NUMBER CRUNCHING BY TALBOT STEVENS

Making the cases for tax prepaid savings plans

Under study by the federal government, TPSPs would address the flaws of RRSPs and give investors more choice and flexibility

FOR MANY PEOPLE, REGistered retirement savings plans represent a sensible way to build retirement income. But for some, especially low-income retirees who face clawbacks of some government benefit programs, they may not be the best answer for providing after-tax retirement income.

With an eye on strengthening the retirement-income system, Ottawa is studying the merits of a new savings vehicle — the tax prepaid savings plan — which may be the answer to the RRSP's drawbacks. Advisors should understand how TPSPs would affect clients.

TPSPs allow savings to grow and be withdrawn tax-free. However, unlike RRSPS, they do not provide a deduction for contributions. They are made in after-tax dollars — in other words, on a tax-prepaid basis.

The real benefit of RRSPs is the deferral of taxes on the contribution and on growth. Ignoring behavioural parameters, RRSPs always benefit clients when taxes are deferred to a time when the marginal loss rate — marginal tax rate plus clawbacks — is the same or lower than levels faced today. If marginal loss rates rise enough, the increased loss to taxes and/or clawbacks can outweigh the deferral benefits.

TPSPs solve this problem because the tax-prepaid contributions and all investment growth are withdrawn tax- and clawback-free.

TPSPs also address a more common yet overlooked challenge with RRSPs. Tax refunds produced by RRSPs are often spent and not invested, contributing nothing to a client's retirement goal. This generally converts after-tax dollars into before-tax dollars.

For example, if I have $1,000 to invest in a fictitious 50% tax bracket, spending a $500 RRSP refund means I make an after-tax commitment of only $500 to my retirement goal. Reinvesting the $500 refund for a total RRSP contribution of $1,500 is better, but is still only a $750 after-tax commitment or cost in a 50% tax bracket. The best approach is to gross up the $1,000 to a $2,000 total contribution (by borrowing $1,000, producing a $1,000 refund to pay off the loan completely). Only with the gross-up strategy does one invest the same after-tax dollars as at the beginning.

Since TPSPs do not produce a refund, they completely eliminate the behavioural risk of spending RRSPs refunds. If a client has $1,000 to invest for his or her retirement, TPSPs ensure that the entire $1,000 after-tax amount is working for them from Day 1, always equivalent to the initial commitment of the best theoretical gross-up RRSP strategy.

Now let's crunch the numbers to see how TPSPs compare to RRSPs.

Consider Sue, who has $1,000 to invest, expects to average 8% annual returns,and is 20 years from a retirement that she expects to last 30 years. Assume she's in a 32% tax bracket.

We can't know what her tax situation will be 20 years from now. All of her retirement income could face higher, the same or lower taxation. It is also possible, perhaps by design for strategic or lifestyle reasons, that some years face tax rates higher than 32%, while some years are lower.

Let's examine a few basic tax scenarios. In the table, Cases 1 through 3 cover the possibilities in which the tax rate during withdrawals is lower, the same as and higher than the tax rate faced when investing in the plans. As TPSP withdrawals are tax-free and RRSPs withdrawals are 100% taxable, comparing before-tax future values is clearly meaningless. That means we must evaluate retirement strategies from an after-tax income perspective. Here, we will compare 30-year ATI values.

The table shows that, for a given return, the annual ATI produced by TPSPs is constant, independent of taxes and clawbacks. This is obvious because withdrawals from TPSPs are tax- and clawback-exempt. Thus, one benefit of TPSPs is they give a degree of certainty in the amount of after-tax retirement income produced. As long as TPSP withdrawals remain exempt from tax and clawback losses, and average 8% returns, Sue can count on $383 of after-tax spendable annual income over her 30-year retirement, regardless of whether she faces the same, lower or higher marginal loss rates (including the impact of clawbacks). To some extent, this would simplify retirement planning, removing one of the unknown variables.

One big political risk often overlooked is how future clawbacks could reduce the net after-tax income benefits of tax-deferral plans such as RRSPs. In 1996, the government proposed the controversial seniors benefit, which would have overhauled the OAS/GIS system and significantly clawed back benefits for most middle-income savers. After more than two years of protest, the program was cancelled, largely because of an improved government deficit

Tax scenarios: RRSPs vs tax prepaid savings plans

30-year after-tax income from $1,000 invested for 20 years ($)

Case	RRSP spend refund	RRSP reinvest refund	RRSP gross-up refund	TPSP
1. Tax rate drops: 32% tax in, 22% tax out	299	395	440	383
2. Tax rate unchanged: 32% tax in, 32% tax out	261	344	383	383
3. Tax rate rises: 32% tax in, 42% tax out	222	293	327	383
4. 20% seniors benefit clawback: 32% tax in, 52% tax out	184	243	271	383
5. 50% GIS clawback: 22% tax in, 72% tax out	107	131	138	383

SOURCE: TALBOT STEVENS' ATI PROFESSIONAL SOFTWARE

INVESTMENT EXECUTIVE CHART

and lower debt levels. Those who fear that weakened government finances and/or demographics will inevitably result in broader clawbacks of retirement benefits at a level somewhere between where we are today and the cancelled seniors benefit could see this risk eliminated with TPSPs.

■ **CASE 1:** This illustrates probably the most common and best scenario for RRSPs, in which taxes are deferred for decades, with funds withdrawn at a lower tax rate. Here, by grossing up Sue's $1,000 (to a $1,471 RRSP contribution), RRSPs produce a 30-year annual ATI of $440, or 15% more than the $383 from TPSPs.

Unfortunately, most clients spend RRSP refunds, resulting in $299 per year after taxes for 30 years. Even in this case, in which the tax rate falls by 10 percentage points, clients who reinvest less than 97% of the RRSP refund would be better off with TPSPs.

To emphasize the importance of behaviour, what portion of clients productively direct some, let alone almost all of their refunds toward their retirement?

■ **CASE 2:** If Sue retires and stays in the same 32% tax bracket forever, the best that RRSPs can do is match TPSPs. If Sue, like typical clients, spent and enjoyed the refund, she would net an annual 30-year ATI of $261, or 32% less.

■ **CASE 3:** Here, Sue retires at a higher, 42% marginal loss rate. This could result from inheriting significant investments or perhaps Sue is a successful business owner who faced modest personal tax rates until the business was sold, pushing her into a higher tax bracket. To understand the impact of potential future clawbacks, recognize that the higher marginal loss rate could also occur if the investor retires in the same income tax rate, but faces a 10% after-tax clawback of retirement benefits.

When the marginal loss rate, including clawbacks, rises, TPSPs are always better than RRSPs, regardless of how effectively the refunds are used. The best gross-up RRSP approach nets $327 a year for Case 3 — 15% less than with a TPSP. Typical investors who spend RRSP refunds in this case would end up with 42% less after-tax retirement income using RRSPs instead of TPSPs.

For context on clawback levels, the GIS is clawed back at a 50% after-tax rate, and the seniors benefit clawback would have been 20% after taxes. OAS is a taxable payment with a 15% clawback rate. For a senior in a 43% tax bracket, the after-tax clawback on OAS is about 8.5%, so a future clawback in the 10%-15% range is not unreasonable.

■ **CASE 4:** This illustrates the impact of a 20% seniors benefit-sized clawback for someone who invested and retired at the same 32% income tax level. The 20% after-tax clawback effectively increases the marginal loss rate from a visible 32% marginal tax rate to 52%. As shown, the net benefits of RRSPs withdrawn in such an environment are significantly reduced, making TPSPs and even non-registered investing much more effective.

■ **CASE 5:** This shows how TPSPs would provide drastically higher after-tax incomes than RRSPs for those who receive the GIS, regardless of how productively refunds were deployed. Contributing to an RRSP to get a 22% refund and defer tax to a 72% environment (because of the 50% after-tax clawback of GIS) clearly makes no sense. In this case, for the majority who spend their refunds, the $107 of annual after-tax retirement income from RRSPs could be more than tripled by using TPSPs.

Regarding the behavioural aspect, we should note that most people do not invest in RRSPs for the tax deferral. The primary reason most Canadians contribute to RRSPs is for the immediate tax refund, with the real benefit of tax deferral being secondary. In light of this, TPSPs, without the immediate and tangible benefit of a tax refund, may be a tough sell, even with the appropriate personalized advice of how giving up $1 of tax refund today could gain 38¢ to 86¢ a year over a 30-year retirement period. After all, a bird in the hand is worth two in the bush.

With savings rates significantly below levels of the past and the amounts needed to retire securely, the addition of TPSPs to the RRSP/ RPP retirement savings system would give all clients more choice and opportunity to build a successful retirement plan. **IE**

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