RETIREMENT & TAXES

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MONEY THING®
Golden Years

HOW LOW CAN YOUR TAX BILL GO DURING RETIREMENT?

Preparation is key in the years leading up to retirement. Rather than reacting to changes in your tax situation, proactive planning can ensure lifelong financial security.

Diversification isn't limited to your investment portfolio. If you're actively saving for retirement, consider diversifying how and when your savings will be taxed. This strategy helps navigate two uncertainties in retirement:

How much of your income will be taxable?

Beyond your retirement savings, you need to consider your Canada Pension Plan benefits, Old Age Security pension, employer pensions, non-retirement investments and other potential sources of income.

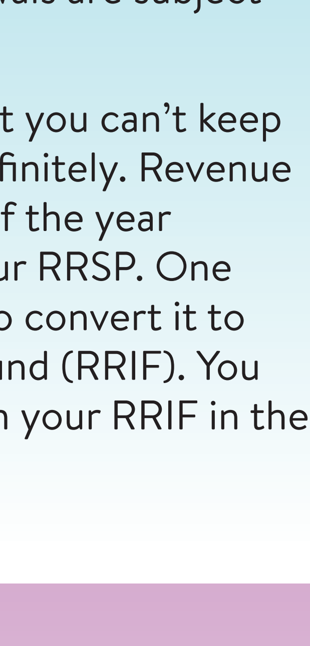
What will your tax rate be after you retire?

Today's tax rates are relatively low by historical standards, and it's possible that they could rise before or during your golden years.

Despite these uncertainties, planning for a favourable tax outcome is possible. One approach is to utilize a mix of accounts with different tax treatments to better manage taxable income in retirement.

You have three main account types at your disposal, each with its own unique tax advantages.

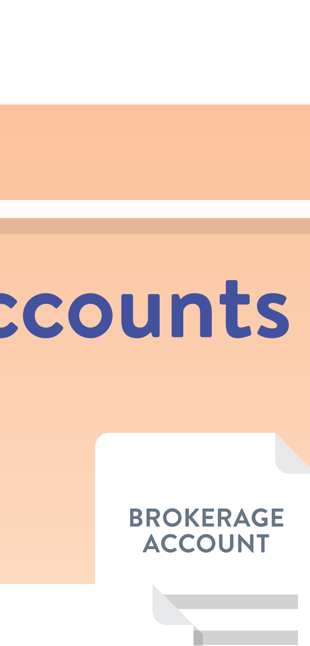
1 Tax-deferred accounts



Contributions made to Registered Retirement Savings Plans (RRSPs) result in a direct reduction of your taxable income for the year in which the contribution is made. Additionally, any pre-tax contributions and gains in these accounts are tax-deferred until retirement, at which point withdrawals are subject to ordinary income tax rates.

However, it's important to note that you can't keep your savings in these accounts indefinitely. Revenue Canada mandates that by the end of the year that you turn 71, you must close your RRSP. One option when closing your RRSP is to convert it to a Registered Retirement Income Fund (RRIF). You must start withdrawing money from your RRIF in the year after you open it.

2 After-tax accounts



Unlike tax-deferred accounts, contributions to Tax-Free Savings Accounts (TFSAs) are funded with after-tax dollars, meaning they do not lower your current taxable income. However, withdrawals from these accounts, including appreciation, income or distributions, are tax-free. Plus, withdrawals can be made whenever you want and you are not required to make mandatory minimum withdrawals from your TFSA during your retirement.

3 Taxable accounts

These traditional bank and brokerage accounts are funded with after-tax dollars. In brokerage accounts, you have the flexibility to trade securities and deposit or withdraw funds at your discretion without facing penalties. Taxable investment income is subject to taxation in the year it's earned, and profits from the sale of investments are subject to capital gains taxes. Conversely, if you sell an investment at a loss, you may offset any gains with it. You are not required to make required minimum withdrawals from your taxable accounts during your retirement.

TAX DIVERSIFICATION IN ACTION

Determining the optimal mix of retirement accounts depends on various factors, such as your current marginal tax rate, anticipated tax rate in retirement and desired flexibility in withdrawals. Nevertheless, there are fundamental principles to guide your decision-making process.

1 CAPTURE EMPLOYER MATCH

If your employer offers matching contributions, prioritize saving enough to receive the full match. This contribution essentially translates to free money, making it unwise to forgo.

2 MAXIMIZE TAX-ADVANTAGED SAVINGS

Determine an appropriate allocation between tax-deferred and after-tax accounts based on your current tax bracket.

Lower tax bracket: Consider maximizing contributions to TFSAs, as your tax bracket in retirement may equal or exceed your current rate.

Middle tax bracket: Split your retirement savings between tax-deferred and after-tax accounts to mitigate uncertainty regarding future tax rates.

Higher tax bracket: Prioritize maximizing contributions to RRSPs, assuming your retirement tax rate remains the same or decreases.

While predicting future tax rates involves some uncertainty, leveraging different account types offers flexibility and control over future tax liabilities.

SEEK PROFESSIONAL ADVICE

Consulting a tax professional can provide valuable guidance in navigating these decisions effectively

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Sources: Canada Revenue Agency, Charles Schwab, Investopia

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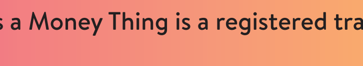
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