FINANCIAL POST

Your biggest tax asset in retirement may be sleeping right beside you

Jonathan Chevreau: Planning jointly for retirement with a spouse pays off

Because Canadians can split certain kinds of income, your biggest tax asset may just be your spouse.*Getty Images*

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As I am discovering while I prepare annual tax returns for myself and my wife (who at 64 is one year my junior), moving from wealth accumulation to "decumulation" is more complicated than holding down a full-time job and investing for growth.

Strange new tax slips start to appear in your mailbox reporting OAS and CPP income and RRSP and RRIF withdrawals, plus there are new tax credits to digest.

You also learn that, because Canadians can split certain kinds of income, your biggest tax asset may just be your spouse.

"The best retirement plan for a couple sets up for each to have (as much as possible) the same levels of income in retirement," says retired financial planner Warren Baldwin, who for decades has been preaching the benefits of planning jointly for retirement.

The goal, of course, is to avoid having one spouse pay taxes at a higher rate, when the other has room to spare.

Pension strategies

The biggest tax benefit available to Canadian couples after they turn 65 is the ability to split employer pensions.

Pension splitting was introduced eleven years ago to compensate for the elimination of the favourable tax status of income trusts, and allows a higher-income spouse to “transfer” up to 50 per cent of eligible employer pensions to a lower-income partner’s hands (this happens when you file your joint election by filling out form T1032).

For example, if one spouse has a $50,000 corporate pension and the other does not, rather than one being taxed on $50,000 of income (much of it in a higher bracket), each receives $25,000. Right off the bat, the first $11,809 for each is tax free as part of the “Basic Personal Amount” (federal, 2018.)

Versions of this gambit can be achieved with RRSPs, RRIFs and other vehicles, as we explore below, but there’s limited scope for splitting the basic government pensions.

Old Age Security cannot be split at all. Spouses can apply to share CPP income if both spouses are at least 60 but even a full split of CPP is modest, moving at best about $6,000 between spouses.

RRSP Strategies

While the benefits of pension splitting can be huge, given political vagaries, Baldwin suggests couples try to equalize income as much as possible through spousal/personal RRSP contributions. That means starting your planning well before you hit retirement age.

Ideally, a couple with disparate levels of earned income would set up a spousal RRSP when both are working.

The higher-income spouse contributes to the spousal RRSP and enjoys the resulting tax refund; then in retirement, the lower-income spouse draws income from the spousal RRSP, paying tax at what’s likely a lower rate.

Individual RRSPs can also be used to split income in retirement, but only after they have been converted into Registered Retirement Income Funds (RRIFs).

Once converted they qualify for pension splitting, again to a limit of 50 per cent.

The spouse whose RRIF (or Life Income Fund) is being drawn upon must be at least 65, but the recipient of the income splitting can be younger than 65, notes Aaron Hector, vice president of Calgary-based Doherty Bryant Financial Strategists.

The Benefits

While a simple reduction in taxes is the main benefit, Adrian Mastracci, a portfolio manager with Lycos Asset Management in Vancouver, says equalizing asset levels can also reduce the clawback of the OAS pension and age credit.

The clawback threshold starts at net income of $77,580 (in 2019), which means senior couples with equalized net incomes can bring in about $155,000 between them before OAS clawbacks even begin to kick in.

He too believes in starting early — setting the stage for income equalization should ideally begin 10 or 15 years before retirement — and suggests that higher-income spouses pay all family expenses while the lower-income spouses save and invest their money.

Spousal loans are also an option. A higher-income spouse can make a loan to the lower-income partner at the prescribed lending rate, currently two per cent. If business owners, they should review the mix of dividends and salary. Finances can also be arranged so capital gains are reported by both spouses.

Doug Dahmer, founder of Burlington-based Retirement Navigator, says couples also need to look at splitting incomes between tax years.

“Too many people get caught up in minimizing their taxes in the current tax year, instead of pursuing the goal of minimizing their taxes over the balance of their lives,” Dahmer says. “Sometimes, it’s better to pay a little more tax early than it is to pay a lot more later.”

This is relevant in the years leading up to mandatory RRIF withdrawals (age 72) and before the years of potential OAS clawbacks. Don’t waste the chance of drawing down on RRSPs when marginal tax rates are low (typically in one’s post-employment 60s).

“The key is to consciously draw enough from these taxable accounts to fill up their lower tax brackets,” Dahmer says. This is a use-it-or-lose it proposition: “Once the current tax year is in the rear-view mirror, you will have lost the opportunity to use these lower tax brackets forever.”

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