September 2024 Financial Planning Email Update

As Canada's baby boomers settle into retirement, many are caught off guard by the intricacies of Retirement Income Planning such as tackling the OAS clawback challenge. Consider the following example.

A single person (age 65) is recently retired. Like many Canadians, this single person is looking forward to taking advantage of the many benefits available to seniors, including an Old Age Security (OAS) pension, which for 2024 will pay a maximum of approximately $8,620 to those who receive full benefits. In the first full year of retirement this person's income consisted of the following:

- Net business income: $10,000
- Registered pension income: $50,000
- OAS/CPP pension benefits: $15,000
- Canadian eligible dividends: $15,000 which is $20,700 taxable.

OAS benefits are "income sensitive," such that benefits decrease as income increases. OAS benefits are "clawed back" at a rate of 15% once net income reaches $90,997 (based on 2024 Income) with full elimination at $148,605 ($153,771 for age 75 plus recipients). Using the example where the total net taxable income in 2024 was $95,700, the repayment would be 15% of the difference between $95,700 and $90,997 ($95,700-$90,997=$4,703 X 0.15= $705.45

The repayment would therefore be $705.45 for the July 2025 - June 2026 following period.

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 2024, the gross-up is 38% for eligible dividends and 15% for non-eligible dividends.

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 planners such as Amanda and I 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(up to $250,000). Therefore, investing for capital gains keeps net income to a minimum, thereby preserving OAS benefits. 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.

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.” 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. 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.

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.

Amanda and I are both qualified CERTIFIED FINANCIAL PLANNER® professionals at your service to assist in all areas of comprehensive financial planning including financial goal discovery, cash flow/budget analysis, retirement income planning, tax savings, estate planning, insurance needs analysis, investment planning, education saving planning, special purpose or major purchase planning. I wish to thank you for your continued confidence and for the opportunity to serve you in all aspects of Financial Planning. As always, I will continue to keep in touch with you but if you have any questions or concerns, that you would like to discuss or review, please do not hesitate to contact either Amanda or I by email or by calling the office at 519-894-2661 or toll-free at 1-800-716-5538.

Have a great day and enjoy your summer!

Respectfully Yours,

Gary

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