Why withdrawing from an RRSP early is more tax-efficient for some clients

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Taking out RRSP money sooner can reduce the size of an account before mandatory registered retirement income fund withdrawals begin.

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Canadians spend most of their working lives stuffing money into a registered retirement savings plan (RRSP) to live off later in life. Yet, advisors say not enough effort goes into figuring out the most tax-efficient way to withdraw those funds.

For some Canadians, the best strategy is to start taking money out of an RRSP sooner than needed to smooth out retirement income, spread out taxes and potentially increase government benefits.

"While it may seem intuitive to keep money in an RRSP and delay the taxes for as long as possible, delaying taxes isn't always in your favour," says Morgan Ulmer, a certified financial planner at Caring for Clients in Calgary.

Ms. Ulmer says the strategy, sometimes called an "RRSP meltdown" (not the kind that involves taking out a loan), often works best when individuals are in a lower tax bracket post-retirement, allowing them to pay fewer taxes later.

The strategy can also help people postpone their Canada Pension Plan (CPP) and Old Age Security (OAS) benefits (and receive higher payments), avoid an OAS clawback and provide some liquidity when combined with a tax-free savings account.

"It's really about taking a broader view of taxes instead of focusing on minimizing taxes year to year," Ms. Ulmer says. "You're looking at your lifetime tax burden, including taxes on your estate, and so it can sometimes make sense to pay more taxes sooner versus later."

Owen Winkelmolen, an advice-only financial planner and founder of PlanEasy.ca and Adviice.ca in London, Ont., says most Canadians approaching retirement should explore making early withdrawals from their RRSPs.

"It's a big part of decumulation planning," Mr. Winkelmolen says.

He says taking out RRSP money sooner – for example, between ages 60 and 70 – can reduce the size of an RRSP before mandatory withdrawals begin when a client is forced to convert it to a registered retirement income fund (RRIF) by the end of the year they turn 71. The percentage of those mandatory withdrawals increases each year based on the accountholder's age.

"What we're trying to do is draw from the RRSP strategically, to take advantage of withdrawals at a lower tax rate," he says.

Early RRSP withdrawals before age 65 can also prevent an OAS clawback and, for lower-income Canadians, help them qualify for the guaranteed income supplement (GIS), Mr. Winkelmolen says.

“With the RRSP meltdown, and when GIS is a factor, we’re just trying to get the money out of that RRSP as fast as we can to avoid these annoying clawbacks,” he says.

Mr. Winkelmolen says the strategy is also helpful for couples with sizeable RRSPs. For example, if a husband and wife each have $500,000 in an RRSP and one dies, their assets will roll over to the survivor, who will wind up paying taxes on withdrawals from a $1-million registered account.

“It’s all taxed in their name instead of in two people,” he says. “And often, what can happen is they’re also losing their OAS. So, not only did they lose their spouse’s OAS because there’s no survivor benefit, but now they’ve lost their OAS as well because they’re being forced to take so much more out of their RRIF every year.”

Mr. Winkelmolen adds that withdrawing RRSP money early can also increase liquidity in retirement, especially when transferring the funds into a TFSA.

“Even if we don’t need the money for retirement spending, we’ll often look at melting down the RRSP a little bit faster just to get money into the TFSA,” he says.

Not only does the money grow tax-free in a TFSA, but it can be used for lump-sum expenses such as helping a child or grandchild with a down payment on a house, or covering medical expenses, or a spouse moving into long-term care.

“That tax will get paid at some point anyway, but with the assets in the TFSA, it’s so much more flexible,” he says.

Aurele Courcelles, vice-president, tax and estate planning at IG Wealth Management in Winnipeg, says starting RRSP withdraws early can also help Canadians delay receiving their CPP and OAS benefits and, in turn, lead to higher monthly payouts.

“Typically, people would retire, start their CPP and supplement with RRSPs as needed,” he says. “They can start receiving CPP retirement benefits as early as age 60, but by pushing out those CPP benefits by five, six or 10 years, they can get a much larger amount of money that's guaranteed for life, which an RRSP is not."

Canadians who hold off until 70 to collect their CPP benefits receive 42 per cent more than if they took it at 65, while those who wait until 70 to take OAS receive 36 per cent more than if they started at 65.

"It's a conversation I have a lot: 'Are you better off deferring your CPP and OAS and living off your RRSPs?'" Mr. Courcelles says.

Many advisors use specialized financial planning software that helps determine when their clients should start withdrawing from RRSPs based on various factors, such as when they take their CPP and OAS benefits, other sources of income and investments, their current and future tax rates and life expectancy.

"There are tons of variables, making comparing results more difficult. I like to look at the estate value at the end to compare results," he says. "Then, you can change the variables to see which gives you the results you're looking for," including how much a client wants to leave behind.

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