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Smart Money: What happens to your money in retirement

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Brad Brain: "I remember one instance where a person based their entire retirement income strategy on a misunderstanding, and the result was unnecessary taxation and the premature depletion of their investment accounts. Make sure your retirement planning is based on good information." | Getty Images

In the world of financial planning there is no shortage of things that are the source of confusion and concern. One of the things on that list is what happens to your money in retirement. Clawbacks, eligibility for benefits, taxes; there are all sorts of questions.

Sometimes people don't figure out the proper answers, and plow forward without a full understanding. This can lead to expensive mistakes, so let's deal with some common misconceptions.

Misconception 1: "The Canada Pension Plan is going broke; I won't see anything from CPP!"

Not true. There used to be concerns about the sustainability of the Canada Pension Plan, but steps were taken and now the CPP is on a strong financial footing. There is $520 billion in the fund now, and there are no foreseeable problems for at least the next 75 years.

Misconception 2: "I don't want to lose my Canada Pension Plan to clawbacks!"

You won't. CPP is not subject to clawbacks. You may pay some tax on your CPP income, but nobody is going to take your CPP away from you.

Misconception 3: "I am going to lose my Old Age Security to clawbacks!"

Maybe. But you won't lose a penny until your income hits $79,845, and you won't lose it all unless you make more than $129,075. Folks, the OAS is intended to provide seniors with a modest retirement income. If you are making more than $130,000 in retirement, you are not who the OAS is intended for.

The paradox is the people that worry about losing OAS to clawbacks are often well below the income threshold, and the people that are making $130K a year usually don't sweat not receiving another $615 monthly in OAS benefit. In other words, the people that are worried usually aren't affected, and the people that are affected usually aren't worried.

Misconception 4: "RRSPs are a big rip-off because you pay tax when the money comes out!"

Tax on withdrawals is true, but misleading. Yes, when money comes out of your RRSP (or RRIF), you will pay tax on it. But let's not forget that you got the tax deduction on this money when it was contributed to the RRSP, and you have had tax sheltered growth as long as the money was in a registered plan. The withdrawal is literally the first time this money has been subject to income tax.

Meanwhile, if RRSPs are used as they are intended, it allows you to save for retirement by getting a tax deduction while you are working (and presumably in a high tax bracket), and have the income taxed when after you stop working (and presumably are in a lower tax bracket).

Misconception 5: "RRSPs are a big rip-off because the government makes you take all your money out and then you have to pay a bunch of tax!"

This is true, but exaggerated. Eventually you will have to tax the income out, but you have until the end of the year that you turn 71 to convert your RRSP into an income stream. You don't have to wait that long though, if you would like some income a little sooner.

Most people will convert their RRSP into a Registered Retirement Income Fund, or RRIF. If you take income from a RRIF at age 65 the minimum amount that you must take out is 4%t of the account, which is taxable. You can take out more if you wish, but you must take out (and pay tax on) at least 4% of the account.

The idea of forced taxation is unappealing but let's dig a little deeper. If you have $500,000 in your RRIF at age 65 that means you have to pay tax on at least $20,000. Hardly a seismic financial event. Most people take money out of their RRIF because they want the retirement income, not because they are forced to by the RRIF minimum.

I remember one instance where a person based his entire retirement income strategy on a misunderstanding, and the result was unnecessary taxation and the premature depletion of his investment accounts. Make sure your retirement planning is based on good information.

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