Mandatory RRIF Withdrawals not as Costly for most Seniors

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Canadian vs US terminology

- Canadian RRSPs ≈ Traditional 401(k)
  - Deductible contributions and taxable withdrawals
  - Annual RRSP limit = 18% of earned income or $32,000
- Canadian TFSAs ≈ Roth IRAs
  - Non-deductible contributions and non-taxable withdrawals
  - Annual contribution limits approximately the same in both countries ($7,000), but Canada allows carryforward of unused contributions
- RRSPs need to be converted into RRIFs by end of year the taxpayer turns 71 (no more new contributions), and mandatory RRIF withdrawals based on age commence

Are mandatory withdrawals constraining?

- Strong advocacy to reduce or eliminate mandatory annual RRIF withdrawals because of longevity, low accumulated savings, low interest rates
- However, mandatory annual withdrawals may not be a threat since most seniors have accumulated low amounts of RRSPs.
  - In most cases, minimum annual withdrawals < amount necessary for consumption
  - Therefore, mandatory minimum withdrawals may not be a binding constraint for most seniors
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Statistics

- 75th percentile of RRIF balances ≈ \$200,000
- 95th percentile ≈ \$600,000
- 7.7% of seniors have RRIF balances > \$200,000
- 47.9% of Canadians have zero balances
- Perhaps low because Canadians are home-owners and their homes constitute their retirement plan?
- This paper examines the mandatory withdrawals of a \$1 million RRIF account showing that incremental taxes are not economically significant
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$1 of RRSP contribution results in

$$\frac{\$1}{(1-t_0)}(1+r)^n(1-t_n) = \$1(1+r)^n$$

- where t_o = tax rate at contribution

  and t_n = tax rate at withdrawal

- If $t_o = t_n$, then RRSPs grow exempt of taxes

$1M RRIF example

- Let us consider 83-year-old Adam who has $1 million accumulated and unwithdrawn in his RRIF. Adam would *have to* withdraw at least $73,800 (or 7.38 percent of $1,000,000) at age 83.
- Mandatory withdrawal lower if Adam was married to a younger spouse
- Marginal tax rate in Ontario ≈ 30% in Ontario
- If Adam needs $73,800 for consumption, then cost of mandatory withdrawal is zero

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Tax on $10,000 excess withdrawal

- Lets assume Adam needs only $63,800 for consumption so $10,00 is a forced withdrawal
- This $10,000 now earns 3.5% (= 5% (1-0.30)) instead of earning 5%, or an annual incremental tax of $150 on $10,000
- Let’s further assume that Adam would have withdrawn this amount 6 years from now if not coerced to withdraw it today
- Income tax paid on early RRIF if withdrawn today: $10,000 x 30 percent MTR = $3,000
- Present value of tax paid if RRIF withdrawn at end of 6 years = $3,000 / $(1.05)^6$ = $2,239
- Incremental income tax paid in present value terms if forced to withdraw early = $ 761
- $761 over 6 years = $127 per annum
- $127 + $150 = $277 on a RRIF balance of $1 million

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Annual tax rate on $10,000 mandatory withdrawal

- Table 1 illustrates that the *annualized* cost of a one-time mandatory withdrawal of $10,000 from a RRIF ranges from $253.80 to $292.86, representing an incremental cost of less than 3 percent per annum.

- This amount is reduced to a range from $103.80 to $142.86 (representing an incremental cost of less than 1.5 percent per annum) if the RRIF-holder has sufficient unused TFSA contribution room.

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Table 1

TABLE 1 Annualized Cost of a $10,000 Mandatory Early RRIF Withdrawal

(A) Year		(B) Tax on early mandatory excess RRIF withdrawal [($10,000 × 30%)/ (1 + 0.05)[a]]	(C) Cost of early RRIF withdrawal [$3,000 – (B)]	(D) Annualized tax cost of early withdrawal (C)/(A)	(E) Annual return inside RRIF or TFSA ($10,000 × 5%)	(F) Annual return outside RRIF or TFSA ($10,000 × (1 – 0.3)5%]	(G) Difference in annual after-tax return (E) – (F)	(H) Total annualized cost of early RRIF withdrawal (D) + (G)
				dollars				
0	Taxes if withdrawn today	3,000.00						
1	Taxes if withdrawn 1 year from now	2,857.00	143.00	142.86	500.00	350.00	150.00	292.86
2	Taxes if withdrawn 2 years from now	2,721.00	279.00	139.46	500.00	350.00	150.00	289.46
3	Taxes if withdrawn 3 years from now	2,592.00	408.00	136.16	500.00	350.00	150.00	286.16
4	Taxes if withdrawn 4 years from now	2,468.00	532.00	132.97	500.00	350.00	150.00	282.97
5	Taxes if withdrawn 5 years from now	2,351.00	649.00	129.88	500.00	350.00	150.00	279.88
6	Taxes if withdrawn 6 years from now	2,239.00	761.00	126.89	500.00	350.00	150.00	276.89
7	Taxes if withdrawn 7 years from now	2,132.00	868.00	123.99	500.00	350.00	150.00	273.99
8	Taxes if withdrawn 8 years from now	2,031.00	969.00	121.19	500.00	350.00	150.00	271.19
9	Taxes if withdrawn 9 years from now	1,934.00	1,066.00	118.46	500.00	350.00	150.00	268.46
10	Taxes if withdrawn 10 years from now	1,842.00	1,158.00	115.83	500.00	350.00	150.00	265.83
11	Taxes if withdrawn 11 years from now	1,754.00	1,246.00	113.27	500.00	350.00	150.00	263.27
12	Taxes if withdrawn 12 years from now	1,671.00	1,329.00	110.79	500.00	350.00	150.00	260.79
13	Taxes if withdrawn 13 years from now	1,591.00	1,409.00	108.39	500.00	350.00	150.00	258.39
14	Taxes if withdrawn 14 years from now	1,515.00	1,485.00	106.06	500.00	350.00	150.00	256.06
15	Taxes if withdrawn 15 years from now	1,443.00	1,557.00	103.80	500.00	350.00	150.00	253.80

Home-made tax strategies to alleviate tax on mandatory RRIF withdrawals

- Reinvest the $10,000 into TFSA
- Annual contribution limit = $7,000 + unused contribution room carry forwarded
- Lifetime contribution room = $95,000
- 83.4% of Canadians have unused TFSA contribution room
- This means that mandatory withdrawals can continue growing at r% instead of growing at r (1-t)%.
  - E.g., grow at 5% instead of 3.5%, or shelter $150 annually
- TFSAs further allow income-tested benefits like OAS to not be clawed back
- Detailed numerical example in paper

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Reduce Complexity

- This paper further advocates that RRIF balances of up to $200,000 be exempt from mandatory annual withdrawals (unlikely to use for estate planning)
- As advocated by advocates, but for small balances
- Withdrawals would still be taxable, but no amounts of withdrawals required each year for small balances
- This would reduce compliance errors by taxpayers or financial institutions, or even service charges imposed by financial institutions
- A measure to reduce tax complexity

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Old Age Security (Safety net for seniors)

- Indefinite deferral of retirement savings allows wealthy Canadians to use such savings for estate planning purposes
- Preventing the misuse of retirement tax preferences for estate planning remains a legitimate policy goal.
- Furthermore, retaining wealth inside tax-deferred accounts while claiming OAS because of low reported income can jeopardize the sustainability of the OAS program.
- OAS was not designed to withstand eligibility from seniors who are asset-rich, but reluctant to draw down on their retirement assets that were accumulated with tax deferrals.
- Payment at LTC facilities based on annual incomes, including RRIF withdrawals

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Questions / Comments?

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