Strategies for maximizing after-tax dollars for retirees

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This is a continuation of our article “Retirement tax planning tips: Sources of income”, which discusses the different sources of retirement income and how they are taxed.

In this article, we will highlight a few strategies that can minimize taxes while maximizing cash flow. These can help in funding your ideal retirement lifestyle.

Strategies to minimize overall taxes

After determining the amount needed from the various types of income and when to draw the funds, you should also consider strategies that impact the amount of taxes owed to the government.

1. **Tax-preferred investment income**

To reduce the tax paid on the investment income outside of registered plans, individuals may consider investments that generate capital gains or Canadian source dividends as they are taxed more favourably than interest income. Not only will this reduce the annual tax liability, it also allows for some tax-free or tax-favoured investment incomes in retirement, which reduces the OAS clawback impact. Furthermore, selling investments at a loss (commonly referred to as “tax-loss selling”) within the non-registered account may reduce the total capital gains that are subject to tax in the year. Please refer to our article Retirement tax planning tips: Sources of income for details on investments’ tax treatments.

2. **Tax credits**

The major tax credits that are intended for seniors are: age amount, pension income amount, and medical expenses. These credits can help reduce tax liabilities.

**Age amount** is for seniors age 65 or older to claim a maximum amount of $7,637, subject to an income threshold. Please refer to our article Retirement planning figures for details on the threshold.

**Pension income amount** allows individuals to claim up to $2,000 if they receive eligible pension, superannuation, or annuity payments. Generally, the eligible pension depends on the type of income and/or the age of the pensioner. For example, Registered Pension Plan payments are considered ‘qualifying pension income’, regardless of the recipient’s age. On the other hand, Registered Retirement Savings Plans (RRSPs) only qualify as eligible pension income if the recipient is at least 65 years of age or the amounts are received due to their spouse’s death.
Eligible medical expenses, including attendant care, that are paid for by the individual, his/her spouse, and their children, can be claimed as a non-refundable tax credit. Often retirees no longer have any employer health insurance to reimburse medical expenses they incur. The credit is beneficial as it becomes available when the total unreimbursed eligible medical expenses exceed the annual threshold. The 2020 threshold is 3% of net income or $2,397, whichever is less. It may be advantageous for the lower income spouse to claim all the expenses as their threshold is lower.

3. Pension splitting

In addition to the pension income credit, another common way to reduce overall tax liability is splitting pension income between spouses at retirement. The higher income spouse may transfer up to 50% of his/her eligible pension income to the lower income spouse. This will reduce the household tax bill as the transferred income will now be taxable at a lower rate in the lower income spouse’s hands.

Eligible pension income is the income received by the pensioner and it depends on their age. If the pensioner is less than 65 years of age, eligible pension income includes life annuity payments from a superannuation or pension plan, RRSP or Registered Retirement Income Fund (RRIF), and retirement compensation arrangement benefits as a result of the death of a spouse. For persons over 65, eligible pension income includes all the above except it does not have to be the result of a spouse’s death. Furthermore, this also reduces the impact of the Old Age Security clawback and the reduction of the age tax credit amount, which will reduce the overall tax payable. Thus, this may also keep the higher income spouse within the threshold for the government allowance.

4. Converting RRSP to RRIF

In the year an individual turns 71, instead of withdrawing the entire RRSP amount, an individual may choose to transfer to a RRIF or purchase an annuity. This will defer the income needed to be reported that year and the payments can be set to smaller, periodic payments that are taxed over a duration of time.

When to draw on an RRSP depends on individual situations and generally, you may consider contributing to RRSPs in higher income years and withdraw when the tax bracket is lower. As it relates to retirement income planning, it is important to consider sources (and tax characteristics) of income to maximize your after-tax cash flow. This may impact your decision on when and how much to draw on your RRSP.

It is important to note that an RRSP can be converted to a RRIF before age 71. If the individual is 65 or older and not receiving other pension income, they may consider converting a portion or all the RRSP to a RRIF early and take advantage of the pension income amount to withdraw tax-free up to $2,000 per year. However, once the amount is converted to a RRIF, the minimum payments will begin in the year after the setup and no contributions can be made to the RRIF. For individuals with a large RRSP balance, mandatory age RRIF withdrawals can translate into large taxable withdrawals and push the individual to a higher tax bracket.

5. Spousal RRSP

Spousal RRSPs are an effective way to split income between spouses during retirement, provided that the RRSP income cannot be split until the pensioner reaches age 65. The higher income spouse contributes to a spousal RRSP plan for the lower income spouse; withdrawals from this account will be taxed in the hands of the lower income spouse after a 3-year holding period and the higher income spouse claims the RRSP deduction. The amount of contribution to a spousal RRSP is limited and will reduce the contributor spouse’s RRSP room. If withdrawn within the 3 years of contribution, the income will be attributed back to the contributing spouse. If the plan owner’s spouse transfers the spousal RRSP into their own RRIF, RRIF minimum payments will always be taxable in their hands regardless of whether or not the funds were contributed with the 3-year period.
Living abroad while retiring

Income earned by Canadians who are non-residents of Canada will be subject to Canadian taxation. The default 25% of withholding taxes are applicable to pension incomes. This rate could be reduced pursuant to the tax treaty Canada has with the country the individual resides in. In the U.S. for example, when the individual receives a periodic pension payment from Canada, the withholding rate can be reduced to 15%. For individuals who are planning to move to other countries, they may wish to consider the treaty tax rate to determine if they should defer their pension income upon emigration. However, pension income splitting may not be applicable to non-residents of Canada as both the transferee and the transferor must be residents of Canada at the end of the tax year when income is split.

Summary

When you are planning for retirement income, you should also consider the source of income and tax implications to maximize your after-tax cash flow. Speak to your advisor today to learn more about Total Wealth Planning and how it can help achieve your goals.

Speak with your own tax advisors about your own tax situation before implementing any tax planning strategies.