TAX, RETIREMENT AND ESTATE PLANNING

RETIREMENT INCOME PLANNING: TACKLING THE OAS CLAWBACK CHALLENGE

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As Canada's baby boomers settle into retirement, many are caught off guard by the intricacies of financial planning. Consider the following example.

Edwin (age 65) is recently retired. Like many Canadians, Edwin is looking forward to taking advantage of the many benefits available to seniors, including an Old Age Security (OAS) pension, which for 2019 pays a maximum of $7,362 to those who receive full benefits. Edwin never envisioned a retirement without work, so to supplement his income, he launched a consulting business that allows him to work part time at his leisure. In his first year of retirement, Edwin's income consisted of the following:

Net business income:	$10,000
Registered pension income:	$50,000
OAS/CPP pension beneifts:	$15,000
Canadian eligible dividends:	$15,000

Edwin has some experience with investments and believes that he has a good understanding of Canada's retirement income system. He is aware that OAS benefits are "income sensitive," such that benefits decrease as income increases. Specifically, Edwin is aware that OAS benefits are "clawed back" at a rate of 15% once net income reaches $77,580[1] with full elimination at $126,058[1].

Given his income ($90,000 for the year), Edwin believed his OAS benefit would be reduced by $1,863 for the year (or $155 a month) calculated as follows:

Net income ($10K+$50K+$15K+$15K)	$90,000
Minus clawback threshold	$77,580
Excess amount	$12,420
Times clawback rate	15%
Clawback bite	$1,863

While filing his tax return for the year, Edwin was surprised to learn that his clawback for the year was higher than he estimated. Instead of a clawback of $1,863 for the year, his clawback was $2,718 or approximately $71 per month higher than he expected (or $227 per month higher than a senior entitled to full benefits). Why the difference? The culprit was his Canadian dividends.

Canadian dividends can be an efficient form of retirement income. Investing in Canadian stocks can allow for capital appreciation while at the same time provide a consistent stream of dividend income. In addition, for residents of all provinces and territories, dividend income is taxed more efficiently than interest income, which makes it a suitable income stream for many Canadians. However, for OAS purposes, the impact of dividends can catch many seniors off guard because of the dividend "gross-up" mechanism.

When calculating taxable income for OAS purposes, Canadian dividends are "grossed-up." This means, instead of including in taxable income the actual amount of dividends received, the dividends are increased by a percentage depending on type of income. For 2019, the gross-up is 38% for eligible dividends[2] and 15% for non-eligible dividends[2]. So, in Edwin's case, his $15,000 of eligible dividends were grossed up to $20,700 with the latter amount being included in net income as follows:

Net income ($10K+$50K+$15K+$20,700)	$95,700
Minus clawback threshold	$77,580
Excess amount	$18,120
Times clawback rate	15%
Clawback bite	$2,718

[1] 2019 calendar year. Thresholds increase with inflation each year.

[2] Eligible dividends are normally received from publicly traded companies. Noneligible dividends are normally paid by privately held companies from small business or investment income.

The gross-up mechanism is part of a larger system related to the taxation of dividends. The system is meant to ensure a balanced playing field between those who earn income through a corporation versus those who earn the same income personally. A dividend tax credit, which reduces tax payable on dividend income, is also part of the system, but the credit applies *after* the calculation of the OAS clawback, leaving many seniors with a smaller OAS benefit than originally expected.

The income-sensitive nature of the OAS program is not new. For years, financial advisors have been implementing strategies to reduce the bite of the OAS clawback. As time passes, strategies are modified and/or new strategies are introduced due to changes in legislation or the introduction of new investment products. Consider the following strategies when faced with the OAS clawback challenge.

CONSIDER CAPITAL GAINS INSTEAD OF DIVIDENDS

Capital gains are not subject to a gross-up and only 50% of capital gains are included in taxable income. Therefore, investing for capital gains keeps net income to a minimum, thereby preserving OAS benefits. Corporate class mutual funds can be an ideal solution in situations such as these. Because corporate class funds are designed for capital appreciation, and also because they tend to pay less in taxable distributions than certain stocks, bonds or mutual fund trusts each year, capital gains over time can be achieved in a tax-efficient manner. Should investors require a regular income stream from their non-registered investments, a systematic withdrawal plan – which produces capital gain/loss treatment on sale of investments – can be considered.

CLASS T MUTUAL FUNDS

Class T mutual funds are tax-deferral vehicles – they allow investors to receive tax-efficient cash flow today, while deferring taxable income to the future. Many Class T funds provide investors with a cash flow distribution of up to 8% of the fund's fair market value (FMV) annually with the distribution being characterized as a tax-free return of capital (ROC). Because ROC distributions are not included in taxable income, OAS benefits are not impacted. Note though, ROC distributions do reduce the adjusted cost base (ACB) of the investment, meaning capital gains tax on sale of the investment. Investors can, however, trigger the capital gain and associated tax liability at a time that is suitable for them.

KEEP DEBT TO A MINIMUM

Where debt is kept to a minimum, less taxable income is required to fund the debt. By paying off debt or making major purchases before retirement, the need for income – and an increased exposure to an OAS clawback – is reduced.

CONSIDER RRSP CONTRIBUTIONS

Canadians age 71 or younger can consider RRSP contributions. Many seniors have unused RRSP deduction room carried forward from previous years and/or are still earning "earned income."[3] RRSP contributions provide a deduction against income, reducing the base on which OAS clawbacks are calculated. For Canadians older than age 71, spousal contributions may be possible if the individual has RRSP deduction room and a spouse or common-law partner (CLP) who is 71 or younger. Spousal contributions also provide income-splitting opportunities, discussed below.

LOOK FOR INCOME-SPLITTING OPPORTUNITIES

For couples, income splitting can preserve OAS benefits. Because OAS benefits are based on individual (and not family) net income, benefit efficiencies can be realized by shifting income from one spouse or CLP to another. Income-splitting strategies include the use of spousal RRSPs, the splitting of eligible pension incomes, and the sharing of Canada Pension Plan (CPP) or Quebec Pension Plan (QPP) benefits. For pension income-splitting purposes (where up to 50% of eligible pensions can be split), eligible pension incomes include periodic payments from a registered pension plan, certain payments received as a result of death and, where an individual is age 65 or older, payments from a RRIF and certain annuity payments[4]. For CPP/QPP purposes, benefits earned during the time of the relationship can be shared.

Spousal RRSPs and the sharing of CPP/QPP benefits require a transfer of cash from one spouse to the other, whereas the splitting of eligible pension income is a tax return transaction requiring no actual transfer of cash.

[3] RRSP deduction room is calculated based on earned income. Earned income includes employment and self-employment income, but does not include pension or investment income.
[4] List is not exhaustive.

DEFER OAS AND CPP/QPP PENSIONS

Effective July 2013, seniors were given the option to defer their OAS pensions without penalty (up to 60 months). By deferring their pensions, seniors see an increase in their pension of 7.2% for each year of deferral (or 0.6% per month). Similar options also exist for CPP/QPP pensions. Whether or not seniors should defer their public pensions depend on several factors, including life expectancy, cash flow needs and perception of the security of the programs (i.e. will they be there when needed?). Where pensions are deferred, clawback issues might be avoided.

CONSIDER GIFTING

Where assets are gifted, future income earned from the gift is normally taxed to the recipient of the gift. This allows the person who made the gift to reduce exposure to OAS clawbacks. This strategy does not work in all cases – gifts to a spouse or CLP cause attribution rules (which tax future income in the hands of the gifting spouse) to apply. A similar attribution rule applies to gifts to minor children.

When gifting appreciated assets to someone other than a spouse or CLP, capital gains tax normally applies at the time of the gift. This can trigger an OAS clawback for the year of the gift, but exposure for future years would normally be reduced. That said, given that Canadians are living longer, healthier lives, individuals should be careful not to gift assets they might need in the future.

STOP WORKING

It might not always pay to work – particularly when subject to OAS clawbacks. Working seniors can consider ceasing or scaling back their work in lieu of an increased OAS pension. Of course, the value of an increased pension would have to be weighed against satisfaction derived from work.

Like Edwin many seniors are caught off guard by the OAS clawback rule. Those who work with an experienced financial advisor are less likely to be so affected.

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