Gobeil's Strategic Case Studies ™

Volume I

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Tammy and Dieter Korinsky

It is January 2016. Dieter and his wife, Tammy, came to you for the preparation of a financial plan. You prepared a draft letter of engagement and reviewed it with your new clients. You have completed the first two steps in the financial planning process and are now clarifying their present financial status and identifying problem areas and opportunities.

Family Situation

Tammy and Dieter were married just over a year ago. Dieter has two sons, Karl and Martin, from his first marriage. His wife passed away when the boys were quite young.

Family Member	Birthday	Age as of January 1
Dieter	May 3	54
Tammy	June 3	28
Karl	February 22	16
Martin	May 31	18
Matthew	August 15	4
Elaine	December 2	1

Tammy has just given birth to Elaine, who has Down's Syndrome. It is too early to tell how severe her disability is.

After giving birth to Mathew, Tammy left her common-law partner, Jason. Matthew was Jason's only child. Tammy currently has custody and Jason paid her child support in accordance with a provincial court order that was last modified on October 12, 2013. The child support was insufficient to cover all of Matthew's needs. Dieter would like to adopt Matthew.

Last week, Jason died intestate leaving behind an estate of $200,000 and he was survived by two brothers. In his province of residence, the preferential share is $40,000.

Tammy and Dieter lived together for about 18 months before they married. She has devoted her time to taking care of Matthew, and now she has to care for Elaine.

Their province of residence has a deferred community of property regime where all property acquired during marriage is subject to division.

Dieter's Business

Twenty-two years ago, Dieter established Rocks Plus Inc., a landscaping design and supply business. Dieter owns 90% of the 1,000 common shares. When the business started, Dieter's sister purchased 20% of the shares for $50 per share. She sold her shares to Dieter for $75 per share. Rocks Plus Inc. is a qualified Canadian-controlled small business corporation.

Rock Plus Inc. has 12 full-time employees and 34 temporary staff. Dieter draws a salary and dividends. The balance in the general rate income pool of the corporation has always been $0. Last year, Martin and Karl worked part-time for Rock Plus.

Personal Assets

Sixteen years ago, Dieter and his first wife bought their home for $130,000 with a downpayment of $50,000. At the time of purchase, they registered the ownership of the property as a joint tenancy. Over the years, Dieter has spent $47,000 on repairs and maintenance and $112,000 on renovations.

Many years ago, Dieter purchased his cottage for $30,000. In 1994, he used the personal lifetime capital gains exemption to increase the adjusted cost base of the cottage to $130,000. The cottage is registered in his name. Since 1994, Dieter has spent $17,000 on repairs and maintenance and $12,000 on renovations.

Dieter's other personal assets include two snowmobiles, a jet-ski, a mini-van, and various household furnishings and personal effects, all registered in his name. Dieter has a stone sculpture that he acquired for $800. A neighbour has offered to purchase the sculpture for $1,400.

Tammy managed to work her way through university without accumulating any debts, but her only assets include her car, a few personal possessions, and a small bank balance.

Retirement Objectives

Dieter has no particular plans to retire. He feels that with his own business he will continue his involvement as long as it interests him and he is capable of contributing. He hopes that either Karl or Martin will participate in the business. While Karl has expressed an interest in the business, Martin is considering a career in medicine. As time goes by, he expects that he will slowly reduce his involvement in the day-to-day operations of the business.

When Dieter is 65 years of age, he expects that they would need about $6,000 of after-tax income each month in current dollars. He is not sure whether this would come from savings or earned income. He would want this amount of income to increase at the inflation rate. He would expect to earn 7% monthly on his retirement assets and he would expect inflation of 3%. He wants ensure that their retirement funds last until Tammy is 90 years of age.

Investment Assets

The adjusted cost base of his unregistered portfolio is $28,000.

Tax-Free Savings Accounts

Last year, Dieter established a tax-free savings account (TFSA) and contributed $5,000. His self-directed TFSA is invested in a one-year guaranteed investment certificate. His investment return will be 3% before tax. He has not yet withdrawn any funds. As of December 31, 2015, he had unused TFSA contribution room of $36,000. This year, he plans to contribute $5,000 and invest the TFSA funds in an equity mutual fund. He expects to earn a return of 6% before tax.

He has designated Tammy as the beneficiary of his TFSA. He has named his sons as the alternate beneficiaries in the event that she should predecease him.

Last year, Tammy established a tax-free savings account (TFSA) and Dieter gave her $5,000 to contribute. Her self-directed TFSA is invested in a one-year guaranteed investment certificate. Her investment return will be 3% before tax. She has not yet withdrawn any funds. As of December 31, 2015, she had unused TFSA contribution room of $36,000. This year, she plans to contribute $5,000 and invest the TFSA funds in another one-year guaranteed investment certificate. She expects to earn a return of 3% before tax.

She has designated her son as the beneficiary of her TFSA. She has named Dieter as the alternate beneficiary in the event that her son should predecease her.

Registered Retirement Savings Plans

Only irregularly has Dieter been contributing to an RRSP in his own name. For a few years, he contributed to a spousal RRSP for his first wife. When first wife passed away, he acquired the funds. His self-directed RRSP is invested primarily in common shares and exchange-traded funds.

Last year, he contributed to his RRSP. He has thought about contributing to Tammy's RRSP, but something has held him back.

Over the past few years, his investment return on his RRSP has been about 8%. This year, he expects that he can earn a return of 6% before tax on his investments. At the end of last year, he had unused RRSP contribution room of $237,000. He has not contributed for this year.

When his first wife died, Dieter changed the beneficiary designations on his RRSP to Martin and Karl in equal amounts.

Canada Pension Plan and Old Age Security

He expects to receive the maximum CPP retirement benefit and she does not expect to receive CPP retirement benefit due to not participating in the labour force. They both expect to receive full OAS benefits.

Risk Tolerance

Dieter has very little interest in his investments. His focus has been entirely on his business. He is not averse to taking the risk of the stock market because he has never found the returns on fixed income appealing. He is also astounded how a marketable bond can increase and decrease in value so much.

Of course, he wants to accumulate the funds that they need for retirement and their other objectives without taking an excessive amount of risk.

Life and Disability Insurance

Four years ago, Dieter purchased a term life insurance policy from RBC Insurance on his life with a death benefit of $200,000 and annual premiums of $1,800. The named beneficiary of the term life insurance policy is his estate. The policy has a child life insurance rider.

Dieter does not have any disability insurance.

Health Insurance

Rocks Plus Inc. has an employee group family medical and dental insurance policy. Through his employment, Dieter has insurance that covers 80% of eligible dental and medical expenses and that covers 100% of prescription medications in excess of the first $200 per year, $200 per family member every second year for optical glasses, and 80% of basic dental expenses.

Education objectives

Dieter would also like to assist all of the children with their post-secondary educations.

Martin is only 18 years of age and will be starting university in the fall. He plans do take a Bachelor of Science degree as a prerequisite to getting into medical school. Martin's first year of school will cost $19,000 and these costs will increase by 4% each year. Last year, he earned about $6,000.

Karl is only 16 years of age and will not finish high school for a couple of years. Dieter figures that it is too late to do much to accumulate education funds for Martin and Karl. Last year, he earned about $6,000.

Mathew is 4 years of age and Elaine is 1 year of age. Dieter would be like to set up an RESP or something for Mathew. He is not sure what Elaine needs and what opportunities are available for Elaine.

Estate Planning

Dieter does not have a will. He figures that under his province's intestacy legislation, most of his estate would go to Tammy as his spouse and some amount would go to his children. Besides he has made beneficiary designations. It is not that he is opposed to having a will; he just never got around to preparing one.

Dieter's principal residence was the childhood home of Martin and Karl. Dieter feels strongly that they should eventually receive title to the home after his death. However, in the event of his premature death, Dieter does not want Tammy to be forced to move out of her matrimonial home. Dieter will leave Tammy enough other property to ensure that she could not contest the division of family property under the provincial matrimonial property legislation. The maximum probate fee, which is applied to estates in excess of $1 million, is $6,000.

Dieter wants the cottage to stay in the family with Martin and Karl eventually acquiring ownership.

Dieter is concerned about Elaine's future. Dieter instructed his lawyer to draft an inter vivos trust agreement for Elaine to provide for her continued care, Dieter named Elaine as the income beneficiary and the final capital beneficiary of the trust, and Dieter gave the trustee discretion with respect to making payments when needed. Dieter is planning to transfer $100,000 of property to the trust.

In addition to arranging for Elaine's long-term care and support, Dieter would like to support the Association for Community Living, a non-profit, charitable organization that supports independent living for disabled individuals.

Many years ago, Dieter acquired 100 shares of Skybound Inc. for $5 per share. They are listed on the TSX. This year, when they were worth $32.25 per share, Dieter donated the shares of Skybound Inc. to the Association for Community Living.

Income Tax Considerations

Dieter's marginal tax rate is 44.7%. Tammy's marginal tax rate is 0%.

The provincial dividend tax credit for ineligible dividends is 5.87%.

Dieter has used $100,000 of his lifetime capital gains exemption and has a cumulative net investment loss of $50,000. Tammy has never used the lifetime capital gains exemptions and has a cumulative net investment gain of $2,000.

They have no carryforwards of charitable donations. Neither of them is subject to a provincial high-income surtax. Dieter has a net capital loss carryforward of $6,000.

Tammy and Dieter Korinsky
Statement of Net Worth
As at December 31, 2015

ASSETS	Dieter	Tammy	Total
Liquid Assets			
Chequing Account	$5,000	$1,000	$6,000
Savings Account	6,000	1,000	7,000
	11,000	2,000	13,000
Investment and Business Assets – Non-registered			
Shares in Rock Plus Inc.	1,898,000	0	1,898,000
Unregistered Portfolio	242,000	0	242,000
	2,140,000	0	2,140,000
Investment and Business Assets - Registered			
TFSA	5,000	5,000	10,000
RRSP	102,000	0	102,000
	107,000	5,000	112,000
Personal Use Assets			
House	640,000	0	640,000
Jetski and Snowmobiles	14,000	0	14,000
Cottage	289,000	0	289,000
Van and Personal Effects	44,000	9,000	53,000
	987,000	9,000	996,000
TOTAL ASSETS	$3,245,000	$16,000	$3,261,000

LIABILITIES AND NET WORTH

Short-term Liabilities			
Credit Cards	$1,000	$2,000	$3,000
Long-term Liabilities			
None	0	0	0
Estimated Deferred Taxes			
Shares in Rock Plus Inc.	240,000	0	240,000
Other assets	45,000	0	45,000
	285,000	0	285,000
Net Worth	2,859,000	14,000	2,873,000
TOTAL LIABILITIES AND NET WORTH	$3,245,000	$16,000	$3,261,000

Tammy and Dieter Korinsky
Projected Statement of Cash Flow
For the Year Ended December 31, 2016

CASH INFLOWS	Monthly	Yearly
Dieter's Salary	$5,000	$60,000
Dieter's Dividends from Rock Plus Inc.	5,083	61,000
Dieter's Other Dividends	667	8,000
	$10,750	$129,000

CASH OUTFLOWS		
Income Taxes	$2,667	$32,000
Property Taxes	383	4,600
Home Insurance	67	800
Utilities	383	4,600
Maintenance and Landscaping	233	2,800
Food and Household Expenses	1,308	15,700
Personal Care and Clothing	725	8,700
Transportation	608	7,300
Entertainment and Gifts	600	7,200
Holidays	483	5,800
Sports/Music Registrations	283	3,400
Medical Expenses	108	1,300
Life Insurance	233	2,800
Income Taxes & Lifestyle Expenditures	8,083	97,000
Contributions to Dieter's Chequing Account	200	2,400
Contributions to Dieter's Savings Account	258	3,100
Contributions to Dieter's Non-registered Investments	708	8,500
Contributions to Dieter's TFSA	417	5,000
Contributions to Tammy's TFSA	417	5,000
Contributions to Dieter's RRSP	600	7,200
Unaccounted for Difference in Cash	67	800
Other Cash Outflows	2,667	32,000
	$10,750	$129,000

1. What would be a consequence if Dieter and Tammy were to divorce?

(A) Any property used for family purposes would be subject to division, regardless of when it was acquired; while business and investment assets would only be subject to division if they were acquired during the marriage.

(B) All property acquired during the marriage, including family property and business and investment assets, would be subject to equal division upon marriage breakdown.

(C) Tammy would be entitled to half of all of Dieter's property and he would be entitled to half of hers.

(D) Tammy would only have a claim on business assets acquired during marriage if she could prove that she made a direct contribution to the growth and success of the business.

(Concepts) A ***deferred community of property regime*** is a matrimonial property regime such that during marriage each spouse retains the right to own and manage property in his or her name, but if that marriage dissolves, the value of the property will be divided between them. The definition of what constitutes community property (i.e., what property must be divided) varies from province to province. All provinces, other than Quebec, operate under some form of deferred community of property regime.

Property acquired during marriage refers to any increase in net worth, which could occur from the reduction of debt, savings of earned income, investment returns and appreciation in the value of property. The form in which this increase in net worth is held is generally irrelevant.

Each spouse would prepare statements of net worth at the time of marriage and at the time of division. The changes in net worth would be the increases in net family property of each spouse. The idea is that each spouse should experience the same change in net worth.

The amount that the husband would pay, if positive, or receive, if negative, is calculated as:

- (change in net worth of husband - ((change in net worth of husband + change in net worth of wife) ÷ 2)).

The form of the division does not require that each asset is divided 50:50. Rather, the increase in net family property of each spouse is calculated and the spouse with the smaller increase will receive a transfer calculated as (the increase in net family property of the spouse with the greater increase - (the total increase in net family property ÷ 2)).

(Client situation) Suppose that Dieter and Tammy were to divorce.

Tammy and Dieter were married just over a year ago. Dieter has two sons, Karl and Martin, from his first marriage. The Korinskys' province of residence has a deferred community of property regime where all property acquired during marriage is subject to division.

The contributed portion of his RRSP during his marriage with Tammy and the portion of mortgage paid during his marriage would be part of the total increase in net family property. The value of his assets including his accounts, shares in Rock Plus and unregistered portfolio, TFSA and RRSP, house and cottage and Jetski would be included in the calculation of his net worth at the time of division. The RPP would be included in the calculation of his net worth at the time of division. The deferred taxed on his assets and shares would be included in the calculation of his net worth at the time of division.

The house would be included in the calculation of their net worths at the time of division. They could decide who is going to keep the house and any transfer of its value would be considered as part of the transfer of assets in the settlement.

The form of the division does not require that each asset is divided 50:50 and does not require that 50% be transferred to Tammy.

(Choice B is true.) In their province of residence, all property acquired during marriage is subject to division, and this includes business and investment assets, even if the spouse cannot prove a direct contribution.

So, all property acquired during Dieter's marriage to Tammy would be subject to division upon their divorce, including any business or investment assets.

2. If Dieter were to sell his shares in Rock Plus Inc., what amount of taxable income would he have to report from the sale?

    (A) $549,000

    (B) □ $561,912

    (C) $564,700

    (D) $924,000

(Concepts) The ***Lifetime Capital Gains Exemption (LCGE)*** is an income tax exemption, available to an individual, from taxation of capital gains realized on the disposition of qualified property: qualified small business corporation shares, and qualified farm and qualified fishing property (ITA 110.6).

The ***LCGE limit*** is the maximum amount of taxable capital gains eligible for the Lifetime Capital Gains Exemption (LCGE). For 2016, the maximum amount of the capital gains eligible for the Lifetime Capital Gains Exemption (LCGE) is $824,176 and the LCGE limit is $412,088 and it is indexed annually to the Consumer Price Index.

A taxpayer's ***unused lifetime limit*** is the amount of the lifetime capital gain exemption that he has not yet used or the amount of taxable capital gains for which the taxpayer has not yet claimed an exemption

A taxpayer's ***unused lifetime limit*** is calculated as:

- ((maximum amount of the capital gains eligible for the LCGE - (capital gains on dispositions of qualifying farm property, qualifying fishing property, qualifying small business shares, and personal property for which deductions were previous claimed)) × the capital gains inclusion rate).

A taxpayer's ***cumulative net investment loss (CNIL)*** is the amount by which the aggregate of investment expenses exceeds the aggregate of investment income for all taxation years after 1987. The taxpayer has to pay tax on an amount of taxable capital gains equal to his CNIL before he can use the capital gains deduction.

A taxpayer's ***cumulative net investment loss (CNIL)*** is calculated as:

- (investment expenses - investment income).

The taxpayer's ***capital gain deduction*** is calculated as:

- (lesser of (unused lifetime limit and (taxable capital gain - CNIL))).

A taxpayer's ***taxable income from disposition of a capital property*** is calculated as:

- (the greater of ($0 and ((capital gain × capital gains inclusion rate) - capital gain deduction))).

A taxpayer's ***liability for income tax*** is calculated as:

- (taxable income from disposition of a capital property × effective tax rate).

Your ***marginal tax rate*** is your tax rate for your next dollar of taxable income or your next dollar of allowable income tax deductions. Your marginal tax rate may not be appropriate for determining the income tax impact of an amount greater than $1.

Your ***effective tax rate*** is the tax rate that would apply to whatever amount of income or deduction that you might be considering. If a question requires the effective tax rate, but only provides the marginal tax rate, you would have to assume that the rates are the same.

(Client situation) Twenty-two years ago, Dieter established Rocks Plus Inc., a landscaping design and supply business. Dieter owns 90% of the 1,000 common shares. When the business started, Dieter's sister purchased 20% of the shares for $50 per share. She sold her shares to Dieter for $75 per share. Rocks Plus Inc. is a qualified Canadian-controlled small business corporation.

According to the Statement of Net Worth, his shares in Rock Plus Inc. have a fair market value of $1,898,000.

In 1994, he used the personal lifetime capital gains exemption to increase the adjusted cost base of the cottage to $142,000.

Dieter has a cumulative net investment loss (CNIL) of $50,000.

Suppose that Dieter were to sell his shares in Rock Plus Inc.

(Choice B is true.) Dieter owns 90% of the 1,000 common shares. When the business started, Dieter's sister purchased 20% of the shares for $50 per share. She sold her shares to Dieter for $75 per share.

So, Dieter's adjusted cost base (ACB) is $50,000, calculated as:

- (number of shares × purchase price per share); or
- (((900 - 200) × $50) + (200 × $75)).

The sale of shares of a qualified Canadian-controlled small business corporation may qualify for the lifetime capital gains exemption. However, this exemption is reduced by any amount claimed under the $100,000 personal lifetime capital gains exemption that expired in 1994.

Dieter had made full use of the personal LCGE to increase the adjusted cost base of his cottage. Dieter's capital gains on dispositions of qualifying farm property, qualifying fishing property, qualifying small business shares, and personal property for which deductions were previous claimed is $100,000, calculated as:

- (ACB of cottage - original ACB of cottage); or
- ($142,000 - $42,000).

Dieter's capital gain would be $1,848,000, calculated as:

- (FMV - ACB); or
- ($1,898,000 - $50,000).

His taxable capital gain would be $924,000, calculated as:

- (capital gain × capital gains inclusion rate); or
- ($1,848,000 × 50%).

Dieter's unused lifetime limit is $362,088, calculated as:

- ((maximum amount of the capital gains eligible for the LCGE - (capital gains on dispositions of qualifying farm property, qualifying fishing property, qualifying small business shares, and personal property for which deductions were previous claimed)) × the capital gains inclusion rate); or
- (($824,176 - $100,000) × 50%).

Dieter's capital gain deduction would be $362,088, calculated as:

- (lesser of (unused lifetime limit and (taxable capital gain - CNIL))); or
- (lesser of ($362,088 and ($924,000 - $50,000))).

So, Dieter would have to report taxable income of $561,912, calculated as:

- (the greater of ($0 and (taxable capital gain - capital gain deduction))); or
- (the greater of ($0 and ($924,000 - $362,088))).

The End