FINANCIAL FACELIFT

How can Patrick, 61, and Ted, 60, successfully blend their finances?

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Patrick and Ted, in Toronto, on April 9. Short-term, their goals include a major home renovation, international travel, and eventually replacing their car.

COLE BURSTON/THE GLOBE AND MAIL

Patrick, 61, and Ted, 60, became a couple later in life. They have no dependents and live mortgage-free in a Toronto condo valued at $850,000.

“Now that we are both retired, it seems a good idea to integrate our finances,” Patrick writes in an e-mail. They’d like to know “how best to maximize our respective savings into joint ones and minimize the tax implications.”

Patrick receives a defined benefit pension of $89,000 per year. Ted has no pension but has substantial investment savings. Their joint retirement spending goal is $122,700 per year after tax, adjusted for inflation.

Short-term, their goals include a major home renovation ($25,000), international travel ($10,000 for one big trip and $5,000 for one or two smaller trips annually), and eventually replacing their car ($40,000).

We asked Andrea Thompson, a certified financial planner and founder of advice-only financial-planning firm Modern Cents of Toronto, to look at Patrick and Ted’s situation.

What the Expert Says

Patrick and Ted’s retirement goals are to balance cash flow needs, tax efficiency and asset longevity, Ms. Thompson says.

Currently, Patrick’s pension covers the majority of their expenses. “To make up the shortfall, Ted is advised to convert his RRSP to a registered retirement income fund (RRIF) now and begin withdrawals of about $65,000 annually, drawn monthly. Because the withdrawal will exceed the minimum RRIF threshold, Ted will have to have taxes withheld at his financial institution,” the planner says. Patrick, who does not require immediate access to his RRSP, should convert it to a RRIF by age 71, the latest age permitted under tax rules.

Both Patrick and Ted are advised to delay taking their Canada Pension Plan (CPP) and Old Age Security (OAS) benefits until age 70 rather than starting at 65. “By waiting until 70, they will receive significantly larger monthly benefits that are indexed to inflation for life.”

At age 70, Patrick will receive $1,977 per month ($23,724 annually) and Ted will receive $1,793 per month ($21,516 annually). This strategy provides a combined additional income of over $45,000 annually starting in 2035 “and significantly enhances the sustainability of their retirement income.”

Delaying government benefits and drawing from registered assets early helps manage their taxable income and avoid the OAS clawback, which begins when individual net income exceeds $93,454 (the 2025 threshold), Ms. Thompson says. “This strategy spreads their tax liability more evenly across retirement and prevents large mandatory RRIF withdrawals later in life from pushing them into higher tax brackets.”

The tax-free savings accounts remain untouched through their early retirement years, and can be used to fund Patrick and Ted’s lump-sum expenses, such as car replacement, home modifications or unexpected larger-scale items, the planner says. “This will be beneficial as TFSA withdrawals are tax free and would not cause any issues with respect to increased taxation or OAS clawback,” she adds. Any surplus income generated from RRIF withdrawals after Patrick converts his RRSP to a RRIF can be reinvested into their TFSAs to maximize tax-free growth opportunities for the long term.

“I would only recommend continuing TFSA contributions if there was cash on hand that is readily available,” she adds. “Because they will be withdrawing from Ted’s RRIF to sustain income, I would not recommend withdrawing more from the RRIF in order to make TFSA contributions.”

To maximize income and minimize taxes, Patrick and Ted will rely on Patrick’s defined benefit pension as a base layer of income and supplement it with carefully managed RRIF withdrawals, Ms. Thompson says. “During the years prior to receiving CPP and OAS, Ted will draw from his RRIF to top up their cash flow needs,” the planner says. These early RRIF withdrawals reduce the size of his RRIF before mandatory minimums begin at age 71, which helps prevent future large withdrawals that could trigger higher marginal tax rates or clawbacks of OAS benefits.

Patrick’s defined benefit pension plan income can be split for income tax purposes with Ted now, Ms. Thompson says. After both Patrick and Ted turn 65, they will become eligible to income-split RRIF withdrawals. Pension income splitting allows up to 50 per cent of eligible income to be reported by the lower-income spouse, effectively equalizing taxable income between them and reducing their overall household tax liability, the planner says.

“Because Patrick has a sizable pension and Ted has no pension income, income splitting helps prevent Patrick’s taxable income from exceeding thresholds that could trigger OAS clawbacks or loss of other age-related tax credits,” she adds.

In the later retirement years, the TFSAs will become a valuable tool. TFSA withdrawals are non-taxable and do not affect eligibility for government benefits. By preserving TFSA balances for as long as possible and using them strategically to top-up income in higher-spending years or to supplement income in years with unexpected needs, Patrick and Ted can maintain flexibility and protect against tax bracket creep, Ms. Thompson says.

Next, she looks at their investments. “Because Ted’s RRSP is 100 per cent in U.S. and Canadian stocks, he is subject to sequence of return risk,” the planner says, “and with volatility being a current reality, this is something to be addressed.” Sequence-of-returns risk is the danger that the market declines when you first retire and/or start withdrawing income, leaving you with less money to grow, meaning your savings could run out too soon.

To test the sustainability of the income plan, she conducted a Monte Carlo simulation, which introduces randomness to a number of factors, including returns. She tested four different asset-allocation models: conservative (30 per cent stocks and 70 per cent fixed income); balanced (50 per cent stocks and 50 per cent fixed income); growth-oriented (70 per cent and 30 per cent); and aggressive (90 per cent stocks and 10 per cent fixed income).

“While all portfolios showed low probabilities of running out of money, the balanced allocation achieved the best combination of outcome consistency and risk mitigation for Ted,” Ms. Thompson says. It is aggressive enough to generate long-term consistent returns, yet conservative enough to minimize downside volatility and preserve wealth throughout retirement, she says.

Patrick's RRSP asset allocation is already conservative and well-positioned for future mandatory withdrawals starting at age 71.

When they eventually begin drawing from their TFSAs, both Patrick's and Ted's allocation could be gradually rebalanced to reduce stock exposure. That way any lump sum withdrawals from the TFSA can be funded by the more conservative investments within it.

Patrick and Ted should be able to meet their retirement spending goal of $122,700 a year with no issues, Ms. Thompson says. That assumes an inflation rate of 2.1 per cent to forecast their future expenses and pensions. Investment rate of return assumptions are 3.4 per cent on fixed income and 6.5 per cent on stocks. That's based on FP Canada's projection assumption guidelines. Their joint life expectancy assumption is age 98.

Client situation

The people: Patrick, 61, and Ted, 60.

The problem: Can they sustain a comfortable lifestyle in retirement with only one pension and a mix of investments?

The plan: Patrick draws from his defined benefit pension while Ted converts his RRSP to a RRIF now and begins withdrawals. Patrick converts his RRSP by age 71 CPP and OAS will begin at age 70 for both, maximizing long-term benefit amounts and reducing OAS clawback risk. TFSA assets are preserved for as long as possible.

The payoff: Peace of mind. Travel, renovations, and lifestyle goals can be achieved without running out of money.

Monthly net income: $10,825 (Patrick's pension and RRIF withdrawals as needed and bank savings).

Assets: Patrick's TFSA: $103,000; Patrick's RRSP: $300,000; Ted's TFSA: $112,000; Ted's RRSP: $675,000; cash and guaranteed investment certificates $49,000; residence: $850,000. Total: $2.9 million.

Estimated present value of Patrick's pension: $1.8-million. This is what someone with no pension would need to save to generate the same income.

Monthly outlays: Condo fees $1,350; property tax $340; home insurance $315; transportation $695; groceries $690; clothing $435; gifts, donations $180; charity $50; vacation, travel $3,410; gym $290; dining out, entertainment $1,670; books, magazines, hobbies $320; health care $715 (mostly refunded from health insurance); cellphones $130; miscellaneous $475; TFSAs $600. Total: $11,665

Liabilities: None.

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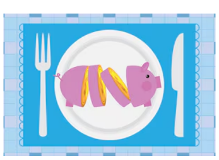

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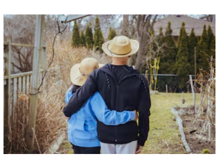

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