Creating an RRSP exit strategy

As one of Canada's best savings programs and biggest tax breaks, the Registered Retirement Savings Plan (RRSP) should be wildly popular. However, Canadians are not taking full advantage of them. Year after year, over 90% of taxpayers eligible to make RRSP contributions fail to make the maximum contribution, leaving unused contribution room on the table.

Canadians do not even come close to maximizing their RRSPs, according to Statistics Canada. By 2008, the cumulative total of unused RRSP room had exceeded $600 billion. Growing by approximately $100 billion per year, experts predict this total to approach a staggering $1 trillion by 2012.

A lack of planning

Many Canadians have no RRSPs whatsoever. Those who do often have a contribution plan, but no corresponding withdrawal strategy. Yet, all funds inside an RRSP must be withdrawn at some point. A plan for withdrawal — an RRSP exit strategy — is just as important as a plan for contribution.

Indeed, advisors often work with their clients to come up with sophisticated plans for RRSP contribution, and subsequent allocation strategies of the investments inside the plan. But one very important consideration remains: How and when will that money come out?

RRSP withdrawal basics

Unless it's a locked-in plan, such as LIRA or LRSP, funds can generally be withdrawn from an RRSP at any time. The problem, however, is that every dollar withdrawn from an RRSP is subject to full inclusion, and taxable as regular income to the planholder. However, two special programs make tax-free withdrawals from RRSP plans possible:

Home Buyers' Plan (HBP)

The HBP allows RRSP planholders to withdraw up to $25,000 from RRSPs in order to buy or build their first home. Participants have to repay the amount withdrawn, subject to certain conditions, or else it is taxable as a regular RRSP withdrawal. To read more about the Home Buyers' Plan, visit http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/hbp-rap/menu-eng.html

Lifelong Learning Plan (LLP)

The LLP facilitates the tax-free withdrawal of up to $20,000 (subject to a $10,000 annual limit) from an RRSP to finance training or education. As with the HBP, funds withdrawn under the LLP must be repaid to the RRSP, else subjected to regular taxation. More

information on the Lifelong Learning Plan can be found on the official Government of Canada website at http://www.cra-arc.gc.ca/tx/ndvdls/tpcs/rrsp-reer/llp-reep/menu-eng.html
Both the HBP and LLP programs have significant restrictions; most notably, the maximum dollar amounts that can be withdrawn. Also, both programs require eventual repayment to the RRSP. In this sense, they are more a means of borrowing from the RRSP — a loan to oneself — as opposed to a strategy for ultimate withdrawal.

Withholding taxes

Apart from withdrawals under the LLP and HBP programs, funds withdrawn from an RRSP are subject to withholding tax. Upon withdrawal, the financial institution or plan administrator withholds a specified amount of tax, which is remitted to the government on behalf of the plan holder. For residents of Canada, the withholding tax rates range from 10% to 31%.

It's a common misconception that withholding taxes are some sort of penalty associated with early withdrawals. On the contrary, planholders receive a T4 RRSP receipt for any funds withdrawn during the year, and a credit for the withholding tax previously deducted.

Tax considerations

In addition to tax-free growth inside the plan, tax savings stem from the fact that contributions are made during working years when income levels are higher, and withdrawals made when regular employment has ceased. Hence, withdrawing funds from an RRSP in retirement would typically result in overall tax savings, as the planholder would often (but not always) be in a lower marginal tax bracket.

While postponing withdrawals until retirement often makes good sense, waiting too long can also create problems. In particular, an RRSP plan must be collapsed by December 31 of the year in which the planholder reaches age 71. The most popular options are conversion from an RRSP to RRIF, or to a registered annuity. If nothing is done, the default action is conversion from an RRSP to a RRIF — Registered Retirement Income Fund. (Note that an RRSP can be converted to a RRIF or registered annuity prior to age 71 should the planholder wish to do so.)

Although neither the initial conversion from RRSP to RRIF nor the purchase of a registered annuity are taxable events, all subsequent payments received are taxable as regular income. This income, whether desired or not, can create additional tax problems and lead to a reduction in other government benefits, such as a clawback in Old Age Security (OAS) benefits.

Upon death, any amounts remaining in RRSP, RRIF or other registered accounts are reported as income on the deceased's final tax return. There is, however, an important exception to this rule. The spousal rollover provision allows the registered assets of a

deceased spouse to be transferred tax-free to the surviving spouse. But note that taxes are deferred as opposed to escaped with this provision, as the funds will ultimately be taxable when withdrawn from the surviving spouse's RRSP or RRIF account.

Potential exit strategies

In order to avoid forced withdrawals and inefficiencies in taxation, advisors can work with the clients to help determine an appropriate strategy for RRSP withdrawal. Let's take a look at a specific example involving the use of life insurance. Note that implementing this strategy would require the advisor to be insurance-licensed.

Life insurance case study: Tom and Jenny Smith

After 35 years in the workforce, Tom and Jenny Smith recently retired. The Smiths, both age 65 and both non-smokers, live modestly and are enjoying their retirement. Both of their two children are grown with successful careers and families of their own. Although Tom and Jenny have a combined total of about $500,000 in RRSP assets, their primary sources of retirement income are their defined benefit (DB) pension plans.

Like many, they hadn't given much thought to exactly how or when they would spend the RRSP savings — they simply saved and invested as much as they could during their working years. They now realize that the income from their DB pension plans, coupled with CPP and OAS, is more than enough to sustain their lifestyle. The Smiths would like to leave the money in their RRSP as an inheritance to their children when they pass.

The problem

The Smiths could simply designate their children as beneficiaries of the RRSP plans, but this approach comes with concerns. First, the RRSPs would eventually be converted to RRIFs, forcing income into Tom's and Jenny's hands whether they wanted it or not. And, by leaving the assets to compound, they would create a potentially huge tax liability at death that would drastically reduce the value of the inheritance. Is there a better way for the Smiths to leave an inheritance?

Solution

Tom and Jenny Smith can designate each other as beneficiary on their RRSPs, and purchase a joint last-to-die life insurance policy with the children as beneficiaries of the insurance. By designating each other as the RRSP beneficiary, and making use of the spousal rollover provision, the Smiths ensure that no RRSP-related taxes are due on the death of the first spouse. Joint last-to-die life insurance works perfectly here, as the insurance proceeds are paid out upon the death of the surviving spouse — exactly when the final tax bill comes due, and exactly when they would like to pass their inheritance along to their children.

How does it unfold? After 25 years, the Smiths would have paid $603,900 in life insurance premiums, yet there is still almost $45,000 remaining in the RRIF account(s). More importantly, they have secured a $1.5 million inheritance for their children. Life insurance proceeds are paid out entirely tax-free to the beneficiary.

It's not that the Smiths have somehow escaped taxation in this example. Rather, they've used a strategy to control their taxes, gradually bleed the money out of the RRSPs over time, and maximize the value of their inheritance to the children.

The bottom line

Like most other aspects of investing, there isn't necessarily a right or wrong way to plan for RRSP withdrawals. Rather, one strategy will often be more appropriate than another, depending on each client's unique situation. Taking a proactive approach, advisors can work with their clients, establishing creative plans to help minimize taxes associated with RRSP withdrawals.

RRSP to RRIF

The RRSPs will be converted to RRIFs and used to pay the premiums due on the life insurance policy, so there is no net "out of pocket" expense for the Smiths. Assuming the Smiths have an average joint life expectancy of about 25 years, we consider the following:

- Joint last-to-die life insurance for $1.5 million
- Insurance premium is $2,013 per month*
- Smiths are in a 35% marginal tax rate
- RRSP withdrawal of $3,097 gross (resulting in $2,013 net)
- Average 6% annual rate of return in RRSP accounts

* Rate is based on RBC UL life insurance illustration, M 65 non-smoker, F 65 non-smoker, joint last-to-die, face value $1,500,000, level premium.

2010 RRSP quick facts

2010 Contribution Limit

The maximum RRSP contribution is the lesser of:18% of earned income from 2009; $22,000; The remaining limit after any pension adjustment (PA) from registered pension plan contributions. Note that the exact contribution limit for 2010 will be indicated on each taxpayer's 2009 Notice of Assessment (NOA).

2010 Contribution Deadline

In order to apply the deduction to 2010 income, the contribution must be made by March 1, 2011. Contributions after this date can be deducted against income in 2011 or later. The ultimate contribution deadline is December 31 of the year in which the plan holder reaches age 71.

How much do I need?

According to a Scotiabank study, 56% of Canadians think they will need less than one million dollars to retire. Half of that 56% believe they will need less than $300,000. 28% think they will need between one and two million dollars. 16% believe they will need two million dollars or more.

“While there’s no magic number that Canadians should be aiming for when saving for retirement, it’s important that Canadians are realistic about how they plan to spend their retirement and how much it will cost,” said Gillian Riley, senior vice-president and head of retail payments, deposits and lending at Scotiabank.

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