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TAX MATTERS

Early RRIF withdrawals could leave your kids more

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Times are tough for the Norwegian military. It turns out there's a shortage of military-issue underwear for the roughly 8,000 young people who are required to serve in the country's armed forces each year. It used to be that the conscripts could keep their underwear, bras and socks when they finished their military service. No longer. Because of delayed supply – partly owing to COVID-19 – the young people are now required to hand back their unmentionables so that others can wear them next.

This story leaves me feeling vindicated. I've told my kids for a long time that the best things they're going to inherit from me are my Batman underwear and Toronto Maple Leaf socks. Now I have proof that second-hand undergarments have value.

To be fair, I'm trying to leave the kids more than just my T-shirts, tube socks and a couple of loincloths. In fact, I want to be smart about the financial assets I leave behind. If you're the same, I want to share an idea that could enable you to leave more financial assets to the kids than you might otherwise.

The idea

Common tax planning wisdom suggests that next to eliminating tax, deferring tax to the future as long as possible makes good sense. And I would generally agree with this. But in some cases, it could make sense to pay tax on your RRIF assets earlier than you might otherwise, in order to leave more to your kids after you're gone. Let me share a tale of two twin brothers, Jack and Benny, to explain what I mean.

Consider Jack and Benny, who are both single. The men turned 72 last year and each has a registered retirement income fund. Let's assume that each can earn 5 per cent on their investment assets and have a marginal tax rate of 30 per cent. Let's also assume the men live to 90 and will face tax in their year of death at a marginal tax rate of 50 per cent. This is a realistic scenario since the men expect to have sufficient RRIF assets at the time of death that they'll be in the top tax bracket in that year (the full value of their RRIFs will be taxable in their year of death).

Jack has decided to follow the advice of a financial adviser who has recommended that he start withdrawing extra funds each year from his RRIF (over and above what he needs to live on) and contribute these funds to his tax-free savings account. Jack will withdrawal $8,571 extra from his RRIF which, at his marginal tax rate of 30 per cent, leaves him with $6,000 to contribute to his TFSA. Jack will have $168,800 in his TFSA at 90, based on contributions of $6,000 starting this year and earning 5 per cent annually. He won't face tax on his TFSA when he dies at the age of 90, so the after-tax value to his estate will be $168,800.

Benny, on the other hand, is not following the same advice. Benny will keep the $8,571 in his RRIF each year, growing it at the same 5 per cent. By the age of 90, those dollars will have grown to be worth $241,100. Taxes at the time of Benny's death on these RRIF assets will be $120,550 (at a marginal tax rate of 50 per cent), leaving his estate with just $120,550.

See the difference between Jack and Benny? Jack, who made withdrawals from his RRIF to contribute to his TFSA, will end up with $48,250 ($168,800 less $120,550) or 40 per cent more in his estate after taxes than Benny.

The nuances

To make this idea worthwhile, it should be true that your marginal tax rate today is meaningfully less than the marginal tax rate you're going to face in your year of death – most likely because your registered or other assets are expected to give rise to taxable income when you pass away. In my example, the difference between the two tax rates is expected to be 20 per cent, but even 15 per cent can work well.

Next, this idea works best when you will have significant registered plan assets still around when you (and your spouse if you have one) are gone. This may be the case if you have other sources of income, such as pensions or non-registered investments to provide for your needs.

Finally, my math ignores the fact that the TFSA contribution room will be increasing in the future, indexed to inflation, and bumped up in increments of $500. As this amount increases, the benefit of this idea grows because more dollars can avoid tax upon death when more is moved from the RRIF to the TFSA.

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