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Large RRSPs can mean huge tax burden

Bryan Borzykowski / April 18, 2008



(April 2008) It's likely that most advisors remind their clients at least once a year to contribute to an RRSP. But how many tell them to withdraw?

A new TriDelta Financial Partners report notes that many clients accumulate a tax bill of more than \$1 million between age 55 and when they die. Frank Wiginton, a CFP and senior financial partner at TriDelta, says the main reason that figure is so high is because people have been taught to save money in an RRSP but not to remove their cash.

"People need to be aware of the fact that they're going to die with all this money still left in an RRSP," he says. "Many people approaching retirement — they've been savers all their life. When they go into retirement, they don't increase their spending, they just reduce their lifestyle.

"What ends up happening is they die in their 80s and still have \$1 million in their RRSPs, and they get taxed at the highest rate," he explains.

Wiginton says getting a client to withdraw money from an RRSP earlier than later is one way to reduce the tax burden. They'll still have to pay tax when they take out the cash, but since the amount will be smaller, the bill won't be so large.

"The real significant thing here is that as we take it out of RRSPs, we're only taking it out dribble by dribble rather than taking out a big lump sum," he says. "We're not waiting until 72 to take out money; instead we're taking it out earlier so we can keep the tax rate much lower."

Jamie Golombek, vice-president of tax and estate planning at AIM Trimark, says this survey proves that tax planning has to focus on more than just what happens at death. "Taxes play a huge role when it comes to both retirement planning and estate planning," he says. "The message here is that tax planning is important throughout retirement instead of just worrying about it before."

He adds that while there is a benefit of leaving money in an RRSP — namely tax-deferred compounding — it might make sense to withdraw cash early. Specifically, if a man in his 50s or 60s is making less money annually because he's retired, he would pay less income tax and therefore less tax on an RRSP withdrawal.

But reducing an RRSP investment isn't the only way to blunt a tax burden. One strategy is to leverage a home's value for investment purposes. Doing this will give your client a tax credit on the interest, which can then be used against the RSP-related tax. "You're effectively drawing out money tax free," says Wiginton.

Another option is to invest in a tax-preferred investment vehicle, like a T-series fund. Clients can also set up a systematic withdrawal on their account, or build up a non-registered portfolio, which Golombek says is generally more tax efficient.

Donating to charity is another way to help clients get rid of excessive cash or stocks tax-free.

Having saved too much in an RRSP will likely be just a baby boomer problem — it's unlikely future generations will have the same tax planning issues. Sandy Cardy, vice-president, tax and estate planning services at Mackenzie Financial, says new savings methods, such as the tax-free savings account that was introduced in the 2008 federal budget, will help people save without worrying about incurring huge tax bills.

"Today we have more tools at our disposal," she says. "You can plan to lessen the liability. RRSPs will always be preferable in some respects due to upfront tax savings, but they can be used in conjunction with the TFSA going forward."

After a few years, when contribution room in the TFSA builds up, clients will be able to withdraw money from their RRSPs and move it into tax-free accounts. If they can cover the taxes related to the withdrawal through tax credits or another method, then they'll essentially never owe the government anything on those savings. "That's pretty significant," says Wiginton. "The money can be withdrawn tax free, even at death."

Pension splitting is another new tool that will help ease the tax hit. Starting last year, someone 65 or older can remove money from his or her RIFF and split it with a spouse. "It's really a wonderful opportunity," she says. "Particularly, where there is one high-income spouse and one who isn't."

"I think we've got a lot of people now well into senior years who are sitting with a huge amount in a RIFF, perhaps too much," adds Cardy. "Going forward, advisors will be able to plan better so that doesn't happen, because a lot of other alternatives are available."

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