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Can Carl, 59, afford a $1.25-million rebuild of his waterfront Toronto house without jeopardizing his retirement plan?

DIANNE MALEY
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For years, Carl has wanted to tear down his dilapidated old house on the suburban Toronto waterfront and build a new, larger one with a couple of rental units for income. Now that he's retired, he's wondering whether he can manage it financially. Carl is 59 and single with one adult child.

"I bought my current house in 2008," Carl writes in an e-mail. "I always intended to renovate/rebuild but I'm only getting to it now in retirement," he adds.

"It's a property with a pretty spectacular view of the water but it is falling apart."

Carl says the build price has increased by 37 per cent from the initial design estimate and this has him looking at selling investment assets to help fund the project. The cost is now expected to be $1.25-million.

Most of his $125,000 in gross income comes from his investments, so the projected rental income "is to help diversify my income sources in retirement," he adds.

His cash flow goal is to continue to generate $125,000 a year before tax.

We asked Ian Calvert, vice-president and principal of HighView Financial Group in Toronto, to look at Carl's situation.

WHAT THE EXPERT SAYS

Because the cost of rebuilding on his lot has risen so dramatically, Carl wonders if the project will jeopardize his retirement plans and security, Mr. Calvert says.

Currently, Carl has an investment portfolio of about $3,665,000. Of that, $840,000 is held in guaranteed investment certificates and short-term savings, $1.8-million in Canadian and U.S. stocks, $385,000 in a registered retirement income fund, $465,000 in a life income fund, $130,000 in an RRSP and $45,000 in a tax-free savings account.

Carl must come up with $1.25-million to fund the building of his new property. It's his goal to fund this amount from the sale of investments and not to take on any additional debt to finance the project, the planner says.

"His first source will the $840,000 in GICs and short-term savings, but after that he will need to consider the tax implication of where to raise the capital," Mr. Calvert says. Carl is considering using some of his registered retirement savings. "This is a good idea, but it will all be taxable income so it will involve some tax planning," he says.

Construction will take place over two taxation years, which will work to Carl's benefit. "The first step is to estimate what his base income will be for the year," the planner says. He estimates Carl's income to be about $55,000 a year from his non-registered stock portfolio.

"Carl should now build a withdrawal strategy that keeps his taxable income below $150,000 a year," Mr. Calvert says. "The rationale for $150,000 is to max out the 43.41 per cent marginal tax rate without being pushed into the higher 40s or even 50 per cent marginal tax rate," he adds.

"A sensible strategy over the next two years would be to withdraw $70,000 from his RRIF in each calendar year, and about $215,000 from his non-registered portfolio," the planner says. This would put his total withdrawal at $840,000 plus $140,000 plus $430,000, which equals $1.41-million.

"This is higher than the $1.25-million to account for withholding taxes on his RRIF withdrawals and expected capital gains to raise the $430,000 in his non-registered account," he says. With an expected taxable capital gain of $25,000 in each year, Carl should achieve the $150,000 taxable income threshold, he says.

The result would be a portfolio size of $2,255,000 after the cost of building, broken down as follows: non-registered portfolio of $1.37-million, $245,000 in his RRIF, $130,000 in the RRSP, $465,000 in his LIF and $45,000 in his TFSA.

"While this is still a healthy asset base, Carl should be prepared for any additional and unplanned expenses," Mr. Calvert says. If additional expenses do occur, he would have to make further withdrawals from his non-registered assets.

After the build, Carl wants to maintain his total income of $125,000 a year, indexed to inflation, throughout his retirement. The renovation to his property will include two rental units that are expected to generate net rental income of about $30,000 a year.

Carl's withdrawal strategy, starting in 2024, and assuming no additional lump-sum withdrawals, should be as follows, the planner says. "First, his LIF account with $465,000 should be a meaningful component of his withdrawal strategy," the planner says. From a tax perspective, the LIF account is no different from his RRIF, he notes. "However, the account has an annual maximum withdrawal because it holds locked-in funds that originated in his pension plan," Mr. Calvert says. The maximum withdrawal is about $30,000 a year.

"Carl should take the maximum withdrawal from his LIF and only the minimum withdrawals from his RRIF," the planner says. The logic behind this strategy is that Carl is utilizing the account that has restrictions now to provide himself with greater flexibility in the long run – leaving more capital in the accounts he can access without restrictions.

This withdrawal is expected to reduce the remaining capital each year from that particular account. "It's never a one-size-fits-all answer, but for many, waiting until 71 and only taking the minimum from LIF accounts can result in adverse consequences for both cash flow and taxes payable, particularly on the final tax return," he notes.

"If planned for correctly, a Canadian's balance sheet shouldn't have a strong weighting to LIFs in the long run," he says. In additional to the $30,000 of rental income, $30,000 from his LIF, and $12,000 from his RRIF, he would need $53,000 from his non-registered taxable portfolio to meet his spending target.

TFSA, RRSP or RESP: How to choose where to invest your money

This is a practical withdrawal amount for two reasons: It will continue to keep his taxable income below the $150,000 threshold with a buffer for annual capital gains. Second, the $53,000 from his non-registered savings is a reasonable rate of withdrawal from his largest source of capital. Currently, this represents a withdrawal rate of about 3.8 per cent of his capital base. "If Carl can maintain this withdrawal rate, he shouldn't run into major problems with the longevity of his assets," Mr. Calvert says.

To reduce the longevity risk and account for inflationary pressure, Carl should focus on portfolio yield at this stage in his life. "Building a globally diversified portfolio with a yield of 3 to 4 per cent is an attainable goal," the planner says. This will enable him to fund a majority of his withdrawal needs from sustainable cash flow (dividends) with less reliance on capital appreciation, "which is far less predictable from year to year."

Withdrawals from his capital will decrease when he turns 70 and starts to collect his Canadian Pension Plan benefits. The forecast assumes Carl's Old Age Security benefits will be substantially clawed back.

CLIENT SITUATION

The person: Carl, age 59

The problem: Can he afford to tear down his house and rebuild at a cost of $1.25-million and generate $125,000 a year before tax?

The plan: Plan withdrawals for construction costs in tax-efficient way. Focus portfolio on yield.

The payoff: A nicer home in his preferred location with rent to diversify retirement income.

Monthly net income: $8,250

Assets: GICs and short-term savings $840,000; stocks in taxable account $1.8-million; registered retirement income fund $385,000; life income fund $465,000; RRSP $130,000; tax-free savings account $45,000; residence $950,000. Total: $4.6-million

Monthly outlays: Mortgage $2,625; property tax $400; water, sewer, garbage $50; home insurance $95; electricity $150; heating $85; maintenance $200; transportation $330; gifts, charity $420; vacation, travel $850; other discretionary $1,530; dining, drinks, entertainment $565; club memberships $475; subscriptions $160; health care $490; communications $155. Total: $8,580

Liabilities: $696,000

Ian Calvert is a Vice President & Principal at HighView Financial Group.