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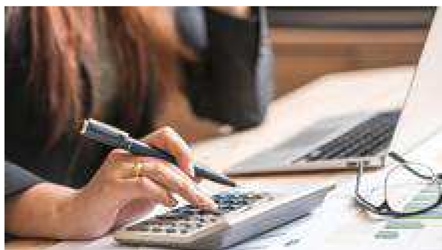
The secret to paying less tax in retirement



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Every day, a thousand Canadian baby boomers turn 65.

But as wealthier boomers cross the retirement finishing line, many will have to wrestle with a problem created by their desire to lower income taxes during their high-earning decades.

In those prime working years, maxing out yearly contributions to registered retirement savings plans (RRSPs) reduces your taxable income and likely results in a tax break. But those tax savings come home to roost and Ottawa eventually starts to get its due beginning at the end of the year you turn 71.

That's when you must convert your RRSP to a registered retirement income fund (RRIF), or choose the less appealing options of annuitizing or cashing out.

Converting to an RRIF means you will have to make annual withdrawals of a percentage of your RRIF's value, fully taxed at your top marginal rate. (Those with taxable income above $202,800 now face a top marginal tax rate that exceeds 50 per cent in several provinces.)

The initial RRIF withdrawal percentage is 5.28 per cent at the age of 71. Minimum withdrawal rates rise steadily over time, hitting 6.82 per cent at 80, 10.21 per cent by 88 and 20 per cent by 95 and beyond.

This has a couple of implications. First, since it's unlikely most investors with balanced portfolios will generate returns as high as the withdrawal percentages, most RRIF recipients will have to start breaking into their capital. Second, they may be forced to withdraw more than they need to live on, and pay tax as they do.

Doug Dahmer, president of Burlington, Ont.-based Emeritus Retirement Income Specialists, says many couples with individual or combined million-dollar RRSPs face a looming tax problem in their 70s. Waiting until then to deal with the issue may leave people with no way to reduce the resulting tax bite.

It's better to confront the problem in the decade leading up to the RRIF age, particularly for those no longer in the top tax brackets accompanying full employment. If so, Mr. Dahmer advocates making early RRSP withdrawals.

"Taxes don't stop with retirement ... In fact, your retirement years provide your greatest opportunity to strategically reduce taxes."

The goal is not to reduce taxes year by year - that can lead to expensive tax traps - but to reduce taxes over the balance of your life. Emeritus has created an app called the Retirement Navigator to help clients make these decisions.

While every circumstance is different, the app shows early conversions of RRSPs to RRIFs can translate into hundreds of thousands of incremental dollars for many people. "It usually means paying a little more taxes sooner to pay a lot less later on."

Among the key decisions is when to commence Canada Pension Plan (CPP) and Old Age Security (OAS) benefits. It often pays to defer one or both of those government programs to the age of 70 while converting RRSPs to RRIFs early.

Mr. Dahmer says if you can't earn more than 8 per cent a year in your RRSP, you're better off drawing it down and enjoying the 8.4-per-cent bump in CPP payments that you get for each year, until 70, you defer the stipend. This ensures you more of an inflation-indexed income you can't outlive.

Matthew Ardrey, vice-president with Toronto-based TriDelta Financial, agrees, saying early RRSP withdrawals can be especially effective if they reduce future OAS clawbacks - "a hidden tax many don't even think about." OAS starts to get clawed back at an income of $72,500, effectively adding 15 per cent to your marginal tax rate.

None of this argues against using RRSPs in your high-earning years, according to Malcolm Hamilton, a retired actuary and pension expert. While it's always better to withdraw money at lower tax rates than at higher tax rates, if your rate is 50 per cent when you contribute and 50 per cent when you withdraw, you still have the benefit of earning the full untaxed rate of return on investments for the time the money is in the RRSP. To fully eliminate the RRSP tax advantage, your tax rate would have to be much higher when you withdraw the money than it was when you contributed, Mr. Hamilton says.

Mr. Ardrey concurs. If a person's marginal tax rate in retirement is less than when they made their RRSP contributions, "they have benefited from the RRSP tax strategy."

Some people may not even want to wait until 71 to start their RRIFs. By beginning one at 65, they can take advantage of pension splitting, which lets couples split RRIF payments as of 65, Mr. Ardrey says. This doubles the amount that can be withdrawn early, which can be particularly advantageous when most of the RRSPs assets are held by one spouse.

A dissenting voice is Adrian Mastracci, portfolio manager with Vancouver-based Lycos Asset Management Inc. He's all for making RRSPs and RRIFs as big as they can get, and just paying the taxes.

As life expectancy continues to rise, the best way to deal with hefty health-care costs later in life is by having as large a stash of wealth as possible, he says.

Either way, Mr. Mastracci quips, a huge RRSP is a "nice problem to have."

Jonathan Chevreau is founder of the Financial Independence Hub and co-author of Victory Lap Retirement.