



NUMBER CRUNCHING BY TALBOT STEVENS

When RRSPs don't reign supreme

Impact of clawbacks means that the popular plans may actually harm some clients

CONVENTIONAL WISDOM ABOUT retirement planning is that RRSPs are always best. But in some cases, unregistered investing can produce better results than RRSPs. Clawbacks of government benefits — such as the guaranteed income supplement and old-age security — and reduction of certain credits as income rises are among the factors that may give unregistered investing an edge.

This is unsettling for many advisors who, for a variety of reasons, have tried to defend the supremacy of RRSPs. However, the fact that retirement planning isn't as simple as "RRSPs first" is actually good for advisors; it illustrates the need for professional advice to identify the most effective investment strategy for a client's unique situation.

There are a number of issues relating to the dilemma of deciding when RRSPs make sense. Because proceeds from registered plans are 100% taxable, the conventional approach of comparing before-tax future values for registered and non-registered investing is similar to comparing apples with oranges, and can lead to the wrong conclusions. The goal of retirement planning is not to maximize a pretax sum the day your client retires; it is to maximize after-tax income over a number of decades.

The key to identifying the best retirement savings strategy is to calculate and compare after-tax income generated by various strategies, accurately accounting for the time value of money, taxes and clawback impact and, perhaps most important, behaviour.

Client behaviour is often the biggest factor in realizing financial success. To help clients achieve financial goals, we need to model the range of possible behaviours and illustrate the impact of their choices. A client's RRSP refund strategy is a key factor in the size of a retirement fund. Refunds can be spent, reinvested or clients can borrow an amount equivalent to the refund and reinvest the total (called "grossing up"). They can also borrow money to top up yearly contributions or catch up on those missed in previous years.

To calculate after-tax income properly, we need to think in terms of personalized marginal loss rates — the portion of the next dollar of income lost to taxes and clawbacks — and the tax efficiency of equity investments.

To make it easier to understand how RRSPs can hurt clients, let's first consider when RRSPs are less valuable.

The main benefits of RRSPs are tax deductions and tax deferral. Whether the tax deduction is productively invested is a behavioural issue that will be modelled for different RRSP refund strategies. This helps advisors illustrate how a more disciplined approach can increase the retirement nest egg. Unfortunately, most clients spend their refunds, resulting in a lower after-tax commitment to their retirements than if they'd invested outside RRSPs.

Rising marginal loss rates — marginal tax rates including all clawbacks — also decrease the benefit of RRSPs. Deferring any expense, including taxes, makes sense if the cost stays the same or decreases. But if real tax rates, including clawbacks, increase enough, the deferral benefit of RRSPs turns into a liability and can hurt clients.

Tax efficiency is also a factor. The more tax-efficient an investment is, the less the tax deferral of RRSPs is needed. Equity investments that are mostly capital gains are taxed less (50% inclusion rate), taxed later (similar deferral as RRSPs) and can produce the same tax deductions as RRSPs if clients borrow for unregistered investing. Also, remember that the adjusted cost base portion of all unregistered approaches is returned to the client without any tax or clawback losses.

Because of foreign-content limits, there is potential for higher returns outside of RRSPs. Historically, the long-term difference in returns between global equities and Canadian equities averaged 1%-3% (in favour of global investing), largely because of the drop in the Canadian dollar. Finally, RRSP trustee fees are a factor, especially for smaller accounts.

Conversely, the benefit of RRSPs is maximized when these factors are reversed. For example, RRSPs are most beneficial to young, disciplined investors who invest 100% of their refunds to defer taxes on their high-interest guaranteed investments.

Now, let's crunch some numbers and illustrate the importance of after-tax income analysis.

■ **CASE 1.** This illustrates the hidden impact of clawbacks. About 1.2 million people, or 37% of seniors, receive the guaranteed income supplement, a tax-free payout to low-income seniors that is clawed back 50¢ on every dollar of taxable income. Combined with an income tax rate of about 25%, the 50% clawback results in a marginal loss rate of 75%.

Consider Gina, who is 60 years old, five years from retirement, with \$1,000 to invest and expecting to average 5% returns. Her goal is to maximize after-tax income over a 20-year

Case 1: Impact of GIS clawback on after-tax income

Strategy	Before-tax value at 65 (\$)	20-year ATI per year (\$)	Note
RRSP, spend refund	1,280	24	Reference
RRSP, reinvest refund	1,600	30	25% better
RRSP, gross-up refund	1,700	33	Best RRSP case
Interest	1,200	67	More than double best RRSP option
Equities	1,260	81	Most ATI

\$1,000 INVESTED FOR 5 YEARS AT 5% RETURNS. GOAL IS TO MAXIMIZE AFTER-TAX INCOME (ATI) OVER A 20-YEAR RETIREMENT. 30% OF EQUITY RETURNS ARE TAXABLE ANNUALLY. 25% TAX DURING SAVINGS PERIOD; 75% TAX DURING WITHDRAWAL PERIOD

SOURCE: TALBOT STEVENS INVESTMENT EXECUTIVE CHART

This leaves the tax-deferral benefit. Deferring taxes is less valuable when there is less investment growth. The amount of growth produced from any invested dollar is determined by the magnitude of returns and the length of time invested.

Lower returns result in less growth, reducing the benefit of RRSPs. Clearly, RRSPs are of no benefit at all when returns are 0% or, worse, negative. As clients get closer to retirement and the length of the savings period decreases, so does investment growth and, thus, the benefit of RRSPs. This explains why a minimum holding period may be needed for RRSPs to be better than unregistered investing, depending on what clients do with the refund and the tax-efficiency of the investment.

retirement. The table (above) shows how RRSPs compare with unregistered interest investments, such as GICs and unregistered equities.

The table compares how much after-tax income can be produced each year over a 20-year period from RRSPs, unregistered interest investments such as GICs or unregistered equities. This 20-year ATI is like an after-tax annuity specific for each strategy, in which all the funds are used up by the end of the withdrawal period, accounting for taxes, adjusted cost base, deferred gains, etc. Recall that the gross-up RRSP strategy is the best theoretical case for which the same after-tax dollars are invested, thus ignoring the fact that most people spend their refunds. In this case, even for fixed-income investors, RRSPs cut the net after-tax retirement income in half or worse.

For example, if Gina invests \$1,000 in GICs earning 5% interest and is taxed at 25%, it will grow to about \$1,200 after five years. If Gina sheltered the same GIC investment inside an RRSP and reinvested the 25% RRSP refund, she would have about \$1,600 in RRSPs after five years. At first glance, \$1,600 is “bigger” than \$1,200, but the RRSP is 100% taxable while the unregistered GIC is 100% tax-paid. By properly evaluating these apples and oranges in terms of Gina’s real goal (how much after-tax income can be annually withdrawn over a 20-year period facing a 75% marginal loss rate), we get a different picture. The \$1,600 in RRSPs produces a 20-year ATI of \$30 a year, vs \$67 a year for the unregistered interest account. In this case, even as a fixed-income investor, if Gina followed the standard industry practice of “RRSPs are always best” and sheltered her GIC inside an RRSP, she would cut her net after-

tax, after-clawback retirement income in half or worse.

■ **CASE 2.** Now consider Tom, a more typical client whose retirement income will not be low enough to receive the GIS but is lower than \$57,879, at which point OAS starts to be clawed back. At 55, Tom plans to invest \$4,500 a year after-tax for 10 years and average 9% returns. His goal also is to maximize 20-year

\$6,290 for RRSPs with 100% of refunds reinvested). The majority of clients who spend their RRSP refunds would produce 20-year ATIs of \$4,490 a year, or about 29% less.

As clients and their lawyers become more sophisticated and demanding, it is clear that income goals of retirement plans need to be analysed from a “net after-tax income” perspective. This provides an opportunity for advisors to differentiate themselves from the pack by presenting before-tax, future-value analyses of alternative strategies.

With industry consolidation, the only way an advisor can grow a business beyond market appreciation is to give competitors’ clients a compelling reason to switch. What portion of your competitors’ clients would like to have their investment strategies analysed from a net after-tax income perspective? One hundred per cent, especially business owners and professionals who are aware of the need to focus on net benefits instead of gross results.

If you’re the only one asking the most important question about the effectiveness of investment strategies and, more important, if you’re the only one who can provide the answer, what will your competitors’ clients do?

In general, clients closest to retirement who have the largest portfolios and investible cash flow have the most to gain from learning whether they could be better off investing outside of RRSPs. **IE**

Talbot Stevens is a financial educator, speaker and author. E-mail him at talbot@TalbotStevens.com.

Case 2: No clawbacks			
Strategy	Before-tax value at 65 (\$)	20-year ATI per year (\$)	Note
RRSP, spend refund	74,500	4,490	Reference
RRSP, reinvest refund	104,300	6,290	25% better
RRSP, gross-up refund	124,200	7,490	Best RRSP case
Interest	60,800	4,790	7% more than RRSP with refunds spent
Equities	72,100	6,350	More than RRSP with all refunds reinvested

\$4,500 INVESTED FOR 10 YEARS AT 9% RETURNS. GOAL IS TO MAXIMIZE AFTER-TAX INCOME (ATI) OVER A 20-YEAR RETIREMENT. 30% OF EQUITY RETURNS ARE TAXABLE ANNUALLY. 40% TAX DURING SAVINGS AND WITHDRAWAL PERIODS. INTEREST-ONLY LEVERAGE WITH 9% INTEREST RATE
SOURCE: TALBOT STEVENS INVESTMENT EXECUTIVE CHART

ATI, facing a 40% tax rate during the savings and withdrawal periods.

Let’s assume Tom is an equity investor disciplined enough to reinvest 100% of every RRSP refund. Using the conventional approach of comparing before-tax values, Tom could retire with \$104,300 in RRSPs or \$72,100 in unregistered equities. Most people would rather have \$104,300 than \$72,100, but comparing apples and oranges can lead to the wrong conclusions. By comparing 20-year after-tax incomes, we see how Tom would produce a slightly better retirement by keeping the equity portion of his portfolio unregistered (20-year ATI of \$6,350 for equities, compared with