NUMBER CRUNCHING BY TALBOT STEVENS

Clawing back at clawbacks

Understanding real marginal tax rates key to good planning

WITH GOVERNMENT deficits falling, income tax rates have dropped slightly over the past few years. Unfortunately, marginal tax rates tell only part of the story. Real marginal tax rates, accounting for various clawbacks, are much higher than we realize and don't increase in a simple, progressive manner as we are led to believe. Because taxes have a direct impact on all aspects of financial planning, understanding the real tax rates clients face is critical to providing accurate advice.

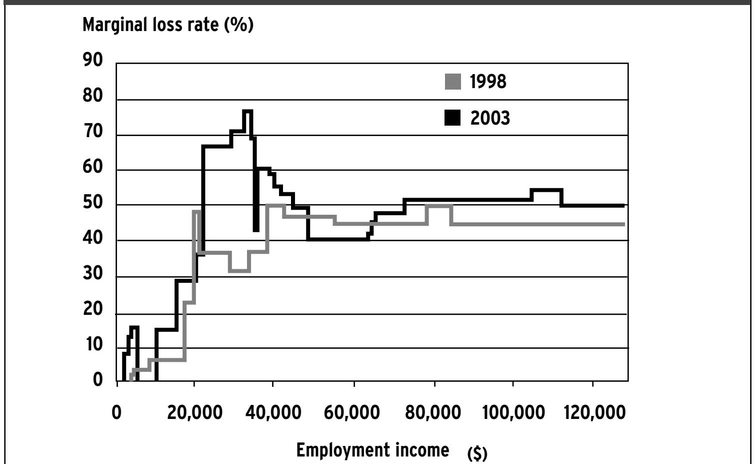
The marginal tax rate is normally defined as the percentage of the next dollar earned that is lost to income taxes. But extra income often costs you more than just federal and provincial income taxes. Canada Pension Plan contributions and Employment Insurance premiums go up as employment income goes up. Almost all forms of income, including RRSP/RRIF withdrawals, result in the clawback of various tax credits and government programs.

The government provides many benefits that are, for practical purposes, income-tested or clawed back depending on one's income. These programs include welfare, the guaranteed income supplement, old-age security and the Canada child tax benefit. Tax credits such as the GST credit, provincial tax credit and age credit, are also reduced as income increases.

Public nursing-home programs are an example of hidden taxation resulting from reduced government benefits. The programs represent a 100% tax: if you have the means to pay the costs, you pay; if you qualify for assistance by not having sufficient income or assets, the government pays.

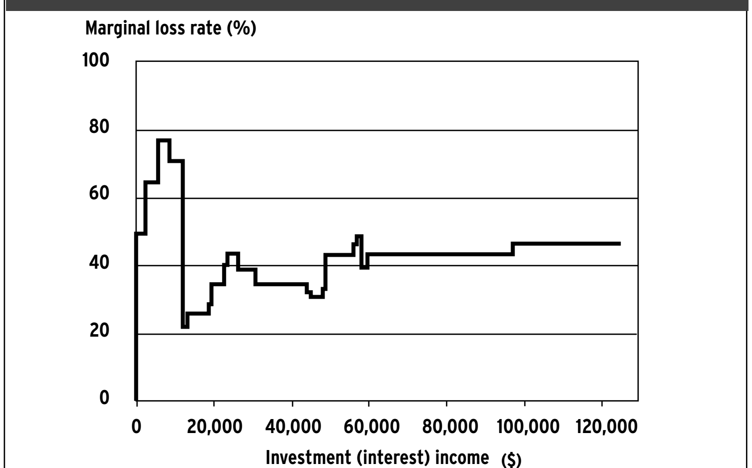
To make effective financial and lifestyle decisions, we obviously need to know how much we gain from our efforts and different financial strategies. To help us understand and quantify this, let's introduce two new parameters. Because the only thing that matters is how much we net, we could call the first and more important parameter the marginal benefit rate, or MBR. An individual's MBR quantifies the net benefit or gain received from earning an additional dollar of income, accounting for all government programs. The marginal loss rate, or MLR, represents the opposite — in other words, what portion of the next dollar earned is lost to taxes, clawbacks, etc.

Marginal loss rates in Ontario: single-income couple, three children



SOURCE: C.D. HOWE INSTITUTE INVESTMENT EXECUTIVE CHART

Marginal loss rates: single senior in Ontario, 2003



SOURCE: C.D. HOWE INSTITUTE INVESTMENT EXECUTIVE CHART

UNDERSTANDING THE IMPACT

One of the lessons of the cancelled seniors benefit legislation is that the clawing back of a government benefit has the same impact as increased taxation. The legislation proposed that the GIS and OAS be combined into one tax-free payment that was clawed back at a rate of 20%. This would have meant that, after age 65, a client in a 40% tax bracket who earned an extra dollar would lose 40¢ to income taxes and lose 20¢ of their tax-free seniors benefit payment. The net benefit is only 40¢, meaning a marginal loss rate of 60%. It was pointed out at that time that contributing to RRSPs in a 40% tax bracket and withdrawing the funds in a 60% effective tax bracket would negate the benefits of RRSPs for most Canadians and turn retirement planning upside down. As advisors, we need to understand the impact of current clawbacks and changes that are proposed in the future. (Some clawbacks affecting clients are outlined in the top table.)

The marginal benefit and loss rates depend on more than just net income and require a deeper advisor/client relationship to provide meaningful advice. For example, advisors need to know the family structure. The clawback rate for the national child benefit supplement with two children is 22.5%. With three children, it's 32.1%. Additionally, clients must apply for the child tax benefit to receive it and notify the government of changes, such as having another child. Some higher-income clients may not apply because they erroneously think their income excludes them, not realizing that partial benefits are paid until taxable family income exceeds $105,000 with three kids.

While advisors can use this information to help all clients, corporate business owners have more flexibility to control how much personal income they draw from their company. With a detailed understanding of the client's specific MLR profile, advisors can calculate exactly how much corporate owners should draw as personal income to optimize the client's net benefit.

The visible marginal tax rate is only a portion of the MLR and, sometimes, like an iceberg, what we see is the small part. The second chart shows the MLRs in Ontario for a single-income couple with three children for earned income, including CPP and EI premiums. For all income ranges, this outlines the incentive to earn additional income, or the benefits of tax strategies such as RRSPs. Note how clients in the $20,000-$40,000 income range face the highest MLRs, largely because of the clawback of the child tax benefit and the national child benefit supplement. Also note how, for most of us, rates have actually increased relative to 1988.

Any accountant can confirm what the charts show. There are times, particularly when tax credits are still a factor, when a lower income results in a higher tax bill. Knowing where these anomalies exist is the first step in advising when to defer claiming part of an RRSP contribution.

Government programs and tax credits that are clawed back

Benefit/credit	Benefit amount ($)	Clawback rate (%)	Clawback income range ($)
Canada child tax benefit	1,169-1,483 per child	5*	33,487-105,267
Nat'l child benefit supplement	1,176-1,463 per child	32.1*	21,529-33,657
Old-age security	5,440/yr.; taxable	15	57,879-94,148
Guaranteed income supplement	single: 6,466/yr.; couple: 8,423/yr.; non-taxable	50	single: 0-12,936 couple: 0-31,344
Age tax credit	3,728	15	27,749-52,602

*FOR FAMILY NET INCOME, THREE CHILDREN
SOURCE: TALBOT STEVENS

INVESTMENT EXECUTIVE CHART

The second MLR chart shows how seniors have high disincentives to earn additional income. As with younger workers, low-income taxpayers face the highest MLRs. It is important for financial advisors to understand the impact of clawbacks affecting senior clients. Retirement planning is about choosing investment strategies that produce the most after-tax, after-clawback retirement income over a 20- to 40-year period. Meaningful analysis of strategies is impossible without considering various clawbacks.

About 1.2 million seniors receive the GIS. A GIS recipient who earns an additional dollar from a part-time job or a withdrawal from an RRSP or RRIF not only loses about 22%-28% to income taxes, but also loses 50% of the tax-free GIS. The net result is a MLR of at least 72%, depending on province.

Conventional industry wisdom is that "RRSPs are always best." With the drop in the capital gains inclusion rate, some advisors are questioning this credo. The fact remains that equity investors aren't the only ones who may be better off investing outside RRSPs. Even conservative GIC investors who use RRSPs to "defer" taxes from a 22% tax bracket can find themselves with an effective tax rate of 72% and could cut their net after-tax retirement income in half or worse.

Several advisors have faced lawsuits related to not understanding the impact of clawbacks on RRSP decisions. Education on the impact of clawbacks is needed to avoid hurting clients and incurring future legal liabilities. Educating clients on the effects of clawbacks and introducing anti-clawback strategies is an opportunity to give better advice.

To help clients avoid high MLRs, advisors need to know when highly taxed income bands start and stop. To learn more or for detailed chart data, e-mail me at the address below. **IE**

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