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Marmer Penner Newsletter

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CONTINGENT TAX ON RETIREMENT SAVINGS PLANS

When calculating contingent tax on the sale of a business, it is generally accepted that the calculation is based on the taxpayer's marginal rate of income tax. For example, a taxpayer with over $100,000 of taxable income has a marginal income tax rate of 46.42% in 2001. The marginal rate is the rate of tax incurred on any incremental income. We use the marginal rate on the assumption that the taxpayer's recurring investment or other income utilizes the low tax rate room on the first $100,000 of annual income. Meanwhile the one-time gain on the sale is left to be taxed at the higher marginal rate.

Conversely, contingent income tax on recurring retirement savings plan income may be taxed at the taxpayer's expected average rate. Let's say a taxpayer is expected to retire with combined annual pension and investment income of $100,000 per annum. This income includes expected RRSP withdrawals of $50,000 per annum. If we assume the RRSP income is the first $50,000 earned by the taxpayer, it would be subject to a much lower rate of taxation than if it were assumed that the RRSP were instead the last $50,000 earned each year. This anomaly occurs as a result of our progressive income tax system which increases the marginal rate of taxation as a taxpayer's income increases. As a result, we generally use an average rate of taxation in calculating the contingent tax on RRSP income.

The chart below summarizes the income tax on $100,000 of pension and investment income earned by a 65 year old single taxpayer in Ontario. The income tax calculation assumes the income consists of $50,000 of pension income, $10,000 of dividend income, $20,000 of interest income and $20,000 of capital gains.

Year	Income Tax	Average Tax Rate
1995	$35,810	35.81%
1996	35,464	35.46%
1997	34,081	34.08%
1998	33,088	33.09%
1999	31,985	31.99%
2000	29,729	29.73%
2001	25,453	25.45%

These average tax rates would be used to calculate the expect future tax and then be further reduced by a present value factor based on the number of years to expected withdrawal of the retirement savings plans.

As a result of decreasing income tax rates and increasing bracket sizes over the last few years, the average tax rate has decreased significantly. Accordingly, the present value of contingent taxes on retirement savings plans should be expected to decrease in a similar fashion.