



# WHAT COULD GO WRONG?

THE CANADIAN PLANNING CRISIS

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## **INTRODUCTION**

As a real estate investor, you are naturally inclined to be positive and look for the upside in every potential opportunity. While it is the necessary mindset for success, bad things do, unfortunately, happen in life. People get sick, divorce, even die. The economy slows, recessions “come out of nowhere” and interest rates can spike unexpectedly. Even weather-related events such as ice storms, floods and power outages can turn into financial challenges.

Stuff happens in life. Good and bad. You can't predict the future but you can prepare for it. Or you can just be carried along in life the way most people do. As Benjamin Franklin famously said: “By failing to prepare, you are preparing to fail.”

So as a real estate investor, are you prepared for something to go wrong or just hoping for the best? Do you have a disaster plan? There is a list of known events that can and often do go wrong for real estate investors and this white paper will discuss them and what you can do to mitigate or eliminate them from your life. Consider it as disaster proofing your life.

## TAKING STOCK



Do you have a clear idea of your financial fitness? Are you in condition to run a marathon or are you just one fiscal shock away from a heart attack?

It is surprising how many people know so little about their current financial health. Here are some questions to get started.

*What is your monthly income and what is your monthly outflow (spending)?* If you are in a deficit, is it temporary such as caused by unexpected repairs to a property or perhaps a major vehicle repair expense, or are you “living beyond your means” and using debt to support your lifestyle? If so, you are not alone. Every month it seems Canadian household debt hits a new historic high, in large part because people refuse to live within a meaningful budget that is defined by money flowing out that does not exceed money flowing in.

*What do you owe and to whom? What do you own?* Is the majority of your debt “good debt” that is related to income-producing investments such as mortgages and education-related debt (improving your earning prospects) or is a significant portion of it caused by non-essential spending on clothing, dining out and vacations?

*Do you have outstanding, stubbornly persistent credit card balances?* If so, chances are that you are not financially fit. The “good news” is that you have company. According to debt monitoring firm Equifax, the average Canadian now owes \$22,081 in consumer debt, a sum that doesn’t include mortgages.

*Do you own your vehicles or are you locked into a lengthy lease or payment schedule?*

*What is the state of your mortgage(s)?* Both personal and mortgages for investment properties. Are they fixed or variable rate and, if rates rise, could you afford to pay the higher cost of servicing your mortgages?

*Where does your money come from?* If you are earning a salary, is that income sufficient to meet current needs and to prepare for retirement? If you are running your own business, is it dependent on one or two key clients or is it well diversified? Just as importantly, is your business revenue growing, stable or declining?

*Do you have an emergency fund?* Financial advisors typically recommend people accumulate an emergency fund that could carry them through three to six months without a steady income. Do you have enough money saved away to cover your personal expenses and those from your real estate investments for a period of time?

*Do you have registered savings (RRSP and TFSA) and how long could you live on them?*

*Do you have non-registered savings, meaning after-tax investments that carry no tax implications should you be required sell them?*

## **WHAT COULD GO WRONG?**



A solid financial footing means preparing not just to prosper in good times but to have the ability to ride out bad times. Canadians received a solid reminder of how things can get scary very fast during the 2007-2009 financial crisis and stock market crash. It was a time of doom and gloom, and there was the

very real threat that the worldwide financial system would seize up, with under-capitalized banks unable to lend and businesses and consumers running out of money.

The crisis that reached its height with Barack Obama entering the Oval Office seems far off today, but it is worth noting that economic recoveries typically run seven years, meaning that we are overdue for a recession and stock market correction.

In Canada, it can be argued that the real estate market is even more overdue for a pullback as it barely paused during the last recession and has been on a steady upward trend since early in the new century.

What is your survival plan for a real estate market downturn? If the real estate market “crashed” – fell 20% to 25% – could you ride it out for a few years or would you be forced to sell one or more properties at a discount, or worse, at a loss? This is of particular concern for property owners who are highly leveraged with large mortgages that could end up being bigger than the properties they are secured against, resulting in owners being “under water.”

For a real estate investor, being underwater is a bad scenario. Being forced to sell a property at a loss is likely worse.

Another potential issue for real estate investors is the threat of losing a tenant. Now is the time to examine your lease agreements and your tenant relationships. Are your tenants happy or are you fearful that they are going to leave? Will it be easy to replace a tenant? Is the rental market soft or tight, and does it make sense to sweeten your arrangement to lock your tenants in for a longer term?

And what about interest rates? Mortgage rates are now in an upward cycle following the U.S. Federal Reserve’s mid-March hike to its benchmark lending rate and its stated intention to raise rates in the future. Not only do “Fed” rate hikes historically act as a catalyst for economic downturns, they directly affect mortgage rates, sending them marching higher in other countries, including Canada. The prospect of higher interest rates should cause real estate investors to weigh the prospect of locking in rates if possible.

## **YOUR FINANCIAL AFFAIRS**

Do you have a will? According to a recent survey by the CIBC, nearly one-half of Canadians do not have a will. That is a national disaster. Not having a will outlining your wishes with respect to the disbursement of your estate can have severe and adverse consequences for your loved ones.

It is not well known that, without a will, a person’s affairs are put in the hands of the provincial government. That means a person’s assets and liabilities are

distributed according to the laws of the province in which the person died. Clearly the government's handling of your affairs is not ideal as your wishes will be beyond consideration. For example, your spouse may not be entitled to all assets if there is no will. In most provinces, a preferential share of the estate goes to the spouse and the remainder is divided among the spouse and the children of the deceased.

If you do not have a will, it is recommended that you seek out professional legal help to ensure that your wishes are carried out with regard to who will receive your assets when you die.



If you do have a will, how old is it? Chances are that it is stale dated. Will and estate professionals suggest that you revisit your will every five years. The simple reason for this is that circumstances change over time. Family situations evolve; divorces and family strife arise; estates

grow (hopefully); businesses are created; real estate assets are added to and grow more valuable; and over time children and grandchildren are added to the mix. If your will is more than a few years old, the odds are high that there is some part of your new life that is not accounted for.

## **DO YOU HAVE A POWER OF ATTORNEY? (AND IF YOU DON'T, WHY YOU NEED ONE)**

As in the case of a will, appointing a power of attorney can be viewed as a way of ensuring that your wishes with regard to your estate will be carried out in the event that you are unable to do so.

The classic example of the need for a power of attorney (POA) is in the event that you become incapacitated or unable to make decisions for yourself (say in the case of a stroke that renders you incapable of communication). A power of attorney cannot be granted after incapacity; you cannot sign such a document if you are not of sound mind and body. This could mean delays and

legal headaches, and costs, for your family. Your spouse, for example, does not automatically have your power of attorney over property that is held under your name only.

There are basically two types of power of attorney: one for personal care, (medical decisions) and one for property such as for assets like real estate, investments and financial obligations related to bills and upkeep.

If you do not have a power of attorney, a visit to your family lawyer to create one for yourself and your spouse is strongly recommended. If you do not have a regular family attorney, now is also the time to consider finding one whose opinions you value and trust to conduct an overview of your legal documents and then replace, update or create the necessary legal papers to ensure that your estate's assets will go to who you want to.

## **WHAT ABOUT A TRUST?**

For real estate investors who have significant assets to worry about, it is often advisable to map out your estate plan with a trust. The key difference between a will and a trust is that a will is only enacted upon your death. In the case of a trust, it takes effect as soon as it is created.

A trust is a powerful legal entity that can be used to carry out your financial wishes and begin distributing property and other assets before death, at the time of your death and even long afterwards. A trust typically serves two types of beneficiaries: those who receive income from the trust during their lives and another group that receives whatever is left over after the first set of beneficiaries dies.

A will deals with assets such as property that are only in your name when you die. It does not include property held in joint tenancy or in a trust. A trust, however, covers only property that has been transferred to the trust. Trusts provide tax benefits such as income splitting and provide an opportunity to plan for future costs such as those associated with future disability and long-term care.

One well-recognized advantage of a trust over a will is that a trust does not go through probate. As a trust is acted upon outside of probate and bypasses a

court, it can save time and money, particularly probate taxes. Trusts also ensure privacy. Unlike a will, which becomes part of the public record, a trust can remain private. No one outside your beneficiaries will know what you own and how your estate is divided up.

## INSURANCE

As with the subject of wills, trusts and estate planning, most people give little attention to insurance. It is human nature, after all, given consideration of insurance is a recognition that you will die sometime in the future.



The chances that you will die are 100 percent. The chances that you are underinsured are also high. According to a 2015 Sun Life Financial survey, a large number of Canadians has little or no insurance protection: 30% do not own any life insurance and 32% of households would run

out of money in just a month or two if the main breadwinner were to die. Sun Life concluded that “despite the financial risks, fewer people are buying insurance products than they used to.” Is that because people are “living beyond their means” and spending on consumer items instead of adopting a disaster-proofing mindset? Likely.

There are many types of insurance intended to cover different (bad) events. The most well-known is life insurance, which itself comes in two basic forms. The easiest way to look at insurance is not the ultimate payout, but how you pay for it. For example, two life insurance policies could both pay your beneficiaries \$1 million upon your death (tax free by the way), but how you pay for those policies (the premium in insurance parlance) would be very different.

How much your insurance costs is a function of whether you purchase term versus permanent insurance products. Term life insurance is typically cheaper than whole life policies which pay a (tax free) benefit to your family in the case of death.

## *Critical Illness and Disability Insurance*



What happens to your business and investments if you become incapacitated? Beyond life insurance, critical illness and disability insurance policies should be seriously considered for those who are self-employed or are not covered by these policies by their employer. Life

insurance might sound like a no-brainer – we are all going to die eventually, after all. But why pay for insurance that you will probably never need? Well, statistics tell a different story. A typical 30-year-old has a four times greater chance of becoming disabled than he does of dying before age 65, and one in every six Canadians is disabled for three months or more before the age of 50.

So what's the difference? Disability insurance gives you monthly income if you can't work because to a serious injury or illness. Critical illness insurance pays out a tax-free lump-sum payment following the diagnosis of one of several illnesses covered by your policy such as cancer, stroke, etc.

### *Insuring Your Assets*

What about insurance for your properties? Homeowner's insurance may be sufficient if you are renting out a portion of your property; however, in most cases you will need landlord's insurance or a landlord policy that will protect against damage to your property and protect against liability if a tenant is injured on your property. It typically does not insure against damage to a renter's belongings, so you might consider renter's insurance a condition of rental for your tenants.

### *Insuring Your Business*

You may hold your investments as part of a small business that may or may not be incorporated. Is your business insured, and if so, against damage or loss to what exactly?

Your business may own assets such as vehicles, equipment, inventory, office space, key employees or a long-term business partner as well as yourself. Obtaining insurance to protect these business assets and cover against potential risks is strongly advised. Ask yourself, would your business falter if one of the partners dies or becomes disabled? Would you have sufficient cash on hand to deal with any business emergency that could arise?



If you operate a family business as a sole owner, consider life insurance as protection for your family, because an owner is personally liable for all the debts of the business. As mentioned above, disability insurance can provide you with income for a specified period of time if you are unable to work due

to an injury or illness, for example, while critical illness insurance can provide a lump-sum benefit if you are hit with a dire illness or disease such as cancer.

Key Person insurance should be obtained if your business relies on specific individuals to profitably run your company.

Partnership insurance or buy-sell insurance should be put in place to ensure that in the event your business partner passes away, insurance will cover the cost to buy his/her shares from your partner's estate and continue on with the normal functioning of your business.

This would also be a good time to review all partnership agreements for your business and/or investments to ensure that they are up to date and all foreseeable eventualities are considered.

To evaluate what insurance is appropriate for your business, you should seek guidance from an insurance agent or broker with experience in your field of business. References can come from your attorney, accountant or trusted business contacts. Your accountant should also be able to determine which insurance policies can be paid for by your business and deducted, and which will need to be paid as part of your personal finances.

## *Other Types of Business Insurance*

Property insurance is insurance you purchase to cover property and buildings owned by your business in the event of damage or destruction.

Contents insurance covers business assets that you store at your business premises. (You may be covered by the owner's insurance if you are leasing space.) However, in the event you are running a business out of your home, you may need separate contents insurance for your business assets.

Business interruption insurance will cover you in the event your business temporarily shuts down due to a fire or natural disaster business interruption insurance can cover the loss of earnings until business resumes normally.

Liability insurance is designed to protect your business in the event of a lawsuit. This might include general liability insurance to cover you in the event an employee or client sustains an injury while on the premises and professional liability insurance to protect against lawsuits by clients for any errors, omissions or negligence in providing professional services.

## **IF I'M NOT AROUND TOMORROW, WHERE'S MY STUFF?**

Imagine that tomorrow you are whisked away to a tropical paradise and unable to communicate with friends and family for a couple months. (It's a nicer idea than death or stroke, isn't it?)



Would your spouse, business partner, or children be able to carry on without you? Chances are that beyond the grief, the people closest to you have no idea where your most important “stuff” is. What sort of stuff, you might ask?

How about your bank accounts, safety deposit boxes, key legal documents and physical assets. If you go away without leaving behind this information (preferably all in one place), you are asking those closest to you to play private detective and treasure hunter to find out where all your stuff is. By not writing it all down and putting it in a safe place, you are asking those closest to you

to go through a time consuming and frustrating process filled with incomplete information, bureaucratic hassles, legal headaches and, likely, costs to your estate that could take the form of overdue bills or even lost insurance coverage because premiums were not paid.

Here's a list you may want to consider drawing up for your spouse/business partner and then place in a location that they know about:

**Your passwords.** Will your spouse/business partner need to know your email and banking passwords to get into contact with people close to you in your personal and business life and access your money? Will they know what expenses are coming due and how to pay for them? Write down those critical items of information and put them in a safe, agreed-upon place or leave them with your attorney with specific instructions as to how/when to release them (such as if you become incapacitated or out of communication in a tropical paradise).

**Your bank accounts.** Chances are that you have different accounts with different banks in different branches. Will your spouse/business partner be able to find and access them? Who holds your mortgages? Are your debt payments automatic (preferable) or will those close to you need to take care of servicing your debts?

- **Your legal documents.** Not only should you have an up-to-date will and potentially a trust set up to cover the inevitable, the people closest to you in your personal life and potentially your business partner need to be able to find those documents. Your spouse/business partner should know which lawyer has those documents. Who has the deeds and other legal documents associated with your properties?
- **Your insurance.** What policies do you have and with what insurance companies? At the very least you should provide contact information for your broker or insurance agent.
- **Your people.** Today it seems that only older people use a Rolodex or have names and numbers written out in a book. Chances are that your personal and business contacts are on your phone (is that written down and in your disaster recovery file with your attorney)? Is key information stored on the cloud with instructions to retrieve it?

- **Your other stuff.** Where are the spare keys to the vacation property, your personal and work vehicles and that big ring of keys for your business? What about the storage locker and your boat down at the marina?

## HOW'S YOUR HEALTH?

To this point this paper has dealt with financial disaster-proofing your personal and professional life in the event of, well, things happening that none of us wants to think about but really need to protect against. Fires, floods, ice storms, dying or being incapacitated by a terrible disease are all negative life events with significant financial implications.

Now, how about doing something strictly for yourself, namely addressing your personal health?

You can buy all the insurance that you can realistically afford, take all the financial, legal and insurance precautions outlined in this document and use all the planning and forethought possible, but chances are that you can do something more immediate and beneficial. Take charge of your health.



First off, when is the last time you had a physical examination by a doctor? While annual physical examinations are falling out of vogue in the medical establishment as health budgets are being strained like never before, there are simple tests that should be conducted regularly, such as having your blood

pressure and cholesterol checked. Add in regular screenings for diseases such as cancer, especially if there is a family history of disease.

Chances are, however, that you have a rough idea of your physical health and whether topped-up insurance policies are a nice-to-have or a grim necessity for your loved ones.

The best investment you can possibly make is in improving your health. What would you realistically pay to live longer and in a healthy manner? A membership to a beautiful health club and regular sessions with a buff trainer may be the ultimate health investment, but simple changes such as regular walking, improving your diet and eliminating your worst habits (junk food, too much alcohol, etc.) can generate dramatic results.

Commonly referred to as “Cadillac health care,” for those who choose to attend a private clinic (and have the means to do so), they are part of a growing trend. One of the fastest growing segments of the medical services industry, private clinics like Medcan and Medisys offer all-day, full-body testing that provides you with a comprehensive assessment of your current health status and provides you with an action plan to improve or maintain it. These day-long visits, geared towards executives and key company employees, screen for cancers, stroke and heart attack risks and emerging illnesses such as Type 2 diabetes. Consider it as a super-annual physical examination that will tell you everything you might want to know about your health.

## **A WORD TO THE WISE**

So there you have it. Disasters may or may not happen to you, your loved ones, your properties or your businesses, but there are plenty of steps that you can take to ensure that you are prepared for any eventuality rather than preparing to fail.

## **CONCLUSION**

For real estate investors, there is a great deal more to guard against than tenants who miss rent payments or unexpected repair bills. The unexpected can and will crop up in life; however, most events can be anticipated and their effects mitigated. Insurance for our vehicles is mandated by law and most of us would not dream of insuring our most valuable investments – namely our real estate.

As outlined in this paper, insuring the things that truly matter – your life, business and investments – can be achieved step by step. The key is to assess what could potentially go wrong rather than hope that everything will go right if we just hope for the best.

In summary, here are the disaster proofing steps you need to take to ensure you are not planning for failure:

- **Assess your financial fitness.** Are you an unexpected bill or interest rate rise from disaster? Is your debt manageable? Can you eliminate expensive debt? Do you have an emergency fund? Do you have investments outside real estate like RRSPs and TFSAs?
- **What is your survival plan?** Can you survive an interest rate rise, the actions of a bad tenant or an economic downturn?
- **Be clear about your estate planning.** Do you have an up-to-date will? Is a trust an option? What about a power of attorney for yourself, your spouse and your parents?
- **Do you have the right kind and right amount of insurance?** Speak with your insurance agent about insuring your life, your loved ones, business partners and your business itself.
- **Could those closest to you carry on without you?** If you disappeared tomorrow, would your spouse and business partners know where how to access your critical information and capital?
- **What about you?** The cheapest form of insurance is taking care of yourself. What is the state of your health and what can you do about it?

So there you have it. Disasters may or may not happen to you, your loved ones, your properties or your businesses, but there are plenty of steps that you can take to ensure that you are prepared for any eventuality rather than preparing to fail.

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