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Retirement Drawdown Choices

RRIF, TFSA and Non-registered Accounts

Executive Summary

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Canadian retirees often have investments in a Registered Retirement Income Fund (RRIF). They are required by income tax regulations to withdraw a minimum amount every year. They are permitted to withdraw more. But should they? Current taxes can be minimized by deferring RRIF withdrawals, but the long-term outcome depends on the taxes that will be paid in the future as well. The choice that will maximize future spendable funds depends on:

- the taxes they pay on a discretionary withdrawal in the current year;
- the taxes they will pay on investment income outside of a RRIF;
- the taxes they will pay in the future if funds are left in the RRIF; and
- the number of years until withdrawal is necessary.

Current tax rates and government benefit plans are known, but it is a challenge to assess the combined effect of the many income-tested benefits and tax credits. Other factors are unknown, since they depend on future returns on investments, longevity and other contingencies. Retirees are forced to make a choice without knowing for certain that a discretionary RRIF withdrawal will improve their long-term financial position.

In some cases, the choice will be clear while, in other cases, it will depend on individual priorities. Some individuals rely on their retirement savings to meet routine living expenses and will be swayed by the "ruin probability" (the chance of running out of money or being forced to reduce spending before they die). Others will focus on the expected value of their estate. By applying an actuarial model that captures and synthesizes the variability in investment returns and ages at death and the complexity of tax rates, we can shed light on both perspectives.

At the outset, it was intended that this research would determine if a manageable set of guidelines for financial planners who are called upon to advise clients on drawdown strategies could be articulated and outline what those "rules" would be. Once the full complexity of investment risks, longevity risks and Canada's morass of taxes, credits and income-tested benefits for seniors was taken into account, this research concluded that simple, single-scenario projections of the value of a drawdown strategy are unreliable and misleading.

Financial planners will need to continue to rely on a combination of professional judgment and financial models to guide their advice concerning drawdown strategies. It is often said that models should be as complicated as necessary, but no more so. By employing a complicated actuarial model to assess the drawdown decision problem, this research could help guide choices in model design. The research indicates that:

- consideration of sequence-of-returns risk in combination with the full range of potential ages at death can lead to different conclusions than analysis based on one or a small number of scenarios
- income-tested benefits that apply during an individual's lifetime but not to the taxation of an estate can sway decisions
- while the uneven pattern of effective tax rates contributes to some of the conclusions in this research, a perfect inventory of all the details of tax rates and jurisdictional differences may not be as important in models used to guide decisions
- accurate estimation of rates of investment return and sensitivity to variations in taxes based on different investment strategies, although important for other financial planning advice, may not be crucial to the choice of which type of investment account to draw down first

When RRIF withdrawals in excess of the minimum prescribed in the tax regulations (and in excess of the requirements for current spending) are invested in a non-registered account, taxes on non-registered investment income drag down any advantage attributable to tax brackets. Despite media stories highlighting opportunities to take advantage of differences in tax brackets, this research found that demonstrating added value can be quite difficult.

Different situations can give very different results. However, in general, the value of accelerated RRIF withdrawals may be overstated when an estimate of the average rate of return on investments is used without regard to variability. Advantages can disappear when investment returns are above average (because of extra taxes on non-registered investments) and when investment returns are below average (because the fund is exhausted before death and the anticipated high rates of taxation on estates never arise). In the analysis in this report, some opportunities that improve the average outcome come with increased risk of financial distress.

Accelerated RRIF withdrawals can also seem attractive for a couple, since tax rates are increased and government benefits are reduced after the death of a spouse. However, it is difficult to demonstrate that taking advantage of income splitting to avoid taxes on funds intended to support a surviving spouse will actually reduce the survivor's financial risk.

Added value from RRIF withdrawals is slightly easier to demonstrate when the excess withdrawals are used to fund Tax-Free Savings Account (TFSA) contributions, partly because taxes on investment income are avoided, but also because the Guaranteed Income Supplement (GIS) and other benefits targeting low-income seniors can offset the risk of below-average returns or an above-average payout period. This is clearly demonstrated in one case study. However, even with the apparent merits of a TFSA, a strategy of maximizing TFSA contributions in another case study fail to deliver the hoped-for results.

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