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Introduction to Retirement Income Decumulation in Canada

By Weichurn Woo

Retirement income decumulation is a critical phase in the financial journey of Canadians, with the primary definition being that of transitioning from the accumulation of savings during their working years to the strategic withdrawal of those funds to support their lifestyle in retirement. This process, often misunderstood, involves converting accumulated assets into a sustainable income stream. As more Canadians approach retirement with substantial savings, understanding decumulation strategies becomes increasingly essential for ensuring financial security throughout retirement.

Note: Please refer to my ‘Financial Longevity for Women’ and ‘Gentlemen, Are You Approaching Retirement?’ articles as great supplementary reads for the social aspects of retirement.

Understanding Decumulation

Decumulation refers to the period when retirees begin to spend down their accumulated wealth. This phase is characterized by the need to convert savings into regular income, which can be complex due to various financial products and strategies available to retirees. The decumulation phase is fundamentally different from the accumulation phase, where individuals focus on saving and growing their wealth through investments in stocks, bonds, and other alternative assets.

A secondary definition, which is also common among my retired clients, is growing of investments from decumulation of RRSP assets to accumulation of assets outside of the RRSP for estate value building. This is due to all sources of income for the retiree still being greater than what is needed for their financial needs. At some point, the retiree will need to convert the RRSP to a RRIF, and in the situation where they have more income than expenses, they may continue to add to their TFSA and non-registered accounts. Whether the retiree will need the RRIF income and other retirement income sources for expenses or decide to reinvest it will depend on individual circumstances.

The Importance of Planning

Effective planning during the decumulation phase is crucial. Research indicates that decisions made during this time can significantly impact retirement income—often more so than choices made during the accumulation phase!

Retirees must navigate various income sources, including government benefits like Old Age Security (OAS) and Canada Pension Plan (CPP) payments, as well as personal savings from Registered Retirement Savings Plans (RRSPs), Tax-Free Savings Accounts (TFSAs), and other investment.

Key Components of Retirement Income

To develop a comprehensive decumulation strategy, retirees should consider multiple income sources:

1. **Old Age Security (OAS)**: A government pension available to most Canadians aged 65 and older.
2. **Canada Pension Plan (CPP)**: A contributory program that provides retirement income based on an individual's earnings history.
3. **Registered Retirement Savings Plans (RRSPs, LIRAs)**: Tax-deferred accounts that allow individuals to save for retirement and eventually be required to convert to RRIF and LIF accounts.
4. **Tax-Free Savings Accounts (TFSAs)**: Flexible investment accounts that allow tax-free growth and withdrawals.
5. **Pensions**: Generally, retirement pensions provided by your employer. Many employers may also give you the option to commit your pension to a LIRA by a certain time upon retirement.
6. **Other Assets**: This includes real estate and taxable non-registered investment accounts. This could also include corporate investment accounts if the retiree was a business owner and now in the winding down stage of the corporation. For some, it could also include receiving of inheritance funds. Among my clients, many of those who have received inheritance are in their mid to late 60s, from their parents who passed in their late 80s to mid 90s. See my article on inheritance.

These components collectively contribute to a retiree's overall income strategy, which must be tailored to individual needs and circumstances.

Strategies for Effective Decumulation

Investment Management

During decumulation, it is generally advisable for retirees to shift their investment portfolios towards less volatile asset allocation mix from their higher growth but higher fluctuations investments when they were younger. I have many articles on the blog section of my website, going over specific segments of my overall investment philosophy for retiree investments regarding this. Rarely would we consider the same allocation as we would for a much younger person with a much longer time horizon, except for specific circumstances such as they have both the financial capacity (they have a pension to cover their expenses or higher knowledge of markets), as well the emotional capacity to handle higher fluctuations during stressful market conditions. That being said, I also wrote on redefining risk of traditional low-risk assets, such as bonds not serving the same risk management tool as it used to for the past few years, and hence the need to shift to other options such as covered put mutual funds (see my article on Covered Put Funds) for diversification of risk management.

Balancing safety with growth potential is essential, as retirees need their funds to last throughout their lifetime or even enhance estate value for beneficiaries if assets are more than enough to provide for their lifestyle costs. On this specific note, I also ask clients that even if they think they have more than enough financially, to consider worst case scenario costs for private health care, as our public health care continues to be under increasing pressure for the foreseeable future.

As an example, some of my clients have opted to pay for much faster private hip and knee surgery instead of waiting for years in chronic pain under the public health system. I do not want any of my clients to be in unnecessary medical pain if money can help alleviate it.

Withdrawal Strategies

When deciding the order of withdrawals from an RRSP, TFSA, or a non-registered account, the default or conventional thought is that is generally advisable to withdraw from non-registered accounts first. This approach helps minimize immediate tax implications, as funds withdrawn from non-registered accounts may only incur capital gains tax if investments are sold at a profit. By preserving tax-free growth in the TFSA and delaying RRSP withdrawals—which are fully taxable—you can potentially optimize your overall tax situation in retirement.

When the RRSP has not converted to RRIF yet, withdrawing from the TFSA should typically be considered next if additional funds are needed, especially if you have already exhausted your non-registered funds. The TFSA offers tax-free withdrawals, making it a valuable resource for managing cash flow without increasing your taxable income.

Finally, RRSP withdrawals should generally be the last resort due to their tax implications. Withdrawals from an RRSP are treated as taxable income, which can significantly affect your tax bracket and can lead to withholding taxes at the time of withdrawal. More importantly, it will delay taxation on compounded investment growth. It is prudent to delay these withdrawals until absolutely necessary, such as when other sources of income have been depleted or when you are required to convert your RRSP into a RRIF after age 71.

Let's look at the reverse order now. Withdrawing from an RRSP before a TFSA or non-registered account can be advantageous in specific scenarios. If you anticipate a lower income in the current year compared to future years, withdrawing from your RRSP can be beneficial as it may allow you to pay taxes at a lower rate now. This strategy is especially relevant if you expect to enter a higher tax bracket later such as pension sources coming in, making it more advantageous to utilize RRSP funds while your tax rate is lower. Additionally, if you have significant capital gains in your non-registered account that you do not want a deemed disposition on, withdrawing from your RRSP first may help you avoid triggering those gains.

Selling investments in a non-registered account can result in capital gains taxes, while RRSP withdrawals are taxed as income which will eventually happen anyways from RRIF conversion. By prioritizing RRSP withdrawals, you can preserve your non-registered investments for a time when you may be in a lower tax situation.

Before age 71, another primary reason for taking out RRSP funds even if you do not need the money for expenses, and this generally should occur in your early 60s, is concerns that at age 71, the RRIF payments, combined with other sources of retirement income, will make you lose out on tax credits and government benefits, such as the seniors age tax credit or the full Old Age Security payments due to OAS clawbacks. Other major concern is that RRIF payments could push you to next high tax bracket.

After age 71, withdrawing more than the minimum from your RRIF can also be strategic. If you anticipate needing additional funds for expenses or wish to decrease estate taxes of RRIF upon death to beneficiaries who are not spouses (the main reason my clients do this). As a reminder, spouses receive tax-free rollover of RRSP / RRIF accounts when their partner passes away. This strategy, however, basically means paying more taxes now to reduce future estate taxes.

As always, it is advisable to also work with a qualified tax expert for your specific tax circumstances, alongside your financial advisor or investment advisor who should be able to aid you in a general way in this important area.

Challenges in Decumulation

Retirees face several challenges during the decumulation phase:

1. **Longevity Risk**: The risk of outliving one's savings is significant as life expectancies increase.
2. **Market Volatility**: Fluctuations in investment markets can impact the sustainability of withdrawals.
3. **Inflation**: Rising costs can erode purchasing power over time, necessitating strategies that account for inflation.
4. **Health Risk** – Unexpected and rising costs of health care.
5. **Caregiving Risk** – Unexpected or expected rising costs of taking care of a loved one. I will have a future article on caregiver finances.

Addressing these challenges requires careful planning and often professional guidance to ensure that retirees can maintain their desired standard of living throughout retirement.

Conclusion

Retirement income decumulation is a vital aspect of retirement income planning for Canadians approaching or in retirement. As individuals transition from accumulating wealth to drawing down their registered savings, or to enhance estate value outside of their RRSPs, understanding the various strategies and products available becomes crucial for achieving financial security.

With ongoing innovations in retirement income investment products and a growing recognition of the complexities involved in decumulation, Canadians can better navigate this critical phase of their financial lives. Effective planning not only enhances individual well-being but also contributes positively to society as more Canadians enter retirement with substantial assets and hopes for a comfortable lifestyle amid ever evolving economic landscape.

If you want to explore post-retirement goals aimed at creating healthy and balanced financial strategies, please contact me at wwoo@researchcapital.com.

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