

Mind your taxes in retirement

Executive summary

One indispensable element of a successful retirement income plan is achieving tax efficiencies, but how many of us are actually aware of how to do so? The more one can minimize taxes, the greater one's after-tax retirement income flow.

Managing taxes during one's working years, when employment income is the principal income source, tends to be focused on maximizing RRSP contributions and allocating investments strategically to attract the least tax possible on investment income for the current year. However, as we transition into retirement, the tax planning spotlight shifts to withdrawing assets in the most tax-efficient manner. There is also a need to be aware of the tax benefits and credits that do not apply until one reaches the age of 65.

To succeed in achieving tax efficiency in retirement, a mindset change may be required – the preoccupation with minimizing current year taxes will have to be substituted by the longer-term objective of maximizing after-tax income for the entire retirement period. This in turn requires a good understanding of how various income sources are taxed, a keen awareness of the tax brackets and threshold amounts for tax credits and making shrewd decisions as to allocation of investments, whether in terms of asset types or in terms of investment vehicles.

The BMO Retirement Institute was established in 2008 to provide thought-provoking insight and financial strategies for those individuals planning for, or currently in, their retirement years.

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Introduction

“The hardest thing in the world to understand is the income tax.”

— Albert Einstein

As the much publicized demographic phenomenon of the “tsunami” of baby boomers moving into retirement continues, retirement income planning has become one of the hottest topics in the financial world¹. There is mounting appreciation of how rising life expectancies, market volatility, constant inflation and unplanned-for expenses pose serious threats to the ability of many a retirement portfolio to last a lifetime. For some, the antidote is to tone down lifestyle expectations in retirement. For others, it is to amass as large a retirement nest egg as achievable. In effect, the former strategy focuses on trimming down the expense side of the equation, while the latter focuses on magnifying the asset side. Still others opt to postpone retirement, a strategy that is a bit of both – boosting the number of income-producing years and shrinking the number of spending years at the same time. There is a further strategy – one that more people should be paying attention to – a strategy that focuses on achieving tax efficiency.

The tax efficiency strategy is a variation of the expense reduction approach. Often, when asked what their major expenses in retirement will be, the instant response of most people will be food, shelter and lifestyle expenses (such as travel and entertainment). It may not be readily apparent that, even in retirement, taxes can (still!) be one of the biggest expenses.

In order to better understand how Canadians finance their retirement lifestyle and in particular the tax planning approach they take, the BMO Retirement Institute recently commissioned a survey of Canadians aged 45 and over. Survey respondents include a comparable number of people who are already retired and those who are not yet retired².

One of the most commonly used tax planning strategies employed by Canadian baby boomers – whether in retirement or not – is to allocate assets efficiently among registered and non-registered assets. For those in retirement, especially those in the middle to higher income echelons, withdrawals from registered assets represent a significant source of retirement income. Since the entire amount of such a withdrawal constitutes taxable income, managing withdrawals in a tax-efficient manner will have a positive impact on after-tax income.

In this report, the Institute takes a closer look at these two important issues in retirement income planning.

Eligible dividend income can be a double-edged sword for a person who is 65 years or older

Tax-efficient allocation of Assets

All investment incomes are not taxed the same way

Tax-efficient allocation of assets is crucial in tax planning because not all investment incomes are equal on an after-tax basis. Interest income, dividend income and capital gains are all taxed differently, so it is possible to create tax efficiencies by astutely structuring one's asset mix. As a general rule, this entails allocating assets which generate income that are the most unfavourably taxed (i.e. interest income) in tax-sheltered investment vehicles (i.e. RRSP or TFSA) where possible, while leaving investments that generate returns that receive more favourable tax treatment (i.e. dividend or capital gain) in taxable accounts.

The efficacy of this strategy continues from working life into retirement, with one caveat. Eligible dividend income³, which is normally considered to be a tax-efficient type of income, can be a double-edged sword for a person who is 65 years or older who is in receipt of the Old Age Security (OAS).

Eligible dividend income: friend or foe?

Eligible dividend income is taxed in a unique way: for tax purposes, the actual amount of eligible dividend received by the taxpayer is grossed-up by a prescribed percentage⁴ and then included as income; but then dividend tax credits (available at the federal⁵ as well as provincial level) are applied to reduce tax payable. For taxpayers in the lower tax brackets, the outcome can be a very low (in some cases, even negative) effective tax rate; and for taxpayers in the top tax bracket, eligible dividend incurs a lower rate of tax than capital gains in some Canadian jurisdictions.

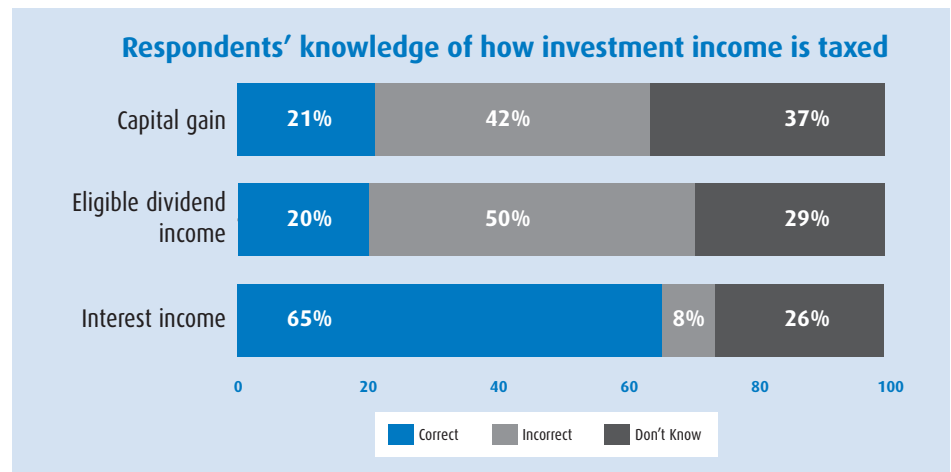
For OAS recipients, however, caution is required. The OAS is a federal government pension that is paid to Canadian residents based on age and residency eligibility. It is income-tested; so one can lose all or part of one's entitlement where net income surpasses a certain level, through a mechanism known as the "OAS clawback"⁶. The connection between eligible dividend income and the OAS clawback lies in the way that the income is grossed-up, effectively amplifying net income, which happens to be the yardstick that determines whether OAS benefit is clawed back or not. As the example in the Appendix demonstrates, although there is still a "dividend advantage" when it comes to taxes in retirement, the advantage is less pronounced in the case where the OAS and age credit clawbacks apply.

Failing the test

What this means is that OAS recipients whose net income level is at the cusp of the OAS clawback threshold need to have a good under-

standing of their own tax brackets as well as the way in which the various investment incomes are taxed, if they do not want to lose their OAS benefit unexpectedly.

Our survey result⁷ demonstrates, however, that while there is a reasonably good understanding of how interest income is taxed, when it comes to the tax effect of receiving dividend income and realizing a capital gain, the majority of respondents gave the wrong answer or didn't know the answer. With respect to dividend income, only 20% of respondents were able to single out the right answer, a stunning 50% selected the wrong one, and 29% had no idea. Knowledge in relation to capital gain is not much better.



The relatively depressed level of knowledge displayed by Canadian retirees and pre-retirees in relation to taxation of the different types of investment incomes throws doubt on how effectively they can apply their preferred tax strategy of “allocating my money wisely between registered and taxable (non-registered) accounts.”

Tax-efficient withdrawal of RRIF assets

We will now examine how Canadian retirees and pre-retirees plan their RRIF withdrawals, but first some background as to how the various sources of retirement income for Canadians are taxed, and a quick look at some of the tax benefits that are exclusively available to seniors.

Major sources of retirement income for Canadians and how they are taxed

One of the questions posed to our survey respondents was the major sources of their retirement income. As expected, public and private pension plans (i.e. Canada Pension Plan (CPP) / Quebec Pension Plan (QPP), OAS and employer pension plans), RRSPs and RRIFs are the most frequently cited sources.

All these retirement incomes are taxed in a way similar to the employment income that most people receive during their work life - the full amount constitutes taxable income, and is taxed at your marginal tax rate. Tax planning opportunities in relation to these income sources are limited, and are predominantly restricted to couples:

- With the CPP/QPP, pension sharing with a spouse or common-law partner is possible.
- With employer pension plans and registered plans⁸, a joint election to split pension income may facilitate income splitting with a lower-income spouse or common-law partner⁹.
- Additionally, with registered plans, it is possible to defer taxes by deferring conversion to their maturity options until the latest possible time (age 71); but once funds are in a RRIF, LIF or LRIF, the prescribed annual minimum withdrawal requirement ensures that the plan holder will have income to report every year.

Aging has its advantages (with conditions)

Individuals aged 65 and over enjoy some tax breaks that were not available to them before. Prominent among them are the age tax credit and the pension income credit.

Certain additional conditions, however, must be satisfied before laying claim to these tax credits.

The pension income credit applies only to certain eligible pension income, so the trick is to ensure that one receives those types of income. For individuals who do not benefit from a private pension plan, it is possible to create an eligible pension income by converting a registered plan to its maturity option at age 65. We will elaborate on this a little further in a subsequent section.

The age tax credit, on the other hand, is income-tested, so individuals at higher income levels may find their entire amount clawed back¹⁰. An individual who has accumulated a sizable RRIF may find their entitlement to the age credit jeopardized due to the effect of the RRIF income on their income level. As an example, an individual who has a RRIF valued at \$750,000 would be required, at age 72, to withdraw the minimum amount of \$56,100 (since the minimal withdrawal percentage at age 72 is 7.48%). Assuming he/she also collects the maximum OAS and CPP/QPP¹¹, the individual already has an income of \$74,076. At this income level, the age tax credit has almost disappeared, some OAS has been clawed back, and in some Canadian jurisdictions, he/she is already in the highest provincial tax bracket (based on 2011 figures).

Traditional approach to RRIF withdrawals: defer, defer, defer...

We have alluded to the possibility that a large registered asset base may produce negative tax impact for retirees. Yet the conventional mentality is to avoid (1) taking RRIF withdrawals early or (2) taking more than is legally mandated. Much of this can be traced back to the deeply ingrained mindset that tax deferral is always good.

The progressive tax system in Canada denotes that the higher your income level, the more tax you pay on an additional dollar of income. Individuals who enjoy relatively high pre-retirement earnings therefore often assume that they will be paying taxes at a much lower rate once they are retired and no longer have an employment paycheque. With this notion in mind, their cherished tax planning approach is to defer taxes as much as possible, in anticipation that when taxes eventually have to be paid, they will be at a much lower rate. The application of this approach in relation to the RRSP and RRIF typically involves:

- Maximizing contributions to the RRSP while working (to get full advantage of the tax deduction).
- Leaving the RRSP investment untouched for as long as possible (to get the most out of the tax-sheltered investment growth).
- Delaying conversion from the RRSP to the RRIF until the last possible moment (i.e. the year one reaches age 71).
- When required to make withdrawals from the RRIF, taking out as little as possible (to minimize the amount of tax payable). This means taking out no more than the legally prescribed minimum payment; and for those who have younger spouses or common-law partners, an additional tactic is to use the age of the younger spouse or common-law partner to calculate the annual minimum payment so as to result in a lower minimum amount.
- When extra funds are required to pay for unexpected expenses (such as replacing a car, taking a once-in-lifetime vacation, etc.), the preference is to withdraw from one's non-registered savings¹².

The end result of this approach is frequently a very sizeable RRIF in later life. Since RRIF minimum withdrawal amounts are calculated by reference to age and account size, by the time the RRIF annuitant starts withdrawing, the minimum withdrawal amount alone can create a substantial taxable income, thrusting the annuitant into a higher tax bracket, and placing various income-tested tax benefits and credits at risk.

Rethinking RRIF withdrawal strategy

In recent years, greater awareness of the concept of marginal effec-

tive tax rate (METR)¹³ has engendered increasing scepticism as to the merits of the traditional approach to RRIF withdrawals described above. The arrival in 2009 of the Tax-Free Savings Account (TFSA) has further intensified the debate.

Is it always better to minimize current year taxes?

As previously mentioned, the traditional approach is deeply rooted in the conviction that it is always better to pay taxes later rather than now, a view which is bolstered by the belief that one moves in retirement to lower tax brackets than when working. In reality, this is not invariably the case – over a quarter of the retirees in our survey reported that, post-retirement, they are in tax brackets that are either the same or even higher than prior to retirement.

OAS recipients who possess sizable RRIF accounts may find themselves losing their benefit due to the elevated level of their income. To avoid this happening, one option they may consider is to rein in the size of their RRSP/RRIF. This can be achieved in the following manners:

- **Converting an RRSP to a RRIF before age 71.** For many people, RRIF conversion at age 65 also has additional perks: RRIF income received at or after age 65 not only qualifies for the pension income tax credit, but is also eligible for the joint election to split pension income with a lower-income spouse/common-law partner. The result can be a much reduced overall household tax bill.
- **Taking out more than the legal minimum from a RRIF.** People who retire early or choose to transition into retirement by gradually reducing work hours will likely be at lower income levels than when they were engaged in full-time work, especially before they qualify for government pensions such as OAS and CPP/QPP. Rather than basking in very low tax brackets for a few years and then getting a rude shock later when RRIF income and government pensions combine to propel their income level to much higher tax brackets, it may be worthwhile paying a little bit more taxes today to avoid a much higher tax bill and clawback of income-tested benefits in future. Needless to say, to successfully employ such a strategy – often referred to as “topping up to bracket” - one needs to be familiar with key tax brackets.

Federal personal income tax rates and bracket for 2011	
Tax Rates	Tax Brackets
15%	Up to \$41,544
22%	\$41,545 – 83,088
26%	\$83,089 – 128,800
29%	\$128,801 and over

“I want to keep the money tax-sheltered for as long as possible”

As an example, individuals who retire early and are currently in the lowest tax bracket (for instance, because their OAS and CPP/QPP benefits have not yet started) will be paying federal taxes at 15% up to \$41,544. For them, it may make sense to withdraw an amount from their RRIF that allows them to take full advantage of their lower tax rate without moving to the next tax bracket. If that means more income than needed, the excess can be reinvested into a TFSA or a non-registered account. Otherwise, the RRIF may grow to such a size that, by age 65, the RRIF minimum withdrawal together with OAS and CPP/QPP will thrust them into the next tax bracket.

Admittedly, the idea of paying more taxes than necessary now is counter-intuitive, but depending on individual circumstances, it may actually produce a better tax result over the long term. In other words, one needs to focus on maximizing one's lifetime after-tax income rather than on the more immediate, narrower objective of minimizing current year's taxes. If our survey result is any indication, while minimizing current year's taxes is still the tax planning approach adopted by the majority of the retirees who are engaged in tax planning, more than 40% have already embraced the broader concept of maximizing after-tax retirement income¹⁴.

Give me (tax) shelter! Enter the TFSA

Apart from the preoccupation with current year's taxes, there is one other powerful incentive behind the proclivity to minimize RRIF withdrawals: the desire to take full advantage of the tax-sheltered treatment within registered accounts. Moreover, once money is withdrawn from an RRSP/RRIF¹⁵, the contribution room is lost permanently. Fifty-two percent of survey respondents who are younger than 71 and who intend to wait until age 71 to convert their RRSPs into RRIFs cited “I want to keep the money tax-sheltered for as long as possible” as their reason for waiting.

This would indeed be a compelling argument at the time when the RRSP (and the RRIF) was virtually the only vehicle that enabled an investor to receive investment income tax-free. But there has been a change of scenery since 2009 – the TFSA now provides Canadians with an alternative way to earn investment income tax-free.

Investments inside a TFSA are indeed truly tax-free rather than just tax-deferred, since there is no tax impact at the time of withdrawal (unlike RRSP and RRIF withdrawals that are fully subject to tax). The TFSA also displays two unique characteristics that evade the RRSP:

- TFSA contribution room regenerates itself via the re-contribution mechanism.

In time, the TFSA will undoubtedly emerge as a potent source of retirement income

- The TFSA has no upper age limit for contributions, making it the ideal tax-sheltered investment tool for seniors who have no RRSP contribution room.

For seniors with a large RRIF who loathe giving up the tax-sheltered treatment of their assets, one possible strategy is to redirect funds out of the RRIF every year into a TFSA (subject to availability of TFSA contribution room) where the tax-sheltering continues. It is a “short-term pain for long-term gain” situation: the RRIF withdrawal will constitute taxable income in the year of withdrawal, but once the funds are in a TFSA, the investment earnings continue to grow tax-free, and better yet, when the funds are later withdrawn from the TFSA for whatever reason, no taxes are payable. Effectively, this transforms tax-deferred money into tax-free money.

Given that the TFSA only began its existence two years ago and that TFSA contribution room is at the relatively low level of \$5,000¹⁶, the extent to which existing retirees rely upon the TFSA as a current source of retirement income is limited. For them, the TFSA is most valuable as a tax-shelter for investment income and as a means to accumulate a tax-free source of income for the future¹⁷. However, for those who are just starting to build their retirement nest egg, the TFSA can turn out to be a significant source of retirement income. For example, a person who turned 18 in 2009 (when the TFSA was born), will have accrued total TFSA contribution room of \$240,000 by age 65, ignoring the effects of indexation. Assuming he/she started contributing \$5,000 to his/her TFSA at age 18, continues to do so every year without fail, and leaves the money untouched until age 65. At an average annual return rate of 5%, the investor will have approximately \$900,000 in his/her TFSA by age 65.

Canadians seem to have grasped the benefits of the TFSA as a tax-free income source: almost 70% of the survey respondents who own a TFSA cited that as their main reason to open a TFSA; and 30% of the pre-retirees indicated that maximizing a TFSA is one of the current strategies they are using in planning for retirement. In time, the TFSA will undoubtedly emerge as a source of retirement income for Canadians as potent as the RRSP¹⁸.

The knowledge gap

It should be apparent that the more dependent you are on your own resources for your retirement income, the greater the importance of tax efficiency in your planning, and the more sophisticated you need to be in terms of tax knowledge in order to succeed in your planning¹⁹.

After all, if government pensions are your major retirement incomes, your chief tax planning concerns probably revolve around preserving eligibility to income-tested benefits and making full use of CPP/

QPP sharing (where applicable). Likewise, if your retirement income staple is an employer pension plan, your most trusted ally in tax planning would be pension income splitting (again where applicable).

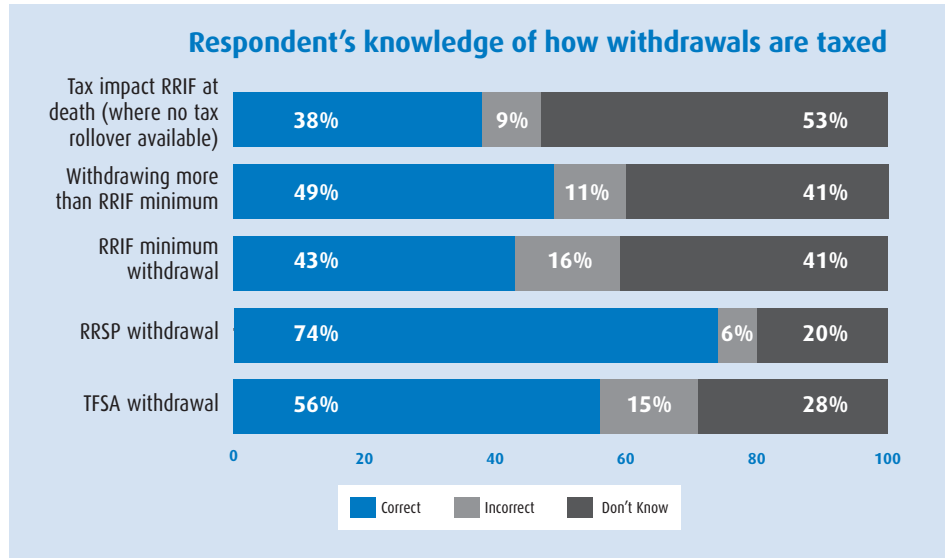
But where you rely heavily on withdrawals from your RRIF, TFSA and/or non-registered investments as retirement income sources, you have many more decisions to make:

- Which account to put my retirement savings into: maximize RRSP, TFSA or non-registered contributions?
- How should I allocate fixed income investments and equity investments among the different accounts?
- When choosing investments, should I prefer those yielding interest, dividend or capital gains?
- When is my RRSP too big? Should I stop contributing to it and forgo the tax deduction, redirecting funds to my TFSA or my non-registered account instead?
- When to convert my RRSP to a RRIF: wait till the last possible moment, or do it earlier to take advantage of the pension income tax credit and pension income splitting?
- Should I use my younger spouse's age to calculate the RRIF minimum?
- Should I make more than the minimum withdrawals from my RRIF, especially in years before my OAS and CPP payments start to come in?
- If I need extra money in a particular year (for a once-in-a-lifetime trip, or to replace my car), where should I take the money from – my RRIF, my TFSA or my non-registered account?
- And so on, and so forth ...

There is no one right answer since everyone's circumstances are different. The age at which you plan to retire, the mode of transition you will take (moving straight from full-time work to full retirement, or gliding from full-time to part-time work and then to full retirement), your desired retirement income level, your other regular income sources, the financial circumstances of your spouse or partner... all these factors will affect your decision.

But one thing is clear: to properly apply a tax-efficient strategy, a good knowledge of how the various types of incomes are taxed is essential. We have already seen earlier that the vast majority of Canadian retirees and pre-retirees have a surprisingly murky idea of how various investment incomes are taxed. As the following chart demonstrates, their level of knowledge when it comes to TFSAs, and especially registered accounts, is equally unimpressive²⁰.

Half the respondents have no idea of the potentially severe tax impact of death on registered accounts



Although more than half of the respondents were able to identify the tax effect of a TFSA withdrawal, more than a quarter of them also professed to be ignorant.

When it comes to registered accounts, while there is a decent understanding of the tax effect of an RRSP withdrawal, far fewer people recognize the correct tax effect of withdrawals from its maturity option, the RRIF. Considering that all the respondents are 45 years or over and therefore should at least be taking the initial steps towards retirement planning, the fact that over 41% of them are unable to answer the question is not encouraging.

From an estate planning perspective, it is also interesting to note that more than half the respondents have no idea of the potentially severe tax impact of death on registered accounts (in the absence of tax rollovers). It is hard not to speculate that this is at least one contributing explanation behind the continued aversion to depleting RRIFs at a faster pace²¹.

Making sense of (1-t)

As defined benefit pension coverage dwindles, Canadians, especially those who expect to be at the higher income echelons, will find that their core financial resource in retirement will be their own investments. For them, the role of tax efficiency in retirement planning should not be overlooked: paying less tax translates into keeping more after-tax income; keeping more after-tax income makes it possible to aim for a lower pre-tax income goal; and aiming for a less ambitious pre-tax income goal permits one to take less investment risk.

In order for them to succeed in achieving tax-efficiency in retirement, they must not lose sight of the fact that the actual income they keep from the funds they withdraw is not the full amount but only

the after-tax amount represented by $(1-t)^{22}$, t being the taxes paid to the government.

This understanding should also influence the way they structure their asset allocation. Rather than looking upon \$1 in a registered account as the equivalent of \$1 in a non-registered account or TFSA, they need to perceive that they do not in reality own 100% of the funds in tax-deferred accounts such as the RRIF. What they own is $(1-t)$; the balance belongs to the Canada Revenue Agency, which will claim its share when money is withdrawn or when they die (unless a tax-free rollover applies). Appreciation of the after-tax value of their investments should make them look at asset allocation among their taxable, tax-deferred and tax-free portfolios a little differently²³.

Conclusion

Canadian retirees and pre-retirees generally recognize the important role that tax planning plays in retirement income planning²⁴. They do however need to address a knowledge gap when it comes to tax planning in action. Understanding taxes is not easy, but it is certainly a worthwhile exercise: the reward is tax efficiency, a better after-tax income and a better lifestyle.

For retirees in particular, tax efficiency will not happen by accident. It entails taking a longer-term vision that extends beyond minimizing the current year's taxes. It requires familiarity with tax brackets and the common threshold levels at which income-tested benefits start disappearing. It is also a result of astute advance planning with an eye to creating flexibility - retirement tax planning will be much less arduous where one's retirement nest egg is comprised of different types of accounts (RRIFs, TFSAs and non-registered assets) that have varied tax effects rather than one jumbo sized RRIF.

To transform achieving tax efficiency in retirement from an aspiration to reality, Canadians need to develop a solid understanding of the impact of taxes on their finances and make the right decisions relating to allocation of their assets well in advance.

- 1 To read more about retirement income planning, please refer to the February 2011 edition of the BMO Retirement Institute report "Retirement income planning: Can we have our cake and eat it too?"
- 2 The BMO Retirement Institute Survey (August 30, 2011) was conducted by Harris/Decima from August 10th to 22nd, 2011, Canadians age 45+ who were pre-retirement (n=499) and post-retirement (n= 54) were surveyed using Harris/Decima's online panel.
- 3 Eligible dividends refer to dividends received by individuals from Canadian public corporations and Canadian-controlled private corporations paid out of business income that has been taxed at the high corporate tax rate.
- 4 For the year 2011, the gross-up percentage for the purpose of the federal dividend tax credit is 41%.
- 5 For the year 2011, the federal dividend tax credit is 16.44% of the grossed-up dividend amount.
- 6 For the year 2011, higher-income taxpayers whose income exceeds \$67,668 will start to feel the effect of the OAS clawback; the entire OAS benefit will be clawed back for those whose income attains \$110,123.
- 7 The actual question posed to the survey respondents was "How do you think taxes are applied in each scenario below". The relevant scenarios here are "A person receives interest income from a GIC in their investment (non-registered) portfolio", "A person receives dividend income from a Canadian stock in their investment (non-registered) portfolio", and "A person realizes a capital gain by selling U.S. stock in their investment (non-registered) portfolio".
- 8 Registered plans include regular RRSPs, locked-in RRSPs and locked-in retirement accounts (LIRA), and their maturity options, the RRIF, LIF, LRIF and PRRIF.
- 9 For RRIF income to be eligible for the joint election to split pension income treatment, the recipient of the RRIF income must be at least 65 years old.
- 10 The age tax credit is a non-refundable personal tax credit that is calculated by multiplying the dollar amount by the lowest tax rate percentage. Both the federal government and the provinces and territories offer this credit to people 65 years or older. However, this credit is income-tested, which means that it will be clawed back once your income attains the threshold level, and is completely eliminated when a more elevated income level is reached. For the purpose of calculating the federal age tax credit, for instance, the 2011 dollar amount is \$6,537, so a person who is entitled to the full age tax credit will benefit from a tax credit of \$980. However, it will start to phase out once your income reaches \$32,961, and will totally disappear when your income exceeds \$76,541.
- 11 For October 2011, OAS monthly maximum is \$537.97 while CPP monthly maximum (at age 65) is \$960.
- 12 When asked which account they would withdraw from to finance a large, one-time expense (such as buying a car, taking a vacation, etc.), 44% of the survey respondents opted for Savings/Investment accounts (Non-registered); 13% selected TFSA; only 5% chose RRSP and 1% chose RRIF.
- 13 The METR differs from the marginal tax rate (MTR) in that it takes into account not just the income thresholds and statutory rates of the personal income tax system, but also the impact of certain tax deductions and credits and income-tested federal and provincial benefits.
- 14 Out of a total of 540 retirees who are actively engaged in tax planning, 57% characterized their approach as "minimizing this year's taxes" while 43% characterized their approach as "maximizing after-tax retirement income".
- 15 Other than pursuant to the Home Buyers Plan or the Lifelong Learning Plan.
- 16 The \$5,000 TFSA dollar contribution limit is indexed based on the inflation rate. The indexed amount will be rounded to the nearest \$500.
- 17 And for those who would like to leave a financial legacy to their heirs, the TFSA can play a useful role.
- 18 Indeed, for certain people, specifically those who expect to be at a higher tax bracket during retirement than before retirement, the TFSA is an even better retirement savings tool than the RRSP. See *Saver's Choice: Comparing the Marginal Effective Tax Burdens on RRSPs and TFSAs* – Alexandre Laurin and Finn Poschmann (C.D. Howe Institute January 2010).
- 19 Our survey results show a correlation between income and the perception of the importance of tax management: respondents whose income level is \$100,000 or more are far more likely to see tax management as an important issue when planning financially for retirement.
- 20 The actual question posed to the survey respondents was "How do you think taxes are applied in each scenario below". The relevant scenarios here are "A person withdraws a sum from their TFSA to buy a car", "A person withdraws a sum from their RRSP to buy a car", "A person withdraws the annual minimum payment from their RRIF", "A person withdraws a sum over and above the annual minimum payment from their RRIF", and "A person with no spouse or children who owns a RRIF worth \$500,000 passes away".
- 21 Although 43% of retirees who are at least somewhat actively engaged in tax planning profess to espouse maximizing after-tax retirement income rather than minimizing current year taxes as their tax planning approach, a mere 5% actually engaged in transferring funds from RRIF to TFSA every year as their strategy, and an even more puny 4% subscribed to the notion of "taking out more than I need from my RRIF in order to lower my taxes in the future".
- 22 We are indebted to the article *Withdrawal strategies to make your nest egg last longer* by William Reichenstein (AAIJ Journal, November 2006) for this formula expression.
- 23 *After-tax asset allocation* – William Reichenstein (Financial Analysts Journal, July/August 2006)
- 24 64% of the survey respondents who are retired reported that tax planning was a consideration when they planned for retirement; and 84% of the survey respondents who are not yet retired reported that tax planning would be a consideration when they plan for retirement.

Appendix

The following table compares the after-tax cash flow of David, an individual whose before-tax income is the same (\$66,000), in various scenarios. The individual is assumed to be a single person¹ and an Ontario resident.

Scenarios	1	2	3	4	5	6
	At age 60 (while working)		At age 65 (retired)			
Income sources	Salary &		RRIF &		RRIF + TFSA &	
	Interest	Dividend	Interest	Dividend	Interest	Dividend
Salary	\$45,000	\$45,000	n/a	n/a	n/a	n/a
OAS	n/a	n/a	\$6,000	\$6,000	\$6,000	\$6,000
CPP	n/a	n/a	\$10,000	\$10,000	\$10,000	\$10,000
RRIF income	n/a	n/a	\$29,000	\$29,000	\$24,000	\$24,000
TFSA income	n/a	n/a	n/a	n/a	\$5,000	\$5,000
Non-registered Interest income	\$21,000	n/a	\$21,000	n/a	\$21,000	n/a
Non-registered dividend income	n/a	\$21,000	n/a	\$21,000	n/a	\$21,000
Total income received	\$66,000	\$66,000	\$66,000	\$66,000	\$66,000	\$66,000
OAS clawback	n/a	n/a	\$0	\$1,276	\$0	\$526
Total taxable income ²	\$66,000	\$75,240	\$66,000	\$73,964	\$61,000	\$69,714
Age amount	n/a	n/a	\$1,422	\$227	\$2,172	\$865
Tax payable ³	\$16,844	\$12,522	\$14,186	\$10,901	\$12,511	\$8,582
After-tax cash flow	\$49,156	\$53,478	\$51,814	\$55,099	\$53,489	\$57,418
Tax payable as a percentage of income received	25.52%	18.97%	21.49%	16.52%	18.96%	13.00%
The dividend advantage	6.55%		4.98%		5.95%	

1. Couples will have more planning opportunities, since pension income splitting applies to RRIF income at or over age 65.
2. Total taxable income is arrived at by adding all the incomes (including the grossed-up dividend income) and deducting any OAS amount that is clawed back.
3. Tax calculation, performed in the Taxtips.ca Canadian Income Tax Calculator 2010, takes into account CPP/EI premiums, pension credits and clawbacks.

Scenarios 1 and 2

David is still working, so most of his income is from employment. However, he also has investment income from his non-registered savings. In Scenario 1, he places all his non-registered investments into interest-bearing vehicles, generating \$21,000 of interest income; in Scenario 2, he places all his non-registered investments into dividend-producing equity investments, generating \$21,000 of eligible dividend income.

As can be seen from the results, there is a clear dividend advantage, in that the dividend income investor's taxes are well over \$4,000 less than the fixed income investor.

Scenarios 3 and 4

David is now retired, and is receiving OAS as well as CPP. To supplement his retirement income, he makes withdrawals from his RRIF to bring his total cash inflow to \$66,000.

Although the dividend income investor still has a tax advantage over the fixed income investor, the dividend advantage has narrowed, mainly as a result of the OAS clawback and the almost complete loss of the age amount credit.

Scenarios 5 and 6

These scenarios illustrate the benefits of generating part of your retirement income from a TFSA.

The only difference from Scenarios 3 and 4 is that David withdraws \$24,000 instead of \$29,000 from his RRIF, taking the remaining \$5,000 from his TFSA.

For the dividend income investor in particular, the fact that the TFSA income is tax-free gives him more flexibility and enables him to keep more of his OAS and benefit from the age amount to a greater extent.

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