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TAX-EFFICIENT CAPITAL PRESERVATION

AVOIDING CLAWBACKS

Avoiding clawbacks is an important strategy to remember in planning income withdrawals in a structured manner, whenever possible, to ensure that the Old Age Security (OAS) stays intact. This is a benefit of over $6,500 per person per year and can go a long way in shoring up cash flow, particularly when investment performance is variable. Old Age Security is clawed back when net income exceeds certain thresholds. Withdrawing too much, or the wrong kind of income, can affect the amount of Old Age Security received by higher net income clients, which leads to the question: why is my monthly income less than last year?

ESSENTIAL TAX FACTS

1. How much is the OAS?

Monthly	1st quarter	2nd quarter	3rd quarter	4th quarter	Year total
2014	$551.54	$551.54	$558.71	$563.74	$6,676.41
2015	$563.74	$563.74	$564.87	$569.95	$6,876.90
2016	$570.52	$570.52	$573.37	$578.53*	$6,878.82*

* these amounts estimated based on CPI

2. At what net income level is the OAS clawed back?

OAS is clawed back at a rate of 15% as net income exceeds the base amount, shown below.

Year	Base amount	Maximum income
2014	$71,592	$115,716
2015	$72,809	$117,954
2016	$73,756	$119,512

Source: Service Canada

AVOIDING CLAWBACKS

Most people know that the majority of income sources received are subject to federal and provincial income taxes. However, many people do not understand how income structure affects a ‘clawback’ of refundable and non-refundable tax credits or, in the case of seniors, social benefits like the OAS. That’s because these credits and benefits are income-tested: the higher your income, the less you’ll receive.

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Good news: income can be structured and deductions can be planned to minimize the effect of clawbacks. The following table shows the clawback zones for the OAS and personal amounts for 2016.

Clawback zones for 2016

Credit	2016 reduction begins	2016 credit eliminated
OAS	$73,756	$119,512
Age amount	$35,927	$83,427
Spouse or common-law partner amount	$0	$11,474
Amount for eligible dependants	$0	$11,474
Amount for infirm dependants	$6,807	$13,595
Caregiver amount	$15,940	$22,728

Source: Service Canada and Canada Revenue Agency.

The importance of the Registered Retirement Savings Plan (RRSP)

In each case where a clawback is possible, it's very important that family net income is carefully monitored. Often a RRSP contribution can preserve tax credits and social benefits, as the RRSP deduction reduces the net income, which determines eligibility.

Retirees and clawbacks

Two common clawbacks can occur in retirement as well, once you reach age 65. The first clawback occurs with the 'Age Amount', a non-refundable tax credit. The second can reduce the OAS, a social benefit available to all who turn 65 in the year and have income under certain thresholds. These clawbacks are a big deal for retirees, as you will see below.

Every resident of Canada who meets the required age and income thresholds may receive OAS. However, newcomers to Canada may not qualify for this benefit until they have been resident in Canada for at least 10 years. As mentioned, higher-income taxpayers may be required to repay a portion of the benefits they receive; this is known as the clawback. Clawbacks are calculated on the tax return and will be calculated in regards to the amount of net income, the figure upon which refundable and non-refundable tax credits are calculated; which in turn, will reduce the monthly amount received, and may require repayment on the tax return. This must be planned for to avoid hardship.

Today, seniors receive just over $550 each month from OAS. That's $1,100 per month in the case of couples. The OAS benefit may be indexed when inflation exceeds a certain threshold. If both spouses live to age 85, the total amount they could potentially receive before indexing is $132,000 each or $264,000 together.

Clawback of the OAS

If your net income exceeds an indexed threshold amount (as above), you will be required to repay 15% of the lesser of:

- Net income in excess of the threshold
- Net OAS (plus net supplements) received

The clawback is known as the 'Social Benefits Repayment' on the tax return. This is something every senior in Canada needs to know about to adjust cash flow: for the following year from July 1 to June 30, the taxpayer's OAS payments will be reduced each month by one-twelfth of the OAS repayment payable on the prior year return. This shows up as a 'recovery tax' on the T4A (OAS) slip the next year.

Example: Assume the individual taxpayer had net income of $80,000, made up of private and public pension income sources and a variety of investments generating income primarily from interest and dividends. The clawback of the OAS in this case would be $936.60, or $78.05 a month, computed as follows:

$80,000 less base amount of $73,756 = 6,244 × 15% = $936.60

Income from investments can be planned to ensure income levels fall below this threshold to avoid the 'recovery tax' of $936.60. Note that in hardship cases, taxpayers can have this 'recovery tax' reduced by filing Form T1213OAS, if net income is lower in the following year. That's important to help preserve your monthly income, especially when the clawback is a result of a one-time income blip.

Clawback of the Age Amount

The Age Amount is a non-refundable tax credit provided to every taxpayer who at the end of the year is at least age 65.

A non-refundable tax credit reduces federal or provincial taxes payable. This means that if you don't owe taxes, the amount will not be useful to you. Most retirees who worked in their lifetimes will have some taxable income, though, as both the Canada Pension Plan (CPP) and Old Age Security (OAS) benefits are subject to tax.

This Age Amount is reduced by 15% of the taxpayer's net income in excess of a base amount. The credit and base income testing thresholds are indexed annually to reflect changes in the average Consumer Price Index. Note that each of the provinces and territories offers a similar credit, but that the Age Amount and base income amount often vary by province.

In the year of death, the Age Amount may be claimed in full on the final return and on any of the optional returns filed for the deceased.

In 2016, the federal age amount is $7,125. As mentioned, the provincial amounts may differ. For example, in Ontario in 2016 the Age Amount is $4,888 multiplied by 5.05%.

Each spouse may qualify to receive an Age Amount if either spouse turns age 65 in the tax year. If one spouse's income is too low to benefit from the credit, the other spouse may transfer the Age Amount to his or her return.

The federal Age Amount begins to be clawed back when personal income begins to exceed $35,927 in 2016. This means that if income is split effectively between spouses, the couple could earn a total annual income of $71,854 before they begin to lose the benefit of the Age Amount. When an individual's income begins to exceed $83,427, the Age Amount will have been fully clawed back.

ACTION PLAN: Checklist for avoiding clawbacks

STEP 1: Determine the tax-free zone for each taxpayer

Usually this is the basic personal amount ($11,474 in 2016) and the age amount ($7,125). Therefore, each taxpayer 65 and over may earn $18,599 before being subject to federal tax.

STEP 2: Determine the tax-free zone for the couple

For a two-income couple, this equates to an income level, split equally, of $37,198 of income before federal tax would be paid. This is the equivalent of just over $3,090 per month, available to cover basic living needs. In retirement income planning, it is always best to try to structure equal incomes if possible.

STEP 3: Structure income to avoid the age credit clawback

Once an individual's income exceeds $35,927, the Age Amount begins to be clawed back. This means that the marginal tax rate will increase, in turn increasing the tax rate to the excess income. To maximize your Age Amount, your advisor will try to structure income sources to remain below this threshold for each spouse.

STEP 4: Structure income to avoid the OAS clawback

OAS begins to be clawed back when individual net income exceeds $73,756 (in 2016). Income received above this level will result in the OAS being clawed back at a rate of 15% for every dollar of earned income above this amount. An option to defer receipt of OAS is available. This may be an option for high-income seniors.

STEP 5: Use retirement income planning techniques

To minimize the impact of both the Age Amount clawback and the Old Age Security clawback, it is a good idea to create multiple sources of income in retirement: fully taxable (RRIF, pensions, CPP, OAS), partially taxable (dividends, capital gains), and non-taxable (TFSA, return of capital).

ACTION PLAN: Avoiding or minimizing the impact of a clawback

Your advisor will work with you to create the optimal retirement income scenario and then adjust how the capital is invested to produce your ideal tax-efficient income sources. This may mean moving assets to other family members (when appropriate), splitting qualifying pension income with your spouse, assigning CPP benefits to your spouse, and/or using different investment tools so they can minimize taxable distributions from your non-registered investments (such as interest or dividends). Some strategies to consider would be:

- Plan income receipts over a longer period of time, splitting them equally between spouses
- Draw RRSP/RRIF income up to the top of the current tax bracket and again, over a longer period of time.
- Move money into a TFSA or a capital class money market fund (i.e.: where the money is safer and no distributions take place until withdrawn)
- Reduce registered or non-registered capital pools and then set up TFSA accounts for adults in the family to generate pools of tax exempt investment earnings.
- Shift taxable cash flow into return of capital products when taking withdrawals from non-registered accounts

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