NUMBER CRUNCHING BY TALBOT STEVENS

Getting the most from your client's RRSP contribution

Which catch-up loan amount maximizes tax, clawback and behavioural benefits? A good strategy should cover all three

YOUR CLIENTS WANT the largest possible retirement fund. You want to help them and add tangible, quantifiable value to solidify existing relationships and earn new referrals. One way to achieve this and increase your RRSP business is to implement the RRSP contribution strategy that is optimal for each client's situation.


BY TALBOT STEVENS

Developing this strategy means considering these issues:

- minimizing all forms of behavioural risk;
- changing tax rates when crossing tax-bracket boundaries;
- getting additional client cash flow by reducing the hidden taxation of clawbacks.

For example, suppose your client earns $75,000 a year and has $2,000 available to contribute this year and $25,000 of unused RRSP contribution room. With a secure income, he is confident that during the next 10 years, he will have at least $2,000 a year of investible cash flow that could be used to catch up on his RRSPs.

Should your client, in this case, use some of his future cash flow to finance a longer-term RRSP catch-up loan? If so, how much should he catch up, knowing that his taxable income is $10,000 past the start of the middle tax bracket? Should he catch up all in one year or over two years to get a larger tax break? Should he claim all his tax deduction in the first year or, if not, what portion? Should the contribution be for his own RRSP or a spousal plan?

Finally, which approach minimizes the risk that he invests less than his intended investible cash flow? The optimal RRSP contribution strategy should address all these issues.

■ **BEHAVIOURAL RISK:** There are many factors affecting a client's financial success, but the key risk for investment plans is often what we call "behavioural risk." For the majority of clients, the most important element of a successful investment plan is an approach that removes or reduces the natural tendency to procrastinate, fail to commit or fail to execute the plan in a disciplined manner.

Some other elements of behavioural risk include spending dollars that need to be invested, acting emotionally instead of rationally, and buying high and selling low because of greed or fear. Any approach that increases the probability that the investment plan will be fuelled early and consistently with the necessary dollars is more important than factors such as higher returns.

Behaviour certainly affects RRSP savings and how individuals use their RRSP refunds. Unfortunately, the most common response to an RRSP refund is for the client to spend the refund and not use it to forward his or her retirement goals. A second, more disciplined strategy is to reinvest the refund in the RRSP. The RRSP gross-up approach — the third option — is the best RRSP refund strategy that doesn't involve ongoing loan payments. This can be achieved by increasing regular contributions by a gross-up factor and adjusting withholding taxes so there is no refund.

Alternatively, a temporary gross-up loan could be used. For example, someone with $1,000 in a 50% tax bracket could borrow $1,000, contribute the $2,000 total to an RRSP and get a $1,000 refund that completely and almost immediately repays the $1,000 loan. Thus, in a 50% tax bracket, $1,000 can be grossed up to a $2,000 RRSP contribution, which is much better than contributing $1,000 and spending the refund, or even reinvesting the $500 refund for a $1,500 total contribution.

The "hidden" taxes of clawbacks are rarely accounted for in financial analysis

Short-term top-up loans are the fourth RRSP refund strategy, and longer-term loans to catch up on unused contribution room are the fifth.

There are fundamentally three ways money can be put into an investment plan. The "ad hoc savings" approach involves investments being made when money is available and the investor is in the mood. The ad hoc approach is the most vulnerable to the behavioural risks of procrastination and succumbing to the temptations that compete for investible dollars.

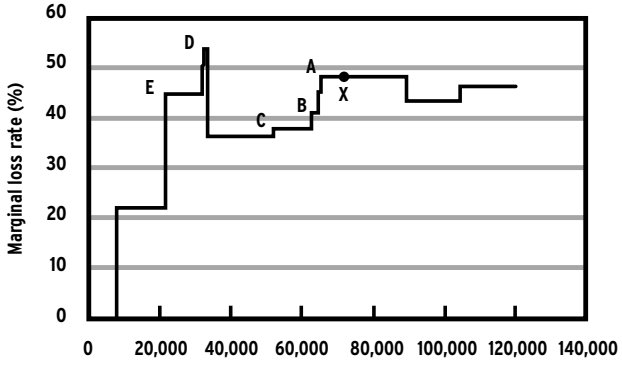
The automatic savings approach of paying yourself first by investing on a regular basis greatly improves the magnitude and consistency of savings, but it is still at risk of temporary interruptions.

For the majority of us, the most effective approach to savings is to commit to a forced savings plan, such as a mortgage, for which payments are mandatory. As long as the payments are not a financial strain, the biggest benefit of a catch-up RRSP strategy is that it locks in the highest level of commitment and all but eliminates the behavioural risks that result in underfunded savings plans. For very disciplined investors with dependable cash flow, the optimal RRSP strategy is to gross up contributions, use the cash flow to finance a catch-up loan, or some combination of the two.

However, if client cash flow is strong but discipline is weak, the

RRSP workshop: Calculating the catch-up loan amount

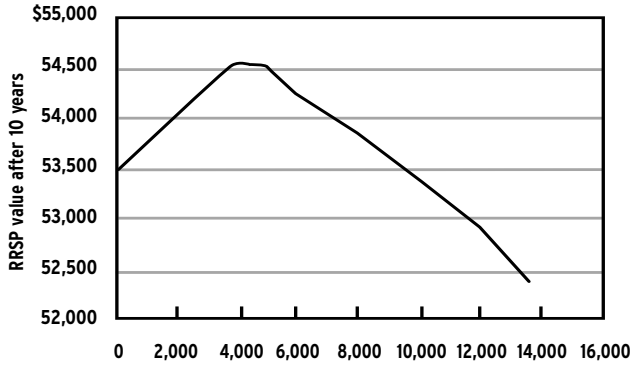
CHART 1: MARGINAL LOSS RATE, ONTARIO, 2003



INCOME TAXES AND CHILD TAX BENEFIT CLAWBACKS FOR SINGLE-INCOME COUPLE WITH TWO CHILDREN UNDER SEVEN YEARS OF AGE. POINTS A THROUGH E REFLECT CHANGES IN THE MARGINAL LOSS RATES CAUSED BY TAX BRACKET AND/OR CLAWBACK CHANGES. POINT X REPRESENTS THE CLIENT'S TAXABLE INCOME OF $75,000

SOURCE: TALBOT STEVENS

CHART 2: IMPACT OF CATCH-UP LOANS ON RRSP VALUES



ASSUMPTIONS: $75,000 INCOME, WITH $2,000 TO INVEST NOW, AND $2,000/YR. OF INVESTIBLE CASHFLOW FOR 10 YEARS, WITH $25,000 OF UNUSED RRSP CONTRIBUTION ROOM. CALCULATIONS ACCOUNT FOR ONTARIO 2003 INCOME TAXES AND CLAWBACK OF CHILD TAX BENEFIT FOR SINGLE-INCOME COUPLE WITH TWO CHILDREN UNDER THE AGE OF SEVEN

INVESTMENT EXECUTIVE CHART

DETERMINING THE RIGHT CATCH-UP LOAN AMOUNT

Here's how we found the optimal RRSP contribution strategy for a client who earns $75,000 a year, has $2,000 available to contribute this year and $25,000 of unused RRSP contribution room. During the next decade, he will have $2,000 a year that could be used to catch up on his contribution room.

As he has unused contribution room and long-term cash flow, finding the optimal RRSP contribution strategy boils down to determining what catch-up loan amount, if any, maximizes RRSP value at the end of the evaluation period, accounting for changing tax brackets, clawbacks and behaviour.

The portion of his $2,000 annual cash flow that is not used to pay off a catch-up loan, along with tax refunds and increased child tax benefits, is grossed up and invested annually.

With a single income of $75,000 and two kids, his marginal loss rate profile, accounting for just CTB clawbacks and income taxes, is shown in Chart 1. Note that marginal loss rates are not simple and increasing.

Points A through E on the marginal loss rate chart reflect changes in the marginal loss rates caused by tax bracket and/or clawback changes. Point X represents the client's $75,000 taxable income.

Note that as we contribute more to an RRSP, taxable income is reduced; this moves us from right to left on the chart. Once taxable income is reduced past Point A, for example, the marginal loss rate drops significantly from roughly 49% to about 41%, thus reducing benefits of additional contributions.

Accounting for the unique combination of tax brackets and clawbacks, the RRSP values after 10 years for various catch-up loan amounts are shown in Chart 2, assuming 6% returns and 6% interest expense on a catch-up loan. The chart shows how RRSP values increase with larger catch-up loans to a point and then drop off.

For the client in this example, the optimal RRSP contribution strategy is an initial contribution of about $10,000. This optimal contribution amount comes from the $2,000 in his pocket, plus n $8,000 loan.

The tax refund of about $4,000 almost immediately reduces his catch-up loan balance to about $4,000, which is paid off over 10 years. The $10,000 initial contribution reduces the client's taxable income to about $65,000 from $75,000, at which point the marginal benefit of further contributions drops significantly.

Note that, compared with catching up on all of his $25,000 in contribution room, the optimal strategy is initially about $2,200 better — and about $1,100 better at the end of the period — than no catch-up loan at all. More important, if the client's current RRSP "strategy" is to spend his refunds — as most people do — after 10 years the optimal contribution strategy will increase his RRSP by 82%, or an extra $24,650.

Particularly in cases in which the optimal RRSP contribution strategy is to catch up less than the maximum possible, this process demonstrates a new level of professional advice that clearly puts the client's interests first.

best contribution strategy could still be to commit to a modest catch-up plan, even if a gross-up-only approach is optimal. This is because the forced savings approach of a catch-up plan has a higher probability of being executed consistently from start to finish than the automatic savings approach of a gross-up plan.

■ **CHANGING TAX BRACKETS:** Because the tax savings benefit of RRSPs can be reduced if the contribution causes the client's taxable income to drop to a lower tax bracket, finding the optimal contribution strategy must involve calculating actual tax deductions based on client income and the marginal tax brackets in the client's province.

For example, if the lower bracket is 22% and a client is $2,000 into the 31% tax bracket, contributing more than $2,000 reduces the immediate tax benefit to 22% from 31%.

■ **IMPACT OF CLAWBACKS:** The final issue to account for is the overlooked impact of clawbacks. Because of limited government resources, many programs that provide financial support, such as the child tax benefit and old-age security, are directed to those most in need. This means the benefits of these programs are reduced or clawed back based on income. Once an individual's or a couple's combined income passes a certain threshold, the benefit is phased out until it is completely gone. Although this approach may be necessary, income-based clawbacks have the same financial impact as taxes: higher income results in higher losses to the government and less money for the taxpayer. Likewise, reducing taxable income by contributing to RRSPs cause taxpayers to appear poorer and increases their benefits. In effect, the government pays taxpayers to contribute to an RRSP, beyond the expected tax savings.

The "hidden" taxes of clawbacks are rarely accounted for in financial analysis, but sometimes are more significant than visible income taxes. For example, in 2003, a single-income couple earning less than about $33,000 with three children had their national child benefit supplement clawed back at a rate of 32.1%.

This loss rate is higher than income taxes due of about 22%. In this case, the marginal loss rate that reflects losses to taxes and clawbacks is about 54% — higher than the MLR of highest-income individuals.

By showing the behavioural, tax and clawback benefits of contributing more than a client's investible cash by borrowing to contribute the optimal amount for his or her situation, advisors can add new value for both their clients and their business. And, by delivering advice with quantifiable benefits, it's a good bet clients will refer friends to take advantage of similar personalized expertise. **IE**

Talbot Stevens is a financial industry consultant, software developer and author.