Planning for the Worst

Tim Fraser's health problems will soon keep him from working. Will they also wreck his finances?

By Pam Withers

Shannon plans to start working full-time. "Tim put me through school, so I guess this is his return on investment"

TIM AND SHANNON FRASER OF NANAIMO, B.C. — rich, athletic and the parents of three children — live a charmed life, and they know it. They also know it's slipping away. Tim, the breadwinner, has a rare joint disease that within a few years will limit his ability to work. Uncertain whether Tim's company disability insurance will cover him, the couple (whose names have been changed for this article) wants to know what they can do now to ensure they maintain their family lifestyle down the road.

At 37, Tim, a senior manager with a pharmaceutical firm, still looks the picture of health. Neither his children nor employer are aware that he has more on his mind these days than what ski hill to tackle on the weekend. In reality, he spends evenings poring over the fine print of his company's insurance policy. Even Shannon, 37, a part-time accountant who knew of Tim's condition when she married him 15 years ago, says it's a struggle to get her head around the fact that their current bliss won't last. "He had no symptoms until recently, and he never complains, so I haven't dwelled on it. We didn't discuss it much the first eight years of marriage, and it had no bearing on our decision to have children."

They didn't begin discussing Tim's disorder, Alkaptonuria — caused by abnormally low amounts of a certain enzyme and characterized by skin discolouration and arthritis-like pain and degeneration in major joints — until Tim started having back pain while exercising, and X-rays showed that the deterioration was starting.

Tim has always known this would happen, so he has placed a high value on living in the present. When he and Shannon met in university, Tim recalls, he fell in love at first sight, but Shannon took a bit longer to come around. "Let's just say she was a long time realizing I was the one for her — six weeks." Tim was forced to hang out in the library near her study cubicle, causing his grades to rise and Shannon's to dip.

She was a graduate student during their first few years of marriage, then worked part-time as the two carefully pursued wealth-building plans, including some risky real-estate investments that paid off. (Tim once visited seven banks before finding one willing to loan him half his annual salary for investing.) Then the children, now aged four, seven and nine, began to arrive.

Shannon plans to begin working full-time when the youngest is in school. And yet she reveals a playful resistance to the notion, saying, with flirtatious sidelong glances at Tim, "My husband reminds me of it daily. Tim put me through school and I've been carried for 14 years, so I guess this is his return on investment."

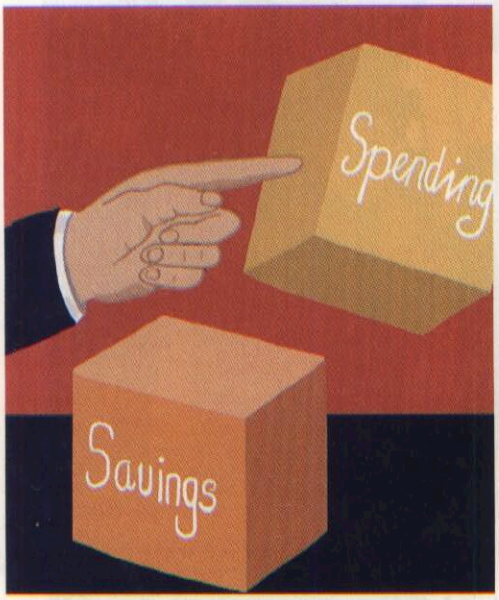
Tim's affliction doesn't kill — it incapacitates. He'll probably need joint replacements within a few years, and then his days will consist of pain management, physio workouts and waits for surgery, with some periods of being able to work. Given his salary, his disability insurance will pay a maximum of $4,000 a month, only 56.5% of his current income.

In theory, Tim will be forced to stop working about the time his wife can comfortably increase to full-time, and her earnings (potentially $75,000) will more than compensate for his. In fact, their income

Illustration by Jackie Besteman

post-disability could be $16,000 more than it is now, and that doesn't take into account the fact that he may not have to pay taxes on his disability income. However, they'll also have new expenses: a move to a house with no stairs, unknown quantities and types of medications and trips to the U.S. for surgery if waiting times become unbearable, or for experimental treatments unavailable here.

There's one question that keeps Tim and Shannon awake at night: Could his company's insurance carrier flat-out refuse benefits on the basis of his having a pre-existing condition? The Frasers want to know their best financial strategy for seeing the kids through post-secondary education while allowing the family to maintain their current lifestyle.



The couple owns two rental properties: "They have 15-year amortizations, which make them either cash-neutral or cash-negative, which is tax-deductible. With this approach, we are gaining about $9,000 in equity per property each year," Tim says.

Other than acquiring the rental properties, they've made no adjustments to their lifestyles, not even cut back on expenses. They love to entertain, attend concerts and travel, and they believe they're striking a balance between saving for the future and enjoying life while Tim is in good health.

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WHAT THE EXPERTS SAY

Tim and Shannon can put their minds at ease about their insurance, says Kathryn Seely, a disability-insurance claims lawyer with Watson Goepel Maledy in Vancouver. Having looked over the wording of Tim's contract, she says that he is covered as long as his doctor confirms he remains "unable to work in any occupation for which he's qualified." While he could be denied coverage for lying to his employer about his pre-existing condition in his application for insurance, Tim doesn't believe he filled out such an application. In that case, he should work until he and his doctor believe he is no longer able to perform the essential duties of his occupation, then follow his doctor's recommendations from there, confident in knowing that his benefits will continue as long as he remains totally disabled — or until he retires or turns 65, whichever comes first.

Brad Brain, a certified and registered financial planner with Berkshire Securities Ltd. in Fort St. John, B.C., says that although Tim's income will plummet when he's disabled, the fact that the disability benefits are tax-free counterbalances this. He suggests the couple investigate whether there is a cost-of-living adjustment for benefits paid, whether there is a provision for partial benefits and, aside from life insurance, whether there are survivor benefits if Tim dies.

Despite this reassuring news, Tim and Shannon still need to cut their expenses, because they're living to the maximum of their income level, says David Hall, a certified financial planner with Assante Capital Management Ltd. in Williams Lake, B.C. "Right now, the Frasers don't look or feel like they're short of money, and that's the danger."

They could easily trim 10% off the $12,000 they spend on entertainment, vacations and recreation without changing their standard of living, says Brain, who also recommends they spend conservatively on their next vehicle. "Do they want to drive a new car today or do they want to have that money tomorrow when Tim's health fails?"

Hall says that even if Tim is eligible for benefits until age 65, given the likely huge costs of U.S. medical treatments, the couple should save as much money as possible, since the government will refund only as much as would have been billed in B.C.

"It's as if Tim and Shannon have been

FINANCIAL SNAPSHOT

INCOME	
Tim's salary	85,000
Shannon's salary	28,000
Rental income	40,000
TOTAL INCOME	**$153,000**
EXPENSES	
Mortgages	28,200
Property taxes	7,200
Home insurance	400
Rental property costs	3,100
Car main., ins., gas and lease	13,800
Tim's income tax	27,240
Shannon's income tax	4,200
RRSPs	13,000
Deductions	1,377
Life insurance	525
Food	8,200
Entertainment	3,700
Home and garden	3,500
Utilities	5,600
Clothing	1,100
Vacation	4,500
Professional services	1,500
Gifts	1,500
Charitable donations	750
RESPs	5,640
Sports and recreation	4,000
Savings	6,000
Miscellaneous	3,968
TOTAL EXPENSES	**$153,000**
ASSETS	
Home	240,000
Rental properties	405,000
Car	10,000
RRSPs	167,000
RESPs	21,550
Savings	11,500
Investments	4,500
TOTAL ASSETS	**$859,550**
LIABILITIES	
Mortgage	266,741
Line of credit	102,945
TOTAL LIABILITIES	**$369,686**
Net Worth	**$489,864**

warned that a bomb will go off in their chequebook about 2006, and the trauma from this may continue for the rest of their lives," Hall says. Where many would go into denial, the Frasers are doing what they can to alleviate future distress. They should start by paying less on their rental properties' mortgages because they'll need the extra cash and it won't be easy to remortgage once banks become aware their cash flow is insecure, says Hall. "They should accumulate savings and fund RRSPs for Tim to use when his income falls."

Tim's income permits maximum annual RRSP contributions of $13,500, while Shannon can tuck away $5,040. When she begins to work more, she should contribute the bulk of her money into plans in Tim's name, since his income and tax bracket will fall once he's off work. That means he'll pay less tax on any RRSP withdrawals than would Shannon, Hall says.

As for RESPs, Brain calculates that Tim and Shannon will spend about $240,000 on post-secondary education for each child. To pay that, they need to invest $900 monthly inside their RESPs and $215 outside, assuming 5% growth on the investments. "That's $7,600 per year in addition to what they are already doing." So much for Tim and Shannon's notion that they need not cut back on spending.

If any of the children do not pursue higher education, the RESP can be rolled into the contributors' RRSP, but only if they have the contribution room to accommodate this. When Tim's earned income drops, he may not be able to accommodate a large transfer. (Earned income includes salary, Canadian Pension Plan disability or group disability benefits and net rental income.) "RRSP withdrawals and investment income are not considered earned income, so neither will generate further RRSP contribution room," says Brain. "Also, rental losses reduce earned income, which means there is even less room to contribute to RRSPs in the future."

As for increasing their income, Hall says that if Shannon isn't willing to work full-time immediately, she should boost her hours by at least enough to bring in another $8,000 to $10,000 per year, even if this introduces daycare expenses.

At the same time, the two should tighten up their rental property business by maximizing rental income (adjusting for inflation and rising costs), while reducing operating expenses without simply deferring costs until later. In other words, they need to look for bargains in all supplies and materials, keep the lid on trade costs, seek out the best possible insurance rates and challenge any property tax increases.

Brain agrees with Hall that Tim and Shannon's primary challenge is freeing up liquidity. They need quick access to cash to cover medications and frequent flights to the U.S. "What would they do if they needed $50,000 fast? There's not a lot of surplus in their income to play with." Pulling it out of RRSPs would create a hideous tax bill, and mortgaging a property or using credit would saddle them with new debt. Even if they were to sell a property, it would take time to get their hands on the cash. And why liquidate a $200,000 house if all they need is $50,000?

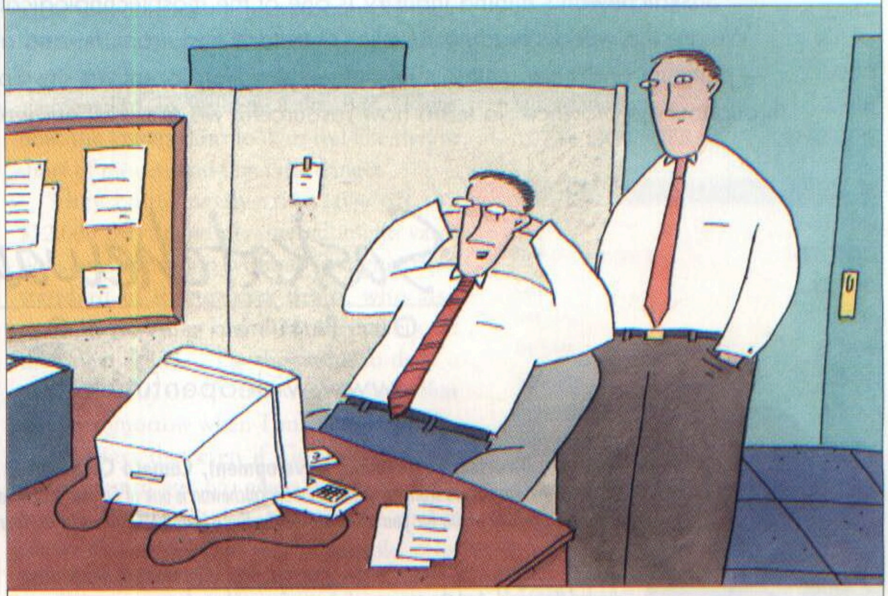
While rental properties may look like a good investment, the responsibilities of being a landlord are demanding even for someone who is not disabled. Brain suggests the Frasers sell one or both properties — unless doing so will trigger excessive capital gains.

If they put $100,000 from such a sale into a return-of-capital fund that pays out 7.2% annually, they receive an annual payout of $7,200, with most of the tax liability deferred until the investment is sold — ideally when Tim is in a much lower tax bracket. "If they need cash, they can sell some units in their investment fund and have the cash in their bank account within three days," Brain says.

CPP's definition of disability is quite stringent (the disability must be "severe and prolonged"), but Tim may eventually qualify, says Brain. And while Tim's pre-existing condition means he won't qualify for long-term care insurance, Brain suggests that others should look into this option; it pays a monthly benefit tax-free for people unable to perform the activities of daily living, such as eating and moving about.

For now, Tim is moving about and he and his family are enjoying life for all it's worth. While no one could begrudge them this, Hall suggests they scale it down to protect against uncertain times to come. "Reducing expenses involves tracking where every nickel goes and questioning the necessity for the expense. Who in the world would want to do that? Someone desperate to accumulate cash for a known future need. This is where we could use a few lessons from the previous generation, who knew how to squeeze nickels till they turned into quarters." **B**

EXECUTIVE SUITE By P.C. Vey



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