The clawback conundrum

How to help reduce your reported income to maximize benefits in retirement.

WHEN CANADIANS AGE 65 OR OLDER think about their overall retirement plan, most focus on ensuring their savings, investments and other forms of income are appropriately managed. But most people's retirement income also includes a range of valuable benefits available from the government, two of the most familiar ones being Old Age Security and the Age Credit. And a critical feature of these benefits is that they're highly connected to your taxable income. They can be clawed back or forfeited altogether if your reported income (line 234 of the federal tax return) is too high.

Therefore, in order to avoid reducing the government benefits you receive, you may want to think about ways to reduce your reported income. Here are a couple of straightforward approaches you can take.

1. Effectively structure non-registered investments

It's important to understand that each type of income from non-registered investment sources is treated differently for tax purposes. For example, only half of net capital gains are included in your taxable income, whereas interest income from investments, such as GICs,[1] is fully reported as income.

Dividends received from Canadian corporations are another consideration. Although the dividend tax credit does provide for preferential tax treatment, it is the grossed-up amount that is reported as taxable income and that is used to determine eligibility for income-tested benefits (such as Old Age Security).

This is where proactive management of your income-generating investments comes into play. Knowing how different investments affect reported income can help you identify opportunities to structure your investments in tax-advantaged ways to help reduce clawbacks and preserve your wealth. As demonstrated in the table below, some options to consider include prescribed annuities, withdrawals from a mutual fund or segregated fund contract, or distributions from a Series T mutual fund.

[1] Refers to guaranteed interest contracts from insurance companies and guaranteed investment certificates from other financial institutions.

Consider the amount reported on your tax return

(Income of $10,000)

Source	Included on tax return (%)	Amount reported ($)
Eligible dividends*	138	13,800
GICs or bonds	100	10,000
Capital gains	50	5,000
Prescribed life annuity	15†	1,500
Mutual fund or segregated fund contract withdrawals	2.5‡	250
Distributions from Series T mutual funds	0§	0

2. Optimize tax deductions

From a tax perspective, the arrival of retirement means that many familiar tax deductions are no longer available, such as Registered Retirement Savings Plan (RRSP) contributions, pension plan contributions, child care expenses and union dues. But you do have other options for generating deductions.

Maximizing RRSPs: If you have any RRSP room left, making a lump-sum contribution before you convert it to a Registered Retirement Income Fund (RRIF) can be advantageous – the resulting deductions can be spread over a number of years.

Borrowing to invest:[2] For those who have additional income over and above what's required for living expenses, coupled with a higher comfort level with investment risk, a borrowing strategy may be worthwhile. Specifically, a tax deduction can be created when you use RRIF or other discretionary income to pay interest on funds that were borrowed to invest.

Speak to your advisor

Whether you're nearing or already in retirement, it's worthwhile to contact your advisor and tax specialist for more information. They are the best resources for information on how to help avoid clawbacks and how to maximize government benefits. ■

*Dividends paid from income that has been subject to the general federal corporate tax rate (e.g., paid by public corporations) qualify as "eligible dividends" and are included at 138 per cent. Other dividends, or "non-eligible dividends," are included at 117 per cent for 2016.

† Taxable percentage is approximated for a 65-year-old female.

‡ Taxable percentage in year one; grows to 20 per cent in year 10. Assumes a five per cent rate of return on an investment of $200,000. Does not take into account year-end distributions or allocations.

§ Distributions are considered return of capital (ROC) until the adjusted cost base (ACB) of the investment falls to zero, at which point they are considered capital gain. This percentage does not take into account year-end distributions.

[2] Borrowing to invest is appropriate only for investors with higher risk tolerance. You should be fully aware of the risks and benefits associated with investment loans, since losses as well as gains may be magnified. Your investment will vary and is not guaranteed. However, you must meet your loan and income tax obligations and repay your loan in full. Please ensure you read the terms of your loan agreement and the investment details for important information. The dealer and advisor are responsible for determining the appropriateness of investments for their clients and informing them of the risks associated with borrowing to invest.

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