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Which Account Should I Draw First In Retirement?

Many clients will ask which account they should withdraw money from to be as tax efficient in retirement as possible. Unfortunately, there is not a one size fits all answer.

However, that answer is easier if you only have one account – typically an RRSP. If you want extra money, you will have to withdraw from that one account your RRSP or RRIF.

If you have money in multiple accounts then some people should draw down their RRSPs first, while others should leave their RRSPs til last.

You can have a <u>tax deferred</u> retirement plan – that is your RRSP and pension.

You can have a <u>tax free</u> retirement plan – that is your TFSA.

And you can have a <u>tax paid</u> retirement plan – that is the money outside your RRSP and TFSA.

Clients need to know that these are all just different tax accounts to save your retirement money in. They each can be used for retirement, but they each have different tax consequences.

RRSPs allow you to contribute and get a tax deduction now at your current tax rate, but you will have to draw the money out later and pay the tax rate in effect in the future. You should contribute to your RRSP when you are in a high tax bracket and you should withdraw from your RRSP when you are in a low tax bracket. For many people they assume that they will be in a lower tax bracket in the future.

However, some people wait too long to withdraw from their RRSP and find that they are in a higher tax bracket after age 65 because of the clawback of their Old Age Security.

TFSAs allow you to pay tax now on your income and contribute $5,500 per year to an account that you never have to pay tax on in the future. This is great for people who are in a lower tax bracket now than they will be later. If you take money from your TFSA after age 65, there is no clawback of your OAS.

Tax paid accounts are funded from your income that has already been taxed. The principal will not be taxed in the future, but any income that you earn on the principal gets taxed every year. This is not as good as a TFSA, but it may be better than an

RRSP depending on when you take the money out. If you take principal out after age 65, there is no clawback of your OAS. However, any investment income you earn after 65 may increase your OAS clawback.

So how should you choose?

One of the factors to consider is your age. The three age groupings I look at are those under age 65, those between age 65 and 71 and those over age 71.

So why those ages? Well those under age 65 are not yet receiving Old Age Security so they can draw money from any account RRSP, TFSA or tax paid account and not lose any OAS.

Generally, once you turn 65 you begin to receive Old Age Security. If you make more than $71,592 you will have to pay back some of your OAS. If your income is already over $72,000 and you take money from your RRSP, you will lose more of your OAS. So between the ages 65 and 71 you can choose whether to take money from your RRSP or not.

As you probably know, in the year that you turn 71, you have to transfer your Registered Retirement Savings Plan to a Registered Retirement Income Fund or annuity and begin to withdraw at least a minimum amount. If that minimum amount pushes your income above $72,000 then you will have to pay back some of your OAS.

So if you had drawn the money out of your RRSP before age 65, then there would have been no clawback on that withdrawal because you were not receiving Old Age Security. By waiting until after 65 to take the money, you may lose more of your OAS.

If you had taken the money out of your RRSP before age 65 and put it into your TFSA, you could withdraw the money from your TFSA after 65 and not lose any more of your OAS.

Even if you had drawn the money out of your RRSP before age 65 and put it into your tax paid savings account, you could spend the principal after age 65 without losing more of your OAS.

So let’s take a look at the effect of the OAS clawback for those over 65.

If your income after 65 is more than $72,000 but less than $88,000 then your effective tax rate on that income is about 42%. For every $1,000 that you withdraw from your RRSP or RRIF, you will pay $150 of your OAS back plus $272 of income tax for a combined amount of $422, or 42%.

If you make more than $88,000 but less than $116,000 then your effective tax rate is about 46%. On $1,000 of additional income, you will pay $456 of tax and clawback.

For people who are under age 65 and earning between $88,000 and $136,000 their marginal tax rate is 36%. For every $1,000 they contribute to their RRSP, they save $360 of tax.

So for people over 65 earning more than $72,000 they have to pay more tax to take the money out of their RRSP than what they saved in putting the money in.

By the way, once your income reaches $116,000 the government claws back all of your Old Age Security. Once they have it all, they do not clawback any more, so your marginal tax rate goes back down to 36%.

I'm already over age 71. What can I do?

There are a few options available. You can purchase flow through shares and lose money exploring for oil and gas or minerals. These losses are tax deductible and would reduce your tax and clawback. Or you can borrow to invest so that the interest you pay on the investment loan is tax deductible.

However, most people over the age of 71 do not want the risk associated with these strategies, and, in many cases the client needs the money to live on.

One sure fire strategy to reduce your tax and clawback was introduced in 2007. That is the ability to share pension income with a spouse. If your income is above $72,000 and your spouse's income is below that amount, you could share up to 50% of your pension income with them. You would want to share enough pension so that your income is reduced to under $72,000 while their income does not increase to more than $72,000.

So if you have a spouse, this may work great. You will have to share your tax information with your spouse to take maximum advantage of this opportunity. You do not actually have to share your pension money with your spouse, but you do need them to sign a form agreeing to include the income on their tax return.

So getting back to the point here, when you are over age 71 and are forced to withdraw from your RRIF, there may be little or no opportunity to avoid the OAS clawback.

What can I do now to avoid the clawback later?

Unfortunately, I find that some clients have missed the opportunity to avoid the clawback because they did not withdraw from their RRSPs prior to age 65, or from their RRIF between age 65 and 71. They have listened to conventional wisdom and have deferred their RRSP to age 71.

Recognize that you do not have to wait until age 71 to start your RRIF. You can start a RRIF at any time. The name – Registered Retirement Income Fund seems to indicate that you should start your RRIF when you retire. Instead of starting their RRIF at retirement, they have withdrawn from non-registered accounts and in some cases pay zero or almost zero tax from retirement to age 71. But now they find themselves having to pay a significantly higher amount of tax after age 71.

Your goal should be to try and smooth the tax burden over your retirement, paying slightly more tax early to pay significantly lower tax later.

A second factor in deciding which account to draw money from is your tax bracket.

Prior to age 65, income up to about $44,000 is taxed at a combined federal / provincial rate of 25%. With tax credits, your average tax rate on $44,000 of income would be about 17% and you would pay about $7,500 of tax. For every dollar you earn above $44,000 up to $88,000, your marginal tax rate is 32%.

So if you will have to pay tax at 46% after age 71, it may make sense to withdraw from your RRSP early, especially if you only have to pay tax at 25%.

For clients who are retired and under age 65, I encourage them to withdraw sufficient funds to use up the lowest tax bracket. In 2014 this amount is $43,953.

If the client has a spouse, I encourage the spouse to also withdraw money from their RRSP or Spousal RRSP to use up the lowest tax bracket.

A concern that some clients have is that they think they might run out of money if they withdraw from their RRSP early. I have to remind them that they do not have to spend the money they take out of their RRSP.

If they do not need the money, they can contribute some of the withdrawal to a TFSA or tax paid savings account. When they need the money, they can withdraw it from the TFSA and avoid the clawback of their OAS.

This concept is difficult for some clients to understand. They have been conditioned to leave the money in their RRSP for as long as possible. They think that paying no tax now is better than paying whatever amount of tax sometime down the road.

Many clients do not know how much tax they will pay later because they do not know what their future income will be. With the help of computers, financial planners can model what that future income may be.

We can determine if it is better to take money from RRSPs sooner instead of waiting until age 71. We can determine what your tax bracket is now and what it might be later.

When you turn 65 and begin to receive OAS, you can earn up to $20,000 and pay no tax. On the next $4,000 you will pay only 15% tax. Once your income exceeds $24,000 you will pay 25% tax on the next $20,000 of income. So if your income is $44,000, you will pay an average rate of tax of 13 ½% and pay less than $6,000 of tax. Notice this amount is less than somebody under the age of 65.

If each spouse earned $44,000 and paid $6,000 of tax, the family would have $76,000 to spend. I think this is the sweet spot in tax planning. You pay a reasonable amount of tax and have a good amount of money to spend.

So if you are receiving CPP and OAS plus any pension or investment income, we can determine how much to draw out of your RRSP to reach the $44,000 target.

What if the higher income spouse has a bigger RRSP than the lower income spouse?

If so, the higher income spouse can share their pension income with the lower income spouse. If the higher income spouse is 65 or older they should withdraw money from a RRIF instead of an RRSP. After age 65, RRIF income qualifies as pension income and can be shared with a spouse.

Keep in mind that once you start a RRIF, there is a minimum amount that you must withdraw. If the minimum amount is more than what you want to take out, then you should transfer only a portion of your RRSP to a RRIF. For instance if you had $200,000 in your RRSP but only wanted to withdraw $10,000 from your RRIF, you could transfer $10,001 from your RRSP to your RRIF and withdraw $10,000 from the RRIF this year. Next year the minimum withdrawal will be based on the remaining account balance of $1 so the minimum required withdrawal will be less than 10 cents. So next year, you would transfer the new amount that you want to withdraw from your RRSP to your RRIF and then you can then withdraw that amount from your RRIF.

A third factor in determining which account you should draw money from is your target spending.

If both spouses are under age 65 and they receive $44,000 of taxable income each, the family will have about $73,000 to spend. For many families, this is more than enough to make ends meet. If their goal was to spend $5,000 per month or $60,000 per year, there would be money left over which could be contributed to a TFSA or saved in their tax paid account. But what if they wanted to spend $100,000 per year?

$88,000 of combined income split equally would give them $73,000 of spending and they would have to get another $27,000 from somewhere.

In their tax bracket they would need to withdraw $40,000 from their RRSP and pay $13,000 of tax to make up their target spending.

If they withdraw $27,000 of principal from their tax paid account they pay no tax. If they sell an investment that has increased in value, there will be a capital gain that they will have to pay tax on. But they will only pay tax on ½ of the capital gain and no tax on the principal. So they might not have to cash in as much of their investment capital if they do not have to pay tax.

If they take money from their TFSA they will not have to pay tax on any of the withdrawal, principal or profit.

So to help those clients under age 65 make the right decision, we will need to know their tax situation now and what their tax situation will be after 65 and after 71. If they are in a lower tax bracket now than at age 65 or after age 71, they should draw more money from their RRSP. If they are in a higher tax bracket now than what they will be in later, they should defer drawing money from their RRSP and withdraw from their tax paid account or their TFSA.

Be careful in assuming that your taxes will be lower in the future. It is possible your income will be lower but your effective tax rate may be higher because of clawbacks. Remember, an individual earning $100,000 per year now will save $360 for every $1,000 that they contribute to an RRSP. His marginal tax rate is 36%.

But if he earns $72,000 or more after age 65, he will pay $422 for every $1,000 he draws out of his RRSP. He will be in a higher tax bracket because of clawbacks even though his income is lower.

As you get closer to your retirement date, you should make sure that continuing to contribute to your RRSP is still the right tax plan.

For some couples that are both over age 65, we will aim for a taxable income of $44,000 for one spouse and $72,000 for the other spouse. This would give the family $94,000 to spend or save over the year.

In a few rare cases between age 65 and 71 we can get both spouses to a taxable income of $72,000 through RRSP or RRIF withdrawals and pension sharing.
With two incomes of $72,000, the family would have $112,000 to spend or give away to children or charities.

For some families it is difficult keeping both incomes below $72,000. So in some cases we will actually transfer pension income from the lower income spouse to the higher income spouse. For instance, if one spouse has an income of $120,000 and the other spouse has an income of $90,000 and they were receiving OAS, then it would make sense to transfer $18,000 from the lower income spouse to the higher income spouse. Since the higher income spouse is already losing all of their OAS, claiming more income will not increase their clawback. However the lower income spouse is also losing some of their OAS. By transferring $18,000 of pension, this would save the family about $2,500 of OAS clawback.

Now most of my clients do not make this kind of income. The majority of my clients do not have to worry about the clawback of their OAS especially since pension sharing started.

Where the clawback begins to hurt is when one spouse dies and the survivor ends up with all the pension, investment and RRIF income. There is no one to share the pension with. So their income is lower and their taxes are higher.

That is why I encourage couples to draw money from their RRSPs early, even if they do not need the money now to meet their spending target.