May 6, 2010

FINANCIAL ADVISORY SUPPORT

Ten Strategies to Pay Less Tax in Retirement

Maximizing Your After-Tax Retirement Income

Are you approaching retirement or have you recently retired? Maximizing your retirement income is likely to be an important aspect of enjoying this exciting new phase of your life. However, your major sources of retirement income may be taxed at your top marginal tax rate with no preferential tax treatment. This is likely to be the case if you depend on such sources of retirement income as employer pensions, Registered Retirement Savings Plans (RRSPs), Registered Retirement Income Funds (RRIFs), Canada/Quebec Pension Plan (CPP/QPP) and interest income. Further, you may no longer have the opportunity to take advantage of making tax-deductible RRSP contributions to reduce your taxable income. This might be the case if, for example, you already maximized your RRSP contribution room and are no longer generating additional RRSP contribution room due to having stopped working, or if you and your spouse are over the age of 71.

Fortunately, there are several strategies you can consider to maximize your after-tax retirement income. Although not exhaustive, this article discusses 10 of the most common tax-saving retirement strategies that you can use as a reference when evaluating your retirement plan.

Prior to implementing any strategies in this article, you should consult with your advisor, a qualified tax advisor, accountant or other professional to determine if these strategies are suitable for you.

Remember, it's not what you make that matters, but it's what you keep!

Ten Strategies to Pay Less Tax in Retirement

The following is a summary of the ten most common tax-saving strategies at retirement.

Strategy #1: Spousal RRSPs
Strategy #2: Order of asset withdrawal
Strategy #3: Tax-preferred investment income
Strategy #4: Pension income splitting
Strategy #5: CPP/QPP sharing
Strategy #6: Spousal Loan Strategy
Strategy #7: Effective use of surplus assets
Strategy #8: Prescribed life annuity
Strategy #9: Leveraged RRSP/RRIF withdrawal
Strategy #10: Minimum RRIF/LIF/LRIF/PRIF withdrawal planning

Strategy # 1 — Spousal RRSPs

Due to our Canadian progressive tax system, you will save approximately $6,000 to $9,000 per year more if you and your spouse each earn $50,000 in taxable income than if you alone earn $100,000. Therefore, equalizing your retirement income can help you achieve significant tax savings year after year.

If you project your retirement income to be higher than that of your spouse, one of the simplest ways to equalize your future retirement income is by making contributions to a spousal RRSP. The sooner you start, the more income you will be able to shift to your lower-income spouse's spousal RRSP by the time you retire.

If you are already retired, but still have unused RRSP contribution room and your spouse has not yet turned age 72, you can continue to make spousal RRSP contributions even if you, yourself, have already turned age 72. Furthermore, it is possible to create additional RRSP contribution room from rental property income or employment income from part-time or consulting work.

However, beware of spousal RRSP and RRIF attribution rules, which could result in some or all of the income from the spousal RRSP or RRIF being taxed in your hands if your spouse withdraws an amount from their spousal RRSP or withdraws more than the mandatory minimum payment from their spousal RRIF either in the year that you contribute or in the two following years.

Strategy # 2 — Order of asset withdrawal

In order to optimize your after-tax retirement income, it is important to determine the proper order of asset withdrawals to cover any income shortfalls. The tax implications resulting from redeeming different asset types may vary significantly. Generally, it is best to first redeem assets that attract the least amount of tax.

You may use the following Asset Withdrawal Hierarchy as a general reference guide to determine the order in which you should withdraw your assets.

Asset withdrawal hierarchy

1. Tax-Free Savings Account (TFSA)
2. Investment income earned from investment holding companies
3. Higher-income spouse's non-registered account
4. Lower-income spouse's non-registered account
5. Lower-income spouse's LIF/LRIF
6. Lower-income spouse's RRSP/RRIF
7. Higher-income spouse's LIF/LRIF
8. Higher-income spouse's RRSP/RRIF

Note that this hierarchy is not set in stone, and may not all be applicable to you. In some cases, it may make sense to withdraw from your registered accounts prior to your non-registered accounts, especially if your income is below $35,000 but you expect to be in a higher tax bracket in the future due, for example, to the receipt of an employer pension. As well, if you are 72 years of age or older, you will need to adjust the order to incorporate your mandatory minimum payments from your RRIFs/LIFs/LRIFs.

Strategy # 3 — Tax-preferred investment income

Since the preferential tax treatment of Canadian dividends, capital gains and return of capital is lost when earned in and withdrawn from an RRSP/RRIF, the following is a general rule of thumb that should be considered when determining your ideal investment allocation.

Hold your fixed income or interest-bearing investments, such as bonds and GICs, in your RRSP/RRIF and hold your equity investments, such as common stocks, preferred shares and equity mutual funds, in your non-registered account.

Again, this is not set in stone, and depending on your total investable assets and overall asset allocation, it may not be feasible. However, it's a good starting point for analysis.

In a non-registered investment account, Canadian dividends, capital gains and return of capital are taxed at a lower rate than interest income. For this reason, you can maximize your after-tax retirement income by holding equity-based investments that generate Canadian dividends, capital gains or return of capital income in your non-registered account. However, these investments typically carry higher risk due to their market value, fluctuating more in price than more conservative fixed income investments.

Here are some other considerations:

- **Foreign dividends:** These are not subject to the preferential tax treatment available to dividends received from Canadian corporations. Instead, foreign dividend income is taxed as ordinary income in the same manner as interest is taxed. For this reason, high dividend-paying foreign stocks where capital appreciation is expected to be minimal should be held in a registered account.

- **Holding company investments:** Similar to personal taxation, interest income earned in a corporation is taxed at a higher income tax rate than Canadian dividends and capital gains. Therefore, if you have assets in your holding company, consider an asset allocation that emphasizes equity investments that generate dividends and capital gains income over interest-bearing investments.

Strategy # 4 — Pension income splitting

If you are in a higher tax bracket than your spouse, you can significantly reduce your total tax bill by allocating 0% to 50% of eligible pension income to your spouse. Only certain income is eligible to be split with your spouse, and the type of eligible pension income depends on your age as the primary recipient of the income. CPP/QPP and OAS pension income is not considered eligible under these pension income-splitting rules.

The amount of tax savings can range widely from about $1,000 to as much as $18,000, depending on a number of factors, including the amount of eligible pension income available to be split with your spouse, the difference in your marginal tax rates and the impact that the reallocation could have on certain government benefits and tax credits. For example, if you are subject to the Old Age Security (OAS) clawback, splitting your eligible pension income with your lower-income spouse will reduce your net income, which will in turn reduce or eliminate your OAS clawback.

If you are under 65 years of age during the entire tax year, you will generally be able to split only the income that is paid to you directly from a pension plan. Alternatively, if you are at least 65 years of age during the tax year, there are more types of income considered eligible to be split with your spouse, including RRIF/LIF/LRIF income. Note that RRSP withdrawals are not considered eligible pension income for income-splitting purposes.

To split your eligible pension income, there is nothing in particular that needs to be done at the time that it is received. In fact, you can delay the decision about how much income to reallocate until it is time for you to prepare your income tax returns for the year in which the income was received. This is because pension income splitting does not involve actually transferring the money to your spouse. You are only splitting the income on your tax return in order to calculate your taxes payable by filing a joint election form (CRA form T1032 — Joint Election to Split Pension Income) together with your income tax returns.

Strategy # 5 — CPP/QPP sharing

Although the CPP/QPP pension is not considered eligible pension income for the purpose of pension income splitting (described in Strategy #4), you can achieve tax savings by sharing your CPP/QPP with your lower-income spouse. This could be a particularly viable strategy if you have a spouse with limited working history and contributions to the CPP/QPP. This is because pension sharing allows up to 50% of your CPP/QPP pension benefit to be received and taxed in your lower-income spouse's hands.

For example, if you share 50% of your maximum CPP/QPP retirement benefit with your lower-income spouse, who has never contributed to CPP/QPP, and you are in the top marginal tax bracket, this could result in an estimated family tax savings of up to $1,470 per year. It may also prevent you from moving into a higher tax bracket and, if you are at least 65 year old, even minimize or avoid the possibility of your Old Age Security (OAS) being clawed back.

Finally, having a portion of your CPP/QPP pension received and taxed in your lower-income spouse's hands may also help you increase your age credit. However, pension sharing does not make sense if you have a lower CPP/QPP entitlement than that of your lower-income spouse during the time you lived together. This will result in additional pension income being taxed at your higher marginal tax rate.

To be eligible for sharing your CPP/QPP with your spouse, you must fulfill certain conditions. Chief among these is that your spouse must be at least 60 years of age and receiving CPP/QPP pension benefits (unless they never contributed to CPP/QPP).

The pension sharing calculation process involves combining the CPP/QPP pension entitlement you and your spouse earned during the time you lived together (either as married/civil union or common-law/de facto spouses) and then allocating 50% of the combined total to each of you. Any individual entitlements you and your spouse earned prior to the time you lived together cannot be shared. Instead, the 50% pension allocated to each of you is added to your individual entitlements, if any. Although pension sharing can reallocate up to 50% of your CPP/QPP pension to your spouse, it will not increase or decrease the overall combined pension benefit paid.

If you meet the conditions of CPP/QPP pension sharing governed by Service Canada/Régie des rentes du Québec and would like to elect to share your pension, simply file an application form available from Service Canada/Régie des rentes du Québec.

Strategy # 6 — Spousal Loan

Normally, you achieve no tax advantage when you simply give funds to your lower-income spouse to invest. The Canada Revenue Agency (CRA) attributes any investment income earned on these funds back to you, as if you had earned it yourself, and it is taxable in your hands at your higher marginal tax rate. This is where the Spousal Loan Strategy can help you save taxes.

By making a bona fide loan to your lower-income spouse at the CRA prescribed rate, and receiving annual interest payments in return, you can avoid triggering the CRA's income attribution rules. Your spouse can then invest these monies, which will be taxed at your spouse's lower rate, without the income attribution rules applying.

The CRA's prescribed rate used at the time your loan is established remains in effect for the lifetime of the loan. Your spouse can claim the interest payments as a tax deduction, but you will need to report them as income. Despite the drawback of your having to report the interest income, the overall tax savings from this strategy should more than compensate for this as long as your spouse earns a rate of return that exceeds the CRA prescribed rate used for the loan.

The lower the loan rate relative to the return on investments, the greater the opportunity to benefit from this strategy. Other factors that could impact the degree of tax savings you can reap from this strategy include the types of investments (i.e. investment asset mix) your spouse purchases with your loan and the difference between your tax rate and your spouse's.

For example, if you are in the highest tax bracket and you lend your low income spouse $500,000 invested at 6% per year, you could save approximately $2,000 - $6,500 of tax per year.

Strategy # 7 — Effective use of surplus assets

If your financial plan determines that you have surplus non-registered assets that you will likely not need during your lifetime, even under very conservative assumptions, then consider directing these surplus assets to other more effective uses.

Three options for using surplus retirement assets effectively are to purchase a tax-exempt life insurance policy, gift some of the surplus assets to lower-income family members or establish a family trust for adult children or grandchildren beneficiaries.

1. Tax-exempt life insurance

If you know that some of your assets will be distributed to your heirs upon your death and you will definitely not need to use these assets during your lifetime, it may not make sense to expose the income from these assets to your higher marginal tax rates during your lifetime. If this is the case, consider directing these highly taxed assets towards a tax-exempt life insurance policy, where the investment income can grow on a tax-free basis similar to your registered plans (e.g. RRSP/RRIF) or TFSA. **This way the amount that would have been payable to the CRA on these surplus assets during your lifetime could instead be paid to your beneficiaries in the form of a tax-free death benefit.**

If required, you can access the investment account within the life insurance policy through tax-free loans using your life insurance policy as collateral, which can be repaid after death with part of the death benefit. Your beneficiaries can also use the tax-free benefit to cover estate taxes, create estate equalization or for any other purpose. The tax-free death benefit can also be used to create a family trust or a charitable legacy.

2. Lifetime gifts

If you have surplus assets you will definitely not need during retirement and you know you will be providing funds to your low-income children in the future to buy a home, subsidize education costs, start a business or pay for their wedding, it may not make sense to continue exposing the income from these surplus assets to your higher marginal tax rate. Instead, consider gifting some of these surplus funds now as an outright cash lump sum.

3. Establish a family trust for adult children or grandchildren beneficiaries

Alternatively, if you do not want to give your adult children control over these assets, you can consider using your surplus funds to establish a family trust. You can direct your surplus funds to the family trust through either a gift (irrevocable) or a demand loan (revocable) for your adult children and/or grandchildren beneficiaries. If structured correctly, the family trust can allow you to allocate income to your adult children or grandchildren and ensure that it is taxed in their hands at their lower marginal tax rate.

To achieve this, you will need to beware of income attribution rules, which could attribute the income back to you, resulting in the income being taxed in your hands at your higher rate. To avoid income attribution rules, you can make an irrevocable gift to the family trust. In the case of grandchildren beneficiaries, a gift will trigger attribution rules on interest and dividend income, but not on capital gains if the family trust is structured correctly. Alternatively, you can consider making a loan at CRA’s prescribed interest rate, which could avoid attribution rules on all investment income allocated to grandchildren beneficiaries if structured correctly.

Note that due to potentially escalating health and long-term care costs, it is imperative that you are prepared for these contingencies before redirecting your surplus assets. Critical illness, long-term care insurance and easy access to credit are a few of the options you may wish to consider.

Strategy #8 — Prescribed life annuity

If you are at least 60 years of age, a conservative investor and not satisfied with your fully taxable cash flow from traditional non-registered fixed income assets (GICs and government bonds), consider using some of these fixed income assets to purchase a prescribed life annuity. The prescribed life annuity will guarantee to provide you with an enhanced income for your lifetime with the advantage of tax deferral.

If you are concerned that your annuity will not provide any payout to your beneficiaries upon your death, then consider purchasing an insured annuity. With an insured annuity, part of your annuity payment is used to pay the premiums on a life insurance policy to ensure that a death benefit is paid to your beneficiaries.

The following is an example of the monthly after-tax retirement income from a traditional GIC yielding 4% per year compared to the monthly after-tax income from a joint last-to-die prescribed life annuity (non-insured and insured) based on spouses who are aged 65, have $250,000 of capital and are subject to a 45% marginal tax rate.

	GIC earning 4%	Life annuity (non-insured)	Insured annuity
Amount invested	$250,000	$250,000	$250,000
Monthly cash flow	$833	$1,419	$1,419
Amount taxable	$833	$536	$536
Tax payable	($375)	($241)	($241)
Insurance premium	N/A	N/A	($301)
Net monthly cash flow	**$458**	**$1,177**	**$876**

As a portion of the prescribed annuity payment is considered a non-taxable return of capital, the after-tax cash flow from the annuity is considerably higher than the interest from a traditional GIC. To generate the same after-tax income as the insured annuity in the above scenario, your GIC would need to generate an annual rate of return of 7.65%.

Further, it's important to note that the purchase of the life annuity is irrevocable, which means that you cannot access the capital during your lifetime as you could with a GIC (subject to term restrictions and redemption features). For this reason, it is not advisable to invest all your savings in the prescribed life annuity, despite the more appealing monthly after-tax cash flows. Instead, consider including a prescribed life annuity as part of your broader well-diversified portfolio strategy.

Strategy # 9 — Leveraged RRSP/RRIF withdrawal

This strategy (often referred to as the "RRSP/RRIF Meltdown") may appeal to you if you have a higher risk tolerance. It involves making withdrawals from your RRSP/RRIF while simultaneously taking out an investment loan to purchase income-producing non-registered investments. The interest you pay on your investment loan is tax-deductible, which helps to offset some of the incremental tax resulting from making taxable withdrawals from your RRSP/RRIF. In essence, this strategy converts your fully taxable RRSP/RRIF account into a tax-preferred leveraged non-registered account, which may increase your after-tax income and assets during retirement.

This strategy is not for the faint of the heart. Despite the interest paid on the loan being tax-deductible, carrying debt in retirement is generally not recommended. However, it could be a suitable strategy for you to consider if you have surplus cash flow to pay the interest costs and you have both a higher risk tolerance and at least a 10-year investment time horizon.

Strategy # 10 — Minimum RRIF/LIF/LRIF/PRIF withdrawal planning

If your pension income and non-registered assets sufficiently meet most of your retirement expenses, then you will likely need to withdraw only the mandatory minimum amount from your Registered Retirement Income Fund (RRIF) or from your locked-in plans such as your Locked-in Fund (LIF), Locked-in Retirement Income Fund (LRIF) or Prescribed Retirement Income Fund (PRIF) each year.

Strategies to maximize the tax-deferral within your RRIF/LIF/LRIF/PRIF in order to maximize your after-tax retirement income are as follows:

- If your spouse is younger than you, base your minimum annual RRIF/LIF/LRIF/PRIF withdrawal on your spouse's age in order to minimize the amount of the annual withdrawal, thereby keeping more assets in the RRIF/LIF/LRIF/PRIF to grow tax-deferred. All provincial locked-in plan legislation (LIF/LRIF/PRIF) permits you to base your mandatory minimum payment on your spouse's age, with the exception of New Brunswick legislation, which determines the minimum payment solely on your age.

- Convert your RRSP/LIRA (locked-in RRSP or Locked-in Retirement Account) to a RRIF/LIF/LRIF/PRIF by the end of the year in which you turn age 71, but don't make your first RRIF/LIF/LRIF/PRIF withdrawal until the end of the year in which you turn age 72.

- Withdraw the annual required minimum from your RRIF/LIF/LRIF/PRIF as a lump sum at the end of each year.

Example

Withdraw a minimum payment from your RRIF at the beginning versus the end of each year, assuming the following:

Your age this year: 71	Marginal tax bracket: 40%
RRIF value: $500,000	RRIF annual rate of return: 6%

If you withdraw the minimum from your RRIF at the **beginning** of each year starting the year in which you turn 72, your after-tax income from age 72 to age 90 would total $409,426 with $238,740 remaining in your RRIF. Alternatively, if you withdrew the minimum from your RRIF at the **end** of each year instead, your after-tax income from age 72 to age 90 would total $450,975 with $267,375 remaining in the RRIF.

Summary

In summary, although the majority of retirement income sources are taxed at a high rate with no preferential tax treatment, there are 10 common strategies that you can consider implementing to maximize your after-tax retirement. Many of these strategies enhance your after-tax income by taking advantage of certain income tax provisions that permit you to split income with your lower-income spouse, while other strategies use insurance solutions or leveraged investing, which can also save you taxes.

Remember, it's not what you earn, but what you keep that matters!

Insurance products are offered through RBC DS Financial Services Inc., a subsidiary of RBC Dominion Securities Inc. When providing life insurance products in all provinces except Quebec, Investment Advisors are acting as Insurance Representatives of RBC DS Financial Services Inc. In Quebec, Investment Advisors are acting as Financial Security Advisors of RBC DS Financial Services Inc. RBC DS Financial Services Inc. is licensed as a financial services firm in the province of Quebec.

This publication is not intended as nor does it constitute tax or legal advice. Readers should consult their own lawyer, accountant or other professional advisor when planning to implement a strategy. The information contained herein has been obtained from sources believed to be reliable at the time obtained but neither RBC Dominion Securities Inc. nor its employees, agents, or information suppliers can guarantee its accuracy or completeness. The examples provided in this article are for illustration purposes only and are not indicative of future returns; fees and commissions are not included in these calculations.

This information is not investment advice and should be used only in conjunction with a discussion with your RBC Dominion Securities Inc. Investment Advisor. This will ensure that your own circumstances have been considered properly and that action is taken on the latest available information.

RBC Dominion Securities Inc.* and Royal Bank of Canada are separate corporate entities which are affiliated. *Member CIPF. ®Registered trademark of Royal Bank of Canada. RBC Dominion Securities is a registered trademark of Royal Bank of Canada. Used under licence. ©Copyright 2009. All rights reserved.