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A Better Riff on Retirement: The Case for Lower Minimum Withdrawals from Registered Retirement Income Funds

By William B.P. Robson

- Current policy forces seniors to make minimum withdrawals from Registered Retirement Income Funds (RRIFs) whether or not they make financial sense.
- Since 1992, when changes to the *Income Tax Act* last adjusted minimum withdrawals, life expectancy is up and real returns on investment are down.
- As a result, RRIF holders now face dramatic erosion in the purchasing power of tax-deferred savings in their later years. The required minimum withdrawals should fall, or even disappear.

Capital accumulation plans (CAPs), such as defined-contribution (DC) pension and registered retirement saving plans (RRSPs), are major elements of retirement saving in Canada.[1] As more Canadians with such plans approach the point where they will start drawing on their funds, the problems awaiting many are coming into sharper relief. An egregious example: a policy that forces seniors to run down their tax-deferred assets, whether or not that makes financial sense.

Often at retirement, and no later than the end of the year they reach age 71, people with CAPs must annuitize or put their funds into a registered retirement income fund (RRIF). The *Income Tax Act* obliges RRIF holders to withdraw funds at a prescribed pace. Since 1992, they have required a minimum of 4 percent of the beginning-of-year balance at age 65, then escalating until, from 94 onward, holders must withdraw 20 percent of their balances each year (CRA 2002).[2]

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1 Fifty-eight percent of families responding to the Survey of Financial Security by Statistics Canada (2007) reported having RRSPs, RRIFs and similar assets. Of the 49 percent reporting employer-sponsored pension plans, data on defined-benefit versus DC plan membership (CANSIM Table 280-0016) suggest some 8 percent had some kind of CAP. Not all DC plan members will become RRIF holders, but the membership data miss DB-to-DC conversions, and so likely understate DC membership.

2 Tax regulations also allow DC plan members to receive "variable benefits" from their accumulated funds, but since these benefits are subject to the same minimums as RRIFs, the analysis here applies to them as well.

These provisions increase current government revenue by limiting tax deferrals.[3] In 1992, the federal government was deficit-ridden and hungry for cash. Absent that need, the present-value cost of such deferrals to governments matters less. Sheltered investments will grow in value before being taxed. If their returns and the discount rate for valuing future payments are the same, and if effective tax rates on bequests and retirement income are the same, the present value of the deferral even until death is zero.

To the RRIF holder, however, the minimums pose a threat. They could oblige the holder to run tax-deferred assets down too rapidly – exposing withdrawals and any returns from reinvestment to income taxes and benefit clawbacks – and reach advanced age with tax-deferred assets badly depleted. In 2008, this threat looms larger. Life expectancy is up since 1992, and real returns on investments are down. RRIF holders now face dramatic erosion in the purchasing power of tax-deferred savings in their later years.

AN OUTDATED SCENARIO: In 1992, then-current life tables – from the years 1985–1987 (Statistics Canada 1991) – showed average life expectancy at age 65 to be 14.9 years for men and 19.1 years for women. The average interest rate on long-term government of Canada bonds was 8.7 percent, and that on three-month money-market paper was 6.7 percent.[4] With the Bank of Canada's new inflation targets anticipating consumer price index (CPI) increases of 2.8, 2.5 and 2.2 percent for 1993, 1994 and 1995, and 2 percent thereafter, the expected compound real (after inflation) return on long bonds over 30 years was some 6.1 percent, and the equivalent yield for reinvested money-market funds some 4.3 percent.[5] Under those circumstances, the required RRIF drawdowns would have seemed tolerable.

Consider a single man retiring with a $100,000 nest egg at age 65. Suppose he invested 75 percent of his funds in bonds and 25 percent in money-market securities, using vehicles with fees that cut net returns by 100 basis points annually (for clarity, it helps to assume that birthdays, retirements, and later RRIF distributions all occur at year-end).[6] The then-current life tables gave this man a 50-50 chance of surviving past age 79.9. The real value he could anticipate for his nest egg at the end of that year, 2006, would have been $80,400 (Figure 1a shows the projections for the RRIF; Table 1 shows projected real balances in likely years of death). Of course, he might live longer than average for his cohort. The 1985-1987 life tables published no uncertainty bands, but if the variation for a 65-year-old male then was proportional to that for his counterpart in the 2000–2002 tables (Statistics Canada 2006), the standard deviation would have been 2.2 years. So this man would have had a roughly one-in-six chance of living past age 82.1. He could have anticipated the real value of his nest egg at the end of that year, 2009, to be $71,900.

Since women outlive men, his female contemporary faced a larger drawdown. By the end of 2011, the year she would reach 84.1 – the age the life tables gave her a 50-50 chance of surpassing – she could expect her $100,000 nest egg's real value to have declined to $65,800. And by the end of 2013, the year she would reach 86.4 – the age, one standard deviation above the average, she had a one-in-six chance of surpassing – she could anticipate its real value at $59,200. Those expecting to reach 100 might dislike the prospect of a two-fifths-plus drop in their nest egg's purchasing power by their mid-80s. But most retirees probably found these forced distributions no serious threat to sufficient tax-deferred funds in very old age.

3 As then Minister of Finance John Manley wrote to Loyola Ream, M.P: "The main purpose of the RRIF minimum withdrawal rates is to ensure that a minimum amount of tax is paid on funds which have benefited from a deferral of tax over a considerable period of time." Accessed July 2008 at www.carp.ca/article_display.cfm?documentid=1159 - 19k

4 Not knowing what interest rates the withdrawal-rule drafters considered, annual averages seem reasonable: I use average month-end rates for government of Canada bonds of 10 years and more (CANSIM series v122487) and three-month prime corporate paper (CANSIM series v121812).

5 Assuming persistent high nominal yields despite successful inflation control might seem unrealistic. The bond rate is a yield to maturity, however, while 1992 money-market rates were so much lower than experience during the prior two decades that many doubted they would last. In the event, inflation undershot the Bank's target in 1993, 1994 and 1995, yet long bond and money-market rates exceeded their 1992 levels in 1994 and 1995, respectively.

6 This arbitrary portfolio is not what an investment manager would recommend. Actual investments in RRSPs and RRIFs do contain about this share of short-term investments, but far fewer bonds, and lots of mutual funds and shares (Statistics Canada 2007, p. 15). Since anticipated returns on those latter investments are not known, I use long bond yields as a proxy. Equity holders might expect a premium; on the other hand, mutual fund investors would generally encounter fees higher than my assumed 100 basis points.

Figure 1a: Projected RRIF for Person Retiring in 1992

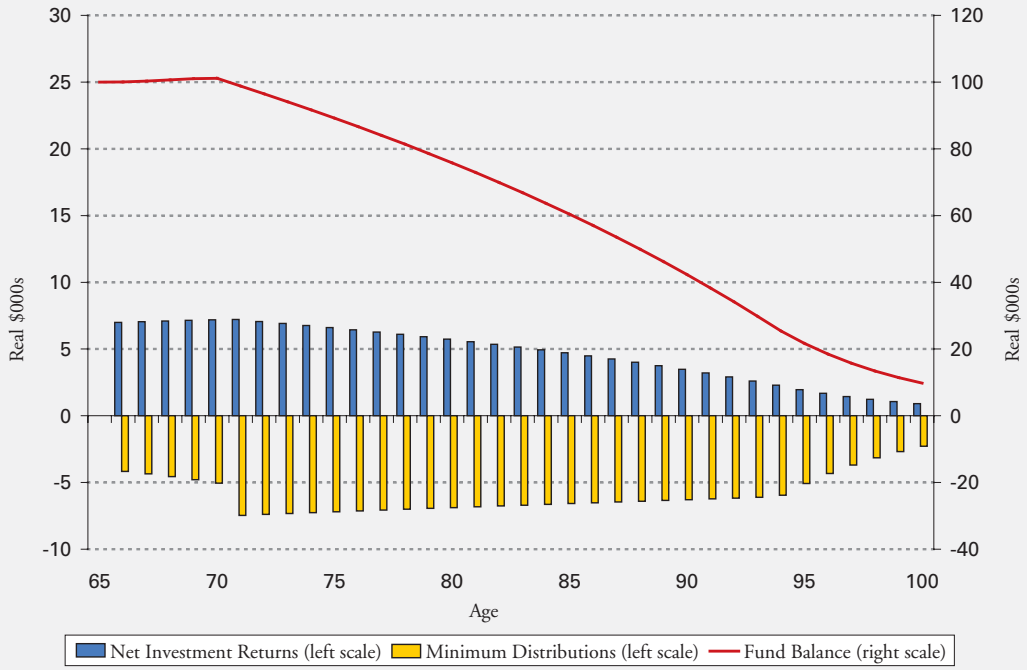
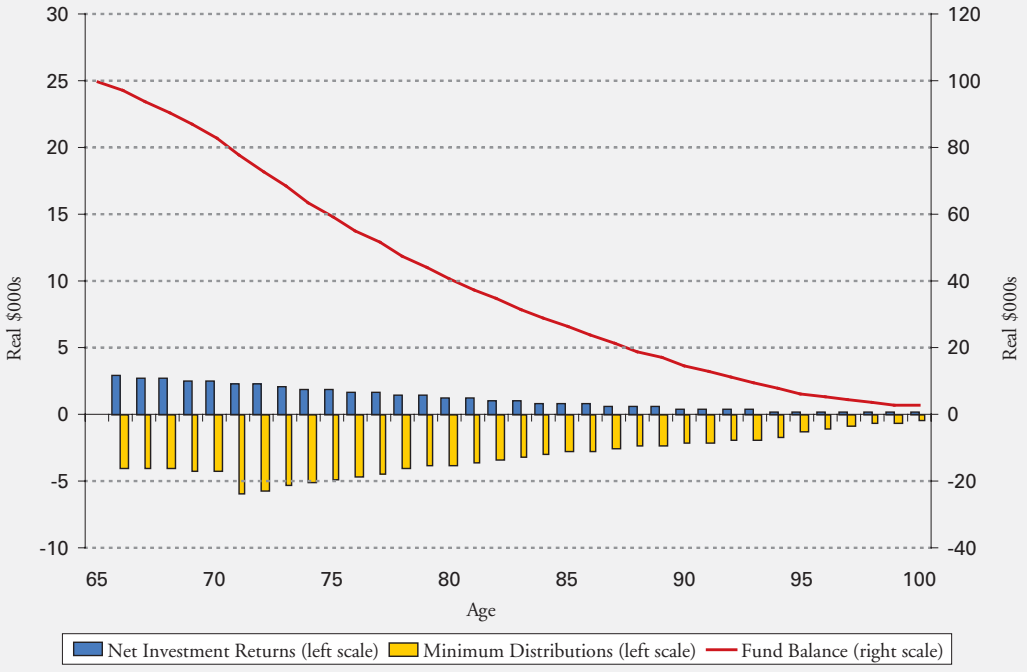


Figure 1b: Projected RRIF for Person Retiring in 2008



AN UPDATED SCENARIO: Today, the outlook for two similar people is radically different. The most recent life tables, from 2000–2002, put average life expectancy at age 65 for men to be 17.0 years, with a standard deviation of 2.6 years, and for women to be 20.5 years, with a standard deviation of 2.5 years. In early July 2008, long government of Canada bonds were yielding 4.1 percent, and three-month corporate money-market paper 3.3 percent. The Bank of Canada is targeting 2 percent CPI inflation indefinitely, so the expected compound real return on bonds is 2 percent, and the equivalent money-market measure is 1.3 percent.

Suppose these retirees also invested $100,000, 75 percent in bonds and 25 percent in the money market, using vehicles costing 100 basis points annually. If they did, the projected real value of the man's tax-deferred nest egg at the end of 2025, the year half his cohort should outlive, is only $34,200 (Figure 1b). Should he be among the one-sixth of men expected to survive one standard deviation beyond the norm, and make it to 2027, the nest egg would shrink to $28,500. His longer-lived female counterpart faces an even direr depletion. By 2028, the year she reaches her expected lifespan, she can expect her nest egg's real value to fall to $25,800. And if she is among the one in six women who survive to 2031, one standard deviation beyond the average, she can expect its purchasing power to dwindle to a mere $18,700.

Because longevity continues to improve in Canada, the 2000–2002 life tables – which use observed mortality at each age, assuming no ongoing improvements – will likely prove conservative. The latest actuarial report on the Canada Pension Plan (OCA 2007) allowed for improvements, and estimated life expectancy at age 65 to be 19.3 years for men and 22.0 years for women in 2007. Those longer periods would see the nest egg's real value fall to $28,500 and $20,900 for the average man and woman. The uncertainties around dynamic estimates should logically be larger, but using the proportional variations from the 2000–2002 tables, the real values for their one-standard-deviation longer-lived contemporaries would be only $20,900 for men and a paltry $16,500 for women.

These examples are stylized. Some seniors will want to withdraw tax-deferred savings faster than the RRIF minimums. Among those who do not, couples can gear withdrawals to the younger spouse's age. Higher-income seniors whose incremental withdrawals do not trigger old-age-security and guaranteed-income-supplement clawbacks will find the burden of paying ordinary income taxes on them tolerable. The Tax Free Saving Accounts announced in the 2008 federal budget will also allow reinvestment of unspent withdrawals without repeated taxation.

For other seniors, however, these forced drawdowns make no sense. These seniors include those whose withdrawals trigger clawbacks and other income and asset tests, who find tax planning and investing outside RRIFs daunting, or who anticipate sizeable late-in-life expenses. Moreover, foreseeable demands on individual and public resources suggest we should encourage saving. Roughly 550,000 Canadians are now age 85 and older; in 30 years that number will roughly triple. To the extent future seniors have ample assets to finance their needs – especially those such as health and long-term care that rise with age – all Canadians will benefit.

What to do? Let's start by thinking big. Why not abolish RRIF minimum withdrawals outright? People more comfortable with incrementalism might prefer adapting the 1992 rules to today's reality by raising the formula's ages to match changes in life expectancy.[7] But today's lower real investment returns would still erode tax-deferred funds well ahead of the ages implicit in the 1992 rules, so the package needs more. Distributions could be geared to real interest rates, by linking them to distributions from a term-certain annuity indexed to 2 percent inflation, for example.[8] But retirement and tax planning are already dauntingly complex: abolition is wonderfully simple.

One way or another, the RRIF drawdown rules need liberalizing. Most Canadians are doing most of their retirement saving in CAPs. Governments impatient for revenue should not force them to run down their tax-deferred assets prematurely. Reforming the withdrawal rules – preferably, getting rid of them – would help them get the post-retirement security they are striving to achieve.

7 The pre-1992 RRIF rules required full depletion by age 90; the 1992 revisions responded to the fact that increasing numbers of people were living past that age (Finance Canada, 1992).

8 The reference annuity should be for a long enough period to cover all but the longest-lived holders. Current rules prevent people using registered funds from buying annuities with terms greater than 90 years minus their age or the age of their spouse.

Table 1: Projected Balance for RRIF Starting at $100,000 by End of Expected Final Year of Life*

	Men		Women	
	Life-Expectancy: Average	Life-Expectancy: One Standard Deviation above Average	Life-Expectancy: Average	Life-Expectancy: One Standard Deviation above Average
	Inflation-Adjusted Dollars			
1985-87 Life Tables; 1992 Real Investment Returns	80,400	71,900	65,800	59,200
2000-02 Life Tables; 2008 Real Investment Returns	34,200	28,500	25,800	18,700
OCA 2007 Life Expectancies; 2008 Real Investment Returns	28,500	20,900	20,900	16,500

* As of age 65.

Sources: Statistics Canada Life Tables; OCA 2007; Bank of Canada; author's calculations.

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