The McCartney Report

July 2007

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The Last Word

"If you want to be happy, set a goal that commands your thoughts, liberates your energy and inspires your hopes."
-Andrew Carnegie

A Very Quick Market Update

June was a negative month for Canada as it was for the US & much of Europe

June Month End & Year to Date World Indices Performance

World Index	*MTD*	*YTD*	*YOY*
S&P/TSX Comp.	-1.07%	7.73%	19.75%
Dow Jones	-1.61%	7.59%	20.25%
S&P 500	-1.78%	6.00%	18.36%
NASDAQ	-0.05%	7.78%	19.85%
FTSE-100 (London)	-0.30%	6.22%	13.28%
CAC 40 (Paris)	-1.29%	9.26%	21.93%
DAX (Frankfurt)	0.50%	21.38%	40.89%
Nikkei (Tokyo)	1.00%	5.30%	16.98%
Hang Seng (H.K.)	5.68%	9.06%	33.84%

YTD and YOY numbers still look strong, as do the 3 & 5 year returns.

June 2007 Three & Five Year Returns World Indices Performance

World Index	*3 Yr*	*5 Yr*
S&P/TSX Comp.	17.62%	14.24%
Dow Jones	8.72%	7.72%
S&P 500	9.63%	8.72%
NASDAQ	8.33%	12.21%
FTSE-100 (London)	13.97%	7.25%
CAC 40 (Paris)	17.49%	9.21%
DAX (Frankfurt)	25.48%	12.81%
Nikkei (Tokyo)	15.22%	11.30%
Hang Seng (H.K.)	21.01%	15.49%

What Rate of Return do you Expect from your Portfolio?

Last month's McCartney Report discussed Year Over Year returns and the reasons why most Canadian Investor's portfolio returns did not match the indexes (i.e. the influence of Bonds & the increasing value of the Canadian dollar to the US Greenback).

This month I'd like to discuss an observation I've made recently.

When I sit down with a client or new prospective client, one of the questions I ask them is "Over the long-term (10+ years), what do you think is a realistic overall return for your investment portfolio?"

In the two to three years following the bear market that occurred through 2001 & 2002, I found that most people would have been happy with annual returns in the 6-8% range.

More recently, specifically in the last six months, I've started to hear people say 8-10% a lot more often. I even

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get 11-12% from time to time and I don't think I've heard that since the tech run up through 1999 and 2000.

So what has changed?

The markets are strong. Very strong. They've been that way for quite awhile in Canada. Perhaps our perspective has begun to change now that 2002 is all but a distant memory. Do you think it's possible that investors are starting to think to themselves, *"I want, **and need** last year's returns or I wont achieve my financial and personal goals?"*

In 2003, many people wanted to switch all their money to bonds and GICs because of the fear that if they got last year's returns (i.e. 2002 & 2001) they would not be able to achieve their financial and personal goals and would likely end up insolvent and destitute (i.e. broke).

So why do you suppose people spend so much time focusing on last year's numbers?

The point I would like to get across is that now is not the time for overconfidence and greed, just as the first couple of years following the bursting of the Tech bubble was not the time for fear.

Now is the time to reflect on your personal and financial goals.

I HAVE A CHALLENGE FOR YOU.

Take out a blank sheet of paper. Number it 1 to 5 down the left hand side (double spaced). Please write down the 5 things that are most important to you.

Next, on that same piece of paper, write the numbers 1 through 5 a second time. Please write down five financial goals that you would like to accomplish in your lifetime.

Humour me on this *and we'll re-visit it next month*

Estate Planning for the Family Cottage

Are you a cottager? Have you been going up to the lake every summer since you were a kid? By mid-March are you chomping at the bit to get out of the city, get the docks in, put the boat in the water, toss out a few casts, take a swim, put the chairs out by the campfire pit and sing a few songs under the stars. Me too. In fact, most of my favourite memories in some way involve being at the cottage with my family. Now the next generation is enjoying the lake in the same way that we do. They squirm with anxious excitement as the car approaches the driveway to go down towards the lake. They can't wait to run down to the dock to see their friends again. We see ourselves in them as we watch them grow and we reminisce about our own adventures. It doesn't get much better.

There's only one thing. I don't own the cottage that I have been going to my whole life. My parents do, yet I still think of it as my own. I also hope that the cottage will remain in our family indefinitely. Whether or not that is indeed the case will depend on a number of factors (some financial and some not).

There are many considerations when planning for the succession of the cottage to children. From a financial point of view, the most serious issue is often the Capital Gains Tax liability, which occurs when the cottage changes hands.

Defining the Capital Gain that exists on the Cottage:

1. First consider what the cottage is worth if sold on the open market today. This is called the Fair Market Value (FMV). A discussion with a local realtor should give you a good estimate of what the value is.
2. Next consider the price that was paid when the cottage was originally bought. Add to that figure the cost of any capital improvements to the property over that time – a deck, a new dock, the construction costs of a re-built cottage, etc. This figure is called the Adjusted Cost Base (ACB) of the property. If the cottage was purchased prior to Dec. 31st, 1971, the ACB of the property is the value on that date (this can be determined by a professional appraiser).
3. The total Capital Gain can be calculated by deducting that Adjusted Cost Base (ACB) from the Fair Market Value (FMV).
4. Multiply the Capital Gain by 50%. This gives you the figure you will pay tax on (Taxable Capital Gain).

Consider the following example:

A young family bought a cottage in 1968 for $12,000. On December 31, 1971, it is worth $15,000. In the years that follow, the owner spends $150,000 on improvements and additions. As it turns out, the lake the family bought on so many years ago has become very prestigious and today the value of their cottage has ballooned to $1,000,000. If the owners of the cottage were to pass away today, the capital gain on the cottage would be $835,000 ($1,000,000 – ($15,000 + $150,000)).

The taxable amount would be $417,500 and assuming a 46% tax rate, the estate would owe $192,050 in additional taxes on the deemed disposal of the property.

IF THERE ISN'T ENOUGH MONEY IN THE ESTATE TO PAY FOR THESE TAXES, THEN PAYING THIS TAX WILL BECOME THE RESPONSIBILITY OF THE HEIRS IF THEY WISH TO KEEP THE COTTAGE. IF THEY DO NOT HAVE THE MEANS THEMSELVES, THEN THE COTTAGE WILL HAVE TO BE SOLD.

Addressing the Capital Gains Issue

Here are a few ideas you should think about when considering passing the cottage on to your heirs.

1. Consider gifting the cottage to children in advance. If you gift the whole cottage, you will deem to dispose of it at FMV and you will have the full Taxable Capital Gain now; however, you could transfer it in stages, that way you reduce the taxes you pay each year.
2. Consider using the proceeds of a Life Insurance policy to cover the taxes at death. Once you have an estimate of what the taxes will be (see example above), you can purchase enough insurance to ensure the taxes are covered. This is a very common strategy. Also common is having the estate beneficiaries pay for the insurance premiums.
3. Consider whether you are able to use the principal residence exemption. The principal residence (or home) is not subject to capital gains tax.

Other Issues in the Succession of Cottage Property

Avoiding Probate Taxes

There are a couple of different strategies for avoiding Probate Taxes. One way is to transfer the cottage property while still alive. This allows the owner to avoid probate taxes at death; however, the "gift" will trigger a deemed disposition, which may lead to taxes payable on a Capital Gain (discussed above), in addition to other expenses (legal, land transfer tax, etc).

Who should get the Property?

It is not always the case that the cottage will go to each child in equal proportions. This may not be the best solution. Some children may not have the same interest in the asset, hence a cash bequest from other estate assets may be more appropriate.

Health and Financial Issues

For the purposes of this article, we have assumed that: 1. our parent's health has allowed them to enjoy the use of the cottage for the remainder of their life and 2. they have not had any financial requirements that require them to sell the cottage (or do a refinancing) during their lifetime. Either of these events or both of them together can complicate the cottage succession picture significantly both financially and emotionally.

Conclusion

The Cottage, for many of us is the source of our fondest memories. Our children are now building their own memories. A little bit of advanced planning for the succession of this property can spare a great deal of expense and frustration. Open discussions between parents, children, or grandchildren as the case may be should be followed up with a discussion with a **Certified Financial Planner (CFP)** and if necessary, a qualified tax advisor.

Taking this step will help you design a strategy for keeping the cottage in the family for generations to come.

-Jeff McCartney, CFP