

# The Navigator

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## 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, a large portion of 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!



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## 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: Tax-free savings account (TFSA)

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

### Strategy # 1 — Spousal RRSPs

Due to Canada's progressive tax system, you will save approximately \$6,000 to \$9,000 (depending on your province of residence) per year 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, are over age 71. 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.

Even with the introduction of the pension income splitting rules, spousal RRSPs still have benefits. Under the pension income splitting rules, you can only reallocate a maximum of 50% of eligible pension income to your spouse. However, the full value of a spousal RRSP can be taxed in the name of your spouse.

If you and your spouse retire prior to age 65 and require income above and beyond whatever fixed sources are available (such as government income sources and a company pension), it may be beneficial for the family to be able to draw on a spousal RRSP or spousal RRIF owned by the lower income spouse.

Another benefit of having a spousal RRSP is that you and your spouse can both potentially make use of the Home Buyers Plan and Life Long Learning Plan rather than just one of you.

## **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 you may have after receiving government and employer pensions. Remember, it is possible to start CPP/QPP as early as age 60 if required. However, if you do so, your CPP/QPP will be reduced. It may also be possible to receive your employer pension prior to the normal retirement age of 65. Keep in mind that your pension may be reduced if you begin receiving payments early.

The tax implications resulting from redeeming different asset types may vary significantly. Generally, if you're in a high tax bracket, it makes sense to withdraw assets attracting the least tax first. If your spouse is in a significantly lower tax bracket, consider withdrawing their taxable assets before yours (and your non-taxable assets before your spouse's).

You may use the following asset withdrawal hierarchy as a general reference guide to determine the order in which you should withdraw your assets. This hierarchy is based on the understanding that it is best to use your least flexible sources of income first. After that, it is best to draw down on assets that trigger the least amount of taxation. Note that this hierarchy is not set in stone, and may not all be applicable to you.

### **Asset withdrawal hierarchy**

1. Capital dividends from your private corporation
2. Repayment of Shareholder loans owed to you by your private corporation
3. Locked-in accounts -LIF/LRIF/PRIF - minimum payments. (there is also the potential to unlock up to 50% for federal and some provincial locked-in plans).

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4. RRIF minimum payments.
5. Taxable distributions from non-registered accounts – dividend and interest income
6. Dividend payments from an investment holding company
7. TFSA- tax free withdrawals
8. Locked -in and registered accounts- above the minimum payments
9. Tax favoured income (partially taxable)- realized capital gains
10. Tax paid capital – principal from a non-registered account

In some cases, it may make sense to withdraw amounts above your minimum from your registered and locked-in accounts prior to your non-registered accounts, especially if you are in the lowest marginal tax bracket now, but you expect to be in a higher tax bracket in the future due, for example, to the receipt of an employer pension.

You may also decide to draw money out of an investment holding company early on if you are trying to wind down the company and have a need for the income personally.

It is best to discuss with your advisor and tax professional about the order of withdrawal that is most beneficial for you and your family.

### **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 registered accounts (RRSP/RRIF and locked-in) 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, TFSA contribution room 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, and may offer greater returns or losses.

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 may be better off 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 which generate dividends and capital gains income over interest-bearing investments while taking risk tolerance and liquidity requirements into account.

### **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 up to 50% of eligible pension income to your spouse. Only certain income is eligible to be split with your spouse depending on the age of the primary recipient of the income. CPP/QPP and OAS pension income is not considered to be eligible under these pension income-splitting rules.

The amount of tax savings can

range widely and you can save up to 14% in federal income tax as well as save on provincial income taxes by allocating eligible pension income from a spouse in the higher marginal tax bracket to the spouse in the lower marginal tax bracket. The tax savings depend 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 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/PRIF income. Note that RRSP withdrawals are not considered eligible pension income for income-splitting purposes.

You can delay the decision regarding how much income to split, if any, 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 are receiving \$10,000 in annual CPP/QPP benefits and you are in the top marginal tax bracket and you share 50% of your CPP/QPP retirement benefit with your lower-income spouse, who has never contributed to CPP/QPP, your family can save up to \$700 in federal taxes (plus provincial taxes). 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. Since

both spouse's CPP/QPP retirement pension must be shared, 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

Generally, 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 reduce your taxes payable.

By making a bona fide loan to your lower-income spouse at the CRA prescribed interest rate, and receiving annual interest payments in return, you can avoid triggering the CRA's income attribution rules. Your spouse can then invest the loan proceeds and the investment income and capital gains earned 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 prescribed

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 the loan proceeds 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, your family could save approximately \$2,000 - \$6,500 of tax per year depending on each spouse's marginal tax bracket and the prescribed interest rate on the loan.**

## 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 may also be able to borrow money using your life insurance policy as collateral. The loan can be repaid after death with part of the death benefit. Your beneficiaries can also use the tax-free death 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 that 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 gift. Keep in mind that you will no longer have control of these assets.

### **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 minor children and 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 minor children and 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. You may want to speak with an insurance advisor about how a prescribed life annuity can benefit you in retirement and the potential tax savings that may be available to you.

### **Strategy # 9 — Tax-Free Savings Account (TFSA)**

You continue to be able to contribute money to a TFSA in retirement up to your contribution

limit. Although, TFSA contributions are not tax deductible, the income and gains generated in the TFSA grow tax-free. Additionally, any money withdrawn from a TFSA is not taxable. Here are some potential opportunities for having a TFSA in retirement:

- In retirement you may have cash flow that is in excess of your needs, for example from investment income or an inheritance, and you may wish to continue building your savings. If you are over age 71 or have stopped working and do not have any earned income to generate contribution room, you are not able to contribute to an RRSP. The TFSA may provide an alternative way for you to save in a tax-free vehicle.
- If you are receiving annual minimum RRIF or pension income that is in excess of your current needs, you may want to contribute the excess to your TFSA to generate tax-free growth and income.
- If you anticipate being in the same or a higher marginal tax bracket in retirement, a TFSA could provide another source of tax-efficient retirement income. Unlike withdrawing funds from a registered plan at a higher future tax rate, withdrawals from a TFSA are not taxable.
- Since withdrawals from a TFSA are not taxable income, they have no impact on income-tested benefits like Old Age Security (OAS). This reduces the possibility of having

your OAS clawed back. The withdrawal will also not limit your entitlement to other government plans like employment insurance, the Canada Child Tax Benefit, the Guaranteed Income Supplement and the Age Credit, as could be the case with other taxable investment income.

### 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 will be lower than your payments would be if the payments were made at the end of the year. Also, at the age of 90, you would have \$238,740 remaining in your RRIF if payments were made at the beginning of the year as opposed to \$267,375 remaining in your RRIF if payments were made at the end of every year.

### 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!

➤ Please contact us for more information.