RRIF meltdown strategy softens retirement income tax hit

With the first wave of baby boomers set to retire in 2011, some of that massive build-up of wealth protected inside RRSPs will start turning into income. For the affluent person with a good pension and sizeable registered portfolio, this income will be taxed at high marginal rates of up to 48%.

So, how do advisors help their higher-end clients avoid the tax hit? In a word: leveraging. But the strategy is not without its risks and controversy.

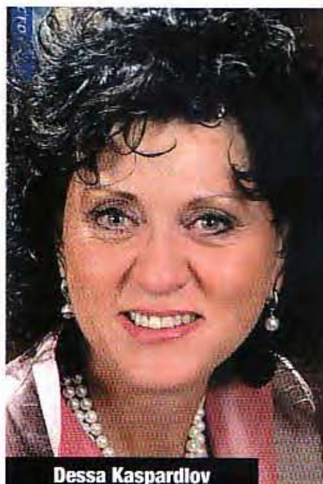
The so-called RRIF "meltdown" involves slowly transferring registered funds into non-registered assets without paying tax. The idea is to set up an investment loan with interest payments roughly equivalent to RRIF withdrawals (it can also be done with RRSPs, referred to as a "freeze"). If a client takes $10,000 out of a RRIF, an investment loan can be set up that will require $10,000 in interest payments. Because the interest payments are for investment purposes, they are fully tax deductible and thus cancel out the registered withdrawal. To make sense, the loan funds should be placed in equity-based investments paying more tax-efficient capital gains or dividends, not interest income.

"Once you trim away the names, whether a 'freeze' or 'meltdown,' what it really comes down to is leveraged investing," says **Doug Carroll**, assistant vice-president, tax and estate planning at **AIM Trimark Investments**. "The source of the money to pay the interest charges is your RRIF or RRSP."

Sophisticated investors

Mr. Carroll notes this strategy will mainly be used by wealthier, more sophisticated investors accustomed to the risks of equity markets. "Take, for example, people heading into retirement after a middle-income existence and they are looking at withdrawing money from a reasonable but not huge RRIF," he observes. "To suggest they are going to relax and retire, oh and also get an investment loan – it just isn't going to fly."

Talbot Stevens


Dessa Kaspardlov

But the allure of tax-savings for people who can afford to play with their RRIFs or RRSPS may be growing in popularity in the roughly 12 to 13 billion dollar leveraging market, according to **Talbot Stevens**, a financial educator and consultant who offers seminars on leveraging strategies.

"I think there is room for the responsible implementation of a RRIF freeze," he says. "Let's say you have a good pension, and you and your spouse have already realistically met your comfortable retirement needs until a ripe old age. If you have more registered dollars than you need, you could use some draws from that registered pool over time to essentially convert registered dollars to unregistered equities that have their own adjusted cost base and tax rates."

Tim Cestnick, a managing director at **The WaterStreet Group Inc.** and a tax specialist, says there may be situations in which people have too much money parked in their RRSPs and a gradual freeze strategy could work. "If you figure out you need $500,000 at age 65 to live on for the rest of your life, then arguably you should not have more than that in your RRSP," he notes. "Having more might not make sense from a tax point of view. In that case, you can consider a leveraged strategy."

Clear risks

There are, however, clear risks. The key danger is the typical exposure associated with any leveraging strategy: it can amplify potential gains – and losses. The problem with the RRIF meltdown is that the time horizon usually recommended for leveraging, roughly ten years, may not be realistic. In other words, the client could decide to exit the strategy, or even die, in the midst of a nasty and prolonged market down turn.

"If you try to do it on too short a term, the risk is you will end up in a situation where your interest charges will keep coming but your investments could be declining," notes

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— Doug Carroll

(Cont'd from page 6)
Mr. Carroll. "You need to expect you are going to be in for at least one investment cycle. Sometimes, you might have four to five years between recessions, other times it could be nine to twelve years."

"Leveraging for older clients can get the industry in hot water," says Mr. Stevens. "One of my guidelines for responsible leveraging is at least an eight to ten year time horizon. If you are 71 years old, you can't guarantee that. It is all fine and good on paper, but to do a RRIF freeze right, advisors really should have the beneficiaries understanding and signing off on it."

Tests to consider

Mr. Cestnick says there are a number of tests to consider before suggesting a freeze or meltdown. "Number one, the client has to be a good candidate to borrow to invest and not everybody is," he explains. "Cash flow is the most important thing. How much money can they afford to make on a loan every month? And are they looking at a sufficient timeframe of eight or more years where they won't touch the borrowed funds? If you have cash flow and a good timeframe, then it can work."

Dessa Kaspardlov, a financial advisor with Windsor, Ontario-based **KL&A** and a leveraging specialist, says her firm has used the strategy. "We have done some leveraging for older people who have RRIFs," she says. "But it is a little more high end, definitely with higher amounts of leveraging."

Universal life twist

In fact, Ms. Kaspardlov cites a unique twist on the RRIF freeze that involves universal life insurance (UL). Here's how it works. A client uses the accumulated value within a UL policy as collateral for a loan from a bank or lender. Instead of drawing income from another source, such as a highly taxable RRIF, the person collects money on the loan, while paying only the interest.

"If you take those two things side by side, it looks great," says Mr. Carroll, who has written in-depth papers on the subject. "Do I want to pay a marginal tax rate of 40 to 48 per cent or pay the interest on the loan of, say, eight per cent? Clearly, I would want the latter. And it can be a useful option to access the money in the UL policy via loan."

However, Mr. Carroll notes that this money may be "tax-free" income but it is not "cost-free" income. "You are paying a bank money to get at your money. It's very complicated, much more complicated than it sometimes gets played out," he says.

For example, if someone lives long, the interest charges on the loan could add up. "Certainly, your loan interest is growing and so is the accumulation over in the UL policy, which in theory should be compounding very well in a tax-sheltered environment," Mr. Carroll notes. "But depending on how aggressive the assumptions are, you can definitely get yourself in some dangerous territory."

Any kind of leveraging has the potential to get clients into trouble, according to Mr. Stevens. But the most dangerous aspect of it, especially for older clients, may be the emotional risk during a period when they may not have the time or appetite to wait out market cycles.

"The biggest risk for both advisors and clients is emotional or behavioural risk," Mr. Stevens says. "The reality is that people get into the equity markets when they are high. And they exit when there are problems. That is the cycle that human nature leads us to over and over. Given that fact, we all have to acknowledge that leveraging is risky for a 45-year- old. It is even riskier for a 65-year-old."

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