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What's the best way for Linus and Pamela to pay for a new RV in retirement?

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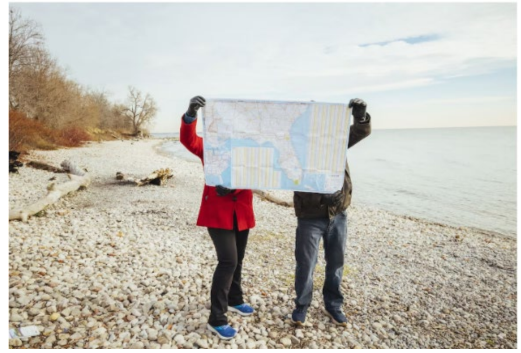

Now in their early 60s, Linus and Pamela have retired from the work force. Their only income is Pamela's Canada Pension Plan disability benefit, which will end when she turns 65.

They have a good-sized nest egg, which they manage themselves, a mortgage-free home in Toronto and two adult children. Pamela has a defined contribution pension plan currently valued at $347,000 that has been converted to a locked-in retirement account, or LIRA. At age 65 they will be entitled to higher-than-average Canada Pension Plan benefits. Linus will be eligible for $1,290 a month and Pamela $1,283, Pamela writes in an e-mail.

They have been living on the money in their savings accounts. They wonder if they should convert their registered retirement savings plans (RRSP) to registered retirement income funds (RRIFs) now to generate cash flow. "When should my husband take his Canada Pension Plan?" Pamela asks. "Or should he go back to work?"

Two substantial purchases are on their horizon: new windows and a new recreational vehicle "to travel North America."

"Our main question is how to draw down our money to create an income stream now and in the future," Pamela writes. "Also, do we have enough money saved to meet our needs?"

Their spending target is $75,000 a year after tax.

We asked Ian Calvert, a certified financial planner and principal of HighView Financial Group in Toronto, to look at Linus and Pamela's situation.

WHAT THE EXPERT SAYS

Linus and Pamela's investable assets total $1,448,000, Mr. Calvert says. With a house worth $1,200,000 and no mortgage, their net worth is $2,648,000.

Their first question is how to tax efficiently decumulate, or draw down, their investments. Linus is not working, not collecting government benefits and not reporting any material investment income other some minor interest on savings. "Having your taxable income this low for too long is a missed opportunity to implement a tax efficient withdrawal strategy from your retirement assets," Mr. Calvert says.

Their first move should be to convert their RRSPs to RRIFs and Pamela's LIRA to a life income fund, or LIF.

Pamela should also explore if her DC pension is eligible for 50 per cent unlocking, the planner says. "This does not apply in all jurisdictions, but if it's an Ontario regulated pension, she would have the ability to move 50 per cent of the account tax-free to her RRSP/RRIF." This does not require that she have contribution room in her RRSP.

"It's important to note that the 50 per cent unlocking does not move funds out of a registered account to a non-registered one," Mr. Calvert says. "The benefit of this process is transferring half of the value from an account that has an annual maximum withdrawal (a LIF) to one that doesn't (a RRIF). "In other words, unlocking provides flexibility for future withdrawals, but the funds will still be taxable income when withdrawn," the planner says.

Drawing on the RRIFs and LIF will create a minimum combined cash flow of $52,700 a year, Mr. Calvert says. Adding Pamela's CPP disability benefit of $18,252 a year would leave them short of their spending target of $75,000. Pamela's income will be higher than Linus's because of her CPP disability benefit, so they should take the shortfall from his RRIF, the planner says.

If Linus increased his RRIF withdrawal to $32,000 a year, it would bring their total withdrawal from their investments to $69,500 a year and their total family income to $87,800. This would cover their combined $12,800 in income taxes, leaving $75,000 for spending.

The highest withdrawal rate from their portfolio would be in 2024 and 2025. Starting in 2026 and 2027, when they each turn 65, they will have a combined CPP and Old Age Security benefits of $48,600 a year (with inflation), the planner says. Linus should then reduce his RRIF withdrawal to the annual minimum, which will be about $15,500.

At 65, Pamela's CPP disability benefit will end and she will start to receive the CPP retirement benefit. At this age, after pension splitting, they will have a taxable income of about $56,000 each, Mr. Calvert says.

Once their full CPP and OAS retirement benefits are received, combined with their annual minimum withdrawals from their RRIF and LIF accounts, it is likely they will have surplus income, the planner says. That assumes they stick to their spending target. "If this is the case, they should focus on getting any surplus cash into their TFSAs." Having larger TFSAs will be a benefit in any scenario, he notes. "Either it's an account to provide for a future tax-free withdrawal, or an optimal account for the transition of wealth to the next generation."

If Linus and Pamela can achieve an annual rate of return of 5 per cent on their portfolio, and their house appreciates at 3 per cent a year, "they should expect a healthy balance sheet of about $4.5-million at age 90," the planner says. This would be a house value of $2.75-million and portfolio assets of $1.75-million. This assumes they can live off their RRIF and LIF minimums and the government benefits, allowing their TFSAs and non-registered investments continue to compound and grow.

With a 4-per-cent rate of return, in comparison, their investable assets would be closer to $1.35-million (rather than $1.75-million) at age 90, for a net worth of $4.1-million.

"One hurdle to this retirement plan is that Linus and Pamela are planning for some major purchases in the short term," Mr. Calvert says. They would like to purchase a new RV and replace the windows in their house for a combined cost of about $120,000. "This is a material withdrawal because it represents more than 8 per cent of their total investable assets," the planner says.

Withdrawing such a large amount from their RRIFs or LIF would trigger a big tax bill. Instead, they should look to their non-registered portfolio and their TFSAs, he says.

Between their cash and non-registered investments, they could fund most of this purchase, but this would eliminate all their short-term funds in their cash and savings accounts. "Completely depleting your cash reserves is never a good idea." A better approach would be to keep $50,000 to $60,000 in cash and short-term savings and take the remainder from their TFSAs, the planner says. This would mean a combined withdrawal from their TFSAs of $70,000.

"While this is a material withdrawal and will impact the size of their portfolio in the long run, it is precisely one of the benefits and purpose of the TFSA," Mr. Calvert says. "The wonderful aspect of this account is that the withdrawal will be added to their contribution room starting the following calendar year," the planner says. This gives them the ability to replenish the funds over time once their cash flow turns positive after age 65.

CLIENT SITUATION

The people: Linus, age 62, and Pamela, age 61.

The problem: How to draw down their savings in a tax-effective way to provide a lifelong income stream. Will they still have enough if they buy new windows and a new RV?

The plan: Take advantage of their low-income years by converting their RRSPs and Pamela's LIRA to RRIFs and a LIF, and begin withdrawing funds. Linus can take more than the minimum withdrawal now, then reduce the amount when they begin getting government benefits. Tap their TFSAs for part of the new RV and window expenses.

The payoff: Enough to meet their cash-flow needs for the rest of their lives.

Monthly before-tax income: $1,520 plus withdrawing savings as needed.

Assets: Joint cash $10,300; his cash $3,000; her cash $50,000; her GICs $51,685; his TFSA $114,190; her TFSA $99,305; his RRSP $430,000; her RRSP $282,295; spousal RRSPs $58,835; market value of her LIRA $347,000; residence $1,200,000. Total: $2.65-million

Monthly outlays: Property tax $375; water, sewer, garbage $100; home insurance $100; electricity $120; heating $150; maintenance $750; car insurance $330; fuel $200; oil changes, maintenance $250; parking $30; groceries $700; clothing $75; car loan $340; gifts $200; vacation, travel $835; RV expenses $225; dining, drinks, entertainment $390; personal $25; sports, hobbies $50; subscriptions $20; other personal $150; doctors, dentists $200; drugs, vitamins $100; health, dental $200; phones, TV, internet $235. Total: $6,150.

Liabilities: Car loan $4,470 at zero per cent.

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