

Proposals to improve the flexibility of RRSPs & RRIFs

The BMO Wealth Institute provides insights and strategies around wealth planning and financial decisions to better prepare you for a confident financial future.

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Executive summary

Canadians are saving considerably less than they were – and many worry that they are not saving enough for retirement. While many of us remain uncertain how our spending patterns will change in retirement, what is clear is that we are living longer lives, which means our savings have to last longer, too. Governments in Canada are wrestling with various proposals to increase the size of government pensions, or even to create a supplementary pension plan; however, these reforms may come too late for people who have just retired or are on the verge of retirement. The BMO Wealth Institute believes there are adjustments that could be made now to the existing regime of Registered Retirement Savings Plans (RRSPs) and Registered Retirement Income Funds (RRIFs) that would allow Canadians to take control of their retirement savings and manage them according to their individual circumstances. We believe this would make for a healthier and more tax-efficient pension regime. Specifically, the Institute reviews five proposed changes to the rules regarding RRSPs and RRIFs that would be of immediate benefit to people entering retirement or recently retired, as well as being helpful to younger adults as they plan for their own retirements.

Introduction

Investors everywhere, and especially people approaching retirement age, had a wake-up call when global equity markets declined significantly in 2008 and 2009 – wiping out billions of dollars that many of them were counting on to fund their retirements. The ensuing “panic” may have subsided now that the recession has been declared over and investment markets have begun to revive, but the warning bells are still ringing. If nothing else, more Canadians are asking themselves if their retirement savings plans are adequate.

Theories, assumptions and rules of thumb abound regarding how much one needs to save to live a comfortable retirement. One thing is certain: Canadians are saving considerably less than they were. As we emerged from recession in 1982, the savings rate climbed to more than 20 per cent. It has been dropping ever since. In 2005, Canadians set aside just 1.2 per cent of personal income for a rainy day¹. (The savings rate has since rebounded to 4.7 per cent in 2008, demonstrating that, in times of economic uncertainty, people tend to save more.²)

Savings Rates. Canada and U.S., 1980 to 2005



Sources: Statistics Canada, National Income and Expenditure Accounts; U.S. Department of Commerce

Canadians are also living longer, healthier lives – which means they will need more to sustain them in a long and active retirement. A person turning 65 this year or next can expect to live another 20 years, on average.³

Depending on how much one has saved as one approaches retirement, this can be a worrying thought, but today’s boomers have other reasons to worry.

For instance, only about 38 per cent of Canadians are covered by a Registered Pension Plan (RPP)⁴. While many of these are Defined Benefit (DB) plans that provide guaranteed income for life, Defined Contribution (DC) plans, which are becoming the norm, put an extra burden on individuals not only to fund their retirement savings adequately, but to manage those savings effectively, as well – an issue highlighted by last year’s market crash.

The financial costs of care-giving are rising rapidly, which means there will likely be a need for additional savings in future – not only for the boomers themselves, but for their parents, who are also living longer. The financial needs of this so-called “sandwich generation” would appear to be greater than any other generation before.

The lifestyle expectations of today's retirees are also likely to be more costly than any previous generation – throwing in question traditional rules-of-thumb about what proportion of their income requirements today will need to be replaced in retirement.

While it may not worry them, boomers are carrying more household debt than any generation before them. Their parents strove to enter retirement free of debt, but today's pre-retirees do not seem fazed by the prospect of having a mortgage. Household debt-to-income levels have hit a record high of about 145 per cent⁵.

Income needs may drop in retirement – but how much?

Most financial planners use 70 per cent as the target income replacement ratio for retirement planning purposes – according to this rule of thumb, if you earn \$70,000 per year in your working years, you will need about \$50,000 to maintain your lifestyle in retirement. This presumes that people who are no longer working spend less on such things as business clothing, commuting, fast food and prepared meals. Some academics argue that a 60 per cent income replacement ratio is adequate for most people – and for higher income earners, some say the replacement ratio could be as little as 50 per cent.

While these rules of thumb may have worked in prior years, it remains to be seen whether they will still be valid in future – especially given the boomer generation's lifestyle expectations and the unpredictable course of future healthcare costs. (If nothing else, it is clear that a "one-size-fits-all" approach to retirement planning is overly simplistic.⁶)

It makes sense, therefore, to focus on improving what they can do with what they already have, rather than introducing major design changes to the plan – which may benefit younger people but not have much impact on those about to retire.

Reasons to re-think RRSP/RRIF rules:²

- **Canadians are living longer, and enjoying better health in retirement**
- **Canadians are working longer (or considering it)**
- **Spending patterns are changing for older Canadians**
- **Defined Benefit (DB) pension plans are decreasing steadily**
- **RRSP contributions are declining**

The three pillars

Canadians generally rely on three components for assistance with their retirement income: government pensions, employer pensions and personal savings, commonly known as the three pillars. The first pillar provides direct assistance from government through the Canada and Quebec Pension Plans (CPP/QPP) and Old Age Security (OAS)/Guaranteed Income Supplement (GIS). The second provides assistance from employers who contribute some or all of our company pension contributions. The third provides assistance through tax deferrals when personal savings are invested in an RRSP.

The government pension component provides a basic level of support. The maximum an unmarried 65-year-old will earn from CPP/QPP and OAS is \$17,413 for 2010; married individuals will receive \$34,826. Most Canadians therefore strive to supplement this with private retirement savings, and about three-quarters of Canadian families have done so – either by enrolling in RRSPs or employer-sponsored pension plans, or both⁷. According to recent taxpayer surveys, however, Canadians do not contribute consistently to their RRSPs. Statistics Canada reported recently that, in 1997, 41 per cent of employed tax filers contributed to an RRSP; by 2008, this proportion had declined to 34 per cent. At the same time, the share of employed tax filers participating in employer-sponsored pension plans remained stable at 32 per cent⁸.

Still, boomers are expected to accumulate more wealth before retirement than any generation before them, despite their low savings rate of late. The equity in their houses alone represents a significant nest egg.

Five practical reforms to the RRSP/RRIF regime

The Organization for Economic Cooperation and Development (OECD) reported that Canadian seniors were #3 in the world with regard to their income prospects in retirement. Likewise, the federal-provincial task force on pension reform, headed by Jack Mintz, completed a careful investigation of Canada's pension regime and concluded late last year that a major overhaul may not be necessary¹⁰.

If not a crisis, however, there is still room for improvement, and it would be unfortunate to allow the developing momentum for change to falter because the perceived urgency has diminished. The system isn't broken,

Five practical RRSP/RRIF proposals:

1. Remove age restrictions for RRSPs
2. Reduce taxes on RRIF withdrawals
3. Broaden opportunities for tax-free RRSP/RRIF rollover on death
4. Lower the rate of mandatory RRIF withdrawal
5. Increase maximum contribution amounts for RRSPs

but parts of it can still be improved. What can we do now to improve the lot of those about to retire over the next five to ten years – adjustments that will be good solutions for everyone else after that?

As governments begin reviewing pension adequacy, the BMO Wealth Institute urges them to focus on the personal savings side of the equation – whatever they may decide about improvements to government pension plans. With this in mind, the Institute recommends that the government consider the following five proposals to allow Canadians to take control of their retirement savings and plan their retirement finances in more flexible fashion.

Remove age restrictions for RRSPs

The conversion age for RRSPs is 71. By the end of the year that plan holders reach their 71st birthday, they must cease contributing to their RRSPs and convert them into RRIFs or annuities – the logic being that, Canadians would be allowed to defer tax while their retirement savings were accumulating, but the money would be taxable when withdrawn.

There is one exception to this rule. A spouse¹¹ can continue making contributions to a spousal RRSP as long as the younger spouse is under the age of 71. For those without a spouse, this option to extend one's ability to garner tax-sheltered retirement savings does not exist outside of a Tax-Free Savings Account (TFSA).

As Canadians live longer and work longer – and save longer – they may feel it is premature for them to cease saving and begin making withdrawals as early as 71. Unnecessary (and unwanted) RRIF payments may even trigger OAS claw-back, causing some seniors to forfeit some or all of the government benefits they might otherwise have received.

The Institute believes that Canadians should be able to choose when to begin withdrawing money from their RRSPs. This will give them more flexibility and allow them to accumulate more retirement savings (in their own plans, or their spouses'). From a government policy perspective, there is no fear that the tax revenue will be lost – merely that its receipt will be deferred somewhat longer.

Reduce taxes on RRIF withdrawals

RRSPs were designed to be tax deferral plans – a way to convert current income into future income so as to defer taxation from today to some time in the future, usually during retirement.

Under current progressive tax rates, the higher one's income, the higher one's marginal tax rate. The underlying assumption regarding RRSPs is that contributions and the income they earn would attract a higher rate of taxation than the later withdrawals. This assumption may not always be true.

Ideally, individuals begin saving for retirement when they are young – typically at a time when their incomes are lower, and so is their tax rate. By the time they convert their RRSPs, they may be in a higher tax bracket than when the contributions were made.

Withdrawals from RRIFs are taxed as interest/salary income – even if the growth in the plan were derived from a combination of dividends and capital gains. Had this growth been achieved outside a registered plan, the income would receive preferred tax treatment resulting in a lower tax rate.

In addition, we note that the loss of the preferred tax status for dividend income and capital gains held in an RRSP may skew one's investment behaviour. The very nature of the tax treatment is an incentive to opt for an abundance of interest-bearing securities in one's RRSP portfolio; at today's low interest rates, such investments will grow very slowly and one's retirement savings may not even keep up with inflation on an after-tax basis.

The Institute recommends that only RRSP contributions themselves should be taxed as "deferred employment income." The investment returns (i.e., the growth in the plan) should be taxed at a lower rate that mimics the tax rate that might have been paid if the investments had been held outside a registered plan.

Broaden opportunities for tax-free RRSP/RRIF rollover on death

Currently, on death, the balance of a plan would be included in that year's income of the deceased, and only the net after-tax amount would be passed on. The balance of an RRSP or RRIF is transferred tax-free to a spouse or common law partner (or, under certain circumstances, and with conditions, to a dependent/disabled child or grandchild). In effect, the law permits the tax to be deferred a while longer, until the survivor withdraws the funds or dies. Generally, no provisions exist for a tax-deferred rollover to anyone else.¹²

Under current rules, there is no incentive to use the inheritance (or whatever is left of it after taxes) to contribute to an RRSP. The Institute proposes that if there are balances in RRSPs or RRIFs when individuals die, these amounts should be allowed to be rolled over tax-free into the next generation's RRSP or RRIF. If RRSPs or RRIFs could pass untaxed, this would be encouragement to keep the funds in a retirement plan. As it stands, the majority of beneficiaries tend to spend their inheritances rather than re-invest.¹³

Ideally, this rollover should be available on top of any unused RRSP room – but even allowing it to be used to top-up a plan to its current limit would be an improvement. Based on current trends, it is projected that unused RRSP contributions will exceed \$1 trillion by 2018.¹⁴

The parents of many boomers are still alive and much has been written about the magnitude of the so-called “inter-generational wealth transfer.” Such a policy change could therefore be of benefit to many Canadians approaching retirement age. And, as with the earlier argument regarding age restrictions, such a move would not deprive the government of its tax revenue; it would merely defer it a while longer.

If there were real concerns that this would stretch out the tax deferral too long – from one generation to the next ad infinitum – the government could create a new registered vehicle to receive the proceeds which must then be paid over a prescribed period.

Lower the rate of mandatory RRIF withdrawal

There are prescribed rates at which funds must be withdrawn from a RRIF. In the first year, 7.38 per cent of the balance is withdrawn, in the second year, 7.48 per cent of the remaining balance, and so on until age 94, when the withdrawal is capped at 20 per cent of the remaining (and presumably declining) balance.

As is the case with the age restriction, this rule forces individuals to make withdrawals from their RRIF whether they need the income or not – for instance, those who continue working into their seventies. They lose their flexibility to do what they want with their personal savings and, more specifically, which of their assets to draw down first.

In addition, the current prescribed withdrawal rates may deplete the RRIF too quickly. It is highly unlikely in today's investment world that investment returns will keep pace with the withdrawals. It is normal to expect that individuals will begin drawing on their principal as their retirement progresses, but they are more likely to outlive their investments if forced to make large withdrawals early on.

For these reasons, the Institute believes that the government has an opportunity to extend the life of a RRIF by lowering the rate at which funds must be withdrawn.

Increase maximum contribution amounts for RRSPs

Finally, the Institute questions whether the annual contribution limit is reasonable under current circumstances. As it stands, Canadians can contribute up to 18 per cent of earned income up to \$122,222, i.e., to a maximum of \$22,000 for 2010. Unused amounts can be carried forward. However, if the investments in your RRSP don't perform as well as expected, there are no provisions – as there would be for the administrator of a DB plan – to make additional contributions to ensure your retirement is funded to the desired level.

For those earning more than this year's maximum, they could argue that they are being forced to under-save for retirement – or, at least, are not being given the same advantages of using RRSPs to save for retirement.

The rules also favour households. For example, a couple earning a total of \$150,000 (\$75,000 each) would be permitted to contribute a total of

\$27,000 to their RRSPs, while the single taxpayer earning the same amount – \$150,000 – would be permitted to contribute only \$22,000.

The Institute recommends that contribution limits be broadened to be more comparable to DB pensions and to offer ample opportunity for all Canadians to save equally for retirement.

Final thoughts: Flexibility will improve system

While others are focusing on broader pension plan reforms, the Institute believes that the personal savings component cannot be ignored. We believe that the three pillars on which we rely for retirement income are sound. The approach advocated by the Institute is one based on the principle that individuals should have the flexibility to take control of their retirement savings and manage them according to their individual circumstances. We believe this will make for a healthier and more tax-efficient pension regime. In April, the BMO Wealth Institute appeared as a witness before the Senate Committee on Banking, Trade and Commerce as well as The House of Commons Standing Committee on Finance, outlining our recommendations and we look forward to continuing to participate in this important debate.

- 1 Perspectives on Labor and Income, Statistics Canada, January 2007.
- 2 Spending and saving, Statistics Canada, CANSIM Table 380-0004.
- 3 On average, a 65-year-old man could expect to live an additional 18.1 years in 2005-2007, an increase of 2.0 years from the previous decade. A 65-year-old woman could expect to live an additional 21.3 years, up by 1.3 years. Source: Deaths, Statistics Canada, Catalogue no. 84F0211X, 2007.
- 4 Statistics Canada, Pension Plans in Canada and Labour Force Survey, 2007.
- 5 "The Current State of Canadian Family Finances," Vanier Institute of the Family, February 2010.
- 6 "Saving for retirement: One size does not fit all," BMO Retirement Institute Special Report, February 2010.
- 7 Perspectives on Labour and Income, Statistics Canada, Vol. 9, No. 2, February 2008.
- 8 "Participation in Private Retirement Savings Plans, 1997 to 2008," Pension and Wealth Research Paper Series, Statistics Canada, March 2010.
- 9 Pensions at a Glance 2009: Retirement-Income Systems in OECD Countries, OECD, 2009.
- 10 Summary Report on Retirement Income Adequacy Research, Jack Mintz, December 2009.
- 11 For the purpose of this report, the term "spouse" refers to a spouse or common-law partner.
- 12 Earlier this year, the Institute had recommended that the government permit tax-free rollovers of RRSP or RRIF balances into a Registered Disability Savings Plan (RDSP). We are very pleased to note that the federal government included this recommendation in its March 2010 budget announcement.
- 13 The Canadian Inheritance Study, Harris Decima Research, 2006.
- 14 The Canadian Retirement Savings Market, Analytica Management Consultants, 2009.

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