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Prepare for the dark side of RRSPs

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There is a dark side to RRSPs.

For the affluent, an RRSP is a vital vehicle in their retirement plan. It creates a tax-deferred environment in which high income earners, particularly well-compensated professionals and successful business owners, can build wealth over their working lives. This is critical since the returns from their non-registered investments, heaped on top of their incomes, are more often than not taxed at the highest marginal rate, which approaches 50% on interest and other income in many provinces.

By postponing taxes on investment returns for a lengthy period, an RRSP magnifies the exponential compounding of wealth. For example, within an RRSP, a contribution of $22,000 per annum for 30 years that compounds at a 6% annual return will grow to $1,739,000. In contrast, outside an RRSP, these same savings earning a 3% after-tax return will grow to $1,047,000, nearly a $700,000 shortfall. Tax deferral over time boosts wealth.

Unfortunately, this deferral always comes to a crashing halt. RRSPs mature in the year in which the annuitant turns 71 and the Canada Revenue Agency (CRA) offers only a very short list of options: take a lump sum amount, purchase an annuity, convert the RRSP into a Registered Retirement Income Fund (RRIF) or some combination thereof.

All of the options involve the payment of previously deferred taxes.

It is at this juncture that the Dr. Jekyll character of RRSPs begins to transform into Mr. Hyde. RRIFs, which most high-net worth individuals opt for, have a required minimum payout of a percentage of the plan's value each year. That payout escalates over time and is fully taxable. At age 71, the minimum payout is 7.38% climbing to 8.75% by age 80 and 13.62% by age 90, finally hitting a constant 20% at age 94.

Because they often have RRIFs valued over a million dollars, aging affluent investors can find that their taxable incomes are swollen by fully taxable six-figure RRIF payments. Since most high-net worth investors have other sources of income, a large part, if not all, of the RRIF payments are taxed at the highest marginal rate. The taxman ends up as a full partner in their retirement. Worse, in today's world of low interest rates and lukewarm stock valuations, the returns generated in the RRIF cannot keep pace with ever-growing payouts. Invariably, the result is a downward spiral in the value of the RRIF.

This all comes as a nasty surprise to many affluent investors. In my experience, most individuals fail to recognize that their RRSPs have an associated deferred tax liability. Hence, their back-of-the-envelope calculations of their balance sheet can materially overstate their net worth. This can be particularly true of affluent working couples where both spouses have amassed sizeable RRSPs.

Regrettably, these investors typically underestimate how long they will need capital. According to actuarial tables, a 65-year-old healthy couple has a 63% probability that one spouse will be alive at age 90. The probability is 36% that one spouse will live to 95. Hence, at least one spouse is almost guaranteed to be a spectator to their RRIF meltdown, with the resulting erosion of estate values and increased challenge of funding long-term care and assistance.

The hefty tax drag on RRIFs means people can blithely assume their retirement years are adequately provided for when, in fact, they aren't. Proper retirement planning incorporating detailed after-tax forecasts is essential given the complex interplay of expenditure levels, marginal tax rates, investment returns and tax and pension laws. Affluent investors also need to fully fund their TFSAs and consider other deferral opportunities such as unrealized capital gains on long-term stock holdings.

RRSPs have a dark side. Thoughtful investors plan for its inevitable arrival.

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