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Ten Strategies to Pay Less Tax in Retirement

Maximizing Your After-Tax Retirement Income

In addition to talking about the weather and hockey, there is another national pastime that Canadians like to chat about and that is… taxes! Well, in all fairness, taxes may not be your typical conversation starter, however minimizing taxes is important for Canadians, especially those that are entering retirement or already retired. In retirement, the major sources of retirement income such as employer pensions, RRSP/RRIF income, CPP/QPP/OAS and interest income are all taxed at your marginal tax rate with no preferential tax treatment. Furthermore, if one is no longer working or they and their spouse are over the age of 69 they will not be able to make tax-deductible RRSP contributions in order to reduce their taxable income. Nonetheless, there are some tried and trued strategies that they can use in retirement to maximize their after-tax retirement income so they have more money to enjoy this exciting phase of their life. Remember it's not what you make, it's what you keep!

This article will discuss ten strategies to reduce taxes if approaching retirement or already retired.

Ten Strategies to Pay Less Tax in Retirement (not an exhaustive list and not in any particular order)

Retirement Tax Strategy #1: Spousal RRSPs
Retirement Tax Strategy #2: Order of withdrawal
Retirement Tax Strategy #3: Tax-preferred investment income
Retirement Tax Strategy #4: CPP/QPP sharing
Retirement Tax Strategy #5: Prescribed rate loan
Retirement Tax Strategy #6: Effective use of surplus assets
Retirement Tax Strategy #7: Prescribed life annuity
Retirement Tax Strategy #8: Leveraged RRSP/RRIF withdrawal
Retirement Tax Strategy #9: Minimum RRIF withdrawal planning
Retirement Tax Strategy #10: Tax bracket management

The above strategies are discussed in more detail as follows.

Retirement Tax Strategy #1 – Spousal RRSPs

Due to progressive tax rates in Canada, a couple with retirement incomes of $50,000 each pay about $6,000 to $9,000 less tax per year than a couple where only one spouse earns $100,000. Probably the best way to equalize a couple's retirement income and achieve these tax savings is by contributing to spousal RRSPs during their work career. To clarify, a spousal RRSP in an RRSP to which one spouse contributes and the other spouse is the annuitant and therefore the legal owner.

Given many retirees plan to do some part time or consulting work during retirement, there may still be opportunities to accumulate earned income and contribute to spousal RRSPs to equalize retirement income. The contributing spouse can be any age (even over age 69) however the annuitant spouse must be turning age 69 or less in the year of contribution. Be careful of the spousal RRSP attribution rules when withdrawals are made from the spousal RRSP / RRIF.

Retirement Tax Strategy #2 – Order of withdrawal

In order to maximize deferring taxes in retirement, a rule of thumb for which type of account one should make withdrawals from to finance retirement is - withdraw from the least flexible and least tax efficient source first.

You can refer to the following "withdrawal hierarchy" to determine the order one should receive income in order to maximize after-tax retirement income (starting from first source to last source; not all sources will be applicable):

1. Guaranteed income sources (i.e. employment income, CPP / QPP, OAS, employer pensions)
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
6. Lower-income spouse's RRSP / RRIF
7. Higher-income spouse's LIF
8. Higher-income spouse's RRSP / RRIF

Note that the above order is not set in stone. In some cases it may make sense to withdraw from registered accounts prior to non-registered account especially if income currently is below $35,000 but expected to be in a higher tax bracket in the future.

Retirement Tax Strategy #3 – Tax-preferred investment income

In a non-registered investment account, Canadian dividends, capital gains and return of capital are taxed lower than interest income. As a result, to maximize after-tax retirement income one should consider purchasing some investments in their non-registered account that can generate Canadian dividend, capital gains or return of capital income. Note however that earning Canadian dividend, capital gains and return of capital income will mean that one will be owning equity based investments that typically carry higher risk and fluctuates more in price than conservative fixed income investments.

The preferential tax treatment of Canadian dividends, capital gains and return of capital is lost when earned and withdrawn from an RRSP / RRIF. As a result, a rule of thumb on where one should allocate investment assets during retirement is:

Hold fixed income in an RRSP/RRIF and hold equities in a non-registered account

Again, this is not set in stone, and depending on total investable assets and overall asset allocation it may not be feasible, however it's a good starting point for analysis. Here are some other considerations:

- Foreign dividends are taxed similar to interest income so high foreign dividend stocks where capital appreciation is expected to be minimal should be held in a registered account;
- Corporate investment tax rates are higher than the top personal tax rates. However, similar to top personal tax rates, interest income earned in a corporation is taxed at a higher income tax rate than Canadian dividends and capital gains earned in a corporation are taxed at the lowest income tax rate. So for assets in a corporate investment account, consider holding part of the equity allocation in the corporation from a tax minimization standpoint.

Retirement Tax Strategy #4 – CPP/QPP sharing

In order to reduce the family tax burden, a couple can share up to 50% of each of their CPP / QPP retirement benefit with the other spouse. There would only be a tax benefit of this sharing strategy if the higher-income spouse in retirement also has a higher CPP / QPP retirement benefit.
The amount of the benefit that can be shared depends on the number of years that they have been spouses compared to the number of years they have contributed to CPP / QPP. Furthermore, CPP / QPP sharing is only

available when the younger spouse is eligible to collect CPP / QPP. Therefore, both spouses must be at least age 60 and substantially retired. An application form must be completed to request that the pensions be shared.

CPP/QPP sharing can result in family tax savings of up to $1,200 per year.

Retirement Tax Strategy #5 – Prescribed rate loan

One of the most common income splitting strategies for couples of any age is the prescribed rate loan strategy. Basically this strategy involves, a high-income spouse lending money to a low-income spouse at the CRA prescribed interest rate (currently 3% per year). The low-income spouse can now invest these monies without the income attribution rules applying. Couples can also employ this strategy in retirement if the high-income spouse owns most of the non-registered assets.

For example, if a high-income spouse loans $500,000 of cash to a low-income spouse invested at 6% per year, the couple can save approximately $2,000 - $4,000 of tax per year.

Retirement Tax Strategy #6 – Effective use of surplus assets

By preparing a financial plan, you can determine if you have adequate income and assets to meet your retirement income needs for your estimated life expectancy. If the 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.

Two options for using surplus retirement assets effectively are to purchase a tax-exempt life insurance policy and/or gift some of the surplus assets to low-income family members.

<u>Tax-exempt life insurance</u>

If you know that some of your assets will be passed on to your heirs upon death and you will definitely not need to use these assets during your lifetime, does it make sense to expose the income from these assets to your higher marginal tax rates? Consider directing these highly taxed assets towards a tax-exempt life insurance policy where the investment income can grow on a tax-free basis. This way the amount that would have been payable to the CRA on these surplus assets during lifetime could instead be paid to your beneficiaries in the form of a tax-free death benefit. If need be, you can access the investment account within the life insurance policy through tax-free policy loans which are repaid after death with part of the death benefit. This strategy should be considered if you have a life insurance need.

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, does it make sense to continue exposing the income from these surplus assets to higher marginal tax rate? Instead you should consider gifting some of these surplus funds now either directly or through an irrevocable trust (if you do not want your children to have control of these assets). There will be no attribution on any investment income earned on the gifted funds if the child is age 18 or older.

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

Retirement Tax Strategy #7 – Prescribed life annuity

If you are at least age 60, a conservative investor and not satisfied with your cash flow from traditional non-registered fixed income assets (GICs and government bonds), you can consider using some of these fixed income assets to purchase a prescribed life annuity. The prescribed annuity will provide you a lifetime of tax-effective retirement income.

If you are concerned that with an annuity there will be no funds payable to your beneficiaries upon 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 so 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 5% per year compared to the monthly after-tax income from a joint last to die prescribed life annuity (non-insured and insured) based on a couple aged 65 with $250,000 of capital and at a 46% marginal tax rate

	GIC earning 5%	Life annuity (non-insured)	Insured annuity
Amount invested	$250,000	$250,000	$250,000
Monthly cash flow	$1,042	$1,462	$1,462
Amount taxable	$1,042	$401	$401
Tax payable	($479)	($185)	($185)
Insurance premium	N/A	N/A	($301)
Net monthly cash flow	**$563**	**$1,277***	**$976**
Capital on death	**$250,000**	**$0**	**$250,000**

* Cashflow represents the fact that the initial capital is being drawn down.

Since 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. Note that the purchase of the life annuity is irrevocable, so they cannot access the capital during their lifetime like they would be able to do with the GIC option. As a result, it is not advisable to invest all savings into the prescribed life annuity even though the monthly after-tax cash flow from the annuity may look appealing.

Retirement Tax Strategy #8 – Leveraged RRSP/RRIF withdrawal

This is a higher risk strategy (often referred to as the “RRSP/RRIF Meltdown”) where withdrawals are made from an RRSP/RRIF and at the same time an investment loan is taken out to purchase income producing non-registered investments. The interest paid on the investment loan is tax deductible, which helps to offset some of the incremental tax resulting from the RRSP/RRIF income. In essence, this strategy converts a fully taxable RRSP/RRIF account into a tax-preferred non-registered account and can potentially result in a greater after-tax income and assets during retirement. Keep in mind that there will be a debt outstanding if the RRSP/RRIF income is used to pay the interest only.

This strategy is not for the faint of the heart. Carrying debt in retirement, albeit tax-deductible debt, is usually only suitable for those individuals that have surplus cash flow to pay the interest costs, a higher risk tolerance and at least a ten-year investment time horizon. To complicate matters, there are proposals by the Department of Finance that once finalized may limit the amount of interest that can be deducted on an investment loan if there is no reasonable expectation of profit from the investments (excluding capital gains) over the holding period of the investment. Quebec has already implemented some interest deductibility restrictions for provincial tax purposes.

Retirement Tax Strategy #9 – Minimum RRIF withdrawal planning

If you have adequate pension and non-registered assets to meet most of your retirement expenses then you will likely only need to withdraw the mandatory minimum amount from their RRIF, LIF or PRIF each year. Strategies to maximize the tax-deferral within a RRIF in order to maximize after-tax retirement income are as follows:

- Base the minimum RRIF withdrawal on the younger spouse in order to minimize the amount of the annual withdrawal, thereby keeping more assets in the RRIF to grow tax-deferred.
- Convert the RRSP to a RRIF by the end of the year they turn age 69 but don’t make the first RRIF withdrawal until the end of the year they turn age 70.
- Withdraw the annual required minimum from the RRIF as a lump sum at the end of each year.

For example, assume an individual is turning age 69 this year with $500,000 in a RRIF that is earning 6% per year. If an individual is in the 40% marginal tax bracket and withdrew the minimum from the RRIF at the beginning of the year, their after-tax income from age 69 to age 90 would total $463,000 with $260,000 remaining in the RRIF. However, if they withdrew the minimum from the RRIF at the end of each year, their after-tax income from age 69 to age 90 would total $486,000 with $292,000 remaining in the RRIF.

Retirement Tax Strategy #10 – Tax bracket management

There are five key taxable income thresholds that you should be aware of in retirement if you want to pay less tax and maximize your after-tax retirement income. They are as follows for 2005:

Taxable income	Why this taxable income threshold is important
$8,100	The first $8,100 of taxable income is tax-free. For those over age 65, the first $12,000 of taxable income is tax-free
$30,000	The age tax credit of about $4,000 begins to be clawed back if net income is over $30,000
$35,000	Marginal tax rate jumps by approximately 10% for taxable income over $35,000
$60,000	Old Age Security begins to be clawed back if net income is over $60,000
$71,000	Marginal tax rate jumps by approximately 10% for taxable income over $71,000

The reason you should be aware of these key taxable income thresholds is that if you are approaching one of the above thresholds then you may want to consider deferring some of their taxable income to the following tax year if possible. For example, you may consider delaying the sale of an appreciated stock until early the following year if the taxable capital gain may put them over one of the above tax brackets. Of course, the investment merits of holding on to the stock must take priority – i.e. don't let the tax tail wag the dog.

Also, one of the earlier mentioned income splitting strategies could be employed in order to stay below one of the above thresholds.
In closing, as you are putting together your retirement income plan, you should consider some of the tax strategies mentioned in this article in order to maximize your after-tax retirement income.

If you have any questions or require clarification of any of the issues discussed in this document, do not hesitate to discuss these with us.