NWM Tactics

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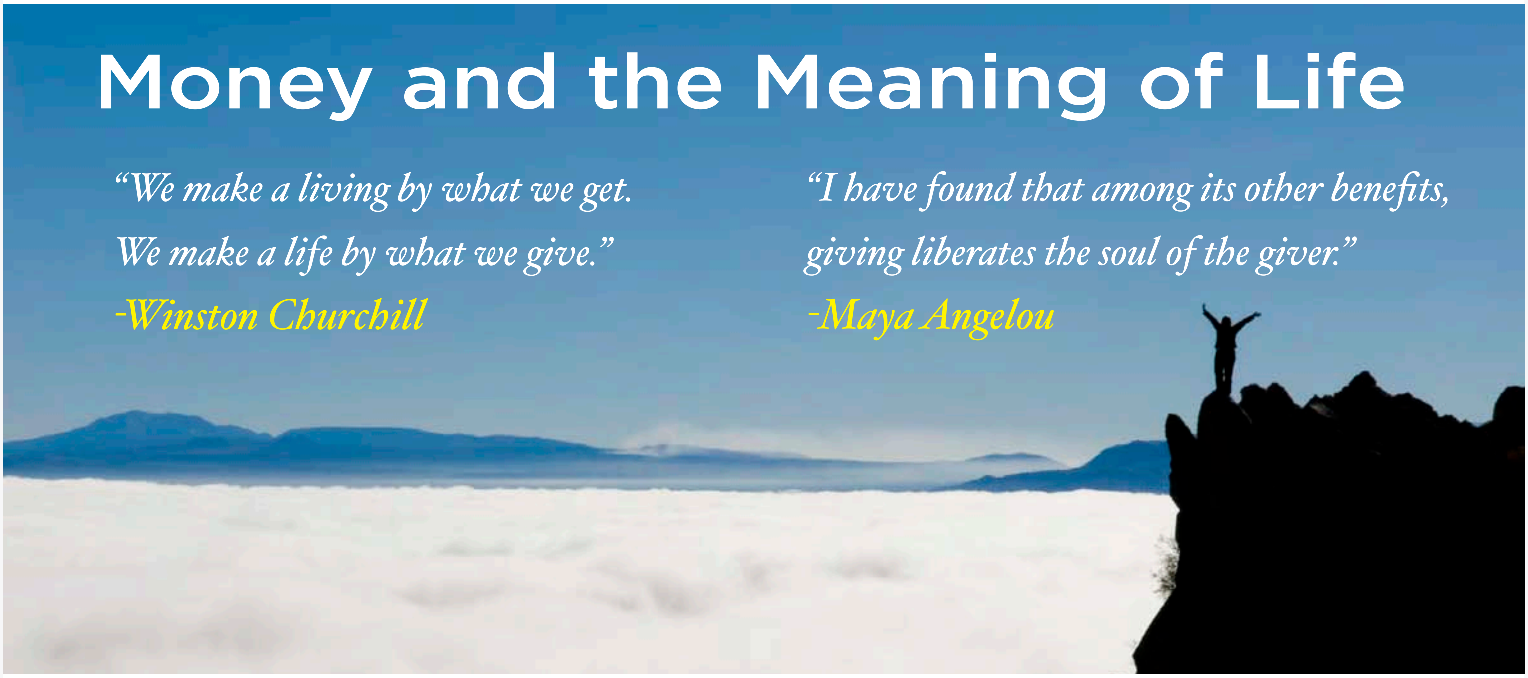
NICOLA WEALTH MANAGEMENT

TACTICS | JULY 2012 | JOHN NICOLA, CFP, CLU, CHFC



# Money and the Meaning of Life

*"We make a living by what we get. We make a life by what we give."*
*-Winston Churchill*

*"I have found that among its other benefits, giving liberates the soul of the giver."*
*-Maya Angelou*

I recently had the pleasure of listening to a presentation by Dr. Paul Schervish who is the Director of the Centre for Wealth and Philanthropy at Boston College. His topic was titled "Guiding Your Clients Through the Troubles and Fulfillments of Wealth."

The title of this newsletter is *Money and the Meaning of Life* which comes from a book of the same name written almost twenty years ago by Jacob Needleman. Professor Needleman has a blog now (http://jacobneedleman.com/blog/?p=98) and in it he writes the following about money and our relationship with it.

*"Money exerts a deep emotional influence on who we are and what we tell ourselves we can never have. Our long unwillingness to understand the emotional and spiritual effects of money on us is at the heart of why we have come to know the price of everything, and the value of nothing. Money has everything to do with the pursuit of an idealistic life, while at the same time, it is at the root of our daily frustrations."*

Canadians are by nature generous and currently give away more than $8-billion each year in tax-deductible charitable contributions (and likely billions more to other worthy, but non-deductible philanthropic causes).

Even in the most challenging of economic times, we are proud to see many of our clients continue to be generous philanthropically.

A number of our clients have been fortunate enough to build wealth beyond what they will need over their lifetimes, and many more are well on their way to achieving that level of wealth.

Building wealth takes a combination of skill, hard work and – I think most of us would admit – a certain amount of good fortune. And while success may result from what one does with their luck, that does not mean we should not appreciate it when we receive it.

## Wealth Planning and Tools for Giving Strategically

Part of the planning work we do with each of our clients is to build what we call a "retirement spreadsheet," an analysis that provides projections of future wealth and the likely cash flows it will support after taxes and inflation based on a variety of assumptions. To allow for what we call "scenario planning" we change the assumptions to examine the impact of lower or higher returns, taxes, life expectancy, spending needs, etc.

From all of this, we work with our clients to make a model they feel best represents their current picture and desired outcomes. Finally, we make sure that this analysis is reviewed regularly to reflect the inevitable changes that occur.

For those clients of ours who have more assets than they require to meet their current and future spending, a cash flow analysis using a "retirement spreadsheet" would seem pointless. Unless an unforeseen disaster occurs, they will easily meet their cash flow needs and continue to build their wealth.

However, the very same tool can be used to assist them in making far better and informed decisions about how they want their wealth handled both now and in their estate, and to assist them in making the right choices when it comes to charitable giving as part of their lifetime wealth plan.

## Understanding Your Reasons to Give

Before looking at how we can repurpose this analysis, consider the following questions:

- What financial resources do you need to provide for your lifetime financial security?
- If there is excess capital now (or likely in the future) where or to whom will it go? To your family? To be used for philanthropy? Under what terms and conditions?
- Is there something special you want to accomplish with your wealth as a legacy?
- When it comes to philanthropy, do you want to be involved financially, personally, or both?

In addition, Dr. Schervish poses the following questions to assist with what he calls "biographical conversations" about wealth and philanthropy. Each of the following questions are asked first about the person, secondly about their heirs, and finally about the world at large (or perhaps a better word might be 'community').

- What are your ultimate goals or deepest aspirations?
- How does your wealth help?
- How does it get in the way?

Finally he asks these questions:

- What is the best thing you have done with your wealth?
- What is the biggest mistake you have made with your wealth?

For those of you who want to explore this area of philanthropy and wealth management we would like to assist in any way we can. First, it would be important to consider the questions above and perhaps write out your own answers. In the sidebar, my wife Claire and I have written out our views as an example of what these questions mean to us *(see: "Dr. Schervish's Questions")*.

Secondly, it is important to build a financial model that helps examine the current and future resources you will have for your own needs, for those of your family, and for those you wish to become part of your philanthropic goals. We now have the tools to accomplish that for you in a meaningful way.

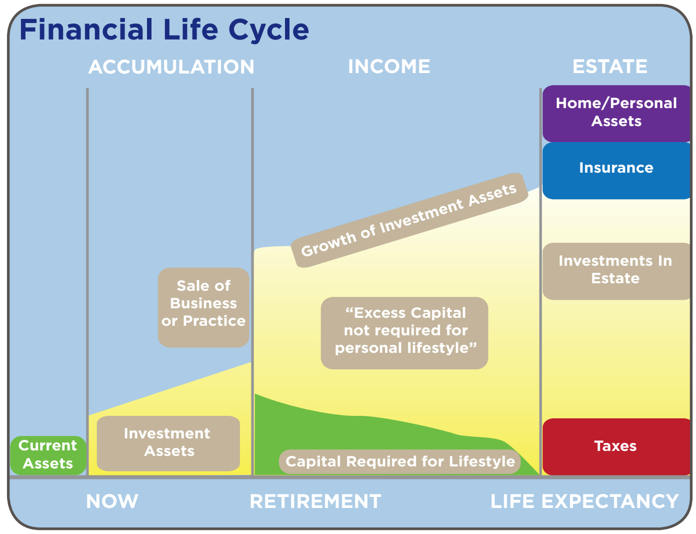
Consider the graphic to the right, which provides a visual way in which one couple's assets might change over their lifetime and what this could mean in terms of their estate. We'll look at two case studies that are very different in terms of age and wealth, but in both cases, they have a strong desire to have active involvement in philanthropy while ensuring they leave a legacy for giving.

The graphic shows a couple who are still accumulating wealth and expect to retire within a few years and sell their business. Let's look at their details.

## The Successful Business Owner

Bob and Thelma Marley are age 50 and 48 respectively with two children ages 19 and 22. They have a successful business worth about $8-million and passive investments (including the building the business operates in) worth $6-million.

Their home is paid for, as is a recreational property in the Okanagan, and together they are worth about $4-million. They also own $6-million of permanent life insurance in the company now, but when they sell they will retain the policies (which will be paid up at that time) and use them either for generating more retirement income or as an estate asset.




Based on retirement projections we have done for them, Bob and Thelma already know they could easily retire today on their current lifestyle needs of $300,000/yr. after tax if they sold their business. However, they like the business and don't plan on selling for another ten years. Perhaps long enough to see if one of their children wants to come into it to try and take it over.

Currently they add between $200,000 and $300,000 to their passive investments each year. They just started a donor advised fund with our public foundation (PGF), put $200,000 into it, and plan on adding at least $100,000/yr. as long as they are working.

While they see the bulk of their assets eventually going to their children and grandchildren, they also worry about leaving too much "easy" money to them. They take to heart these words from Matt King in the movie *The Descendants* (played by George Clooney), "Leave your children enough so they can do something, but not enough so they can do nothing."

They support a number of charities each year, but are particularly committed to both their local church and third-world development projects that provide infrastructure to locals that can have a dramatic effect on their ability to earn a much better standard of living.

### Long-Term Financial Projections

Bob and Thelma went through the questions we posed earlier and wanted us to complete some long-term projections based on the following possible outcomes.

- Taking 20% of the future sale of their business and adding it as a lump sum to endow their donor advised fund.
- Making loans or gifts to their children in the amount of $750,000 each (in today's dollars) when it comes time for them to be in the housing market.
- Leaving 25% of their estate to their donor advised account (or by that time it might be their own foundation) and having their children manage the distributions and investments of the fund or foundation.

They wanted to know what effect all these decisions would have on their own financial well-being and what difference it might make to any future inheritance for their children or future grandchildren.

Using some conservative assumptions about their long-term tax rates and investment returns, we performed the projections and produced the following outcomes.

## DR. SCHERVISH'S QUESTIONS

**Ultimate goal or deepest aspiration:**

This has changed over time. When I was young, my relatively poor childhood made me focus on building financial security and independence when I started my career. Now that we are older and financial security has been achieved, we want to build legacies through our family, business, and philanthropy.

**How does your wealth help?**

It allows a luxury of choices that would not exist without it. Our wealth is a combination of hard work and good fortune; a mixture perhaps of skill and serendipity. Wealth can help our heirs in times when they have legitimate financial needs that are onerous or painful for them, but relatively modest for us.

**How does wealth get in the way?**

There are times when we feel an embarrassment of riches and we want to keep our profile and financial position quiet. It can sometimes affect how others see us and interact with us. If wealth is taken for granted, then its value greatly diminishes.

**What are the ultimate goals for your heirs?**

One of my favourite quotes is from Isaac Newton who once said, "If I have seen so far, it is because I have stood on the shoulders of giants." We think, ideally, that each generation should want to see their heirs perform better, achieve more and provide more than they did. Not so much in providing them comfort and privilege, but in giving them values, skills, and desires to lead a happy and productive life. We have been blessed with a wonderful family and life, and we can only wish the same for our children and extended family and friends.

**The best and worst thing you've done with your wealth?**

So far the best thing we have done with our wealth is to start a foundation. It is still developing but it has allowed us to better focus on the many needs of others. As far as mistakes with wealth are concerned we have the usual minor ones, but our experience has been that often failure is a prerequisite for success and often gets an undeserved bad reputation. Perhaps our biggest potential mistake would be to be unsuccessful in achieving our legacy goals.

First the assumptions:

- Long-term average tax rate on their retirement income = 25%
- Average tax rate in their estate = 20%
- After-inflation rate of return on all investments = 3% (they have, in fact, averaged about 4.5%/yr. for the last 10 years)
- Growth rate in house and recreational property prices = 3% (historically has been 7%/yr. for about 50 years)
- Retire at age 60 and life expectancy to age 90
- Business value grows at 7% annually until 60 (historical growth has been 12%/yr. since they started about 15 years ago)

The purpose of using assumptions is to make them conservative, but also flexible so that we can change them to measure the impact of each one over a long time frame.

**Here are the key results** all measured in nominal (not inflation adjusted) numbers.

- When they retire in 10, years the business will be worth about $16-million.
- Their lump sum charitable gift will be about $3.2-million; when added to their then-growing donor advised fund, they will have a fund (or future foundation) with assets of about $5-million. This fund would be required to distribute $175,000 to various charities (3.5% per year), but assuming overall growth of 6% per year, it would continue to grow to about $9-mllion if one them lives to age 90 (and at that time distributing over $300,000/yr. in gifts).
- They plan on giving or lending (interest free) $750,000 to each of their children for housing when they feel the time is right.
- If you remember from above, their own spending goals are $300,000 in today's dollars after-tax for life.

Even with all of the above, it is likely that if one of them lives to age 90, they will end up with a net estate of more than $100-million (about $30-million in $2012). That would change if they gave away more capital in their lifetimes (either to their donor advised fund or their family); however, the remaining estate is substantial.

To Bob and Thelma, it seems reasonable that they would leave 1/3 of that eventual future amount to their donor advised fund or foundation and work with their children to decide how best to manage that legacy. The residue of the estate (66.7%) would go to their children and future grandchildren in trust.

The testamentary gift to their foundation is tax-deductible and, as such, delivers a tax credit that reduces the overall expected tax liability in their estate by about 75%. In fact, the reduction in assets going to their family is quite modest. More importantly, they feel they are building a lasting legacy that is endowed indefinitely.

**After their death, we project that their donor advised fund or foundation will have capital of almost $45-million and be able to fund over $1.5-million of gifts each year.**

I wrote above that we would look at two case studies different in circumstances of wealth and age. Let's do that by continuing the family story of Bob and Thelma.

## The Generous Retiree

Thelma's mother, Gladys, is age 72 and in good health. Her other circumstances are as follows.

She is 72, has pension, RRIF, and investment income totaling $100,000/yr. of which about $75,000 is taxable (that means some of her OAS is being "clawed back"). Gladys donates $5,000 to her church each year and has for many years. She is a widow and in her estate she has a bequest to the church for $200,000 and then the rest of her estate goes to her children and grandchildren.

Right now she has a $200,000 GIC maturing and she has been told her renewal rate will be 2.5% or interestingly the exact $5,000 she donates each year. The principal is also the amount she wants her estate to give the church.

We suggest a potentially much better result for her that could either improve her standard of living or allow her to increase her giving to the church.

- **Step One:** She applies for an insured annuity. The annual annuity income is currently $15,500/yr. and the annual Term-100 premium is $7,500/year. Therefore, the net income is $8,000/yr. Of this amount, only $1,300 is taxable each year as a prescribed annuity. Initially her income is 60% more than a GIC and her after-tax income is more than three times that of the GIC.
- **Step Two:** She donates the insurance part of the Insured Annuity to her church and funds the premiums. That will provide her with a charitable receipt of $7,500/yr. She also donates $5,000 in cash from the annuity as she has always done. The combined annual tax savings is about $5,500/yr. (because the gifts are a tax credit effectively at 44% vs. her actual marginal tax rate).

When we compare the two options, we have the following:

- **GIC Option:** If she buys the GIC, she will donate 100% of the income from it to her church and ultimately the capital will also flow to the church upon her death. She will have no tax to pay, but she will also have no income to spend from that asset.
- **Insured Annuity Option:** If she creates an insured annuity she will have $3,000/yr. to spend from the IA after giving her church $5,000. In addition, she will receive tax credits she can use against other income that will lower her annual tax bill by about $5,500 on a net basis.

**All in, Gladys will be $8,500/yr. better off after tax and, if she chooses, could increase her annual donations.**

This approach to philanthropy allows Gladys to deal with an interest environment that has reduced what she can earn from her assets and at the same time ensure she can continue to make the kind of gifts that matter to her. In this arrangement, she also guarantees her legacy continues after her death. One does not need to be very wealthy to develop better strategies for giving.

It is important to remember that over the years many things will change for Bob, Thelma, Gladys, and their family – the organizations and causes they may wish to champion, their health, and in some cases their overall objectives. Scenario planning as described above can allow one to make plans based on their current situation and then keep monitoring it so that adjustments can easily be made as circumstances warrant.

**As wealth advisors, we see our role in this to be the following:**

- Working with our clients to help them with some of the earlier questions and perhaps other ones that will help them determine how they want to best manage and distribute their wealth.
- Build models so they can get a realistic idea of how the future might unfold financially and to consider the major factors that could change their outcomes.
- Develop an effective structure to allow for tax-efficient giving (e.g. donor advised funds such as PGF) and advice on the best use of trusts and holding companies to minimize both current taxes and estate liabilities.

Most individuals who build wealth have done so through hard work and discipline. If they have had luck, they have made the most of it. Schervish ended his lecture by referring to the Roman Goddess Fortuna who was often depicted as either veiled or blind (as in the statues that today represent justice). She could give out both good and bad luck and one never knew what they might receive.

There are a great many people in this world who work hard and are disciplined who have had mostly bad luck and tough outcomes. Most people who have been fortunate enough to build wealth know that while they maximized their good luck, they were also the recipient of something good they had no control over.

Schervish argues that most philanthropy comes from the belief these people have in giving others some of that good fortune they have been blessed with. We could not agree more.

*"No one has ever become poor by giving."*
*-Anne Frank*

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