Retirement Planning: Understanding your RRIF Options

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Marcelo: Welcome to the Empowered Investor Podcast. My name is Marcelo Taboada, and I'm joined today by our very own Lawrence Greenberg. Lawrence, since you last were on the podcast, a lot has happened. You got married, you're at the finish line of your CFA, and we have hired two people, so we are growing as a firm as well. Tell me about all these nice events in your life.

Lawrence: Yeah, it's been around a year since I've been on the podcast. Last really happy to be back. It's been a big summer for me. I did get married to my lovely wife Danielle. So we're thrilled. It's been a very fun summer, and we're hopefully in an endemic. So there's been a lot of activity, socializing, and public gatherings. That's been really great. And yeah, the firm's doing great. We hired two new young people to join the team. So we're getting a lot younger. We're now seasoned vets, Marcelo. Yeah, it's great.

Marcelo: I don't know how I feel about that, but it's all good stuff. All right, so in this episode, we're gonna talk about what is an RRSP and what is a RRIF. We're also gonna break down what LIFs are. A lot of people have questions about this. We're gonna talk about converting your RRSP to your RRIF, drawing down from a RRIF in retirement, planning your RRSP to RRIF conversion, and the estate considerations for your RRIF and your LIF. So Lawrence, let's start with the very basic: What is an RRSP? It's important to note that before we think about RRIFs, it's what precedes the RRIF, right? So we got to break that down for listeners. What is an RRSP?

Lawrence: 100%. So you can't talk about RRIFs without covering the RRSP. The RRSP has been around since 1957. For many Canadians, it's the main driver of retirement savings. It's a registered plan, the Registered Retirement Savings Plan, and that allows you to add contributions based on a percentage of your income each year. The formula is 18% of your previous year's income, which gives you this year's contribution room. The RRSP has three primary benefits. First, you get a tax deduction for your contribution in that given tax year. The nice thing about the RRSP is the investments grow in the account tax-deferred, not tax-free, but tax-deferred. So you pay it at the end when you withdraw. And third, generally speaking, the idea behind putting in money when you're in your working years, when you're in a higher tax bracket, you get the deduction. Hopefully, in retirement, you're in a lower tax bracket at withdrawal, so you hopefully have a tax savings there. Not the case for everybody, but as a whole, yeah.

Marcelo: So that's important to note because you said it's 18% of the previous year's income. So if you make $100,000, it'll be $18,000, but there is a max. So we have to mention that. So if you make $500,000 or a million dollars, there is a limit on how much you can put in. So the limit for 2022, do you know how much it was?

Lawrence: Yeah, it's $29,210, and the 2023 number came out. It's a little over $30,000. So if you're in that highest marginal tax rate, that's the maximum you could put into your RRSP.

Marcelo: Yeah, and I think you alluded to a very important point because a lot of people say, "Oh, I'm not paying taxes when I put into my RRSP." And that is partially right. So for example, if you put $1 today in an RRSP, it'll grow tax-deferred. So you won't pay taxes on that growth. When you take it out, let's say when you have to convert it into a RRIF, which we will get into, if that dollar turned into $10, you will pay taxes then. But the idea is that you will have a lower tax bracket, therefore, you'll pay less money on that withdrawal, right? So as opposed to spending the dollar and paying the taxes today.

Lawrence: A hundred percent. No, I think it's well put. The big thing is when it stays in the account, you're not paying taxes on it. So that would contrast to a non-registered account where you are taxed on interest income, on dividends, and capital gains if they're realized. And that'll pivot nicely off of what happens when you stop your working years. We'll pivot off of this now and talk about the RRIF, the Registered Retirement Income Fund. And that continues the path in your savings journey where for decades and decades, you were contributing to your RRSP. Now what happens is, how do you take money out of that account? The requirement is at age 71, you have to convert your RRSP to a RRIF. And that flips the switch from contributions to withdrawals.

Marcelo: So just to be clear, the RRSP becomes the RRIF, right? Because I think that's where people get confused. They think that it's a different account, and it's not.

Lawrence: You have to open up a RRIF account and transfer the funds in. There are options in terms of how to work with your RRSP, and we'll talk about that in a little bit. But generally speaking, yeah, it's considered a conversion. It's staying in the account.

Marcelo: Okay. So what are the rules for an RRSP to be converted into a RRIF?

Lawrence: So you have three options for converting your RRSP to a RRIF. You could either withdraw the funds at age 71, that is taxed as regular income, generally not advisable. The second would be to purchase an annuity. And the third would be to convert your RRSP to a RRIF, which is generally what we'd advise for most Canadians and for our clients as a whole.

Marcelo: There's a lot of confusion too, and people will be familiar with the LIRA/LIF. So can you break that down for us? I think they're part of the same because the idea of the RRSP is during your working years, you're working. You're creating a pension essentially for yourself by contributing to this vehicle that allows you to save money tax-free for when you retire. And when that last paycheck stops coming in, you're going to start withdrawing from the

RRIF, and you're going to build yourself a pension. But people are also familiar with the LIRA/LIF. So can you break that down for us, please?

Lawrence: Yeah. So it's along the same vein. LIRA has a kind of unique origination where it comes from a transfer out of a defined contribution plan or defined benefit plan. So this would be if you left your employer and had either of these plans, you have the option to transfer out all or some of that pension to a LIRA account. And then once you turn 71, you have to convert it to a LIF account. So very similar to the RRSP to RRIF, you go LIRA to LIF. The big distinction is a lot of the rules are the same in terms of at 71, you must convert and start pulling funds out of the account. However, there is one big distinction for the LIF account. Once you convert it, there is a minimum payment, which we'll allude to for the RRIF, and a maximum payment as well. So it's like a personal pension that could be self-managed, could be with your advisor, but does not have to stay with your previous employer or even current employer.

Marcelo: So that's a huge distinction because like the RRIF, you have a prescribed minimum per age. And if you want to take more, yeah, there's going to be some withholding taxes. There's going to be some taxable scenarios that you have to think about. But the LIRA, once you convert it into a LIF, it has a minimum and a maximum. So you have a limitation on liquidity. So that's a very important distinction.

Lawrence: And it has to be factored in with your cash flow.

Marcelo: Perfect. So now let's talk about when you get to the point where you have to convert your RRSP into a RRIF. So what happens then? How do you start drawing down from a RRIF?

Lawrence: Yeah, so this is a point of a little bit of tension sometimes because for so long, you're adding funds, you're saving aggressively, you're doing all the right things, and then all of a sudden you have to start taking money out, and you're being taxed on it. There are different implications, right? So there's a change in mindset that has to be done when you convert your RRIF and when you're retired as a whole. So what happens is you make the conversion, and there is a percentage of the account that must be taken out each year. So there is a minimum RRIF payment that must be taken, and the formula is a certain percentage of the previous year's ending balance must be taken out in that current year. So for example, when you turn 71, the percentage you must take out is 5.28%. So 5.3%, 5.4% the following year. The important thing is that your RRIF payments are not stable like a pension, for example. Each year, the percentage that you have to take out of the RRIF increases with time as you age, and hopefully, your account balance goes up and your RRIF payment also increases with that increase of the account balance.

Marcelo: Yeah, I think the idea behind it is the percentage keeps increasing, right? So every year you're going to be taking more. And the idea for that is that if your account fluctuates because you're going to be taking more every year, it tries to add a level of stability to people's payments. So they may be different, more or less, but the idea is because you're withdrawing from a pile of funds, and the percentage is increasing every year of how much you're taking out, the idea is that as that pile starts decreasing, if you're not getting enough growth, you're going to get the same payment. Now, there is a lot of discussion that needs to be had into what's in the RRSP. That's not what we're doing here, right? We're not talking about where to invest in the RRSP, but the important distinction here, Lawrence, is that the payment will be based on the December 31st value. If on December 31st, your value of your RRIF is $500,000, it'll be a percentage of that $500,000, and it'll be locked in for the year. You're going to get that consistency of payments as you go.

Lawrence: Yeah. So on a year-by-year basis, you have some continuity, and you can bank on that cash flow coming in because at this point, generally, you're retired. You need a steady flow of income coming in to pay for your cash needs. That's a very important caveat, Marcelo. Thank you. So we'll use the example of a $500,000 RRSP that's being converted to a RRIF. So at age 71, you open the account. At age 72, you take your first payment.

Marcelo: It's $500,000, right?

Lawrence: Yes, correct. And you use a percentage of 5.4%. That's the required percentage that must come out at age 72, and that's $27,000 gross per year. Now, I emphasize gross because you are being taxed on this RRIF payment as regular income, and that's a very important distinction to our next conversation on planning around your RRIF conversion.

Marcelo: Yes, 100%. So that $27,000, you have the option. You can take a lump sum, you can take a quarterly payment, you can take a bi-yearly payment, you can take a monthly payment. So you have some flexibility. Across the range of clients that we have, I think the most common one is the monthly one, but I have seen some people who get the $27,000 upfront or they break it down into payments. I think that depends on how you manage your money, but it's definitely the flexibility is there.

Lawrence: Yeah, absolutely. We even see clients who don't necessarily need the cash flow and may opt to have that minimum payment come out. You must take that payment out, you get taxed, and you reinvest it in, for example, a non-registered account. So it's all depending on what your cash needs are in retirement.

Marcelo: Yeah, that's a good point. I think a lot of people will say, "Okay, at 65, if you have some other assets, right? If you have a non-registered account, a TFSA, maybe you have a pension from work, you may not need those assets." So you have the opportunity of taking it out. You'll still be taxed. There's no confusion here. And then you can reinvest it back into the portfolio. So that's a great point.

Lawrence: You've sheltered your assets long enough, and the Canadian government needs their tax dollars.

Marcelo: Taxes can only be deferred, right? Eventually, you'll pay taxes no matter what. You can defer them as long as you can with various strategies, but at the end of the day, at some point, you are going to have to pay your taxes.

Lawrence: Absolutely.

Marcelo: All right. So let's get into the weeds here of the mechanics of how you convert the RRIF. So there are a few things to know. Let's go through them right now.

Lawrence: Perfect. Yeah. So the first planning point that we're going to cover is basing the minimum payment on your spouse's age. So this works as a strategy. If your spouse is younger than you are, you could base your minimum payment on their age. The reason why I say that is since your minimum required payment is based on age, you could lessen the required payment by using your spouse's age and therefore pay less taxes on that payment.

Marcelo: Let's break that down into a very practical example. So let's say I'm turning 71 next year. I have to convert my RRIF at 72, I'll start taking it. So if I take it based on my age, Lawrence, that means that I'll be taking it at 5.4%, like we said before, right? But if my wife is 68, I can start taking it at 4.55%, which is based on the table that we're looking at here. So I still have to convert it at 71 and start getting paid at 72, but I can use my wife's age and therefore take a bit less on that RRIF, right?

Lawrence: Yeah, absolutely. And you're saving taxes that way. If you don't need that cash flow, if you need more money coming out to pay for your lifestyle, you must do it. But there are strategies in place to try to reduce the tax impact if you don't need it from the RRIF.

Marcelo: Okay, what about the taxes around that payment? How can we plan for that?

Lawrence: Yeah, so we've been dancing around the idea that the payments are taxable, you avoid that. But there's some planning techniques that you could put in place to make these things a little more palatable, a little smoother. Applying withholding tax would be one of them. So the rule is, if you take the minimum payment and you opt not to take a higher payment, you do not technically have to apply withholding tax. However, we would advise clients and the average person to deduct some amount of percentage of tax on those payments. So you receive in your bank account the net amount, the after-tax amount, so you know you could spend it. Because what would happen if you don't apply these taxes on your payments is the tax season comes around and you have this large tax bill by this new amount of income coming in and you have a tax bill to pay. It could be quite sizable depending on the size of your RRIF. Smoothing out the payments, receiving the net amount by applying a withholding tax percentage based on your tax rate is generally advisable for most people to help with budgeting and cash flow management.

Marcelo: So the withholding tax, you're essentially telling the government, "Retain some of this payment so I don't have to come back 12 months from now and pay you a lump sum of money." And that's important because even if you take the minimum, like you said, you're not going to get that withholding tax, but you may have other sources of income. You may be getting QPP and CPP, you may be getting OAS, you may have a pension, you may have other sources of income. So even if you're not getting that withholding, you may still be taxed at the end of the year. And I think a lot of people will prefer to prepay. But of course, there's some planning that needs to be done around this. You don't just throw a number out there and say, "Okay, I'm going to withhold 30%." I think some calculations need to be made and then say, "Okay, this is the amount I should be doing." Because at the end of the day, if you pay too much, you're going to end up getting money back. So the idea is that you end up at a net amount where you're neither paying nor getting back, right?

Lawrence: Yeah, and that's the important thing. You need to rely on this cash flow coming in. So if you're receiving the net amount, you could spend that money without thinking about, "Oh, I need to carve X amount out for April/May for my payment."

Marcelo: I think it's admirable when I see clients who get the lump sum at the beginning of the year because I think it's like a human behavior, right? If you have the money upfront, you'll spend it, and then you won't think about it, and it's too much temptation. So I think from a behavioral perspective, it's better to add some withholding and plan ahead than to get that sticker shock at the end of the tax season with a huge tax bill, right?

Lawrence: Absolutely.

Marcelo: All right. So you did a really cool scenario here. And I like this because I think that a lot of people will have the question, "Let's say you retire at 65. Do I convert my RRSP at 65? Do I wait? If you have any other sources of savings, you have a non-registered account, a TFSA, do you start taking from that and defer the RRIF until 72?" So it's one thing to say it, but you ran a nice projection, so we have the numbers and we know tangibly what's better. So why don't you run us through that, Lawrence?

Lawrence: Yeah, so to run that back, there's a lot of considerations that would factor into how you tackle your RRIF. For example, taking it at 65 if you're retired or deferring till you're required to at 71. You have to factor in things like your spending, your tax brackets, other sources of income, what other accounts you may have, your tax situation, what goals you may have—all these factor in. So we took a simulation. We're pretty nerdy over here. So we're always playing with these programs and algorithms and building models and asking ourselves questions to help you guys hopefully and make things a little clearer. So we ran a simulation. It's simplistic. It's not all-encompassing. Every person's profile is quite unique, so I want to add that caveat right off the front. So we took a single person. He's retiring at 65. He'll be spending $70,000 in retirement. This person has a portfolio of $1,000,000, of which $350,000 is non-registered, so taxable, $150,000 in a TFSA, and $500,000 in an RRSP. So they have their federal and provincial pensions coming in, and we have some expected returns for stocks and bonds, and we're forecasting that into the future. So how does it work?

Marcelo: But hold on. The $70,000, we have to say it's after tax, right? So it's $70,000 you're spending in your pocket. So that turns out to be about $5,800 a month. And what's the asset allocation you used on the portfolio? So you have the expected returns for fixed income, equity, and cash, but what is the asset allocation that you use?

Lawrence: So I use a 75/25 mix. That's 75% stocks, 25% bonds. And I tied a 1.55% expected return for bonds. That's after tax, after fees, and so on, and 5.5% for equities. Now, tying future expected returns to asset classes is not an easy thing to do. We think they're fairly reasonable and, to be frank, on the fairly conservative side of the spectrum, but we want to make sure...

Marcelo: Which is better.

Lawrence: Exactly. Things look very rosy in a retirement plan if you put these lofty expected returns. We want to make sure we're putting these models in a place where they're realistic and they don't over-promise things. So the idea here is to look at two scenarios. One in which the person is converting their RRSP to a RRIF at retirement at 65. So taking it before you need to do it versus taking from other accounts like a non-registered account, which is still taxable, to bridge that gap from 65 to 71. To keep things concise, the first model has the person taking from the non-registered account from age 65 to 71. So they're being taxed on it, but taxed more favorably, for example, than a RRIF as regular income, and then converting the RRIF at 71 and then taking the minimum payment from then on, in a mixture of other accounts for their other cash flow needs. So the second scenario is at retirement, the individual converts their RRSP to a RRIF and funds all of their lifestyle needs for the $70,000 net with only RRIF payments, and then from 71 taking only the minimum payment and mixing it with other accounts. So everything is being held equal. The only difference is, for one scenario, you're converting the RRIF earlier than you need to and taking from that account to fund your cash flow needs.

Marcelo: Which, by the way, a lot of people—like, this has happened before where I've had clients say, "You know what? Maybe it's better to start paying taxes earlier than letting the RRIF grow up to a point where I have to pay even more taxes, even if it's a lower marginal tax bracket." So the question does come up. People would say, "Maybe we'll do it at 65, and we'll just pay the taxes now, pay them over the years, and that way we'll end up paying less at the end." But as you're going to show us now, it's not as clear-cut, right?

Lawrence: Absolutely. So it's an important distinction. This is a straight-line example. Everyone's person has other circumstances in there. But the big takeaway here is, when I look at the impact of paying yourself at 65 to 71 with only RRIF payments versus taking from other accounts that may be more tax-efficient, the impact is quite striking. So if you project the impact of those six, seven years of earlier RRIF payments out into the future, the difference is $150,000 roughly of after-tax real-dollar future estate value. Now that's a mouthful.

Marcelo: Yes, break it down for us.

Lawrence: So what that means is, at the end of the projections at age 95, did this change make you better off or worse off? And in this scenario, by taking the RRIF payments at 65 and taking that to fund your lifestyle, you lost $150,000 of after-tax value. So your estate was lower as a result, meaning you were worse off.

Marcelo: Your beneficiaries will get $150,000 less, give or take.

Lawrence: Correct.

Marcelo: Okay. So that's a great example. And again, like you presented all the caveats because every person in every situation is different. So it's important that a lot of planning is done around this issue. So we just wanted to do something very basic to show people the tangible difference of what the deferral looks like and what impact it can have on their life at the end of the plan or at the end of the person's life when it comes to assets. So that's great. Okay. Anything else we're missing from the scenario?

Lawrence: No, so I think that covers it. I just think it's important again to reiterate that this was a simplistic example just to isolate the difference of making those decisions when you retire, right? So these are extremely important. There's tax implications, which is the main driver here. So you have to look at the overall scenario.

Marcelo: It's a great point because we always say here the importance of looking at these things on an ongoing basis. So one of the things that we do with our clients during the annual review is we're running all these projections. When that moment comes when the person retires, we're not going to be just thinking about this today, right? We've been thinking about this person's retirement for the last five, six, seven years. So we've been running these projections and having an idea of what the impact will be. So it is a huge thing to be mindful of how important planning is in all this, converting a RRIF, where the money's going to come from when you retire.

Lawrence: Absolutely. Absolutely. And while I was running these projections and we're forecasting the prototypical example of your retirement at 65, I asked myself, "What happens if you're still working at age 71?" Because people are extending their working years, maybe not working the same job you were working in your main earning years, but people are working longer and longer. This is an important question to ask yourself, so this does factor in. And there's a nice technique that we may use with clients and for the average Canadian as well. If you're still working at 71, you still must convert your RRSP to a RRIF. However, when you make that conversion, you lose any accumulated RRSP room. So an important planning note to take is, if you're in that situation, there's a strategy where you would optimize that room right before the conversion. So you would overfund your RRSP to take advantage of that available room the December before you make the conversion, and then you have that value in there. So you're only over-contributing for that one month, but you're optimizing that available RRSP room to be using your RRIF going forward.

Marcelo: So what that means, Lawrence, is let's say I'm working at 71, right? And I have to convert at 72. Like we know, that's the rule. So if I have, let's say, $15,000 of room in my RRSP that I haven't used, so I haven't maxed that room, I can take a lump sum of $15,000 and throw it into my RRSP before I convert, and I can use those deductions going forward, right? So if at 85, I have a big capital gain coming from a non-registered account, I can use some of those deductions. I can wait a few years. I don't have to take them the year I made the contribution.

Lawrence: Absolutely.

Marcelo: Yeah. So that is a smart thing because at the end of the day, if you leave that room unused, you may be leaving money on the table, and that's not good. All right. So before we wrap up here, the other thing I was thinking about as we were going through the episode is there are a few things to think about when it comes to the estate because whether you're in Quebec or in the rest of Canada, it will make a big difference. So we know in Quebec, everything when you die goes to the estate. If you have a notarized will and you're properly set up, then it won't be an issue. But in Quebec, you don't have to designate a beneficiary on the RRIF. So everything goes to the estate, and then the will is read and everything gets transferred in your estate settlement as it should. And then for the rest of Canada, it is very important to name a beneficiary because if you don't name a beneficiary on the RRIF, it'll go to probate. So probate is just like an extra cost in the rest of the provinces. It's based on a calculation based on your assets. But if you designate a beneficiary in your RRIF, it'll go straight to that beneficiary and it'll avoid probate. So that could save you costs at the end when you're doing your estate settlement if you're in the rest of Canada. So that's an important distinction.

Lawrence: That's a really useful tip for the rest of Canada, not so much for Quebec. Yeah, wow.

Marcelo: Talk about being different, right? Like we always have been.

Lawrence: Always the case.

Marcelo: All right, so what's your takeaway, Lawrence?

Lawrence: Yeah, we've alluded to it before, but I think the major takeaway is it's very important to have a firm understanding of these core concepts when you're in that point of transition in your life. Whether you're 65 or in your late 60s, early 70s, whatever you are, you have to understand your circumstances. And it's important to understand how the RRIF works and to plan around that. So these caveats and these planning items can't be used in a silo. You have to look at your overall circumstances, your overall needs. It's one piece of the puzzle for your retirement.

Marcelo: Yeah, and this is one of the things I agree 100%. Like you stole my thunder there. I love it. I agree 100%. A costly mistake in planning for your withdrawals and your cash flows when you're retired can be very damaging for a person's financial situation. So it is important to look at every single angle. Do you have pensions? Do you have rental income? Do you have money coming from an investment that you made? Do you have money coming in from a business or a Holdco or TFSA, non-registered? So all these things have to be integrated and planned 100%. So listen, thank you so much for doing this episode. You did the legwork here. You did a really great job in drawing all this research and the scenarios.

Lawrence: Happy to be back.

Marcelo: All right, so we'll see you in two weeks. Thanks, guys.

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