



**B L Garbens Associates Inc.**

Independent Financial Advice

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# inBrief

financial information you can use  
Fall 2005

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## PRESIDENT'S MESSAGE



*Some financial planning strategies appear simple. It's the careful alignment of these choices with your goals, lifestyle and life stage that can get complex – especially when it takes so much hard work to amass wealth. As one client commented as we considered his bequests, "We should never lose sight of the value of a dollar." We do need to be mindful of mortality. We also need to recognize that we are not just saving for some distant day 25 years from now, but remembering to enjoy our wealth along the way. In this issue, we explore some ideas for those fortunate enough to come into money. Helping my clients open up their financial thinking in order to consider their best options is always a welcome conversation. Enjoy the fall.*

*Barb*

Barbara L. Garbens  
MBA, RFP, CFP



## Suddenly Wealthy

Most of us spend our working lives building wealth gradually. But for some, the acquisition of wealth happens overnight – often as the result of an inheritance or the sale of a large block of corporate stock. While some people may feel that sudden wealth is one of the better problems to have, it does present its challenges.

If the money's been received as the result of a death in the family, feelings of grief, shock, and even guilt are common psychological reactions. Some people can be overwhelmed by these responses, leading to a state of confusion and reluctance to take any action on the financial side.

Other people react to the money as a windfall, and respond by going on a spending spree, often depleting the capital in short order.

If you've become suddenly wealthy, what advice can we offer you? First of all, don't

do anything! It takes a while for the psychological dust to settle, sometimes even a year or two. During that time, you should attend to the obvious, such as paying off high-interest consumer debt, but hold off on major decisions such as buying a new house or vacation property or taking an early retirement. If you have a hankering to spend, limit yourself to perhaps 5% of your new capital rather than going on an open-ended spree.

Once you're ready, work with your financial planner to explore the boundaries of how far your money will go. There's a tendency for people to underestimate the value of smaller windfalls and overestimate what larger ones can do, so make sure you have a clear idea of the scope of what you can accomplish.

Realize that there are really only four options to consider: invest, spend, pay down debt, or give money away. You will need to spend some time exploring the possibilities and prioritizing your goals within these four categories before you decide on a course of action. Your financial planner can prepare projections that will help you determine just how achievable your goals are.

While early retirement is a common response to a large inheritance, it's not always the right move. You may be in a financial position to retire, but it's not just about the money. You'll also need to spend some time doing life planning as well as financial planning. People who haven't prepared adequately for this stage of their lives often find themselves bored and looking to go back to work within a few months of retirement.

At B L Garbens Associates Inc., we would be happy to help you explore life planning issues as well as financial matters. We look forward to being of assistance.



## Income Trusts

Like many investors, you've probably heard a lot about income trusts and wondered if they would be a good investment choice for you. Although income trusts have grown in popularity over the past several years, they're still not well understood by many prospective purchasers. How exactly does an income trust work?

Basically, an income trust is a structure that holds an underlying business and distributes the excess cash flow of that business to investors in a tax-efficient manner. In contrast, publicly listed companies usually retain and reinvest their earnings, with some paying out a small portion of these earnings as dividends.

The oil and gas royalty trusts and real estate investment trusts which first appeared in the 1980s are perhaps the most familiar examples of income trusts. But today, many other types of businesses are taking advantage of the income trust structure, including restaurant chains, pet food manufacturers, and, of course, the Yellow Pages. In fact, the Yellow Pages typifies the kind of company that suits the trust structure best – a stable business with solid cash flow, few risk factors, and some growth potential.

The payments from an income trust can consist of several different components: royalty income, return of capital, and

capital gains. While royalty income is taxed at the investor's marginal tax rate, some types of royalties are eligible for certain deductions. For example, oil and gas properties are entitled to Canadian oil and gas property expense and Canadian development expense deductions, which partially shelter the distributions from tax.

Any tax-free distribution from an income trust, such as return of capital, reduces the adjusted cost base of your investment dollar for dollar. Sometime down the road, when you sell your investment, the difference between the adjusted cost base and the selling price will be taxed as a capital gain. Since only 50% of a capital gain is taxable, the income trust structure provides a very tax-efficient way of earning investment income.

The performance of income trusts over the past five years has been very strong in comparison to both the stock and bond markets. However, investors should be aware that, unlike fixed-income investments, the regular distributions are not guaranteed. Although returns have not been as volatile as common stocks, they do fluctuate, and may respond negatively to increased bond yields. This is one of the major risks of income trusts. However, a new risk has surfaced recently in the form of the federal Finance Department. There is some concern that the tax attractiveness of income trusts could be reduced as early as the next federal budget. Whether any changes would include exemptions for current trusts is not known at this time.

While some commentators have referred to income trusts as a "third asset class" in addition to stocks and bonds, we feel that they represent a subset of stock investments, and should be treated as such in the asset mix of your portfolio. They may be particularly suitable for retirees who want to invest in equities, but are looking for income as well as relatively low volatility.

## Taxation of Income Trusts

Here's an example of how return of capital from an income trust becomes taxable in the future. Let's say that Bob invests \$10,000 in ABC Trust. A year later, he receives a \$1000 distribution from the trust, \$400 of which is taxable. For the current year, he'll receive a T3 slip showing \$400 of royalty income. However, the \$600 tax-free portion of the distribution reduces his adjusted cost base (ACB) dollar for dollar. Since his original investment was \$10,000, his new ACB will be \$9400.

Two years later, Bob sells his investment for \$12,000. His capital gain at that time will be calculated as \$12,000 minus the new ACB of \$9400, or \$2600. Only 50% of that gain, or \$1300, will be taxable. With tax-free income up front, and the deferral of capital gains tax to future years, it's easy to see the appeal of income trusts.

## MATTERS OF INTEREST

### Year End Tax Planning Tips

- Make the following payments by year-end in order to claim a deduction: charities, investment counsel fees, professional memberships and political contributions;
- Make RESP contributions for children or grandchildren by December 31st
- Consider deferring the tax from the exercise of stock options to a future year
- If you turn 69 in 2005 and still have earned income, consider making an advance RRSP contribution by year-end (December 31)
- Consider tax loss selling to offset capital gains realized during the year
- Consider waiting until next year to purchase mutual funds outside your registered plans to avoid paying tax on year-end distributions

Call us to discuss whether any of these strategies are appropriate for you.



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