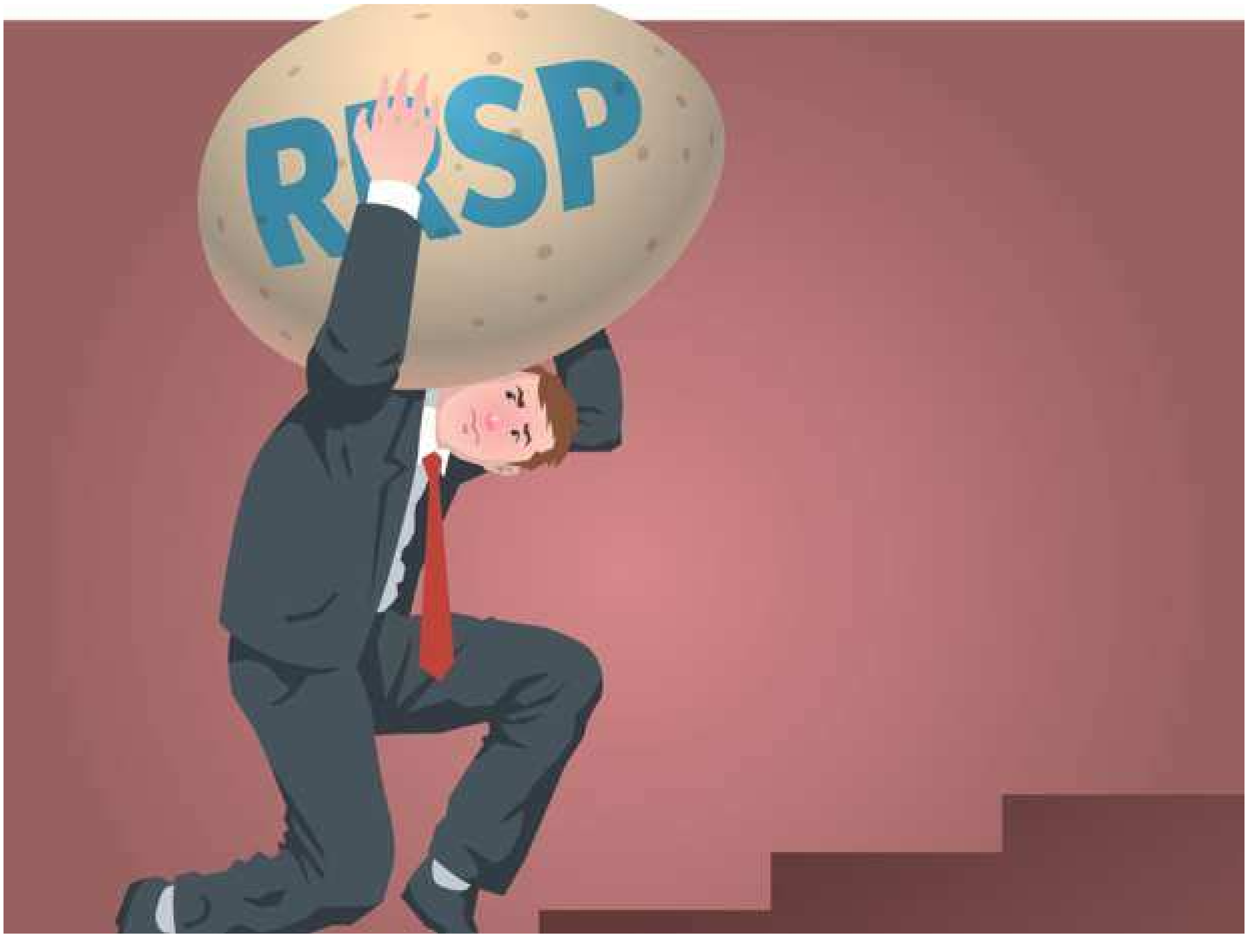
Confronting the issue of big RRSPs, taxes



By Jonathan Chevreau

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Compared to the wealth-accumulation years, the “work optional” years leading up to full retirement can be fraught with trade-offs and difficult decisions.

When you’re a salaried employee, building wealth is straightforward: you simply set up a pre-authorized chequing (PAC) arrangement and divert part of your regular paycheque to savings, whether that be a Registered Retirement Savings Plan (RRSP), a Tax-free Savings Account (TFSA) or both.

But once you reach what retirement income specialist Doug Dahmer terms the “work optional” stage of life — typically in your 60s or perhaps earlier — things become trickier.

He calls the period between the saving and spending years the Retirement Risk Zone Years. The critical period includes the last ten years of earning an income and the first ten years of drawing down a retirement income. The choices you make can be critical and often irrevocable.

Dahmer — president of Burlington, Ont.-based Emeritus Retirement Income Specialists — says Baby Boomers have a huge looming tax problem ahead with their 6-figure RRSPs once it comes time to start withdrawing money or securities from them. This occurs either when forced and taxable annual withdrawals are imposed by RRIF (Registered Retirement Income Fund) rules starting in the year you turn 71, or if you start to "melt down" your RRSP savings in your 60s or even 50s, as some financial advisors recommend.

The big bugaboo is the combined impact of income tax and clawbacks of government benefits like Old Age Security (OAS). Dahmer argues RRSPs can get "too large," which is why he also advocates delaying CPP until 70 and instead making earlier-than-necessary RRSP withdrawals while temporarily in lower tax brackets. At least for those who want to minimize income tax and maximize OAS, Dahmer suggests $1 million in a couple's combined RRSPs is large enough, or $500,000 per individual.

Certified financial planner Ed Rempel says the combined impact of tax and OAS clawbacks can result in effective tax rates in retirement as high as 58 per cent (43 per cent income tax on incomes between $86,000 and $120,000 plus 15 per cent OAS clawback equals 58 per cent)

Rempel makes a valid point: "Most people just assume they will be in a lower tax bracket after they retire, because their income will be lower. In many cases, that is not true." For retirees expecting to be in a higher tax bracket, Rempel likes TFSAs. While TFSA contribution room is very limited, there may be situations where adding to non-registered savings is preferable to further RRSP contributions, Rempel says.

"Large RRSPs cause large income taxes," says Christopher Cottier, investment advisor, and Jay Gangnes, insurance specialist, both of Toronto-based Richardson GMP. The firm offers an RRSP drawdown strategy that involves transferring RRSP assets to a tax-exempt insurance structure to alleviate hefty taxes on RRSPs. But, the pair add, "As always, consult a professional to see if this applies to your family's tax planning."

Adrian Mastracci, portfolio manager with Vancouver-based Lycos Wealth Management Inc., quips the problem of million-dollar RRSPs is "a nice problem to have." He's in the camp of keeping your options open, which means continuing to maximize RRSP contributions.

At age 69, Mastracci continues to do so himself. You don't know how long you will live, whether inflation will soar, interest rates rise or stocks will crash, so the more money you salt away the more flexibility you will have in old age, especially if medical expenses start to soar. So even if a huge RRSP will ultimately mean a little more tax and a little less (or no) OAS benefits, Mastracci is in favour of going for "as large a stash" as you can.

Mastracci says RRSP early withdrawals between ages 60 and 71 are taxable in the year of withdrawals and that — unlike TFSAs — any RRSP withdrawals cannot later be redeposited.

(The only two withdrawals that must be redeposited are the Home Buyers Plan and Lifelong Learning Plan, which generally are used by younger people).

“A large RRSP is a wonderful problem to have. No investor can say with certainty that their RRSP is too large…. Retirement could last a long time, even for just one spouse.”

Warren Baldwin, an Oakville, Ont.-based senior vice president with T.E. Wealth, agrees a large RRSP is a nice problem but warns the “real crunch” arrives when the first partner passes away. Once the RRSP or RRIF assets pass to the survivor, the combined nest egg could subject the remaining partner to “super high tax levels” as RRIF funds are withdrawn. And ultimately there may be a hefty tax bill for the estate once the second partner dies.

So there may be a case for pulling money from RRSPs if you occupy lower tax brackets in your late 50s or 60. Compared to taxable investments, the “tax overhang on the deferred funds in an RRSP is pretty severe.”

On the other hand, large RRSPs may be necessary to fund late-life medical or healthcare costs. As always, every case is different, Baldwin suggests: “For some, $1 million is too big. For others, it’s not.”

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