Chris Ball

Income Strategies to Consider

Strategy # 1 – GICs

For people who don't require a substantial "after tax and inflation" growth rate and who have a very low tolerance for risk! The question for most people is "can you afford to own a GIC?"

It is said that "Slow and Steady Wins the Race". If that were the case then Guaranteed Investment Certificates (GICs) would be the hands down winner.

Normally issued by Canadian banks and trust companies, these investments are very popular with Canadian investors. The reasons are simple: they are convenient to purchase; the rate is guaranteed; and, they are offered by very familiar Canadian financial institutions.

One strategy you can use to help maximize GIC returns while maintaining a secure portfolio is to stagger your GIC maturities. This proven method of investing can help you reduce the risk of interest rate fluctuations and increase the portfolio's overall return. The goal of the strategy is to reduce interest rate risk and to increase rate of return.

The problem is that maybe they are too steady and you are paying for that peace of mind factor. Back in November 1981 you could have invested in a 5 Year GIC that paid 17.5%, while today a 5 year GIC will pay you less than 4.5%.

GICs are very tax sensitive. Any interest earned by a GIC is taxed 100%. For example:

If you have a \$100,000 GIC that is paying you 3.9% and your Marginal Tax Rate is 40% you would earn \$3,900.00 in interest. You will pay the Canadian Revenue Agency (formerly Revenue Canada) \$1,560.00 next April in taxes leaving you with a net return of 2.3%. Drop that by inflation, (which is hovering around 2.5%) your net after tax and after inflation return is -0.2%.

Strategy # 2 – Bonds

A critical piece of your retirement income portfolio – but not without challenges caused by timing, taxes and inflation!

Bonds can be the rock of your retirement income portfolio. These investments can provide you secure interest income and protect your principal, provided you hold on to them until maturity – (timing).

If you are still looking for a low risk investment, but want higher rates of return than found with Guaranteed Investment Certificates (GICs) then maybe you should be looking at Bonds.

A bond portfolio can be tailored to your personal needs. This can be done by varying the term to maturity, interest payment dates and other variables. They can help you build a retirement income portfolio just right for you.

All is not perfect, here are some considerations:

1. Your return may be lower than compared to other types of income investments;
2. You will pay a highest rate of tax on interest income – (taxes);
3. Your income is fixed, so you have no protection from the effects of inflation.

Therefore, it is often necessary to include other investment types as well, to improve your overall rate of return.

Strategy # 3 – Income Trusts

Yesterday's "Flavour of the Month" still worth consideration

Income Trusts were one of the hottest investment trends to hit the Canadian markets in a long time. These investments were so popular that the federal government changed the tax act to reduce their attractiveness. For a while it looked like all publicly traded companies in Canada were either converting, or considering converting into an income trust structure. It was the easiest way for the company management to give their stock price a nice “pop up”. It was getting so “out of control” that the Federal Finance Minister had to step in and throw some cold water on the party.

Income Trusts are business structures that operate in a variety of different industries from oil to pizza. The goal for the people, who run these businesses, is to provide you, the investor, with a steady flow of income. Does this sound too good to be true? Think of that the next time you fill your car with gasoline and go home to order a pizza.

So what is the big deal?

They tend to provide a high cash return to their investors (also known as unit holders) currently ranging from 6.0% to 11% per year, or more. This income also attracts less tax, when compared to ordinary interest income. Many income trusts have a history of increasing their cash payments over time. This provides some protection against inflation.

If this sounds too good to be true, here are some points to keep in mind:

1. Income trusts are businesses, subject to all the risk that businesses can be subject to when operating in their marketplace;
2. They are definitely not risk free. Some say, they should not even to be considered conservative investments.

Despite being less attractive than a few years ago, Income trusts can play an important part of a well-diversified retirement income portfolio. The key word is “part.”

Strategy # 4 – Dividend Paying Stock

The Gift That Keeps on Giving – A regular income, preferred tax treatment and potential for capital growth but exposure to the volatility of the equity markets.

Here are the possible benefits from these types of investments:

1. They provide you with a regular quarterly income;
2. The income attracts less tax than interest income;
3. The company will likely want to pay out slightly more next year;
4. You will have the potential to earn a capital gain on any growth in your capital value.

You come across these companies every day; they are the banks, utilities, telephone companies, and other blue-chip Canadian companies. Welcome to the magical world of “dividend paying stocks”.

The income that these great Canadian companies pay to their investors is called “dividends”. These payments can be made quarterly throughout the year. Once these companies start paying dividends, they traditionally want to increase their dividends slightly to demonstrate that they are continuing to grow. If a company’s growth slows dramatically, a dividend may be cut as well.

The federal government rewards you by investing in dividend paying stocks so they also give you something called the “Dividend Tax Credit.” This typically means you pay 1/3 less tax dividend income than if you earned your income in the form of interest only.

Of course you would be subject to the business and market risks as one of the owners of that company, which means that the price of the stock could go up or down and/or the dividend could get reduced or not paid at all.

So, when considering the merits of purchasing dividend paying stock it is important to remember a couple things.

- Your principle is not guaranteed. Share prices fluctuate daily.
- There are no guarantees that the company will pay a dividend every quarter. Should the company hit a rough patch they can stop paying dividends. This opens the door to a range of problems if you are dependent on the income. Do you reduce your spending until they pay a dividend again? Do you sell the

stock to buy another company stock that does? If you sell the stock you have, will you have to pay capital gains tax?

Dividend paying stocks can be a very good investment as part of a well thought out written financial plan that considers your lifestyle requirements for income and all other forms of investment tools.

Strategy # 5 – T-SWP (Tax-Effective Systematic Withdrawal Plan)

A T-SWP is a Creative and Effective method for creating income from mutual fund units.

“T-SWP” is an acronym for “tax-efficient systematic withdrawal plan”. This really is a service and not a separate type of investment. It can enable investors to receive a monthly cash flow from a range of different mutual funds.

The benefits:

- Enjoy a higher monthly cash flow if you need it;
- Lower your short-term tax bill;
- Participate in the growth potential of a range of mutual funds.

How does it work?

By investing in a mutual fund that has the T-SWP service, you can defer taxes until you redeem the investment. Thanks to the unique structure of its monthly distributions, this doesn't require you to redeem individual units of the investment. These distributions consist primarily of “return of capital”, which is considered to be part your original investment and is therefore not subject to tax when you receive it back monthly.

Again, this can work very well when used for the right people!

Strategy # 6 – Annuities

Guaranteed Income for Life – Provides the security of knowing you will not outlive your money but includes the worry that your savings may not keep up to inflation.

An annuity contract is another form of investment. You can pay a lump sum to a financial institution, such as an insurance company or bank to buy an annuity based

on set terms for the contract. After making this one time deposit you will receive regular income payments.

The income payments are generally fixed at the time the annuity contract is set up. The income payments will contain both interest and principal. Annuity payments can continue for the rest of your life, no matter how long you live. Below are three reasons some investors find annuities an attractive investment alternative:

1. It provides a dependable stream of income for life;
2. It is a simple investment strategy with no further investment decisions needed once the contract is set;
3. You won't outlive your money.

Some issues to consider before buying an annuity:

1. Increases in interest rates cannot be reflected in your retirement income because your contract is fixed at the outset;
2. Once the program is started, the annuity **cannot** be redeemed.

Used carefully in the context of your complete financial situation, annuities can be an attractive option for some people.

Strategy # 7 – Guaranteed Income Plan

This strategy can provide reasonable monthly cash flow while protecting the value of your estate.

The first retirement planning objective for most Canadians is to be sure they don't outlive their money! Given a choice, most people would also like to leave a legacy for their family, church or their favourite charity. Unfortunately, if you do not plan properly, a substantial portion of any legacy may have to be paid in taxes to the Canada Revenue Agency.

A Guaranteed Income Plan could be a solution.

For example:

Assumptions

1. Mary Jones is 65 year old.
2. Her Risk Tolerance is Low and she is uncomfortable with any changes in her income.
3. She has \$250,000 to invest.
4. Her Marginal Tax Rate is 45%.

Investment Option # 1 – GIC

1. Mary purchases a GIC for \$250,000 with interest at @ 3.35%
2. The GIC creates \$697.91 per/month gross interest income.
3. The interest is all taxable at 45%. Loss to taxes \$314.05
1. Mary's net after tax monthly income = \$383.86

***Benefits Mary will enjoy with the Guaranteed Income Plan**

1. There is an increased cash flow because a Guaranteed Income Plan provides a blend of interest and return of capital, with tax due only on the interest portion. With a GIC, the interest income is fully taxable at the marginal tax rate.
2. By returning a portion of the capital to produce a higher net after-tax cash flow, this preserves Mary's estate for her family, and improves her lifestyle.
3. Upon Mary's death, payments will stop, but a Guaranteed Income Plan provides her family beneficiaries with a tax-free benefit, allowing her beneficiaries to recover all, or a portion of the amount initially invested.

Potential Risks to the Guaranteed Income Plan

1. This is a long-term strategy. Any future increases in interest rates will not result in increases in your retirement income.
2. Once the plan is started, the investment capital **cannot** be redeemed.
3. Capital is only repaid upon death of the insured.

*For Illustration Only

Strategy # 8 – Personal Tax Strategy

The “PTS” is similar to the previous strategy but includes the purchase of life insurance. It provides a reasonable monthly cash flow while protecting the value of your estate.

A Personal Tax Strategy (like Strategy # 5) is in fact a service and not a separate type of investment. For example:

Assumptions

1. Bill and Fran – Age 70 and 68 respectively, have 3 adult children and 6 grandchildren.
2. A review of their estate plan reveals that Bill and Fran have not made any provisions to preserve the value of their estate aside from designating beneficiaries on their RIFs and RSPs, i.e. all investments other than their personal residence will be taxable when they have both died.
3. They have suitable executors and up-to-date Wills and Powers of Attorney.
4. The estimated Marginal Tax Rate on their Estate is 46%
4. Their assets are as follows:

Description	Estimated Value
The combined value of their RSPs / RIF	\$700,000
GICs and Bonds from sale of home	\$200,000
Family Cottage (Estimated Value)	\$550,000
Family Cottage (Adjusted Cost Base)	\$150,000
Estimated Capital Gain on The Cottage (Within the Estate)	<u>\$400,000</u>
Estimated Taxes Owing within the Estate	<u>\$460,000</u>

What can Bill and Fran do about this now?

1. Nothing...
2. Sell the cottage and pay the taxes before they die.
3. Use a Personal Tax Strategy

Consider the merits of a Personal Tax Strategy (PTS)

The Canadian Revenue Agency (CRA) has closed most of the legitimate “loop holes” that allow tax savings on earned income. One of the few options left for Bill and Fran is a Personal Tax Strategy (PTS). A PTS uses a permanent insurance contract in combination with an investment portfolio. This strategy is often identified by the “Big 3” accounting firms as the most effective way to save taxes to your estate.

CRA states that all investment earnings generated within the cash value of a permanent life insurance contract are exempt from taxation. There are a full range of investment choices within a life insurance contract including guaranteed investments, index funds, mutual funds and actively managed investment portfolios. These investments are allowed to grow on a tax free basis until the cash value is redeemed.

How does the PTS work?

Instead of withdrawing the cash value of the life insurance policy, Bill and Fran can arrange a loan with a banking institution, to be secured by the collateral value of the investments within the life insurance policy. The bank will establish a line of credit on their behalf. This will allow Bill and Fran access to tax free capital, and interest will accumulate within the line of credit until the line of credit is paid off upon death.

Upon their death, the bank will take enough proceeds from the investment accounts with the insurance policy to repay the capital owing, plus accumulated interest. The remaining proceeds from the PTS investment accounts are paid to the beneficiaries’ tax free, directly, without attracting probate fees within the estate.

Additional Benefits

The death benefit proceeds from the insurance policy are also available to pay the taxes that are owed by the estate on the RIF and RSP assets, and any deemed capital gain on the cottage.

As you can see, a PTS can be extremely effective to provide a suitable level of income during your life time and protect the value of the assets from unwanted tax liabilities within your estate. This should only be considered within the context of a well understood written financial plan.

Strategy 9- Insured Annuities

You purchase a *prescribed life annuity* (which provides a series of payments guaranteed for life by the issuer) and then buy a *life insurance policy* with a face value (insurance benefit) equal to the amount of the annuity principal. The annuity payments you receive will pay the insurance premiums and also provide you with income. With an insured annuity you'll pay less tax compared to interest income received from a GIC. That's because the income from the annuity will be comprised of a combination of the return on capital and interest, and the taxable amount of interest will be averaged over the life of the annuity. Your annuity income payments are guaranteed for life and the insurance benefit can be left to your heirs tax-free.

Compliments of Chris Ball, CFP, CIM, FCSI, Financial Planner
Assante Capital Management Ltd. (Member – CIPF)
1477 South Park Street
Halifax, Nova Scotia
B3J 2L1
902-431-3850



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