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Investments

Tax strategies for converting your client's RRSP to a RRIF

With the move towards retirement, many Canadians will be looking to create an income stream by converting their Registered Retirement Savings Plans (RRSPs) to Registered Retirement Income Funds (RRIFs).

Here are four tax and estate planning strategies to consider that can maximize the effectiveness of your clients RRIFs.

1 One final RRSP contribution

If your client is 71 and has unused RRSP contribution room, they can consider making one final RRSP contribution. Because individuals cannot contribute to RRSPs beyond age 71, this may be their final opportunity for a large tax deduction in one year.

If your client is 71 and still working, but does not have RRSP contribution room, they can consider making an overcontribution to their RRSP in December of the year they turn 71. If the excess contribution exceeds $2,000, there will be a 1% overcontribution penalty for the month of December. However, because the client is still working, the penalty will cease in January of the following year when new RRSP room becomes available. Your client will be able to use the RRSP contribution room that becomes available the year after they turn 71. This will lower the tax bill for that year, a benefit that may far exceed the 1% penalty tax paid for December.

Clients younger than 71 can continue to contribute to an RRSP until the end of the year they reach 71, provided they have contribution room. Their contributions will create a tax deduction that can be used to offset any form of income, including part-time employment income. The earlier contributions are made, the longer RRSP assets can grow tax deferred.

If your client is older than 71, has unused RRSP contribution room and has a spouse or common-law partner (CLP) who is younger than 72, they can contribute to a spousal RRSP. Contributions to a spousal RRSP will create a tax deduction on your client's tax return. Provided withdrawals from the spousal RRSP take place three years after the contribution is made, the lower income spouse/CLP will be taxed on the withdrawal. An exception to this attribution rule applies if the spouse converts the spousal RRSP to a RRIF and withdraws only the minimum amount.

2 Base RRIF payments on age of the younger spouse

When setting up a RRIF, your client has the opportunity to calculate future RRIF payments based on their age or the age of their spouse/CLP. If the goal is to maximize the tax-deferral opportunity of their RRIF, it is generally best to calculate annual RRIF payments based on the age of the younger person. This results in smaller mandatory withdrawals and allows for a longer period of tax-deferral.

If your client does not require the cash received from mandatory RRIF payments, they can transfer their RRIF back to an RRSP if they are under the age of 72, or contribute their after-tax RRIF payments to a Tax-free Savings Account (TFSA) where future income would grow free of income tax. Contributions to a TFSA would require TFSA contribution room. Contributions to a non-registered investment account are also possible where tax-efficient dividends and capital gains can be realized.

3 Name a beneficiary

Beneficiaries named on RRSP applications are not automatically carried over to RRIFs. If, at death, your client wants their RRIF assets to transfer directly to beneficiaries without flowing through their estate, they should name beneficiaries directly on their new RRIF application. Otherwise, their RRIF assets may pass through their estate, and may be subject to complex estate settlement matters, probate fees and/or unintended distributions.

Estate administration fees may also apply. In Quebec, when the annuitant of a trusteed RRSP or RRIF dies, the proceeds of the plan flow through the deceased's estate and are subject to the terms of the deceased's will, regardless of designations made on a plan application. Therefore, the distribution of RRIF assets through the terms of a will continue to be of importance for RRIF annuitants who reside in Quebec.

If your client intends for their spouse/CLP to inherit their RRIF, you can highlight the option to name their spouse/CLP as either "successor annuitant" or "beneficiary" on their RRIF application. Assuming tax minimization at death will be a priority, the successor annuitant designation allows spouses/CLPs to receive the deceased's RRIF based on the plan's original terms and conditions. For example, if the deceased annuitant was receiving RRIF minimum payments based on their age, payments to the spouse/CLP would continue as such.

If the deceased was younger than the surviving spouse/CLP, using the deceased's age would result in smaller mandatory RRIF payments and a longer period of tax-deferred growth. Where a spouse/CLP is named beneficiary, future RRIF payments would be calculated based on the survivor's age, which would mean larger RRIF payments if the spouse/CLP was older than the deceased.

4 Pension split with RRIF income

If your client is 65 or older and receiving (or about to receive) RRIF income, they can claim the pension credit on their federal tax return for up to $2,000 of RRIF income, provided the credit has not already been claimed for other eligible incomes (e.g., payments from a defined benefit pension plan). A similar credit is also available provincially. The federal credit is worth $300 and can be used to offset tax payable on any form of income. This credit cannot be carried forward to a future year, so your client should claim it when available. If your client is under 65, the pension credit is only available for RRIF income if it is received due to the death of a spouse or common-law partner.

If your client is eligible to claim the pension credit for RRIF income (i.e., age 65 or older), they can split up to 50% of RRIF income with their spouse/CLP regardless of their spouse/CLP's age. Income eligible for the pension credit is also eligible for pension income-splitting. Where a spouse/CLP is in a lower tax bracket, an effective income-split will be achieved. Also, by allocating the RRIF income to a spouse/CLP, your client may be able to double the pension credit for their family, provided their spouse/CLP is 65 or older.

When splitting income, you should be mindful of Old Age Security (OAS) clawback thresholds to ensure that income-sensitive OAS benefits are not reduced as a result of the split.

While RRSPs don't need to be converted to RRIFs until December of the year annuitants turn 71, many clients choose to convert earlier. Some will require the income to fund their day-to-day needs, while others will convert for tax or estate planning reasons (e.g., to reinvest in a TFSA or avoid high tax rates at death).

With the number of clients expected to retire over the next decade, financial professionals have a wonderful opportunity to position themselves as valued partners in their client's financial security. Assisting in the transfer of RRSPs to RRIFs is part of that process and an opportunity to highlight some key tax and estate planning concepts.

Mackenzie's Tax & estate planning team can partner with you to help you consider the most effective tax strategies for retirement income to incorporate in your client's financial plan.

For more information please contact your Mackenzie Investment Sales Team or Mackenzie client services team at 1-800-387-0614.

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