Heed this tale about retired taxpayers

By PETER MASSON
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Mr. A, Mr. B, and Mr. C were frugal men who supported their wives and families, and each saved a part of what they earned.

Each reached the age of 55 during 1967, and retired on December 31st of that year, looking forward to the good times and trips as now their children were settled into lives of their own.

Each pooled all their assets together and discovered they each had $100,000 to invest, and this, combined with their Old Age Security, Canada Pension Plan and pension from work, would see them comfortably through the remaining years of their lives.

How best to put that $100,000 to work?

Mr. A decided to invest in a mortgage (in 1968 mortgages were around seven or eight per cent) and was especially pleased when he found a developer who was willing to pay him 9 per cent annually.

Mr. A stated all he wanted was the 9 per cent interest ($9,000) each year with the principal remaining intact. All agreed. And Mr. A was very pleased at having found such an exceptional "interest-earning" deal.

Mr. B decided to talk to his insurance agent who talked him into buying an annuity (now called a prescribed annuity) which paid him $750 per month ($9,000 per year), guaranteed 10 years and life.

Mr. C decided to talk to a financial planner and invested his $100,000 in an investment fund call Templeton Growth Fund. Because he too wanted a monthly income, he started a "withdrawal plan." Although he could have any amount he wanted, he decided on $750 per month, which is $9,000 per year.

Why did Mr. B and Mr. C seem to have more money to spend?

So, for the next 29 years, Mr. A, Mr. B and Mr. C continued to receive their incomes each year, plus their other pension benefits.

Then, for some reason or other, they sat down and started to compare what had gone on with their $100,000 investments.

Mr. A initiated the comparison because it always appeared Mr. B and Mr. C had more money to spend, even though they all started with the same "income."

This is what they discovered:

Mr. A was in the 42 per cent marginal tax bracket but because he had a prescribed annuity, he had only paid $58,500 in income taxes on the same income of $261,000 over the 29 years. This is because a prescribed annuity is deemed to have returned a set amount of his original principal as part of the $9,000 income each year so that only the remaining interest is taxable income. Frankly, Mr. B had over $51,000 more to spend than Mr. A!

They decided to talk to Mr. C and received the shock of their lives!

Mr. C was also in the 42 per cent marginal tax bracket but had only $113,149 in income taxes on a whopping income of $721,547 over the 29 years. This is because Mr. C's financial planner had arranged to index his income to the Canadian Consumer Price Index. Mr. C's income rose each and every year from the original amount of $9,000 to $48,516 in 1993. This maintained the purchasing power of his income throughout the 29 yeas and will in the years to come.

In other words, Mr. C had over $457,018 more money to spend than Mr. A and over $405,989 more to spend than Mr. B.

Type of income makes all the difference.

Mr. A's income was interest and therefore fully taxable.

Mr. B's income was made up of interest and a return of part of his original principal each year. You could say he exchanged his principal for a tax benefit.

Mr. C's income was made up of three things:

1. Return of principal - completely non-taxable.
2. Capital gains - seventy-five per cent of which is now taxable.
3. Dividends - more favorable tax treatment than interest.

Mr. A learned something else...

While his $100,000 was still intact in the mortgage (he's been receiving interest only), Mr. B had given up his $100,000 to the insurance company. Mr. C's value in the fund was ow $3,462,143 because the fund had been earning more than Mr. C was withdrawing.

These three retired gentlemen are now all age 84 and if they are in good health and still enjoying their retirement but wouldn't you rather be Mr. C who had an income of $48,516 in 1993 than either Mr. A or Mr. B who still had an income of $9,000?

If all three were now to die (29 years later), from their original investment of $100,000, Mr. A would have an estate of $100,000, Mr. B would have no estate, and Mr. C would have an estate of $3,462,143 for his widow. Mr. C's widow would be in the best position because the cost of living was considered in the original planning.

As you can see it makes a great deal of difference how you plan to use your investments during retirement. Contact a qualified financial planner to help maximize your income.

Peter Masson is a Financial Planner with Regal Capital Planners Ltd.

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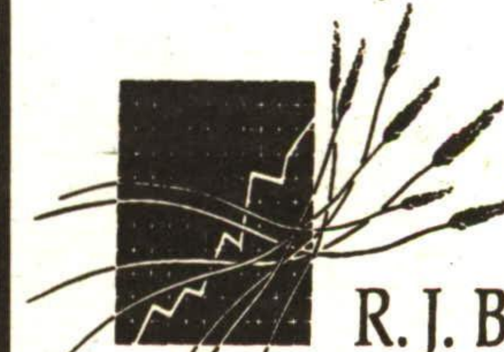

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