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# Dreams for sail: One couple's journey around the world by sea

It's not so much where you live, but *how* you live. This is the message of John and Cheryl Ellsworth, who took an incredible 10-year journey around the world, visiting more than 60 different countries. If you've ever dreamt of doing the same, there are a few things you should know. John tells us their story.

**T.E. Wealth:** What's the story behind the name of your boat, 'Sea Mist'?

**John Ellsworth:** Cheryl, the creative one in our duo, came up with the idea of a "Magical Mystery Tour." I leaned towards more practical names that could be easily understood in radio communications, which are necessary when plying foreign waters and entering ports to undergo the immigration, customs, health quarantine and harbour entry. This meant names with two to three syllables were preferable. And it meant finding a name that was relatively easy to spell phonetically and could be understood by non-English-speaking parties over the radio.

So, we ended up with *Sea Mist*. We then did various searches to see if we could find any instances around the world of that name, and found none! So there we were, with a name that passed official scrutiny in the registration process with British Virgin Island Authorities as we registered *Sea Mist* under the BVI flag. Surprisingly, many Anglophones we encountered did not recognize the word 'mist'…. I guess they had never experienced the likes of Bay of Fundy fog.


**TEW:** What inspired you to take this journey, and why did you choose the destinations that you did?

**JE:** In my 30s, with a two-year-old and second baby on the way, I went into full-time studies at McGill earning a B Eng and MBA. This designation supported my journey through management consulting into executive management in major global companies with, of course, an abundance of travel around the world. Fortunately, Cheryl was able to accompany me on some of those distant trips and together we became increasingly interested in the foreign countries and cultures to which we were exposed. That appetite for travel, but without the usual related hassles and relatively short durations on location, led us to think of retirement as an opportunity to see far-off lands at a leisurely pace.

We liked the idea of not having to go through airports and hotels, or having to make it back to a home that would require our ongoing attention. The move to the sailing life was driven by these desires and parameters. We did not specifically list a set of destinations or rush to

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circumnavigate the globe, but rather chose to set out upon a 10-year experience in the sailing life.

In that life, we let our journey be dictated by positive and interesting experiences, while not ignoring the proven seasons and routes established by those who know how and when to cross the oceans. So, if we liked the people and location in a specific country or region, we might stay for months or more than a year. If we found a place unappealing, we might move on within days or hours. In this way, our voyage to more than 60 countries around the world unwound.

**TEW:** What kind of financial preparations did you have to make before leaving?
**JE:** We sold our home in New Jersey extremely quickly in a strong seller's market in 2002, which was three years ahead of my retirement. That move freed up funds for the sailboat. We moved from a 7-bedroom/7-bathroom home to a 1-bedroom/1-bathroom apartment, which forced us to reduce our footprint immensely in terms of possessions. We then proceeded to search out potential blue water sailboats and selected an Oyster 56 as our new floating home in 2003.

We moved all of our retirement income into fixed income annuities so there would be no distractions brought on by paying attention to financial markets and cycles in economies of the world. We left our tax filings in the careful hands of our long-serving financial advisors at T.E. Wealth.

We sold all land possessions – home, furnishings, automobiles, etc. – and shipped what we wanted for the sailing life via container from New Jersey to Ipswich, England, where we'd had *Sea Mist* built to coincide with the timing of our retirement. From there, we sailed off into the wild blue yonder in September 2005.

**"We let our journey be dictated by positive and interesting experiences."**

**TEW:** How did you stay in touch with friends and family?
**JE:** Staying in touch was not really difficult. We had SSB/HAM radio service and Iridium satellite phone service that enabled access to real-time weather forecasts, voice, email, and internet. We also had a powerful cellular antenna that enabled cellular phone service as far from land as 15 nautical miles (25-30 kms). When closer to civilization, we would use shore-based internet cafés and services, and we could often acquire reasonably low-cost local cellular calling plans that enabled voice, internet, Skype, etc.

In the early years, we sometimes had difficulty getting satisfactory data transmission speeds, but in the latter half of our years, we had good transmission data plans giving us access to global networks. We were regularly updating our blog, which gave friends and family the opportunity to keep up to date with our happenings, even as we spent up to a couple of weeks crossing the open waters of the Atlantic and Pacific.

**TEW:** What did you miss most about land living?

**JE:** We didn't "miss" the life on land; better to say that our personalities do not ever lead us to "miss" a former era. Our nature has always led us to look forward and engage in the present and plan for the future… not to focus on former aspects of life or yearning for earlier experiences. We tried to keep in touch with important life-long relationships while, at the same time, deeply engaging in building new friendships and sailing community relationships with fellow blue water sailors.

That being said, we did find that some activities, like provisioning (finding food and other consumables, as well as needed boat parts etc.), were drastically more difficult and time-consuming. To go for groceries, we would need to launch our dinghy and find a place on shore to moor it for the day. Then, find a rental car via word-of-mouth recommendations and drive a fair distance – sometimes to multiple locations – to find what we wanted to buy. After the car would be loaded up, we would head back to our dinghy on the shore and carry everything from the car to the dinghy then from the dinghy to *Sea Mist*, often transiting through rough waters. Then there was off-loading the dinghy to the deck of *Sea Mist*, hoisting it into the cradle on the stern of our yacht, and then getting all of the goods down below to the storage areas. It's a huge difference from life on land where grocery shopping is a walk in the park.

**TEW:** Did you ever come close to throwing in the towel?

**JE:** Never! We jointly conceived of and committed to a 10-year plan for immersing ourselves in the sailing life and never looked back. The community of fellow sailors is perhaps the richest part of the experience. You build treasured relationships that carry on well beyond your sailing proximities and even beyond the sailing life as you return to land. We never once thought of quitting the sailing life. Just re-evaluating our plans as to where in the world we would wander next.

**TEW:** Did it cost less or more than what you thought?

**JE:** Operating costs over the 11 years were about as expected with the exception of major, unanticipated, currency differentials. The largest annual costs were related to yacht insurance and private health insurance. In the early years, when we were voyaging in European waters, the costs were the highest in terms of day-to-day provisioning and the purchase of diesel fuel. For reference, we paid over 1.60 euro per litre at a time when the euro/USD rate was in the 1.50 - 1.60 range. Those were expensive years!

And it seemed that we managed to pick the most expensive times to be in other countries. An example would be our timing in Australia in 2011/12, when the Aussie dollar was trading at close to US$1.10. Our first "break" came during our last three years in Southeast Asia when the Malaysian ringgit, Thai baht, and other currencies in that region (Laos, Vietnam, China, Myanmar) were historically weak, bringing living costs down considerably.

**TEW:** How did you plan to reintegrate into the non-boating life?

**JE:** We'd learned from others' experiences in the yachting market that selling could very well take two years, so our original 10-year plan had included the period to market the yacht and complete the sale. As the end came nearer, exiting *Sea Mist* was a much bigger focus than our actual plan for subsequent life on land.

> **"The largest annual costs were related to yacht insurance and private health insurance."**

Our yacht was our most valuable asset and we needed to plan for where and when to sell her, and decide on what specific refit to do in order to maximize marketability and proceeds from the sale. At the same time, we were very much enjoying life in Southeast Asia, and the pleasure of taking in the features of that region led us to extend our sailing life to 11 years before putting *Sea Mist* up for sale.

We thought it would be more like 13 years before the sale would be realized, and we would have the funds in hand to start a land-based life. Those couple of years would give us lots of time to evaluate our options, such as geography and accommodations. We knew that we had flexibility to get through the couple of years as I jointly owned, with my three sisters, a log home on the Bay of Fundy in New Brunswick where we could relocate after moving off *Sea Mist*. The surprise, when we sailed back into Ipswich Harbour in England in May of 2016, was to be fortunate to have sold *Sea Mist* to a new owner within a couple of weeks of our arrival.

We arrived back in Canada with enough funds in hand to find a new home, as well as a comfortable temporary residence to stay in while searching for something permanent. Due to our age, and the associated dependence on health care

**TEW: What kind of person would like the sailing life? What kind wouldn't like it?**

JE: A multi-year life in blue water sailing is certainly not for everyone. It could be for you if you are:

- truly an adventurer and can handle rough oceans far from land;
- very self-sufficient in terms of all the demanding mechanical maintenance of a complex sailing vessel;
- naturally inclined to engage in long-term planning for everything from meals to understanding and working with ocean currents and weather patterns over large-scale geography and local aberrations;
- okay with being alone by yourselves for weeks without perhaps seeing another vessel when on the major ocean crossings;
- someone who values and respects foreign cultures and ways of doing things;
- attracted to language challenges in non-English-speaking countries, and enjoy eating food that is very different from Western menus.

If these things appeal to you, then maybe a sailing life is worth considering. A person who finds themselves to be the opposite of these characteristics should not consider it!

in our later years, we knew that Canada would be our permanent home. But where?

After viewing some 25 waterfront homes in the Saint John to St. Stephen areas of New Brunswick, we decided to build a new home on some land that my father had given to me back in 1975 – immediately next door to the house I grew up in. Cheryl did not have the same connections to this vicinity but both of us had come to be very attracted to ocean views and access to the shore. Additionally, she'd had many years to think about and conceive of the home she believed could be built so as to create an environment which we could both enjoy, and would be welcoming to family and friends. The house is well underway and we expect to move in this November.

**TEW:** How did this lifestyle change impact your long-term finances?

**JE:** There wasn't much long-term financial impact on our day-to-day finances, but we were hit very hard by the global economic downturn and even more so by the substantial swings in currency differentials. We had *Sea Mist* built in the UK at a time when we paid over US$1.90 per pound sterling (GBP). When we sold it, the rate was approximately US$1.29/GBP, which meant we lost a third of the value of the boat just in currency differentials. To make matters worse, we sold the boat in GBP and though the transaction was supposed to close three days before the Brexit vote, due to a legitimate issue for the Australian buyer, it closed afterwards instead. The result was a reduction of over 12% in the amount of Canadian dollars realized versus the Canadian dollar value on the day of the actual sale. Those were the big hits as far as our long-term financial picture is concerned.

**"We think of memories sort of in categories."**

**TEW:** What is one of your favourite memories from your trip?

**JE:** We think of memories sort of in categories. Our best experiences underwater, with the abundance of sea life and swimming with sharks, would be in the waters of Fakarava South in the Tuamotus of French Polynesia. The warmest, friendliest people found were in the small islands of Indonesia. We will remember them for the way they welcomed us into their homes and villages, as though we were long lost friends. Perhaps the most beautiful bays (calas), beaches and hiking trails were found on the south coast of Minorca in the Spanish Balearics. The scariest memories will stay with us as we recall the ever-present dangers of crocodiles and snakes in Australia. And when it comes to food, our love of Thai food would be at the top of our list.

But the truly treasured memories are of the fellow sailors, the delightful experiences and close relationships built within the sailing community. Though neither party is still sailing the oceans of the world, many of those relationships have continued today.

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*Lucy Conte, T.E. Wealth, Toronto*

# Is there an opportunity in preferred shares?

In the previous issue of *Strategies* (May 2017), T.E. Wealth examined the possibility that the decades-long bull market in bonds might be coming to an end. Long story short, having touched 35-year lows last September, yields seem to be on the rise. Indeed, in mid-June, the U.S. Federal Reserve raised its overnight interest rate for the fourth time since the global financial crisis ended. For its part, the Bank of Canada raised interest rates by 25 basis points this past July, and some speculate that rates could climb further before the end of the year.

If interest rates are in fact in the early stages of an upward trend, this presents a problem for bond investors, as bond prices fall when interest rates rise. Moreover, given that rates have been so low relative to history, it would not take much of an increase in rates for capital losses on bonds to exceed the interest payments received by an investor.

No one can know, except with the benefit of hindsight, whether the long-term bond bull market is over. That said, it may be prudent, especially for yield-oriented portfolios, to consider bond alternatives. One of those alternatives is preferred shares.

A quick recap of what exactly preferred shares are might be useful: as their name implies, preferred shares rank ahead of common shares in a company's capital structure. What this means is that preferred shareholders must receive their dividend payments before common shareholders are paid. However, preferred shares still rank below a company's debt obligations.

> **"If interest rates are in fact in the early stages of an upward trend, this presents a problem for bond investors."**

Given their nature, preferred shares are often characterized as hybrid investments, part equity and part fixed-income.

So, why may now be a good time to consider preferred shares? For one thing, preferred shares provide a much higher yield than bonds or common shares. Investors can earn close to 5% before-tax on the S&P/TSX Preferred Share index, versus a 1.4% pre-tax yield on a benchmark 5-year Canadian government bond (data as of June 30). Also, preferred share dividends are subject to a preferential income tax rate compared to bond interests, which results in an even larger yield spread after tax. Relative to history, preferred shares also seem attractively priced compared to government bonds. When they were first issued several years ago, these securities typically paid investors about 1% over the 5-year Canada bond yield. Now, however, given that government bond yields are so low, the spread has ballooned to about 3%. Preferred shares also handily provide a much better yield than common shares: the pre-tax dividend yield for the S&P/TSX Index is just shy of 3%, by comparison.

There's another reason to believe preferred shares might currently present a compelling alternative to traditional fixed-income investments. While fixed-income products suffer when rates are on the upswing, the composition of today's preferred share market means that they actually could do quite well in such an environment. Rate-reset preferred shares now make up over two-thirds of the Canadian market. This kind of preferred shares "reset" to a higher dividend when government bond yields rise, so if the era of ultra-low interest rates is truly behind us, they should provide higher income streams for investors in the future.

Finally, there's the simple fact that preferred shares have not enjoyed the sort of performance of other asset classes. As of June 30, Canadian preferred shares have only provided a total return of just over 6%, whereas the FTSE/TMX Canadian Bond Universe has returned nearly 18% and common shares, as measured by the S&P/TSX Composite index, show a total return of 52% over the last five years. Conceivably, the coming years could see this gap in performance start to close.

Whether an increased allocation to preferred shares is right for you will depend on many factors, such as your current exposure as well as your risk tolerance. Talk to your investment counsellor about the role these stocks could play in your portfolio as a diversification from traditional fixed-income investments.

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# Renting versus buying in today's real

In recent years, Canadian real estate prices have risen substantially—especially in places like Vancouver, Victoria and the Greater Toronto Area (GTA). For people who have owned real estate throughout the boom, this price appreciation tends to leave little cause for worry. But what about those who are faced with the increasingly unattainable goal of home ownership?

Many people who do not own a home, but perhaps would like to, such as renters, new graduates, or young professionals looking to start a family, are now at a loss as to what they should do. Real estate prices have risen so much that owning a home is now out of reach for many. But does this actually place such individuals in a worse financial position than their home-owning counterparts? After taking a closer look at the high-level financial implications of renting versus owning, the answer to that question might surprise you.

Home ownership is arguably a generational preference. Numerous sources state that millennials are happy renting their living space, preferring flexibility over certainty. Baby boomers, on the other hand, tend to insist that home ownership is a crucial and necessary facet of a sound financial plan. This difference of opinion is both philosophical and quantitative. In this article, I will address one side of the debate; specifically, the more practical side - comparing the dollar cost/value of renting versus buying.


I thought now would be a good time to address this issue, given the recent and dramatic increase in home prices, versus the more modest changes we have seen in the cost of renting.

To conduct this analysis, a number of assumptions must be made. Where possible, I will try to use historical data. For example, history suggests that housing prices have appreciated at an average rate of 3% annually. Accordingly, I will assume the continuance of this rate in my analysis. If housing prices were to grow by 35% per year, as they have in some parts of the GTA in recent years, then my conclusion would be obvious – buy as much house as you can afford, and do so immediately!

In a desirable, yet ordinary, neighbourhood in the West GTA, you can easily find houses listed for $1 million dollars these days. Similar houses in the same neighbourhood are typically available to rent for approximately $2,500 per month. These figures are what I will use for my test case.

## Annual Costs

Firstly, we need to consider the annual cash flows associated with renting, and compare them to those associated with buying. In the case of renting, a renter's annual cash outflow is simply their rent payment. Using the above-noted example, $2,500 per month equals $30,000 per year.

> **"Consider the annual cash flows associated with renting, and compare them to those associated with buying."**

In the case of home ownership, there is a lot more to it. Specific and major 'rent-like' expenses include property taxes, the interest an owner pays on their mortgage, and home maintenance/upkeep. This is where assumptions come into play. If we assume property taxes of 0.8%, mortgage interest of 2.6% on an 80% mortgage (with a 20% down payment, such is the going rate at the time of writing), and annual upkeep of 1.5% (which I'm told by several home owner 'veterans' is a conservative estimate, if you want to maintain or maximize your home's value), we arrive at the following annual 'rent-like' expenditures:

Property Taxes – $8,000 ($1 million x 0.8%)

Mortgage Interest – $20,800 ($1 million x 80% x 2.6%)

Upkeep – $15,000 ($1 million x 1.5%)

This amounts to a grand total of $43,800 per year (as compared to $30,000 per year in the case of renting).

I realize that I have left out a few expenses (e.g., utilities, home/tenant insurance, etc.) This is intentional – I'm trying to focus on expenses that make up major differentiators. Arguably, you could be on the hook for utilities whether you

# estate market – Which is better?

rent or buy, so, comparatively, such things would make little or no difference in this analysis.

It is also important to note that if or when interest rates rise, so too will the cost of mortgages. Moreover, as time passes and the value of your home increases, property taxes and the amount you spend on upkeep would arguably increase commeasurably.

The above-noted figures may come as a shock. But before you rush into a rental, or text your baby boomer parents who have been on your case to buy a house, please hold on for a few more paragraphs - there is more to this analysis.

### Cumulative Costs

We also have to consider that rent tends to increase over time. And, assuming you pay down your mortgage (and that interest rates don't go to the moon), the amount of interest you pay on your mortgage will decrease with every payment you make. As such, I've decided to not only consider what your costs of living would be on an annual basis, but also over the life of a mortgage - which is typically 25 years.

If your rent increases by, say, 3% per year (consistent with our assumed growth rate in housing prices), you would pay a grand total of $1,093,778 in rent over a 25-year period (I know – yikes! But read on).

Conversely, if we assume that your property tax and upkeep rise commeasurably with the value of your home (3% per year), you would pay grand totals of $291,675 in property tax and $546,889 in upkeep over 25 years.

> **"We also have to consider that rent tends to increase over time."**

You would also pay $1,087,109 towards your mortgage ($287,109 of interest and $800,000 of principal). A summary of the totals you would have paid under each scenario is as follows:

### Owning

Cumulative Property Tax – $291,675

Cumulative Mortgage Interest – $287,109

Cumulative Upkeep – $546,889

### Renting

Cumulative Rent - $1,093,778

This gives you a grand total of $1,125,670 of 'rent-like' expenses associated with owning a home (as compared to $1,093,778 in the case of renting).

Again, I should point out that changes to the above-noted assumptions would impact these figures. For example, rising interest rates would result in even higher cumulative mortgage costs. With that in mind, renting once again looks to be superior from this vantage point. Still, before you go and list your home on MLS, there is more to consider. Specifically, the assets you would have in your pocket after 25 years.

### Asset Value

The next step in this comparison is to analyze the growth of your 'assets' while renting, versus your 'asset' in buying. Before all of you *Rich Dad, Poor Dad* enthusiasts jump all over me for calling a house an 'asset', please bear with me. I do so partly out of convenience, and partly because your house could be considered a financial asset if your intention is to sell it one day.

First, let's consider renting. If you rent, you will keep your down payment and could presumably invest it. In our example, your down payment would be $200,000 (20% of your $1 million dollar suburban home). If you invest that $200,000 in a properly balanced, long-term portfolio, you could reasonably expect a 6% rate of return. After 25 years, your $200,000 would grow to $858,374 ($200,000 x $1.06^{25}$).

Moreover, you would be able to save and invest your excess cash flows if you are renting. Remember, you are spending less on rent every month than you would be on mortgage payments, new roofs, property taxes, etc. I realize that your spending would not be uniform throughout the life of your mortgage; however, if we assume your 'average' annual cash flows renting are $43,751 (cumulative rent paid divided by 25), and your 'average' annual cash flows owning are $77,027 [(cumulative property tax, upkeep, and mortgage interest, plus mortgage principal payments of $800,000) divided by 25 years], that would mean you could presumably save and invest an additional $33,276 ($77,027 - $43,751) while renting, because your monthly and annual expenses would be that much lower.

Saving and investing $33,276 per year at 6% would give you additional investment assets of $1,825,658, at the end of 25 years. Combine that with the $858,374 that your saved down payment will become, and you would have investment assets of $2,684,032 ($1,825,658 + $858,374), before taxes. I appreciate that at times, saving money is easier said than done. Many people fall subject to 'lifestyle creep' – whereby their spending increases in line with their cash flow. For the purposes of this analysis, we will assume that the home owner/tenant in question is a stout saver.

Next, let's consider your house and its estimated future value, assuming prices grow in line with our assumption of 3% per year. Under those assumptions, your $1,000,000 home would have grown to $2,093,778 in value after 25 years of 'normal' 3% annual growth ($1,000,000 x $1.03^{25}$). Again, note that housing prices, like the stock market, can move up or down. Several factors drive both markets' respective directions, and one should never take past performance as a projection for future performance as a given.

> **"Several factors drive both markets' respective directions, and one should never take past performance as a projection for future performance as a given."**

Again, renting looks to be superior, albeit for one final caveat – income taxes. As the rules stand now (who knows what things will look like 25 years from now), the growth on one's principal residence is tax exempt. In other words, every family can sell an appreciated principal residence and pay no tax. So, after 25 years, a $2,093,778 house could translate to $2,093,778 in your pocket, should you choose to sell (before real estate commissions, etc.).

On the other hand, your $2,684,032 investment portfolio – the one you have only managed to piece together due to your savings through renting – would be full of deferred tax which you would have to pay if and when you liquidate the portfolio. Here is a quick estimate of the amount of income tax you would have to pay (assuming TFSAs and/or RRSPs haven't been employed):

| | |
|---|---|
| Portfolio Value: | $2,684,032 |
| Tax Cost Base (down payment): | ($200,000) |
| Tax Cost Base (annual savings): ($33,276 x 25). | ($831,894) |
| Net Growth: | $1,652,138 |
| Assumed Tax Rate: | x 25% |
| Estimated Tax: | **$413,035** |

As such, your investment portfolio wouldn't be worth a full $2,684,032. Rather, it would be worth (after estimated taxes) only $2,270,998 ($2,684,032 in total value, less $413,035 of anticipated tax).

Again, renting seems to be the way to go.

I should finish by re-affirming that the above-noted conclusions are full of assumptions. Real estate prices could rise faster (or slower) than 3% per year (yes, millennials, there have been times when housing prices have fallen) and mortgage rates could climb drastically[1]. Investment markets could perform at rates lower than 6% per year. You could experience unexpected expenses whether you buy or rent (like when your landlord tells you he's selling, one week after your child is born – which happened to me!). Your landlord could decide to 'reno-vict' you (which is a non-technical term for them choosing to renovate and subsequently evict you) at any time, etc. The possible alterations to my assumptions are endless.

The overall conclusion of this analysis isn't that everyone should rent. Rather, the message here should be that renters, before rushing to buy into the hysteria of an overcooked housing market, should take a step back and consider how quickly prices have risen - especially in comparison to rents. The numbers seem to suggest that, in the long run, renters (provided they save and invest) will be just fine and, in fact, could be much better off.

Another way to look at this analysis would be from the perspective of a current home owner. Perhaps such individuals would be better off selling their current home, and renting instead. I'm not the type of planner who encourages things like reverse-mortgage or home equity loans. I just thought I would mention this possibility as 'food for thought'.

Best of luck to all of you would-be home buyers.

*Brent Soucie, T.E. Wealth, Toronto*

[1] In April of 1982, a five-year rate reached as high as 19.41% according to the Bank of Canada, Data and Statistics Office. http://www.bankofcanada.ca/wp-content/uploads/2010/09/selected_historical_v122497.pdf

# Things to consider when buying a U.S. property

Owning property in the U.S. is desirable to many Canadians, whether it be as a vacation/retirement retreat or an investment. While it does add an element of complexity to your financial situation, it certainly is manageable as long as you take a few things into consideration.

### Have a discussion around ownership

There are many different ways you could structure your U.S. real estate ownership. The simplest, of course, is owning it directly either as an individual or jointly with your spouse. However, a lot depends on your plan for the property (personal use vs. commercial), your personal net worth (as it relates to estate tax exposure), and whether you expect there to be any liability risks associated with owning the property. You may wish to explore other holding options including ownership within a trust, corporation, limited partnership, or some planned combination. Obtaining professional cross-border advice is crucial here.

### Know what your operating costs are

Before you pull the trigger on your purchase, you should take the time to know what your operating costs will be for your new property. Things to consider are property taxes, home insurance, utilities, and maintenance services for both your Canadian and U.S. properties (remember, you will be away from each home for a large portion of the year). You may also need to hire a house sitter or ask a family member or friend to keep watch over your Canadian property while you are stateside, as it is common for insurers to require that vacant homes are not left unattended for too long. Lastly, don't discount the cost of travelling between your two properties.

When adding up these expenses, make sure to leave some wiggle room to allow for currency fluctuations. If you budget for operating costs with 80-cent Canadian dollars, is your plan still feasible with 65-cent Canadian dollars?

To balance some of the concerns over currency fluctuations, you may find it worthwhile to line up your personal savings with your travel plans. If you spend one third of the year in the States, perhaps one third of your portfolio should be invested in USD denominated securities. Then, you can link that investment account to your USD bank account, thus protecting yourself from short-term currency fluctuations.

### Plan for health insurance

If you plan to be in the United States for a significant portion of the year, you should also plan for the possibility of a medical emergency while there. It's important to have adequate health coverage wherever you go. Don't just assume that your provincial health plan or your credit card will cover you. Instead, take the time to make sure you know what coverage you have and then top it up as required. Pre-existing conditions are especially concerning as most travel health plans will not cover them.

### The amount of time you can spend stateside is limited

If you had thought that you could sell your home in Canada and move to the States permanently, think again. There are specific rules that Canadians need to abide by, and failure to do so could result in your being considered a U.S. tax resident, meaning that you would be subject to U.S. taxation on your worldwide income, along with a host of other IRS-induced disclosure requirements.

The U.S. domestic tax residency rules are based on what is called the Substantial Presence Test. This test considers the days that you were present in the U.S. during the past three calendar years, with a higher weighting given to the most recent year, and progressively less weight being given to the second and third most recent years. Specifically, you need to add up all the days in the most recent year, plus one third of the days in the year before that, and one sixth of the days in the year before that. If the combined total is less than 183, then you have not met the conditions of the test and you will not be considered a U.S. tax resident. If, however, you have met the test (meaning that your combined total is 183 or more), then you are considered to have been "substantially present" in the States and will be classified as a U.S. tax resident under U.S. domestic tax law. If that is the case, you still have an out if you file an IRS form called the "Closer Connection Exception Statement for Aliens," otherwise known as Form 8840. (Yes, to the U.S., anyone not from there is referred to as an "Alien.")

I should also point out that Form 8840 must be filed by June 15 of the following calendar year (e.g., 8840 forms for the 2017 tax year are due to be filed no later than June 15, 2018). If you forgot to file your 8840 form, speak to a cross-border tax advisor – you have a final fallback position that you can take under the Canada-U.S. income tax treaty.

Form 8840 will keep most snowbirds out of trouble as long as they have not spent more than 180 days in the U.S. in any 12-month period. The twist here is that, for immigration purposes, you are not looking at a calendar year – you need to be aware of a continually rolling period of 365 days. Be careful. If you get on the wrong side of the immigration rules, you could find yourself being barred re-entry into the U.S. for three years – which would really put a damper on your plans for that shiny new U.S. home.

To summarize, be prepared to count days. Keep a log of your trips, and note that partial days count as full days. If, on average, you spend more than 122 days per year in the U.S. for any reason, then file Form 8840 and do not exceed 180 days in any rolling 12-month period. Period!

### What are the tax implications?

As is the case with a Canadian property, the tax implications for your U.S. home will largely depend on your intended use for the property.

If you are planning to own the property for personal use only, there are no ongoing annual tax filing requirements on either side of the border.

> **"You may find it worthwhile to line up your personal savings with your travel plans."**

If you are planning to use the property to generate rental income, you will have to report this rental income annually. Because the income is sourced from within the U.S., you will need to file an annual federal income tax return to the IRS (1040NR – the NR stands for non-resident) and also the applicable state tax return. You will also need a U.S. tax identification number (a.k.a. an 'ITIN') number, or, if you qualify for one, a U.S. Social Security Number. ITIN numbers are far more common for Canadian snowbirds as the latter requires a work visa.

In Canada, you will have to report the same rental income again on your annual filings. Any tax that you pay south of the border can be claimed as a foreign tax credit to lower your Canadian taxes. Assuming the property was purchased for more than $100,000 CAD, you will also need to report the property as a foreign income producing asset on Form T1135 each year.

One significant difference is that, in Canada, you are able to choose whether or not to claim depreciation on your rental property to lower your net rental income (for the tax savvy people out there, I am referring to claiming CCA), whereas in the U.S. depreciation is mandatory. The rate at which the depreciation must be claimed on your U.S. return is 1/27.5.

### What are the tax implications when the property is sold?

When you ultimately decide to sell the property, you should be aware that it is very likely you will not receive the full proceeds of the sale on closing. Rather, in accordance with the Foreign Investment in Real Property Tax Act (FIRPTA), the U.S. will withhold up to 15% of the gross sale proceeds. Under normal circumstances you can apply to reduce the 15% withholding by proving that the tax will only apply on net proceeds (proceeds after closing costs and your purchase price), but, your paperwork needs to be impeccable and filed in a very timely manner (prior to closing). Alternatively, when you file your U.S. tax return, you will get a refund if your actual tax payable is less than what was withheld. On the other hand, if your actual tax is greater than the withholding, you will have to pay the difference.

The actual tax is based on the gain over and above your cost to purchase the property. On your U.S. tax filings, all figures will be reported in USD, and on the Canadian tax filings all figures will be reported in CAD. This sounds simple enough, but it is easy to be caught off guard by the significance of currency fluctuations over time. For example, consider a property that someone may have bought for $500,000 USD in 2011 when the USD and CAD were at par. Now, let's assume that you sold that same property in early 2017 for $450,000 USD when the Canadian dollar was worth $0.65 USD. In the U.S. you have a loss, but on the Canadian return you have a gain of $192,000 ($450,000/0.65 = $692,308 - $500,000).

### Choose your state wisely

All states are not created equal. Here's a tip: if you are only just embarking on your quest to find the right U.S. property, it would be advisable to compare the tax regimes of the various states you are considering. You might be surprised to find that some states have no income taxes (so no capital gains taxes to worry about when you sell your property – at least at the state level), while other states have no sales tax. And some states will impose a higher property tax levy on non-residents. Also of note is that Hawaii imposes its own state withholding (5%) on the sale of a property by a foreigner (similar to FIRPTA). Depending on your circumstances, these state-level differences may swing you one way or another.

### The estate debate

The always-trendy and ever-changing discussion of U.S. Estate Tax. From a Canadian's perspective, as of the date of this writing, you could fall subject to U.S. estate tax if you die while holding U.S. situs assets and your worldwide estate is greater than $5.49 million USD ($10.98 million USD for a couple). U.S. situs assets would most commonly be U.S. real estate, shares held in U.S. companies, and assets held with a U.S. brokerage firm. U.S. estate tax is then levied against your U.S. assets based on progressive tax brackets that start at 18% and max out at a top rate of 40%.

There are ownership structures that can be put in place to avoid U.S. estate tax that might make sense for certain individuals. For the general public, the problem with spending too much time and money trying to devise a structure that protects you from U.S. estate tax is that you can only plan based on the current rules. In the past 10 years alone we have seen several changes to the U.S. estate tax regime, and President Trump would like to do away with the estate tax altogether. From a more practical perspective, you can mitigate your exposure using much simpler methods. For instance, you could carry extra life insurance, or take out a non-recourse mortgage. You could perhaps even plan to sell your U.S. property during your lifetime, and while you of course don't know when you will die, you could likely look at an actuarial table and get a guideline that could be more reasonable than trying to predict the policy changes of future U.S. governments.

### Closing Comments

My intention is not to discourage you from buying a U.S. property, but to help you think of things that you may not have otherwise considered. I have many clients who have properties in the United States and they love the lifestyle. So if you think this might be right for you, it's worthwhile to have a conversation with your planner to figure out the most tax-efficient way to proceed.

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*Aaron Hector, Doherty & Bryant, Calgary*

# Real estate or stocks: Which is right for you?

Investment advisors are often asked, "Should I invest additional funds in real estate or stocks – which is better?" There's no easy answer, and arguments can certainly be made for either. Each approach has its own unique advantages and disadvantages, so having a good understanding of both will help you decide which one is right for you. You may even find that it's in your best interest to invest in not one or the other, but in both.

To help you decide, here's a quick list of the main advantages of real estate and stock market investing:

## Advantages of investing in the stock market

### Liquidity

Stocks are much more liquid than real estate. They can be sold online instantly with the click of a button. Depending on the location, real estate could take weeks, months or even years to sell. With stocks, you can sell a portion of your portfolio, while with real estate, you would have to sell the entire investment.

### Less work

A stock portfolio typically requires less work to manage than a real estate property. With stocks, you could enlist the help of an investment manager or choose to invest in a passive index fund that doesn't require much decision making. With real estate, it takes time and work to find good tenants and you are responsible for fixing any issues with the property. Being a landlord may not appeal to those who don't have the time, or would prefer to do something else with their time.

> "Real estate commissions, property transfer taxes, and legal fees can add up quite quickly."

### Smaller investment required

With stocks, you're not limited to a single large investment. If you have some extra money to invest, for instance $20,000, this can easily be invested in the stock market. But $20,000 will likely not be enough for a down payment on a property. With real estate, you would need to have at least a 20% down payment if you wish to avoid the CMHC mortgage insurance requirement.

### Lower transaction costs

Real estate commissions, property transfer taxes, and legal fees can add up quite quickly with real estate transactions – especially with the current high cost of real estate. Buying and selling stocks through a discount broker costs typically around $10 per trade, and there are no-load mutual funds that do not charge any commissions.

### Better diversification

It's easier to diversify with a stock portfolio. Mutual funds or ETFs are good ways to diversify with minimal costs. It's more difficult to diversify with real estate, unless you own multiple properties, which requires substantially more money. Diversification helps to reduce volatility and overall risk.

## Advantages of investing in rental properties

### Greater control

As a property owner, you have total control and responsibility for the property. If you want to do a minor renovation because that will allow you to increase the rent, you can do so without anyone's approval. Or you may wish to do a major renovation like redoing the kitchen or adding an extra bathroom because you think it will increase the resale value. You don't have that control as a shareholder. You have to trust the management of the companies that you invest in.

### Leverage

If you take out a mortgage when you purchase real estate, you are using leverage. For instance, if you put down a 20% down payment, any increase in property value will be magnified fivefold. A 2% property increase will yield a 10% rate of return. Of course, the reverse is also true. If property prices were to drop, losses would also be magnified. You could also leverage with stocks, by using a margin account. The biggest risk of using margin is the potential for a margin call, where the financial institution may recall the loan if the value of the portfolio has dropped too much. With real estate, you will not be forced to sell if property prices start dropping.

### Less volatility

With real estate, you don't get the same day-to-day volatility that you get with the stock market. Real estate does have its ups and downs, but it tends to follow a more gradual curve. Stocks can experience significant daily swings from factors such as quarterly earnings reports, global or economic news, and investor sentiment. Since stock and mutual fund prices are so readily available, it's easy to see when markets are dropping. It may be difficult for the average stock investor to stomach a 10 to 20% drop. With real estate, since there is no specific price list, you wouldn't necessarily know if the value of your rental property has dropped 10 or 20%. Because of this, you're more likely to stay the course and not panic when prices are falling.

### Tax advantageous

In the case of rental properties, you can deduct operating expenses, such as mortgage interest, property taxes, property management fees, insurance, and repairs. All of these expenses can be deducted against the rental income. If your rental expenses exceed your rental income, you can deduct the rental loss against other sources of income. You also have an option to deduct Capital Cost Allowance (CCA), which allows you to claim depreciation, reducing your current tax obligation and deferring it to future tax years when your income may be lower. Rental income generates RRSP deduction room for those still eligible to contribute. Canadian stocks do provide preferential tax treatment on the Canadian dividends, but the tax deduction and potential tax deferral are a significant advantage of investing in real estate.

**"Rental income generates RRSP deduction room for those still eligible to contribute."**

### Tangible asset

Real estate investors like the ability to use their physical piece of property. For those of you who may be considering downsizing in the future, moving into the rental property is always an option. With stocks, you won't be able to use what you own. You only get statements showing that you own a particular stock or mutual fund. If the world were coming to an end, real estate investors can always take shelter in their property!

While this list can serve as a guideline to help you figure out which option seems intuitively better, you should look at your complete financial situation with your planner to figure out what the best investment solution is for you.

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