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Can Wesley and Claire afford to retire early at age 57?

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Wesley and Claire want to retire and travel while they are still relatively young. Wesley is 54 and earns $144,000 a year, Claire is 53 and earns $76,000 a year. Both are professionals with defined benefit pension plans.

Short term, the couple plan some renovations to their Southwestern Ontario house costing $25,000. They're also thinking of buying a recreational vehicle.

Longer term, they aspire to a comfortable retirement with plenty of travel during their "active retirement years," Wesley writes in an e-mail, "say until age 70." They also want to make sure they have enough money for health care in their old age.

They wonder whether they can afford to take early retirement at age 57 with a budget of $110,000 a year, including $24,000 a year for travel. "We've recently got married and need to look at combining our finances," Wesley writes. They're a blended family with two children, 18 and 21, the younger of whom lives with them part of the time. They also ask about splitting income after they have retired.

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

WHAT THE EXPERT SAYS

Claire and Wesley want to ensure they have a tax-efficient cash flow plan and longevity of their financial assets, Mr. Calvert says.

At age 57, Wesley will be entitled to a pension of $8,350 a month, which includes a bridge benefit of about $850 to age 65. From age 65 on his pension will be $7,500 a month. When Claire is 57, she'll get a pension of $2,085, including a bridge benefit of $400 to age 65, falling to $1,685 thereafter.

"The early years between 2025 and 2032 will be very important to their retirement plan," he says. "Not only will these be the years where they require the largest withdrawals from their retirement savings, they will also be their lowest taxable income years," the planner says. The couple will begin drawing Canada Pension Plan and Old Age Security benefits starting at age 65.

"In these years, after income splitting, their base income is expected to be about $70,000 each," Mr. Calvert says. This income splitting is possible at such an early retirement age because the majority of their retirement income will be coming from two defined benefit pensions. Annuity payments from a registered pension plan can be split before age 65, whereas withdrawals from a registered retirement income fund (RRIF) can only be split at age 65 and older. Because Wesley's pension is four times' larger than Claire's, they should be sure to split his eligible pension income, the planner says. This would be done when filing their tax returns using Form T1032.

This base income is a combination of registered pension income and investment income from their non-registered portfolio, the planner says. “At this income level, they have the ability to withdraw some taxable income from their RRSPs/RRIFs, but not too aggressively,” Mr. Calvert says, because their strong pension income “has filled up most of the favourable and lower tax brackets.” Annual RRSP/RRIF withdrawals of about $10,000 each would be an ideal target in these years.

Having taxable income of about $80,000 each would achieve two goals. “It would manage their current income tax bracket while getting a head start to draw down their RRSPs/RRIFs in a tax-efficient way,” he says. “Their goal should be to not have too much of their wealth in their RRSP/RRIFs in the long run.”

In the year 2026, the first full year of retirement, their family cash flow would be about $126,000 a year in combined pension income, $20,000 of RRSP/RRIF withdrawals and $17,000 from their non-registered savings. This would provide a gross family cash flow of $163,000, less $30,000 in taxes, $121,000 of living expenses ($110,000 indexed at 2 per cent a year for inflation), and $12,000 to top up their tax-free savings accounts, the planner says. “This withdrawal plan would require very little from the non-registered assets because $12,000 of the $17,000 would be an internal transfer from their non-registered account to their TFSAs,” he says.

“Continuing to draw down their RRIFs and cycle funds from the non-registered to their TFSAs each year should be a consistent component of their estate planning,” Mr. Calvert says. When they turn 65, their work pensions will be reduced by the amount of the bridge benefits. With a drop in their pension income, and by reducing their RRIF withdrawals to the minimum each year, they should both be able to collect full Old Age Security benefits, the planner says.

After the age of 65, their pension plans plus government benefits will account for 80 per cent of their total family income, “leaving very manageable withdrawal requirements from their portfolio.” In 2037, when their travel expenses have fallen, “their pension income, government benefits and RRIF minimums should satisfy all lifestyle needs with a small buffer, Mr. Calvert says. This assumes they can achieve an annual rate of return of 5 per cent on their investment portfolio and a long term inflation assumption of 2 per cent per year.

“Because this is a recent marriage, their finances and assets have been kept mostly separate,” the planner notes. “There can be valid reasons to keep their assets separate based on the financial and estate goals of each individual.” However, if their goal is for the surviving spouse to receive some or all of the assets, they should designate their spouse as the successor annuitant on both the RRSP and TFSA accounts. “This will ensure a tax-free rollover of the RRSP/RRIF,” and that the TFSA can go to the surviving spouse’s TFSA regardless of available contribution room.

Currently, the majority of their non-registered portfolio – $269,000 – is held in cash, comprising about 67 per cent of the non-registered assets. Holding so much cash poses an inflation risk and the loss of purchasing power over time, Mr. Calvert says. “With a solid foundation of recurring pension income, they should certainly consider building a portfolio that includes dividends and the potential for capital appreciation offered by stocks and other equity investments.” They should set aside short-term cash needs in a high-interest savings account.

The couple are planning on consolidating their investments at some point using exchange-traded funds, he says. If their goal is broad diversification at the lowest possible cost, then this is a practical solution that can be achieved by owning three or four ETFs tracking major global indexes.

“Accordingly, when building this type of portfolio, it’s important to keep it simple and stay away from the explosion of niche products in the ETF universe,” Mr. Calvert says. “One major mistake that can derail attempts to build truly passive, low-cost portfolios is the active management of passive products.”

CLIENT SITUATION

The people: Wesley, 54, and Claire, 53

The problem: Can they afford to take early retirement at age 57 with a spending budget of $110,000 a year, falling by $24,000 after age 70?

The plan: Retire at age 57 and draw on their savings to supplement their income until they start collecting CPP and OAS benefits. Split their work pension income as soon as they retire. Melt down their RRSP/RRIF and build up their TFSAs.

The payoff: The secure retirement they aspire to.

Monthly net income: $13,960

Assets: His cash $251,000; her cash $18,000; his non-registered stocks $48,000; her non-registered mutual funds $80,000; his TFSA $97,400; her TFSA $77,000; his RRSP $298,000; her RRSP $142,000; her locked-in retirement account $64,000; estimated present value of his pension $900,000; estim. p.v. of her pension $375,000; registered education savings plan $97,000; residence $900,000. Total: $3.35-million

Monthly outlays: Property tax $440; water, sewer, garbage $25; home insurance $175; heating, electricity $525; maintenance $400; garden $50; car insurance $365; fuel $225; maintenance, oil $150; parking $40; groceries $700; child support $1,000; clothing $220; gifts, charity $150; vacation, travel $425; other discretionary $400; dining, drinks, entertainment $750; personal care $75; memberships $600; pets $100; sports, hobbies $75; subscriptions $200; other personal $500; drugstore $75; health insurance $120; life insurance $100; disability insurance $60; communications $400; RRSPs $350; RESP $200; TFSAs $1,100; pension plan contributions $1,745. Total: $11,740

Liabilities: None

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