Personal Finance

Woman struggles after drop in income

Removing money in small increments could help avoid tax penalties

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Kaitlin has been making life work on less than $24,000 a year. Living mostly off CPP Disability — about $889 a month — she's been patching together a steady cash flow with her registered retirement savings and payments from a high-income mutual fund.

That last piece of the patchwork had been a major boon for her finances until recently.

"My mutual fund had been paying $589 a month, but in September it dropped to $168," the 63-year-old says. "So it was a big shock."

Now Kaitlin is earning about $1,200 a month, and many of her leisure activities, such as travel, are at risk of being pared back.

She does have savings she can use to make up for the loss of income. She has more than $350,000 spread across an RRSP, a life income fund (LIF), a retirement income fund (RRIF), non-registered savings and a TFSA. About two-thirds are in GICs after she got spooked last year by falling markets.

Much of the remaining sum — about $116,000 — is invested in the aforementioned underperforming fund. Another $35,000 is invested in an income fund that has been performing well.

That has Kaitlin thinking about moving her money from the bad fund to the good one. The problem is she can't do it until June or she will pay a penalty (as a result of trailing fees).

Kaitlin's finances

Income: $23,925

Monthly expenses: $1,600

Home: $240,000

RRIF: $38,000

RRSP: $36,000

LIF: $36,000

LIRA: $101,000

Non-registered mutual fund (poor performer): $116,000

Non-registered mutual fund (good performer): $35,000

TFSA: $46,000

She is looking for alternatives. But she doesn’t know which ones will address her needs.

"You’re looking at someone who is trying to maximize what she’s got left, while leaving something behind to my kids and charity," Kaitlin says. "The tricky part is you don’t know how long you’re going to live either."

Certified planner Karen Diamond says Kaitlin’s experience is all too common. "With prolonged periods of low interest rates and limited opportunity for capital gains, it is hard for some funds to sustain payout rates that were struck under much different conditions," says the adviser with Diamond Retirement Planning Ltd. in Winnipeg.

"Managers have no choice but to cut the monthly distribution — and this has happened in many cases."

Fortunately, Kaitlin has plenty of savings and can create a sustainable income that’s not only more tax-efficient than what she currently receives, but that would leave her with substantially more money. This strategy wouldn’t necessarily involve her moving money from one fund to the other.

"If she does that, she might trigger a capital gain and expose herself to taxation," Diamond says.

Because Kaitlin has owned the poor performing income fund for a very long time, it’s likely the capital gain is significant. As a result she could end up paying thousands of dollars in tax in one fell swoop. She can find out what the tax bill might be by calculating the investment’s adjusted cost base (ACB): the original price paid for the investment, plus costs incurred that may decrease its value. (Her financial adviser can help her with this calculation.)

"The difference between the ACB and the market value is the capital gain, half of which is taxable," Diamond says.

If the gain is significant, Kaitlin should consider other options.

For example, she could move the money to another income-oriented fund within the same mutual fund company. That could still trigger taxes, but it would avoid trailer-fee penalties for early redemption.

Another path involves removing money in small increments over time — as income — while reinvesting the distributions from the fund.

"In this case, she could set a dollar value on the withdrawal she wants — i.e. $600 a month — and it would remain consistent."

She would need to sell fund units and could probably withdraw about 10 per cent of the fund's value without incurring the penalty for early redemption.

"This systematic withdrawal plan would also cut the capital gain into income in smaller portions over time," Diamond says.

This would help minimize taxation because some of the withdrawals would be made up of a return of capital, which isn't taxable.

Still, this strategy does not address another problem: the asset allocation of the current fund. Diamond says the fund is largely made up of high-yield U.S. bonds. These have performed well, but the fund is not as diversified as the other one she owns, which invests in bonds and stocks.

Moreover, the income the fund in question generates is mostly made up of interest, which is fully taxable, so it is not tax-efficient. By comparison, a fund that invests also in dividends would be much more tax-efficient. Based on her income, she'd pay less than four per cent tax on dividends.

Given the potential tax savings, Kaitlin should move her money once the redemption penalty period has expired, but not en masse. Instead, it should be transferred in tax-efficient portions over time to the other income fund she owns, which is more diversified and better performing.

In the meantime, however, she has everything required to create a tax-efficient income for the long term.

"Kaitlin could afford to take a somewhat larger retirement income from her assets — probably something in the neighbourhood of about $30,000 with an inflation factor built in —but she would need to realize a long-range rate of return of at least three per cent on her retirement savings."

This can't be done with most of her money sitting in GICs earning about two per cent.

Government benefits at 65 years old — CPP and OAS — will provide a good portion of guaranteed lifetime income, allowing her to take on more risk in her portfolio in exchange for more return.

"Even then, she could employ a ‘cash wedge’ in her savings portfolio to secure the value of her anticipated withdrawals in the short term," Diamond says.

This would consist of two years’ worth of income needs in a high-interest savings account. Kaitlin would still have to bridge an income shortfall between now and when she turns 65, which is thus, when she will eligible for OAS. To do this, Kaitlin can tap into her registered savings more than she has been.

While she fears spending too much of her savings at the expense of her estate, Diamond suggest Kaitlin could use her TFSA as the inheritance piece to her plan. She could even grow that sum over time by withdrawing money — over and above what she needs — from registered accounts in a tax-efficient manner.

Meanwhile, the TFSA could be invested in an income fund paying out tax-free income to supplement her lifestyle while keeping the capital intact.

But Diamond says the main part of any tax-efficient strategy involving estate planning would focus on generating income from her LIF, RRIF and RRSP while she’s alive, because all are fully taxable on death.

Moreover, she could leave any remaining capital in these accounts to charity, because the donation would trigger a tax credit that could nullify most — if not all — taxes payable by the estate. (Her home could be a source of estate wealth, too, but she may need to sell and use the proceeds for assisted living accommodations, for example.)

Certainly, Kaitlin has a lot to digest, and assistance from a financial planner would help her build a sustainable strategy to meet her needs, Diamond says. But the money is there. All she needs is a good plan.