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Gordon Pape: Why you should be concerned about the new federal tax bracket

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When the federal Liberal government introduced a new 33-per-cent tax bracket, Canadians were assured that only those with income over $200,000 would be affected. Most people breathed a sigh of relief and went about their business. “Let Ottawa soak the rich,” was the attitude. “It doesn’t affect me.”

Actually, it might cost you or someone in your family thousands of dollars at some point, even if your income is modest. Everyone who has an RRSP or RRIF is at risk – or, more precisely, his or her heirs are. The new rate has become an estate planning concern.

That’s because at death these retirement plans are deemed to have been terminated and cashed in. Unless there is a surviving spouse, all the money becomes taxable at the deceased’s marginal rate. If there is a substantial amount in the plan, the tax bill will be huge, swelled by the new bracket.

As an example, let’s assume that an Ontario widow dies, leaving behind a RRIF with a taxable value of $500,000 to her two children. Up until she passed away, she had received taxable income in that year of $50,000.

According to accounting firm EY, the tax increase pushed the top marginal rate in Ontario to 53.53 per cent (federal and provincial combined). That’s up from 49.53 per cent in 2015. Remember, that rate only applies to taxable income over $200,000 so in this case $350,000 is exposed to the highest rate. (We’ll leave tax credits and deductions out of this to simplify the calculation.)

Had she died in 2015, the tax bill on that $350,000 would have been $173,355. This year it will be $187,355. By living a year longer, she cost her heirs $14,000!

If she wanted to reduce her final tax bill, she could have moved to B.C. before she died. Even with the new bracket, the top rate there is 47.7 per cent, less than in Alberta which used to be considered a domestic tax haven. The rates in the territories are even less but they can be a little chilly in winter. Nova Scotia has the dubious honour of the top federal/provincial marginal rate in Canada, at 54 per cent.

So what can you do to beat this? In the past I have not been a big fan of drawing down RRSPs but this new tax bracket has changed matters. You may now want to consider a plan to gradually reduce your RRSP/RRIF exposure and move the money into a Tax-Free Savings Account (TFSA).

After the Liberal government rollback, the annual TFSA contribution limit is $5,500, or $11,000 for a couple. If drawing enough money from an RRSP to move $5,500 (after tax) to a TFSA does not push you into the top bracket or expose you to the Old Age Security claw back, it’s a strategy you should seriously consider. An Ontario resident with taxable income of $70,000 has a marginal rate of 31.48 per cent. He or she could withdraw $8,000 from an RRSP, pay tax of about $2,500, and move the rest to a TFSA. That would result in a tax saving of 22 percentage points compared to what would have to be paid at the top marginal rate in the event of death.

If you're already into the RRIF phase, taking a top up over your minimum withdrawal and moving it to a TFSA will have the same effect.

Over time, this strategy will gradually reduce the tax exposure of your RRSP/RRIF and build your tax-protected TFSA.

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