THE GLOBE AND MAIL

Should Ryan and Theo annuitize some of their savings to offset longevity risk?

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Special to The Globe and Mail

Published Friday, March 11, 2022

Ryan and Theo enjoy an enviable lifestyle thanks in part to Ryan's high consulting income, their mortgage-free house in small-town Ontario and the freedom that comes from being self-employed.

Ryan, who nets about $196,000 a year after business expenses, is 57. He wants to slow down significantly in three years. Theo, who is 65 and earns $25,000 a year after expenses, wants to stop working next year. While neither has a company pension, they have substantial savings and investments. Their jointly held stock portfolio generates $25,000 in investment income.

"Travel is our highest priority for the foreseeable future when we are both well," Ryan writes in an e-mail. "Because we have no children, it is not a priority for us to leave a large inheritance to anyone," Ryan writes. "Our plan is to use all our assets including the value of our primary residence, which would fund our long-term care in the last decade of our lives," he adds.

Their main question is how to mitigate longevity risk. "Should we annuitize some of our savings?" Ryan asks. "If so, should we wait to do so later, say, when we dispose of our primary residence in 15 or 20 years? Or should we start doing so when we start full retirement?" They also wonder how to "decumulate" their assets in the most tax-efficient way. Should Ryan continue to make contributions to Theo's spousal RRSP?

Their retirement spending goal is $146,500 a year after tax.

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

WHAT THE EXPERT SAYS

Although Theo plans to retire next year, the biggest transition will happen in 2026, the year after Ryan retires, Mr. Calvert says. Ryan's registered retirement savings plan, which has nearly $900,000, will play an important role in their retirement plan.

"Their withdrawal plan should have two stages," the planner says. Starting in 2029, when Ryan turns 65, he can split with Theo the withdrawals from his registered retirement income fund, which will be one of the biggest sources of the couple's retirement income.

"However, before 2029, they should be careful to balance the withdrawals from their RRSP/RRIFs," the planner says.

In 2029, their retirement cash flow breaks down as follows: Ryan gets $75,000 from his RRIF; $7,700 from his locked-in retirement fund; and $700 in Old Age Security for part of the year. (Ryan plans to delay taking CPP.) Theo gets $10,500 from his RRIF; $14,000 in Canada Pension Plan benefits; $8,800 in Old Age Security benefits; and $60,000 from their joint non-registered investments, for a total of $176,700. "After $22,300 of income taxes (accounting for income splitting and portfolio income), they would have net cash flow of $154,400 to meet their spending goal of $146,500, indexed to inflation, Mr. Calvert says.

An important component of their withdrawal plan will be balancing their taxable income from their RRIFs, life income fund, CPP and OAS, the planner says. "They must also ensure their non-registered portfolio doesn't get depleted too quickly because this and their tax-free savings accounts provide greater longer-term flexibility."

Under this withdrawal plan, their taxable income is expected to be about $72,000 each, Mr. Calvert says. "From an income tax planning perspective, this is a good place to be because they are avoiding the top tax brackets, preserving their OAS from claw-back and leaving a buffer for the tax Ryan will have to pay when he gets full government benefits and for capital gains on their joint account."

Assuming an annual average rate of return of 5 per cent of their investable assets and 3 per cent on their real estate, by 2047, when they are at the ages of 91 and 83, they are expected to have a net worth of $2.8-million, of which $1.7-million is held in real estate, Mr. Calvert says. "By this stage, they should be in a great place to liquidate their real estate and move into a higher-end care facility and not worry about the longevity of their assets." This also means they could comfortably increase their travel budget by $10,000 to $20,000 a year for the first phase of their retirement, the planner says.

They ask about buying an annuity to mitigate longevity risk, he notes. An annuity is a financial product issued by insurance companies that offers a guaranteed income stream for life. "In other words, Theo and Ryan would not be able to outlive their income stream from the annuity," Mr. Calvert says.

Although this type of product can be a good hedge against uncertainty and longevity risk, there are two other risks to consider, the planner says. "First is the loss of liquidity and the ability to access your capital for large or unexpected spending needs," he says. Second, and perhaps more important in today's environment, is the interest rate risk on annuities. "By buying an annuity in this historically low interest rate environment, you are essentially annuitizing the current low rate and locking it in forever."

A better idea would be to have a diversified portfolio with predictable and growing income from dividends, interest and other distributions. "A cash flow yield of about 4 per cent, with the potential for capital growth, would provide a steady stream of cash flow to meet their spending goals while still giving them access to their capital."

Ryan is in one of the top combined marginal tax brackets at 48.35 per cent, the planner says. "At this rate of tax, the RRSP contributions are a valuable deduction each year." He recommends Ryan continues to make RRSP contributions for the following reasons: First, neither of them has any pension income. In their first year of retirement, their taxable income will plummet, putting them both in a much lower tax bracket. This lower bracket presents an opportunity to withdraw from their RRSPs/RRIFs, he says.

"When you're paying a lower rate of tax on withdrawals while deducting the contributions at one of the top tax rates during working years, you're capitalizing on one of the key benefits of the RRSP."

One thing to consider is the income attribution rules on withdrawals from spousal RRIFs.

Once an RRSP is converted to a RRIF, there is no income attribution on the minimum withdrawal for the year. If the withdrawals exceed the minimum, though, the excess will be attributed back to Ryan if a contribution was made in the year of withdrawal or in the two previous years.

"Because it's likely Theo will take more than the minimum before Ryan turns 65 and can split his income with Theo, Ryan should consider making the contributions to his own RRSP rather than Theo's for the final years before retirement."

CLIENT SITUATION

The people: Ryan, 57, and Theo, 65

The problem: Should they annuitize some of their savings to offset longevity risk? What is the most tax-effective way to draw down their savings?

The plan: For the time being at least, low interest rates make annuities less attractive. Instead, consider building a solid portfolio that offers dividend and interest income as well as the potential for capital gains. Monitor withdrawals to equalize taxable income. Ryan can split his income with Theo at Ryan's age 65.

The payoff: If their investments turn out well, they could spend even more on travel in the early years, secure in the knowledge they will still have enough to last the rest of their lives.

Monthly net income: $13,415

Assets: Joint cash $21,490, Ryan's cash $20,450; Theo's cash $7,135; joint stock portfolio $710,600; Ryan's TFSA $98,505; Theo's TFSA $92,505; Ryan's locked-in retirement account from previous employer $159,600; Ryan's RRSP $891,660; Theo's RRSP $224,790; residence $800,000. Total: $3-million

Monthly outlays: Property tax $310; home insurance $310; utilities $520; maintenance $450; garden $375; vehicle lease $940; other transportation $405; grocery store $2,400; clothing $150; gifts, charity $550; vacation, travel $2,500; dining, drinks, entertainment $1,700; personal care $200; subscriptions, club membership $60; doctors, dentists $480; drugstore $30; health, dental insurance $455; communications $410; TFSAs $1,000. Total: $13,245.RRSP contributions come either from surplus cash flow or taxable investment income.

Liabilities: None.

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