The TaxLetter®

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TAXPLANNING

Eliminate unnecessary taxes. Proper planning now will…

Protect your RRSP

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A 70-year-old, unmarried client came to see me last month, worried about an issue that's common to many affluent Canadians.

He has accumulated $2.8-million in a RRIF and is now concerned about what will happen to his hard-earned nest egg when he passes away.

I had to deliver the bad news: when that day comes, his estate will face a 46 per cent tax bill that will cut his RRIF savings by almost half. The government will collect $1.3 million in taxes.

If he was married, my client could leave behind the entire $2.8 million to his wife. Being single, however, his estate will instantly diminish to only $1.5 million – a sizeable amount to be sure, but nothing like the original $2.8 million. It was time for me to help him protect his RRIF.

Most people don't know there is a tax-free rollover to a surviving spouse – but on the second death, all the money accumulated in RRSPs and RRIFs is considered income and gets taxed at the highest rate.

Divorced people, older singles, widows and widowers need to know about this, and find ways to protect their savings.

You decided to protect your financial future when you started buying RRSPs or RRIFs, so isn't this the time to think about protecting your RRSP?

Many Canadians actively squirrel away money into an RRSP every month or make an annual contribution (usually on the deadline!) in order to build up a healthy retirement package. Since the money is in a registered plan, it will be subject to tax only when it is removed from the plan.

That's because when you originally bought your RRSP, you received tax relief as an incentive to put money away to fund your retirement (a good move on their part, considering Ottawa does not want you to rely solely on the federal government for your retirement income).

That money has accrued over the years, free of income tax. The idea is that when you retire and start withdrawing the money, you will be in a lower tax bracket than when you made the original RRSP deposit. The tax bite shouldn't sting as much.

That explains why many people withdraw the prescribed minimum from their RRIF while the balance continues to accumulate, tax-free.

And for the same reasons that you should diversify the holdings and investments within your RRSP – to ensure safety and reduce risk – you also need to protect your RRSP.

Aside from ultimate tax liabilities, protecting retirement goals can be very difficult if certain unfortunate life events occur along the way. You have probably heard real stories about people without disability or critical-illness insurance being off work because of an injury or an entrepreneur or self-employed person who gets sick and has no company benefits.

Many companies today

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respond to financial pressures by reducing or eliminating employee benefits, leaving workers under-insured or completely exposed.

Companies with household names like Eaton's and Nortel are now gone, having left employees and their benefits in the lurch. Big companies – not just Blackberry, but even some of the big banks and other large corporations – are also reducing head counts.

What this all means is that you need to take responsibility now for your own health and retirement needs, and not rely on your employer to stay in business or keep a plan in place.

Besides, treating and coping with a serious illness often brings significant and unexpected costs not covered by government or employee health plans anyway. Consider just the lost income resulting from time away from work for both patient and caregivers.

But you still need money – to eat, to pay for the children's education or to cover everyday expenses. Most Canadians have their money in two main areas: their RRSPs and their homes. If they become ill or unable to work, chances are they won't have the strength or desire to sell their home (they still need a place to live) even if they wanted to.

Most people reach for their money in the next best place: their RRSPs. But as soon as you remove money from a registered plan, two major things happen:

- You will be taxed on this amount whether you are ill or well.
- It has taken years to build up your RRSP and the time required to replenish it will likely be no longer available.

Protect your investment.

Consider a critical illness insurance policy that would pay up to $2 million following the diagnosis of heart attack, stroke, cancer or any one of more than two dozen conditions. A healthy individual now contributing $500 a month to an RRSP should seriously consider reducing the monthly deposit RRSP to $400 and use the $100 difference to fund a defensive retirement strategy with critical illness coverage. It won't make a big dent in an individual's ultimate retirement "pot," but it will make a huge difference if he or she gets sick along the way.

Another defensive strategy in case of sickness: taking out a long-term care policy now to pay the expenses of home care or facility care if one cannot perform daily living activities or suffers a cognitive impairment like Alzheimer's or dementia.

Less than 25 per cent of all financial advisors have ever sold a living benefits policy ("living benefits" includes Critical Illness, Long Term Care and Disability Insurance).

It's understandable, therefore, that fewer than 10 per cent of Canadians actually have a critical illness policy, and even fewer have long-term care insurance. People often confuse critical illness with long-term disability insurance.

Aside from the obvious benefits of a large cheque provided by a critical illness policy to someone who gets sick, some policies will return all of the premiums paid just for staying healthy and not making a claim.

The optional Return of Premium can also return all the premiums paid to the beneficiaries of someone who doesn't survive a 30-day period beyond the diagnosis.

Married people should consider inexpensive joint-and-last-to-die life insurance to fund the tax that will be due on second death. It is a great way to ensure you leave something to your children and/or your favourite charities.

People who want to leave a sizeable portion of their estate to a charity, by the way, should consider a charitable legacy. If you have made arrangements for your non-registered assets or insurance to go to your children, perhaps name a charity as beneficiary for all or some of your RRSP/RRIF.

Most people would prefer to be remembered for leaving $1 million to charity instead of donating $460,000 to the government via taxes. If there are additional estate taxes due, the charitable receipt will reduce or eliminate those costs too.

Some may also want to consider buying a life insurance policy that names a charity as the owner and beneficiary of the policy.

As an example, one could take out an additional $50,000 a year from their RRIF or RRSP and, with that money, make a charitable donation which will eliminate the taxes due on the withdrawal and at the same time reduce the amount of taxes that would be going to the government on their death.

Or, they could consider taking out $50,000 year and buying a life insurance policy valued at $1million (assuming age 70). The charity would be the owner and the beneficiary of the policy.

The $50,000 from the RRIF is used to pay the premiums and therefore is considered a charitable donation.

That charitable donation will come in very handy at tax time to eliminate the person's taxes on the RRIF withdrawals. So not only is that person reducing the amount of tax paid that year, he or she will also be remembered as a philanthropist who left money to a worthwhile charity.

My favourite reason for adopting this strategy, however, is that it instills in our children and grandchildren charitable values as they can become the "board of directors" who decide where your gifts are distributed each year in perpetuity.

There are many strategies available to help reduce your final taxes and leave more to your loved ones or favourite charities.

Get good advice from an experienced professional with knowledge and expertise to get started. Work with a certified financial planner or trust and estate practitioner and avoid unforeseen problems. ❑

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