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Cracking the nest egg

Couple have saved for retirement; now they just need to know how to use it

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Unexpected and early retirement -- courtesy of corporate 'right-sizing' -- can often throw people off course, but not Tom and Harriet.

Tom lost his job a couple of years ago, about 10 years before he planned to retire.

Fortunately, he was able to take a reduced pension that, while not indexed to inflation, has provided him with a base income annually of $21,000.

So far, the couple has avoided dipping into savings because Harriet -- a health-care professional in her early 50s -- earns about $120,000 a year.

Yet, even if they did need to draw on their retirement money, they likely would have more than enough. All told, the couple's savings -- including TFSAs, LIRAs and RRSPs -- exceed $1.5 million. Moreover, when Harriet plans to retire in about three years, she will also have a work pension that will pay $1,200 a month.

Tom and Harriet's finances

INCOME
Harriet: $120,000 ($6,500 net a month)
Tom: $21,000 ($1,500 net a month)

MONTHLY EXPENSES: $4,575

DEBTS: none

ASSETS
Non-registered accounts: $1,011,000
Home: $575,000
Harriet's LIRA: $315,000
Harriet's RRSP: $135,000
Tom's RRSP: $66,500
Harriet's TFSA: $53,000
Tom's TFSA: $52,000
Harriet's work pension: $1,200 a month

NET WORTH: $2.21 million

Although they're happy with the management of their investments, trying to figure out how to create a retirement income from a variety of sources of savings is a baffling undertaking.

"One of our biggest concerns is how to fund our retirement years and in what order do we start to draw down on our accounts to feed the need for cash," says Tom, in his mid-50s.

Running out of cash isn't a concern, but preserving wealth is. While they do not have children, they do have plenty of nephews and nieces.

"I was fortunate to have a rich aunt who passed away who helped us out," he says. "You always like to spend your last penny on your death bed, but we would like to be the rich aunt and uncle who leave something behind."

Certified financial planner Daryl Diamond says Tom and Harriet are well-positioned to achieve their retirement goals.

"There are a number of favourable factors at play for Tom and Harriet to make their savings work efficiently," says the financial adviser with Diamond Retirement Planning Ltd. in Winnipeg.

For one, they have defined benefit pensions to provide base incomes. It is also helpful the majority of their investments are in taxable accounts, which provides flexibility in developing a tax-efficient income.

But Tom and Harriet have also done a lot of legwork on the planning side. For instance, they've done a good job of tracking expenses, even forecasting their future retirement costs: about $4,600 a month.

Now, all they need to do is develop an income plan to match, says Diamond, author of Your Retirement Income Blueprint.

"In Manitoba, at their age, it takes approximately $40,000 of pre-tax income for each of them to create a combined $5,400 monthly after tax," Diamond says, adding this sum gives them a little breathing room in their budget for additional costs such as travel.

Equally important is this level of income is very tax efficient, keeping them below the second federal tax bracket (currently $44,701).

With a pension paying $21,000 a year, Tom is already halfway to this target. For the remaining $19,000, he should look to dividend and interest income from their jointly owned non-registered investments of about $1 million.

"Before retirement, it is fine to reinvest that income," Diamond says. "When they retire, though, they should have these paid out to them to form part of their income."

Interest income is fully taxable, but dividend income from Canadian publicly traded companies is very tax efficient. For example, Tom would pay only about 6.5 per cent tax on dividends to achieve his income goal.

Harriet, who will draw a pension of about $14,000 before taxes annually, should consider converting her LIRA -- worth about $315,000 -- to a Life Income Fund (LIF) that would generate about $24,000 a year before taxes.

This would bring her base income at age 55 up to more than $38,000 a year.

"There will immediately be some opportunity for Harriet to pension split her defined-benefit pension income of $14,400 with Tom," says Diamond, adding LIF income cannot be split until Harriet is 65.

Combining their pension income with income from their taxable investments -- estimated at about $25,000 annually from dividends and interest -- they should have enough to fund their lifestyle until they are eligible for CPP.

And Diamond says Tom and Harriet should take their CPP at age 60 because it will reduce the burden of having to draw on their savings. Early receipt of CPP will be especially beneficial for Tom.

"Tom stopped making contributions to CPP at 50, but the Canada Pension Plan does not view that as the end of his contribution period, so unless he commences his retirement benefit early, the end of his contribution period is age 65," Diamond says. "This means he will have 15 years with no contributions that could negatively affect his CPP payment if he waits until age 65."

Drawing on CPP as early as possible will reduce the period Tom isn't making contributions by five years, which will actually increase his benefit over the long-term even if his benefit will be reduced by 36 per cent for early receipt compared to waiting until 65.

Should they require more income, Tom and Harriet can draw from their RRSPs. While fully taxable, the registered withdrawals would not have a significant impact on their tax situation. In fact, they may want to consider making withdrawals from their RRSPs regardless of whether they need the income or not.

"Ideally, they would take out enough to bring them to the top of the first federal bracket ($44,700), but that will depend on the amount of annual taxable distributions from the non-registered accounts," Diamond says. "So while it would make sense to top up with some RRSP money, it will be a year-to-year decision."

Furthermore, because their registered accounts only make up a little more than $200,000 of their overall assets, leaving the RRSPs relatively untouched early in retirement would not have a profound impact on their taxes at age 71, when annually prescribed withdrawals are mandatory.

Still, Diamond suggests they consider a little investment planning to improve returns, income and tax efficiency.

Among them is unifying their investments. At the moment, they're split between two financial institutions.

"There may be personal reasons for having accounts split between a broker and an institution, but I have found that the best outcomes result when clients consolidate their assets with one adviser."

About $275,000 is sitting in cash accounts with a different institution while the rest is under professional management. Consolidating all their investable assets under the guidance of their money manager would help them balance their need to fund their retirement with their desire to leave a legacy. Yet, this is just a minor consideration in the overall scheme of things, Diamond says.

"The level of after-tax cash flow Tom and Harriet want should very comfortably be provided by their pensions and the taxable distributions from their sizable, non-registered accounts," Diamond says. "This means they should be able to create the income they want without selling invested assets and this, in retirement, is the ideal situation."

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