Taxation of Retirement Income

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As our population ages, the need to fund a comfortable retirement becomes a priority for more and more Canadians. Many Canadians planning for retirement focus on the "magic number" — that is, the amount of total savings needed to ensure a comfortable life throughout retirement. While having a savings goal based on one's anticipated needs during retirement certainly makes sense, it's important to consider as well the annual income which those savings will generate, and even more important to understand how much of that income will remain for the individual to live on after the inevitable taxes are paid. The sources of income available to retired Canadians are many and diverse, and while the rules applied to the taxation of that income aren't complicated, those rules can sometimes vary, depending on the income source. As well, the tax credits and tax-planning strategies available to retirees are generally different from those utilized

prior to retirement, and they can make a significant difference to how much of one's annual income is left after taxes are paid. This article outlines the tax rules governing the most common sources of retirement income and the credits and planning strategies that allow retirees to minimize the tax bite on that income.

Public-source retirement income

Canada Pension Plan

Retirees who participated in the paid work force during their adult years are generally eligible to receive payments from the Canada Pension Plan (CPP) during retirement. The amount of CPP for which one is eligible depends on the level of contributions made during one's working life — the maximum monthly benefit receivable in 2016 is about $1,093, but the average benefit received is substantially less.

CPP benefits, which do not start automatically but must be applied for, can begin any time between the ages of 60 and 70. In the past, most taxpayers have elected to begin receiving benefits at the "traditional" retirement age of 65, although there is no requirement to do so. Where benefits are received at age 60, those benefits can be about 36% lower than they would have been if receipt had been deferred until the recipient was 65. Conversely, where benefits are not received until the retiree is 70, benefits can be about 42% higher than they would have been at age 65. For tax purposes, however, the treatment of all benefits, regardless of amount or age of recipient, are the same. All CPP retirement benefits received are fully taxable and must be reported on the annual return on line 114.

Many Canadians over the age of 60 continue to work, on at least a part-time basis, for either economic or social reasons, and it's possible to work while receiving CPP benefits. However, if CPP benefits are applied for before the age of 65, one of two requirements must be met. Either the applicant must not be working at the end of the month before benefits start and during the month that benefits are first received or monthly income for each of those months must be less than the maximum CPP payment allowable (currently about $934) In either case, full- or part-time work can be resumed thereafter. Since 2012, once CPP benefits start and the recipient resumes employment, he or she may have to (or wish to) continue contributions to the CPP Post Retirement Benefit. If age 60-65, the recipient who returns to work must continue to contribute, and the recipient age 65-70 can elect to stop contributing if they continue to work past age 65. Contributions to the Post Retirement Benefit are treated as a separate form of benefit to the CPP.

Where spouses or common-law partners are each at least 60 years of age, they can apply to "split", or share, Canada Pension Plan benefits. Essentially, each spouse can receive a one-half share of the total Canada Pension Plan benefits that were earned by both of them during their years of marriage or cohabitation. So, if a couple had been married for 30 years, they would add together the pension benefits earned by each during that 30-year period and divide it equally between them. The pension benefits then received by each person would be taxed in his or her hands, resulting in potential tax savings, depending on their relative incomes.

Old age security

Many retirees who collect CPP benefits are also entitled to receive Old Age Security (OAS) payments, but the rules regarding eligibility for the two programs are very different, as is the tax treatment of amounts received. While CPP entitlement is based on whether and to what extent a retiree con-

tributed to the plan during his or her working life, eligibility for OAS depends entirely on Canadian residency during one's adult life. OAS benefits are paid to Canadian residents who are 65 years of age or older. Full benefits are generally paid to those who were resident in Canada for 40 years between the ages of 18 and 65. There are other circumstances in which a person may be eligible for full benefits, and the criteria that apply to those circumstances can be somewhat complicated. A summary of the requirements can be found on the Web site of Human Resources Development Canada at www.esdc.gc.ca/en/cpp/oas/index.page.

A person who has lived in Canada for less than 40 years as an adult may still qualify for partial OAS benefits. If the total OAS benefit is thought of as a pie containing 40 pieces, a person can receive one of those pieces for each complete year of residence in Canada after the age of 18. So, a person who lived in Canada for 20 years between the ages of 18 and 65 will be able to receive 50% (20/40) of the usual OAS benefit.

For 2016, the maximum monthly OAS pension currently receivable (the amounts are indexed for inflation and adjusted quarterly) is about $571 per month, or $6,852 per year. However, unlike the CPP, OAS entitlement can be affected by the income of the recipient, through a mechanism known as the "clawback". Essentially, the clawback reduces OAS entitlement where a taxpayer's income is over a specified threshold, which is indexed annually. Where income exceeds the threshold, OAS entitlement is reduced by 15% of "excess" income. The threshold is currently $73,756.

Guaranteed income supplement

The federal government provides what is known as a Guaranteed Income Supplement (GIS) for taxpayers who are eligible to receive OAS benefits and whose income falls below certain specified minimum. The Supplement is paid to single taxpayers whose income otherwise calculated is less than $17,304, while the income threshold for couples will vary, depending on their sources of income. The maximum supplement payable is about $774 per month.

The GIS differs from CPP and OAS payments in one significant respect: GIS payments, regardless of amount, are not taxable, although they must be reported on the annual tax return.

The income sources outlined above all arise from programs administered or funded by the federal government. Most taxpayers at or near retirement will also have private-source retirement income, whether from employer-sponsored pension plans, registered retirement savings plans (RRSPs), registered retirement income funds (RRIFs), or annuities. All such income sources represent taxable income, but the tax rules applied to each can differ.

Private-source retirement income

TFSAs

A new investment vehicle, the tax-free savings account (TFSA), was enacted in 2008 to become effective in 2009. Beginning in 2009, everyone resident in Canada who is 18 years of age or over will accumulate $5,500 ($5,000 prior to 2013) of TFSA savings room each year. The limit was $5,000 for 2009 to 2012, $5,500 for 2013 and 2014, $10,000 for 2015, and $5,500 after 2015. To the extent that you have accumulated contribution room, you can contribute to a TFSA, which is like an RRSP in that it is a trust account administered by a bank, trust company, credit union, or annuities issuer (typically a life insurance company). Contributions are not deductible, but investment earnings accumulate tax-free in your account,and can be withdrawn without penalty at any time. Eventually, as the system matures, you will be able to earn tax-free investment income on substantial amounts.

RRSPs

Nearly all Canadians are familiar with the basic structure of RRSPs and the benefits that can be obtained through regular RRSP contributions. During their working years, taxpayers can make annual contributions to an RRSP of up to 18% of their previous year's earned income (basically income from employment or self-employment), plus any amount not contributed for prior years, which

is carried forward. A tax deduction is allowed for contributions made to the RRSP during the year, thereby reducing current-year tax liability, and funds contributed to the RRSP can earn income on a tax-free basis until the end of the year in which the planholder reaches the age of 71. At that time, the balance in the plan is usually transferred to an RRIF fund or is used to purchase an annuity.

As long as the funds in the RRSP are transferred to an RRIF or used to purchase an annuity, there will be no immediate tax consequences to the planholder. It is possible, although rarely advisable, to simply collapse the RRSP and receive all of the accumulated funds. If that option is chosen, the entire balance is included in income for the year in which the plan is collapsed, and tax is paid on the entire amount.

RRIFs

Taxpayers who wish to keep their retirement funds invested and who are comfortable with continuing to manage those investments, perhaps with professional assistance, often choose to transfer the funds held in the RRSPs to an RRIF. As with an RRSP, funds held in the RRIF can continue to accumulate and grow on a current tax-free basis. The only real differences between holding the funds in an RRIF and in an RRSP are that no contributions may be made to an RRIF and, more important, that the planholder must withdraw a specified percentage of the balance each year from the RRIF. That percentage is based on the age of the planholder, and it increases each year. Note that the withdrawal is not optional; even if the funds are not needed, the withdrawal must be made and the withdrawn amount reported on the annual tax return. Recipients of RRIF income who are 65 years of age or older or who received the amount as the result of the death of a spouse must report the income on line 115. In all other cases, the income is reported on line 130.

The following chart shows the required withdrawal amounts at each age. The minimum required withdrawal is determined by multiplying the fair market value of plan assets at the beginning of the year by the appropriate figure. That figure is determined by the taxpayer's age at the beginning of the year for which the minimum required withdrawal is being calculated.

Age on January 1	Minimum Withdrawal Figure
71	.0526
72	.0540
73	.0553
74	.0567
75	.0582
76	.0598
77	.0617
78	.0636
79	.0658
80	.0682
81	.0708
82	.0738
83	.0771
84	.0808
85	.0851
86	.0899
87	.0955
88	.1021
89	.1099
90	.1192
91	.1306
92	.1449
93	.1634
94	.1879
95 or older	.2000

Note that it is always possible to withdraw more than the minimum amount, where funds are needed. However, tax will be payable on any amounts withdrawn.

Annuities

Many retirees (and those still planning for retirement) worry about not having enough money to last throughout their retirement years, perhaps because anticipated returns on invested funds are not realized or because inflation erodes the value of accumulated savings. Taxpayers who are looking for certainty of income in their retirement years (or who simply want to be relieved of the burden of making investment decisions and monitoring the results of those decisions, or both) often choose to purchase an annuity with the funds accumulated in their RRSPs. Essentially, the purchaser of an annuity gives up the right to any further increase in the value of his or her savings in return for a guaranteed income stream for the balance of his or

her life, and, depending on the type of annuity, for the life of a survivor spouse. The amounts received from an annuity (most often in the form of monthly payments) are taxable and must be reported on the annual return. Annuity recipients who are 65 years of age or older or who received the annuity amount as the result of the death of a spouse must report the income on line 115. In all other cases, the income is reported on line 130.

Annuity terms can vary widely, and the cost of purchasing an annuity is dependent in large measure on the prevailing interest rates at the time of purchase. There are significant long-term financial consequences to the decision to purchase an annuity and to the choice of annuity terms. Retirees contemplating such a purchase are well advised to seek independent professional advice to assist with those decisions.

Retirement compensation arrangements

Where it is determined that registered plans such as RPPs, RRSPs, or DPSPs will not provide an adequate retirement income for a particular individual, an additional unregistered plan may be required. If the unregistered plan is funded by the employer, it will usually be considered a retirement compensation arrangement (RCA). An RCA is defined as an arrangement (usually a trust) to which contributions are made by an employer or former employer of a taxpayer to provide benefits to be received or enjoyed by the taxpayer upon retirement (or upon any substantial change in employment, or loss of employment). Specifically excluded from the definition are RPPs, RRSPs, and DPSPs.

An RCA is essentially an unregistered pension plan; it is not a tax-assisted savings plan and there are no real tax advantages. It is a plan funded by your employer to provide benefits on retirement or termination of employment, or a substantial change in the nature of the services you render to your employer. Your employer's contributions to such a plan have no immediate tax consequences to you, but are subject to a special refundable tax in the plan, to ensure that they cannot be invested on a pre-tax basis. Payments out of the plan to you will be taxable when received.

Certain arrangements are excluded from the RCA rules. These include permissible salary deferral arrangements for professional athletes (and in some cases for league officials), and plans for the benefit of non-resident employees. However, where contributions are made to a foreign pension plan for the benefit of Canadian resident employees, the plan will be considered an RCA in respect of that employee and there will be a 25% withholding tax on the payments unless the employee was a member of the plan before he became a Canadian resident and has been resident for no more than 60 of the preceding 72 months. This exception accommodates temporary transfers to Canada. Certain government pension plans may be, or may choose to be, treated as RCAs.

Tax credit and tax-planning strategies

Retired taxpayers typically have a number of additional tax credits available to them, either by reason of their age or their income sources, and those credits can make a significant difference to overall tax liability and, therefore, to after-tax income.

There are also a number of tax planning possibilities open to retired spouses, generally involving the transfer of income and/or credits between spouses to achieve the best overall tax result.

Age credit

While eligibility for the age credit doesn't depend on being retired — it's available to any Canadian who is 65 or older — the fact is that most taxpayers claiming the credit are retirees. The age credit, like most federal non-refundable tax credits, is a specified amount which is then converted to a credit by multiplying by the tax rate applied to the lowest income bracket — currently 15%. The age amount for 2016 is $7,125, and the credit is therefore $7,125 × 15%, or $1,069.

Unlike many other non-refundable tax credits, however, eligibility for the age credit can be affected by the income of the taxpayer claiming that credit. For 2016, any age amount claimable is reduced by 15% of the taxpayer's income over $35,927, as shown in the following example.

Taxpayer A, aged 67, has income for the year of $50,000. In completing his annual tax return, Taxpayer A must calculate his eligibility for the age credit as follows:

$50,000 – $35,927 = **$14,073**
$14,073 × 15% = **$2,110.95**

$7,125 (age amount otherwise claimable) – $2,110.95 = **$5,014.05** (revised age amount)

$5,014.05 × 15% = **$752.11** (revised non-refundable age credit)

Consequently, the age credit which may be claimed by Taxpayer A has reduced from $1,037 to $752.11. For 2016, a taxpayer's eligibility for the age credit will be eliminated once his or her income exceeds $83,427.

GST credit

As with the age credit, there is no requirement that a taxpayer be retired in order to receive the GST credit. Rather, the credit, which is structured as a quarterly payment, is available to moderate- or low-income Canadians, and many retirees fall into those income categories.

The basic GST credit is $276 per person, per year. Where a taxpayer's family net income (that is, the total income of all family members as shown on line 236 of the income tax return) is more than $35,926, eligibility for the credit is reduced by 5% of every dollar over that threshold amount. Single taxpayers may also receive the GST credit supplement. Eligibility for the supplement also depends on income, and the supplement amount is equal to 2% of net income over $8,948, to a maximum payment of $145 per year.

In order to receive the GST credit or the supplement, it's necessary to file a tax return, and the application for the credit can be done on page 1 of the T1 return. The Canada Revenue Agency (CRA) will calculate the taxpayer's eligibility for the credit and advise him or her of the amount to be received, if any. One quarter of the annual credit amount will then be sent to the taxpayer in each of January, April, July, and October.

Pension income amount

Taxpayers who receive qualifying pension income during the year can claim a credit of up to $2,000 in respect of such income on the annual tax return. Like the age credit, the pension amount is converted to an actual credit by multiplying by 15%, meaning an actual reduction in federal tax of $300.

The definition of qualifying pension income is quite broad, and it essentially covers most private pension income, whether arising from an employer-sponsored pension plan, an RRSP or RRIF, or an annuity. However, where a taxpayer is under the age of 65 throughout the year, there are restrictions placed on the types of income for which a pension income credit can be claimed. Specifically, where a taxpayer is under 65 throughout the year, a pension income credit can be claimed for only the following types of income:

- payments from a superannuation or pension plan (other than lump-sum payments);
- annuity payments from an RRSP, RRIF, or deferred profit sharing plan, where those payments arose as a consequence of the death of the taxpayer's spouse; and
- the income portion of any other annuity payment received as a consequence of the death of the taxpayer's spouse.

It's important to note that, regardless of the age of the taxpayer, the pension income credit cannot be claimed in respect of public-source pension income — that is, Canada Pension Plan payments or Old Age Security or Guaranteed Income Supplement benefits. As well, $2,000 is the maximum amount that may be claimed. The actual pension amount on which the 15% credit is based is the lesser of $2,000 and the amount of eligible pension income received during the year. Consequently, if a taxpayer receives less than $2,000 in eligible pension income during the year, that income amount represents the maximum which may be claimed for purposes of the pension income credit.

Credit transfers between spouses

Most federal tax credits are non-refundable tax credits, meaning that available credits can be used only to reduce federal tax otherwise payable. Once federal tax is reduced to zero by the application of the non-refundable credits, any "excess" credits are simply lost, as there is in most cases no provision for carrying over such credits to another year.

However, where a taxpayer is married, it is possible to transfer such excess credits to a spouse who has a federal tax amount owing. There are restrictions: not all such credits are transferable, and in any

case the person who earned the credits must first use them to reduce federal tax to zero before any transfer of credits to a spouse can take place.

Where a taxpayer's circumstances permit the transfer of credits to a spouse, the following four credits may be transferred: the age amount, pension income amount, disability amount, and any current-year tuition and education amounts.

Pension income splitting

In the 2006 Budget, the federal government announced that spouses who were receiving pension income that would qualify for the pension income credit would be allowed, beginning with the 2007 taxation year, to split that income for tax purposes. In effect, up to one-half of qualifying pension income can now be allocated to the non-recipient spouse and taxed in his or her hands.

The ability to split pension income represents a significant tax-planning opportunity for those able to take advantage of it, and it can affect both the amount of tax payable and eligibility for other government benefits for both spouses.

As with the pension income credit, public-source pensions like the CPP and OAS/GIS benefits do not qualify for pension income splitting under these provisions, although CPP benefits can be split between spouses in the manner outlined above. Similarly, taxpayers who are under the age of 65 are restricted in the types of pension income that may be split with a spouse.

The mechanics of pension income splitting are relatively simple. There is no need to make any change in the actual payment or receipt of qualifying pension amounts, and no need to notify the pension plan administrator. In addition, the decision of whether and to what extent to split pension income does not have to be made until the return for the year is filed (for 2016 returns, the spring of 2017). At that time, the pension recipient and his or her spouse must file a joint election with their returns, using Form T1032, available on the CRA Web site at http://www.cra-arc.gc.ca/E/pbg/tf/t1032/t1032-08e.pdf. The pension recipient will also claim a deduction for the amount of any pension income allocated to his or her spouse, and the recipient spouse will report the allocated pension income on his or her return.

The splitting of pension income has a number of implications for both spouses. The income of the spouse who allocates pension income received will, of course, be reduced. That reduction in income can have the effect of putting that person into a lower tax bracket and increasing (or creating) eligibility for income-tested benefits like Old Age Security. On the recipient spouse's side, the receipt of qualifying pension income can create or increase eligibility for the pension income credit. The overall benefits to be obtained from pension income splitting can be significant, as shown in the following example:

John and Jane are married, and both spouses are over the age of 65. John has annual retirement income of $84,800, including $74,000 in private pension and annuity income, $8,000 in CPP payments and $2,800 in OAS benefits, while Jane receives OAS payments of $500 per month ($6,000 per year), but has no other source of retirement income.

If a joint election was made to allocate one-half or $37,000 of John's qualifying pension income to Jane, their income for tax purposes would be as follows:

John

Income Type	Amount
Pension and annuity	$37,000
CPP	$8,000
OAS	$6,000
Total income	**$51,000**

Jane

Income Type	Amount
Pension and annuity	$37,000
OAS	$6,000
Total income	**$43,000**

Although the couple's total family income has risen from $90,800 to $94,000, the federal taxes payable on that income will be reduced, as both spouses will, after pension income splitting, have a top federal tax rate of 20.5%. Prior to allocating one-half of such income to Jane, John would have paid a top federal rate of 26%. As well, John will now be eligible for full OAS benefits, rather than the partial benefits which he formerly received, as his income has dropped below the OAS clawback threshold of $73,756 (for 2016). Finally, as Jane will be receiving qualifying pension income for the first time, she will be able to claim a full ($2,000) pension income deduction, which was formerly not available to her. As John will continue to claim that $2,000 amount as well, the pension income amount available to them has doubled.

Note that eligibility for some tax credits, specifically those based on net family income, are not affected by the splitting of pension income.

Finally, the tax benefits of pension income splitting outlined in the example are shown only for federal tax purposes. As many of the provinces have indicated that they will adopt the federal pension income splitting proposals for provincial tax purposes, similar savings may be achieved with respect to provincial income taxes. The actual dollar figure savings will vary by province, owing to differing provincial income brackets and tax rates. However, the benefits will be greatest in those provinces and territories that levy a high-income surtax on individuals, where the income of the higher-income spouse can be reduced below the level at which the surtax is imposed.

Conclusion

It may seem from the foregoing that getting a handle on one's finances during retirement is an overwhelming task, but that's not the case. For most retired taxpayers, once the major decisions (RRIF vs. annuity; pension income splitting strategies; tax-payment arrangements) are made and implemented, perhaps with professional assistance, an annual review of one's existing arrangements should suffice to keep things on track. There are a number of commercial sources of information available with respect to managing one's finances in retirement, in bookstores and online. And when it comes to retirement and tax matters, the CRA publishes a very useful booklet entitled *When You Retire*, which is available on the its Web site at www.cra-arc.gc.ca/E/pub/tg/p119/p119-e.html.