Retirement Income and the Order of Asset Withdrawal

by Frank Di Pietro

Canada's population is aging quickly. According to Investor Economics, there will be more than 10 million Canadians over the age of 65 within 20 years, representing nearly one-quarter of the total population. Since the average retirement age is 63 and Canadians are living longer, the average retirement could last 25 to 30 years or more in some cases, using current mortality tables.

Today, those 65 and older hold financial wealth of $2.4 trillion and this number is expected to nearly double to $4.7 trillion by 2030, representing 50% of Canadians' wealth. If you expand the current group to include those aged 55 plus, the number increases to $6.4 trillion or two-thirds of Canadian financial wealth. That's a lot of money in the hands of near retirees and those already enjoying retirement.

Financial advisors for years have focused on accumulation, helping clients build their savings, maximize RRSP contributions, utilize their TFSAs, taking advantage of long-term horizons, encouraging investors to stay invested despite short-term market gyrations, and helping Canadians understand the effects of compounding to grow wealth.

This demographic shift is well underway and financial advisors find more and more of their conversations with clients are turning from "accumulation" to "decumulation." Client fears revolve around the fundamental question of, "Am I going to be OK?" but beneath the tip of the iceberg, the clients are really thinking the following:

- "Have I saved enough?"
- "How much money can I get?"
- "How long is it going to last?"
- "Can I afford to retire, or should I work longer?"
- "Where is the money going to come from?"
- "How can I minimize income tax?"

As clients move into retirement, financial advisors will not only need to continue to refine their investment strategy, but also incorporate a decumulation plan that balances the needs for continued growth, inflation protection, capital preservation, and income. Helping clients reduce taxes and maximize the tax efficiency of their income is a powerful way to extend clients' assets and reduce the risk of outliving savings.

Clients who are in or entering retirement may have several sources of income that collectively will make up their retirement paycheque. The most common sources Canadians will rely on include Canada Pension Plan retirement benefits as early as age 60, Old Age Security benefits (age 65), and defined contribution and/or defined benefit pensions (although the latter are becoming more and more scarce amongst the private sector). Clients may also have other sources, such as rental properties, spousal support payments, annuities, and part-time work.

For all remaining income needs, your clients will look to their personal savings, and consider drawing additional income from their Registered Retirement Savings Plan (RRSP), Registered Retirement Income Fund (RRIF), Tax-Free Savings Account (TFSA), and/or their non-registered/taxable investments.

The question most clients ponder is: How should they draw down from their various personal savings accounts, and in what order to maximize the tax efficiency of their income and assets? Does it really matter how clients draw down from their accounts? Yes, it does matter and advisors can deliver real value to their clients by devising a tax efficient order of asset withdrawal strategy in retirement.

At the crux of the "order of asset withdrawal" dilemma is determining and building an RRSP/RRIF exit strategy for each client. RRSPs are great vehicles for savings, allowing clients to build up wealth on a tax-deferred basis in their working years, but the problem is that in retirement, upon withdrawal, every single dollar is taxable as regular income at the client's marginal tax rate. As a result, it can be tempting to defer RRSP/RRIF withdrawals (above any mandatory minimum payments) to reduce taxes on a current basis.

But the drawback to this prolonged RRSP/RRIF deferral strategy is it could potentially expose clients to a large tax liability on death (or death of the last surviving spouse in most cases). That is, with most provinces' top marginal tax rates at or above 50%, more than half of the value of the clients' RRSP/ RRIF assets could be lost to taxes in the year of the last spouse's death, hardly a tax efficient result for many. So, what are your clients' RRSP/RRIF exit strategies?

While endless permutations exist with creating a withdrawal strategy for each client, you can begin by assessing at least three withdrawal strategies, and in each case, giving the RRSP/RRIF assets a different priority of withdrawal.

Financial information

Gina

63

Ontario resident

No DC pension plans, nor LIRA

Has a DB plan that is **paying $20,000** of annual income indexed to inflation

At age 65, will start collecting **CPP** of **$14,000** per year and **maximum OAS**.

Tom

65

Ontario resident

No DC pension plans, nor LIRA

Currently **collecting CPP** of **$10,000** (expected for age 65 based on his contributions) per year and **OAS** of **$7,000** per year.

They plan to downsize their home in five years and expect to **net $500,000 in additional funds for investment.**

+500k

Retirement goal: **$120k** per year

Based on a review of their retirement expenses, you anticipate that **they have a current need of $120,000 per year after-tax.**

1. RRSP/RRIF accelerated drawdown:
This withdrawal strategy looks to minimize taxation to the estate by giving RRSP/RRIF withdrawals the highest priority, with a goal of completely depleting these assets by the client's assumed mortality age. This strategy also seeks to take excess income from a registered plan, over and above the client's income needs where advantageous, and redirect the excess to more tax-efficient savings, such as TFSAs and non-registered accounts. Thus, paying taxes now at lower tax brackets to create a more tax-efficient estate in the future.

2. Hybrid strategy:
Under this strategy, RRSPs/RRIFs are given a slightly lower priority than 1) above, by using non-registered investments to fund income needs first, but the strategy is also mindful to use registered funds over and above the minimum, so as to minimize the risk of having significant RRSP/RRIF assets at mortality age. This could be viewed as the middle of the road strategy relative to 1) and 3).

3. Maximum tax deferral:
On the opposite end of the spectrum, this withdrawal strategy gives RRSPs/RRIFs the lowest priority of withdrawal, and seeks to maximize the tax deferral by avoiding RRSP/RRIF withdrawals above any mandatory minimum payments to the extent possible. This strategy maximizes the RRSP/RRIF assets that are left to the estate, which can create a large estate tax liability.

Case: Tom & Gina Amos
Retirement Income Illustration

Tom (age 65) and Gina Amos (age 63) own 95% and 5% of shares in TG Inc., respectively. Tom has always been actively involved in the business and Gina was only added as a shareholder for income splitting purposes before the new tax on split income (TOSI) rules came into effect in 2018. Gina and Tom are retired.

Above is a summary of some key information; Tom and Gina's financial assets are summarized on the next page.

The investment assets will be invested in a portfolio of 60% fixed income, 40% equity, with a 5% expected rate of return. Inflation is assumed to be 2% throughout retirement. The Amoses need to know whether they will be OK and can generate $120,000 of after-tax income throughout retirement.

Tom and Gina's personal and corporate wealth is summarized in the table below:

	Tom		Gina		
	FMV	ACB	FMV	ACB	Total
RRSP	$400,000		$200,000		$600,000
TFSA	$90,000		$85,000		$175,000
Non-Reg	$300,000	$200,000			$300,000
TG Inc.					
Cash	$400,000				$400,000
Investments	$600,000	$450,000			$600,000
					$ 2,075,000

TG Inc. Tax Accounts

CDA	$150,000
NERDTOH	$250,000
ERDTOH	$150,000
GRIP	$150,000
LRIP	$250,000

The Results (Age 92 & 90)

Hybrid Strategy
Net Estate **$1,609,371**

RRSP/RRIF Accelerated Drawdown
Net Estate **$1,543,776**

Maximum Tax Deferral
Net Estate **$1,524,852**

A retirement income withdrawal plan that produces $120,000 of after-tax income is illustrated under the three withdrawal strategies, with each strategy changing the priority of withdrawal as discussed earlier. This point-in-time snapshot takes the clients to age 92/90 respectively, the assumed mortality according to the Society of Actuaries Annuity 2000 Basic Table. The net estate values incorporate all the remaining personal investment assets available to the estate, net of taxes and fees (i.e., probate) in today's dollars.

Fundamentally, Tom and Gina are going to be OK. Given the level of wealth they are expected to still have at mortality, they should be able to safely draw on $120,000 of after-tax income from their assets and various sources of income without running the risk of outliving their savings.

From a tax perspective, the order of asset withdrawal makes a difference. In Tom and Gina's case, the hybrid strategy produces the highest net estate value, nearly $85,000 more than the second runner-up strategy (maximum tax deferral). This net difference represents taxes paid by the clients under the various strategies. Therefore, drawing down from their personal assets in a specific order produces nearly $85,000 of tax savings for the client. This is tremendous value an advisor can bring to their retiree client segment. Order of asset withdrawal matters, and can make a significant difference in your client retirement income planning. ©

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