



The RRSP Trap

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Like many of us in the post-dot-com era, you've conceded that you probably aren't going to retire a multi-millionaire. You just want to have a reasonable amount put away to ensure your golden years are comfortable. How much of an RRSP are you going to need? \$300,000? \$650,000? \$1 million? If you're like many Canadians you simply have no idea. Unfortunately, the answer is not as easy as applying a rule of thumb because we each have a financial situation that is as individual as our fingerprints.

How Much Money Will You Need?

Imagine for a minute that you are a track and field athlete entering the Olympic Games. Your specialty is running. You show up at the stadium for your race, but there's a problem: you have no idea how long the race is. Are you entered in the 100 yard dash or a marathon? It obviously makes a huge difference to how you should have trained for the event. Training for a marathon isn't going to help much in a race that's over in 9.79 seconds.

That's how many people approach retirement. They know they are going to be in an event when they retire. In this case the event is money planning and most people aren't that good at it. To take a page out of one of my favourite books—*The Seven Habits of Highly Effective People* (Stephen R. Covey, Simon & Schuster)—the best way to play this game is to begin with the end in mind. That is, determine about how much money you will spend each year, how long you are likely to live, and work backwards to determine how big your RRSP needs to be.

Without this personal information, what do most people do? They assume the maximum RRSP contribution levels are what they'll need to invest each year to secure their retirement. This could be a major mistake. Let's dig deeper to find out why.

RRSP Problem #1: Age 69

The mandatory age at which you must convert your RRSP into retirement income was 71 years old for 1996 and prior years. Since 1997, however, that age was reduced to 69. Why? Because the government wants you to pay taxes earlier.

The new rules state that during the year you turn 69 you must convert your RRSP to a Registered Retirement Income Fund (RRIF—see Margaret Blank's article "A RRIF Primer" in the April 2004 issue) or annuity and begin withdrawing set amounts by December 31st of the next year. That next year, you will still be 69 at the beginning of the year and will turn 70 during the year (note that the RRIF rules are based on your age at the beginning of the year *not* the age you turn during the year). The minimum RRIF withdrawal percentage for the year you are 69 at the beginning is 4.76% of the opening market value of the RRIF. The next year, it's 5%. These percentages are based on the formula $1/(90-\text{age})$. So, $1/(90-69) = 0.0476$ for the year you start at age 69 and $1/(90-70) = 0.05$ for the year you start at age 70.

Be careful not to miss those first two years as many of the minimum RRIF charts start at age 71 (see http://www.canadianmoneysaver.ca/rc_charts.aspx). Also remember that if you have a younger spouse, you can and probably should base the minimum withdrawals on his/her age for the mandatory withdrawals.

For the years when you are 71 plus at the beginning, the formula no longer works for RRIFs opened after 1992. The rates have been set by the government and, as you probably guessed, they are higher than they otherwise would be. For example, the year you are 71 at the beginning (and turn 72 during) the rate is 7.38% not 5.26% as the formula would dictate. Again, it's a way of getting more tax revenue out of your pockets sooner. The fixed percentage rises to 8.15% in the year you start at age 77 (the formula would dictate 7.69% in that year).

One of the problems with these rules is that they penalize people who have their finances under control. What if you don't need that much money to live the way you would

like? You don't have a choice; you must withdraw the minimum amount and pay tax on it.

Let's consider an example:

If you had a RRIF worth \$1,000,000 at the beginning of the year you started at age 71, you would have to withdraw \$73,800. What if you could get along comfortably on \$50,000 because you have no debt, you own your cars and your kids are self-sufficient? You would have to pay tax on the extra \$23,800 anyway, and that's about \$8,100 at current 2004 Ontario rates.

The second problem is that a large RRIF may lead to clawbacks of the Old Age Security (OAS) pension.

In the above example even without any other income (CPP, investments etc.) the Feds would have clawed back \$2,101.50 (15% of the excess above \$59,790 in 2004—see Dale Ennis' article "Canada's Government Retirement Income System" in the April 2004 issue). I don't know about you but giving away "free" money doesn't sound like a good strategy to me.

RRSP Problem #2: Death

As long as you name your spouse or common-law partner as the successor annuitant in the terms of your RRIF contract or your will, your RRIF payments will continue to be paid to him/her after your death. Upon the demise of your spouse, however, the entire remaining balance of your RRIF comes into income on his/her final tax return along with the balance of his/her RRIF (there is an exception for financially dependent children or grandchildren). Often the majority of this is at a high rate of tax.

For example, say the RRIFs had a fair market value of \$400,000 immediately before the death of your surviving spouse. Even if he/she had no other income, the tax bill in Ontario would be about \$168,000 in 2004.

Let's look at a scenario to see the effect of the OAS clawback and the taxation of RRIFs upon death.

Meet Jim Bradley

Jim Bradley was born on January 2, 1960 and is, therefore, 44 years old in 2004. Jim is good at what he does to earn income, but by his own admission he lacks financial expertise. Securing his retirement years is simple in his mind since it's what he has been hearing since he was a kid: maximize RRSP contributions each and every year no matter what. He has been doing just that since he was 30 years old. (Okay, so if he was really listening he would have started at age 22 but he resisted and enjoyed the next 8 years free of worry about retirement.)

In 1990 when he turned 30 he contributed the maximum RRSP allowed—\$7,500. He continued doing that every year until 2004 when he contributed the maximum—\$15,500 (allowed since he earned \$100,000 in 2003). At an average annual rate of return of 5%, his RRSP portfolio

will be worth \$276,754 at December 31, 2004.

Assuming he puts in the allowed \$16,500 in 2005 and \$18,000 from 2006 until 2025 (when he turns 65), and that the portfolio grows at 5% a year on average, his RRSP will grow to a value of \$1,409,995 at December 31, 2025.

He plans to retire when he is 65 and begin collecting the CPP and OAS pensions at that time.

Jim wants to know:

- How much OAS pension will be clawed back after he retires?
- Will his minimum RRIF payments exceed what he'll need to live comfortably on?
- What will his RRIF be worth upon his death?
- How much tax will be payable on the RRIF on his final tax return?

To answer Jim's questions, we need to make some assumptions. Let's do that now.

The Assumptions

- Jim is eligible for the maximum OAS pension, which at present is \$5,556, and the amount will grow at the assumed inflation rate;
- Jim is eligible for the maximum CPP pension, which at present is \$9,768, and the amount will grow at the assumed inflation rate;
- Jim will require approximately 50% of his last year's pre-retirement income to maintain his lifestyle after he retires because his mortgage will be paid off, any kids will have moved out and he will no longer be saving for retirement. In today's dollars that is \$50,000 (2003 income of \$100,000 x 50%). This amount is adjusted for inflation;
- Jim will not have any other income after retirement (ie., from company pensions, self-employment income or investments outside his RRSP);
- The taxable income when the OAS clawback begins is \$59,790 in 2004 and this amount will increase at the assumed rate of inflation;
- Jim's RRSP/RRIF will earn an average of 4% per year after he retires since he is shifting to more conservative investments;
- Inflation will average 2% per year from now until Jim dies;
- Jim will live until he is 82;
- His wife is the same age as Jim and she does not outlive him;
- Federal and Ontario personal income taxes are calculated at 2003 rates.

The Results

Now let's look at Jim's spreadsheet.

Interestingly enough, the clawback of the OAS pension does not seem to be much of a problem for Jim except for

the years when he is between the ages of 72 and 79 starting at \$4,331.13 and declining to practically zero during that period. Interestingly that coincides with the increased RRIF percentages under the new rules.

The real problems arise when we look at some of the other columns. Have a look at the amount of RRIF income Jim will have to withdraw above what he has determined he'll need in the year he turns 72. The "Total Income after Additional RRIF" is \$132,970.04. This includes the minimum RRIF payment, OAS and CPP pensions (there is no additional RRIF income required in this case). Now look at the "Required Income"—\$87,051.21. (For the technically inclined that's 50% of the future value of his current salary of \$100,000 for 28 years at 2% inflation per year.) The difference is \$45,918.83. That's extra income that Jim will have to withdraw and pay tax on even though he doesn't need the money.

What about when Jim dies? If he dies at age 82, his RRIF will still be worth \$878,732.32 and that'll cost him about \$407,819.67 in taxes. Currently Canadian males live on average for 75.2 years while females live for 81.2 years. What if he dies at 75? His RRIF will be worth an astounding \$1,231,362.14. The tax bill on that? About \$571,000.

Conclusion

Your personal situation will almost certainly be different than Jim's but there is a useful lesson that can be learned: Perhaps you should concentrate on *optimizing* the amount of your RRSP rather than trying to *maximize* it. More about how to do that next time.

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Retirement Optimizer Results for:

Jim Bradley

INPUT SUMMARY

Date this analysis was prepared: 01/09/2004
 The age you will be this month is: 44
 Value of your RRSP on most recent statement: \$276,754.00
 Annual RRSP contributions you plan to make from now until retirement: \$18,000.00
 Age you plan to retire and stop making RRSP payments: 65
 Annual rate at which you expect your RRSP to grow until you retire: 5.00%
 Annual rate at which you expect your RRSP or RRIF to grow after you retire: 4.00%
 Average annual inflation rate for the remainder of your life: 2.00%
 Are you eligible for Old Age Security (OAS) pension at age 65? Yes
 Are you eligible for the maximum Canada Pension Plan (CPP) pension at age 65? Yes
 Amount of money from other sources in today's dollars you expect each year after you retire: \$0.00
 Age at which you expect this income from other sources to stop: 69
 Your current total income before taxes is: \$100,000.00
 Income before tax in today's dollars you think you will need after you retire: 50.00%
 Age you think you (or your spouse) will live until: 82

RESULTS

1 At retirement your RRSP will be worth: \$1,413,972.82
 (NOTE: In Jim's case he puts in \$16,000 in 2005 not \$18,000 so the future value is (per separate spreadsheet) \$1,409,995.00
 2 The amount of RRIF income you will be forced to withdraw in your 72nd year that you won't need: \$45,918.83
 3 The amount of OAS that will be clawed back in your 72nd year: \$4,331.13
 4 The value of your RRIF that will be taxed on your death (or your spouse if he/she lives longer): \$878,732.32
 5 The approximate amount of income tax that will be lost on the RRIF amount in #4: \$407,819.67
 6 If you (or your spouse if he/she lives longer) live to age 94 your RRIF will still be worth: \$93,224.81

DETAILED RESULTS OF YOUR RETIREMENT YEARS

RRSP YEARS

Age During Year**	RRSP Value Beginning of Year	RRSP Withdrawals	Increase in RRSP Value During Year	RRSP Value End of Year	OAS Payments*	CPP Payments*	Other Income*	Total Income	OAS Clawback*	Total Income	Required Income*	RRSP on Death
55	\$0	\$0	\$0	\$0	\$0			\$0	\$0	\$0	\$0	\$0
56	\$0	\$0	\$0	\$0	\$0			\$0	\$0	\$0	\$0	\$0
57	\$0	\$0	\$0	\$0	\$0			\$0	\$0	\$0	\$0	\$0
58	\$0	\$0	\$0	\$0	\$0			\$0	\$0	\$0	\$0	\$0
59	\$0	\$0	\$0	\$0	\$0			\$0	\$0	\$0	\$0	\$0
60	\$0	\$0	\$0	\$0	\$0			\$0	\$0	\$0	\$0	\$0
61	\$0	\$0	\$0	\$0	\$0			\$0	\$0	\$0	\$0	\$0
62	\$0	\$0	\$0	\$0	\$0			\$0	\$0	\$0	\$0	\$0
63	\$0	\$0	\$0	\$0	\$0			\$0	\$0	\$0	\$0	\$0
64	\$0	\$0	\$0	\$0	\$0			\$0	\$0	\$0	\$0	\$0
65	\$1,409,995	\$0	\$56,400	\$1,466,395	\$7,719	\$13,571		\$21,291	\$0	\$21,291	\$0	\$0
66	\$1,466,395	\$53,608	\$56,511	\$1,469,298	\$8,589	\$15,101		\$77,299	\$0	\$77,299	\$77,299	\$0
67	\$1,469,298	\$54,681	\$56,585	\$1,471,202	\$8,761	\$15,403		\$78,845	\$0	\$78,845	\$78,845	\$0
68	\$1,471,202	\$55,774	\$56,617	\$1,472,045	\$8,936	\$15,711		\$80,422	\$0	\$80,422	\$80,422	\$0
69	\$1,472,045	\$56,890	\$56,606	\$1,471,761	\$9,115	\$16,025		\$82,030	\$0	\$82,030	\$82,030	\$0

RRIF YEARS

Age During Year**	RRIF Value Beginning of Year	Minimum RRIF Withdrawals	Additional RRIF Withdrawal to meet Required Income	Increase in RRIF Value During Year	RRIF Value End of Year	OAS Payments*	CPP Payments*	Other Income*	Total Income Before Add. RRIF	Total Income After Add. RRIF	OAS Clawback*	Total Income	Required Income*	Excess Income
70	1,471,761	70,084	0	56,067	1,457,745	9,298	16,346	0	95,727	95,727	0	95,727	83,671	12,056
71	1,457,745	72,887	0	55,394	1,440,252	9,483	16,673	0	99,044	99,044	0	99,044	85,344	13,699
72	1,440,252	106,291	0	53,358	1,387,320	9,673	17,006	0	132,970	132,970	4,331	128,639	87,051	45,919
73	1,387,320	103,772	0	51,342	1,334,890	9,867	17,346	0	130,985	130,985	3,721	127,264	88,792	42,192
74	1,334,890	101,318	0	49,343	1,282,915	10,064	17,693	0	129,075	129,075	3,116	125,959	90,568	38,507
75	1,282,915	98,913	0	47,360	1,231,362	10,265	18,047	0	127,225	127,225	2,514	124,712	92,379	34,846
76	1,231,362	96,662	0	45,388	1,180,088	10,471	18,408	0	125,541	125,541	1,930	123,611	94,227	31,314
77	1,180,088	94,289	0	43,432	1,129,231	10,680	18,776	0	123,745	123,745	1,322	122,423	96,112	27,634
78	1,129,231	92,032	0	41,488	1,078,687	10,894	19,152	0	122,078	122,078	727	121,350	98,034	24,044
79	1,078,687	89,855	0	39,553	1,028,385	11,111	19,535	0	120,501	120,501	139	120,362	99,994	20,506
80	1,028,385	87,721	0	37,627	978,291	11,334	19,926	0	118,981	118,981	0	118,981	101,994	16,986
81	978,291	85,600	0	35,708	928,398	11,560	20,324	0	117,485	117,485	0	117,485	104,034	13,451
82	928,398	83,463	0	33,797	878,732	11,791	20,731	0	115,985	115,985	0	115,985	106,115	9,870
83	878,732	81,458	0	31,891	829,165	12,027	21,145	0	114,631	114,631	0	114,631	108,237	6,394
84	829,165	79,434	0	29,989	779,720	12,268	21,568	0	113,270	113,270	0	113,270	110,402	2,868
85	779,720	77,426	671	28,065	729,688	12,513	21,999	0	111,939	112,610	0	112,610	112,610	0
86	729,688	75,377	4,283	26,001	676,030	12,763	22,439	0	110,580	114,862	0	114,862	114,862	0
87	676,030	72,944	8,309	23,791	618,568	13,019	22,888	0	108,851	117,159	0	117,159	117,159	0
88	618,568	70,084	12,794	21,428	557,118	13,279	23,346	0	106,709	119,503	0	119,503	119,503	0
89	557,118	66,631	17,904	18,903	491,487	13,545	23,813	0	103,989	121,893	0	121,893	121,893	0
90	491,487	62,468	23,758	16,210	421,471	13,816	24,289	0	100,573	124,331	0	124,331	124,331	0
91	421,471	57,404	30,546	13,341	346,862	14,092	24,775	0	96,271	126,817	0	126,817	126,817	0
92	346,862	51,093	38,616	10,286	267,439	14,374	25,271	0	90,737	129,354	0	129,354	129,354	0
93	267,439	43,111	48,392	7,037	182,973	14,661	25,776	0	83,548	131,941	0	131,941	131,941	0
94	182,973	32,789	60,545	3,586	93,225	14,954	26,291	0	74,035	134,579	0	134,579	134,579	0
95	93,225	18,645	76,555	-79	-2,054	15,254	26,817	0	60,716	137,271	0	137,271	137,271	0

* Amounts adjusted for inflation

** You must convert your RRSP to a RRIF in the year you turn 69. The next year you must make your first RRIF withdrawal before December 31st. During this next year you are 69 at the beginning of the year and you turn 70 during the year.

340,286