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FINANCIAL FACELIFT

Can Irene give her children an advance on their inheritance without triggering a huge tax bill?

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At age 91, Irene is more physically active than some much younger people, hiking, skiing and boating over the trails and lakes of her rural Ontario home. She feels she could live to be 105 – so no wonder she worries about running out of money.

When her husband died a few years ago, he left Irene his defined benefit pension plus a stock portfolio that had risen substantially in value. But when her husband's long-time broker retired, Irene was adrift, her account transferred to a stranger in Toronto. Now, with almost half of her $1.8-million portfolio sitting in her bank account, Irene is looking for advice on investments, tax planning and estate planning.

"She has no one advising her on any of her accounts," her daughter Milly writes in an e-mail. "She wants to find the right balance for her age between simplicity and safety."

Irene's problem – not a bad one to have – is the substantial unrealized capital gain in her portfolio, which would trigger a big tax bill if she sells. She's thinking of giving each of her three children an advance on their inheritance "to lessen the tax burden in settling her estate" when she eventually dies.

Irene gets $29,000 a year in pension income, $11,700 in Canada Pension Plan benefits and $7,400 in Old Age Security, for a total of $48,100 before tax, indexed to inflation.

We asked Warren MacKenzie, head of financial planning at Optimize Wealth Management in Toronto, to look at Irene's situation.

WHAT THE EXPERT SAYS

Even if she lives to be 105, Irene is unlikely to run out of money, Mr. MacKenzie says. That assumes she invests in a balanced and diversified portfolio with an average annual rate of return of four per cent. The inflation rate is forecast at two per cent.

Because Irene is healthy and active, "to be on the safe side she needs to plan for another 15 years of retirement," the planner says. "Fortunately, she has more wealth than she needs, even assuming she requires five years of care in a top of the line retirement home and then a nursing home." He has built $120,000 a year for five years into his forecast to cover this eventuality.

Irene's problem is that after years of saving and investing, she is having a hard time switching gears, Mr. MacKenzie says. "She might make the mistake that many financially secure seniors do: that is to keep saving for a rainy day when they should be using their surplus capital to improve their lifestyle, give advances to their heirs, or donate to their favourite charities," he says.

Irene's investment portfolio is poorly diversified, consisting only of 16 Canadian blue-chip companies and bank savings accounts. "Irene's husband invested $112,000 in these companies about 30 years ago," Mr. MacKenzie says. "Today those securities are worth $708,000 and there is an unrealized capital gain of about $600,000." Irene's tax-free savings account is invested entirely in stock. "Overall, including the stocks in her TFSA account, her portfolio is about 48 per cent dividend-paying Canadian stocks and 52 per cent cash," the planner says. "She has no exposure to international equities, small capitalization stocks, government or corporate bonds, or real estate investment trusts," he says.

"Given that the Canadian stock market is near its all-time high, and Irene does not need a high return to achieve her goals, she is taking more risk than necessary," Mr. MacKenzie says. "She should move to a lower-risk and more diversified portfolio." If the stock market were to turn down and stay there a while, Irene "does not have 20 years to wait for a recovery."

Next, Mr. MacKenzie looks at advance inheritances. Irene would enjoy seeing how the inheritance helps her children. She'd also save income tax and probate fees. "If she gave $200,000 to each of her three heirs, so they earned the investment income instead of Irene, in the long run they would benefit more than if she kept the money, paid tax on it for the next 15 years and left it to them as part of her estate." If the heirs lack investment experience, they could learn by investing some of the money. Finally, Irene's estate would be smaller and less complicated if she gives some money away now.

Mr. MacKenzie's projections show that if Irene was to give each child an inheritance advance of $200,000, she would still leave an estate of nearly $400,000 even if she lives to age 105. "Eliminating the interest and dividend income she is receiving on the $800,000 of investments that she is considering liquidating – by paying the tax and gifting the balance to her heirs – would reduce her taxable income by more than $20,000 a year. This would lower her income tax and move her out of the Old Age Security clawback zone," the planner says.

She could also donate to charity, Mr. MacKenzie says. "If she donates a stock with a cost of $10,000 and a market value of $100,000, she would receive a tax deduction of $100,000, and would also avoid the tax on the capital gain that would be triggered if she sold the stock."

Irene has delayed making changes to her portfolio because she is reluctant to sell securities and trigger capital gains, Mr. MacKenzie says. "The reality is that some day these gains are going to be triggered. If they are all triggered in the year of her death, much of the taxable portion of the capital gain (half the gain is taxable) will be taxed at more than 50 per cent." Irene is likely to benefit more from lowering her investment risk than holding on to defer the payment of income tax, the planner says.

If she decides to give her children an advance inheritance, she should spread the capital gain over two years by selling $400,000 of securities in 2021 and $400,000 in 2022, he says. As mentioned, the stock initially cost $112,000 and the market value is $708,000. This would trigger a gain of $596,000 – $298,000 of which would be taxable. After paying the capital gains tax, the after-tax proceeds from the sale of her shares, along with some funds from her savings account, would leave her with more than enough to give $200,000 to each child.

Irene should have a family meeting to discuss the gifting idea so the children and their spouses know what to expect, Mr. MacKenzie says. "It is the surprises when the will is read that often lead to conflict. Good communication reduces the possibility of quarrelling over the estate."

CLIENT SITUATION

The person: Irene, 91, and her children

The problem: Drawing up a plan that will cover her investments, possible inheritance advances, tax planning and estate planning

The plan: Shift to a balanced and diversified portfolio. Consider giving her children an advance inheritance. Doing so will save the family taxes and simplify estate planning.

The payoff: By making her investment portfolio more diversified, and by giving her children advances on their inheritance, she is not only managing her money wisely, she is using her surplus wisely.

Monthly net income: $7,000

Assets: Savings account $685,245; chequing $9,950; non-registered savings $20,195; brokerage account $911,835; TFSA $157,855. Total: $1,785,080

Monthly outlays: Rent $2,785; home insurance $30; transportation $250; groceries $500; clothing $100; gifts, charity $400; vacation-related expense $1,250; dining, drinks $420; health care $220; communications $240; TFSA $500. Total: $6,695

Liabilities: None

Warren MacKenzie is Head of Financial Planning at Optimize Wealth Management

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