



# Do the math

## with the other half

### Income splitting and other ways to save tax in retirement

#### Making the most of your opportunities

Under current tax law, you can contribute up to 18 per cent of your previous year's earned income to the dollar maximums shown in the chart.

You can also carry forward any unused contributions from previous years. This gives us all an opportunity to make up for those years when we didn't – or couldn't – make RRSP contributions.

If you are currently in a 40 per cent marginal tax bracket, a \$10,000 RRSP contribution would reduce your current year income tax by \$4,000. Looking at it another way, it only costs you \$6,000 to save \$10,000.

#### At retirement

At retirement, you simply use the money in your RRSP to provide some form of payment or income. You can:

- use the money to purchase an annuity (that will provide you with a regular income).
- convert your RRSP to a registered retirement

income fund (RRIF) and continue to invest/ manage the money.

- withdraw the money in cash.

These payment options are discussed in detail in the section entitled "Incoming" on pages 16-21 of this guide.

Regardless of the option you select, the payments will be taxable. However, the amount of tax payable can vary significantly depending on the choice you make.

In Canada, we have a progressive tax system. The more you earn in a given year, the more tax you'll pay – both in absolute terms and percentage terms (see "Understanding marginal and effective tax rates" for a more detailed description of marginal tax rates). If you withdraw the money in one lump-sum payment, there's a good chance that much of the payment will be taxed at a higher marginal tax rate than if you spread the income or related withdrawals over an extended period (perhaps your total retirement). If you withdraw the money when you are in a lower tax rate than when you contributed it you're ahead of the game.

**Maximum RRSP contribution<sup>7</sup>**

2005	\$16,500
2006	\$18,000
2007	\$19,000
2008	\$20,000
2009	\$21,000
2010	\$22,000
2011	indexed

## As we all know, there are only two sure things in life... and the other one is taxes.

We pay taxes on the income we earn as active employees. In most cases, we will also pay taxes on the income we receive in retirement – whether it's from our company pension plan, government-sponsored programs, or personal savings.

The bottom line: we have very little control over whether or not we pay taxes. We do, however, have some control over how much tax we'll pay... and when we'll pay it.

As with most things in retirement, it's all a matter of planning.

### The power of RRSPs

The easiest and most prudent way to manage taxes during your active work life is to contribute to a registered retirement savings plan (RRSP).

Consider the advantages:

- Contributions to your RRSP are tax-deductible (subject to Income Tax Act limits) – that is, they will actually reduce the amount of income tax you pay each year. The more you contribute, the less tax you will pay.
- RRSP contributions will grow on a tax-deferred basis. Unlike the interest you earn, for instance, on your bank accounts, you do not pay tax on positive investment returns as long as the money remains in the plan. Thanks to the magic of compounding, this important feature can dramatically increase the amount you accumulate over time.
- RRSPs can help you manage the marginal tax game. Most of us will make RRSP contributions when our marginal tax rate is at its highest levels – and make RRSP withdrawals when our marginal rate is lower. The difference, from your perspective, is like a tax-free bonus.

In short, RRSPs allow you to reduce your annual tax burden while building retirement savings.

<sup>7</sup> Income Tax Act

## Saving on tax by splitting your income

One of the best ways to win the marginal tax game is to "split your income" in retirement. Most income splitting strategies originate from the same basic idea: dividing your income among family members so that, as a family, you pay less overall tax. The government has put restrictions into the *Income Tax Act* to eliminate any tax advantage for most types of income splitting. The restrictions are called the attribution rules.

An easy way to split income that is still permitted is through a spousal RRSP – an RRSP opened in your spouse's name. You still get the tax deduction, but the plan is in your spouse's name. More importantly, in most cases, the RRSP income received during retirement is taxed in your spouse's hands – and at his or her marginal tax rate. The exception is that you, not your spouse, will be taxed on any withdrawals up to the amount you contributed to any spousal RRSP in the current or preceding two years.

For a simplified example, assume you earn \$100,000 and your spouse earns nothing. You fall into a high marginal tax bracket while your spouse

pays no taxes at all. But if the income were split so that you each earned \$50,000, you would both fall into lower tax brackets. As a couple, you would pay less tax. This is what you would like your retirement to look like.

If your total retirement income will be much larger than your spouse's, you might want to consider contributing to a spousal plan now in order to help balance out your retirement income and reduce your overall tax bill.

## Taxes and clawbacks

There's another reason for splitting your income where possible. OAS benefits start to be clawed back if you earn more than about \$60,800 in annual retirement income. Once your retirement income reaches about \$98,500, you lose all your OAS benefits.

Careful planning can help couples avoid the clawback.

## Split CPP/QPP payments

CPP/QPP benefits are taxed as regular income. If you are 60 or older, you can choose to have up to half of your CPP/QPP payments paid to your spouse, as long as he or she is also at least 60.

This strategy won't help if both you and your spouse qualify for the maximum payments. However, you may find it useful if you are entitled to a much higher CPP/QPP benefit than your spouse, or if your spouse is receiving no benefits at all. If your spouse receives lower benefits than you and is also in a lower tax bracket, you can transfer up to half of your CPP/QPP benefits to your spouse to reduce tax payments. If you make this election when your spouse chooses to receive their CPP such payments must be split with you. Note that you can only split benefits that were earned while you were married or in a common-law relationship.

While you cannot avoid paying tax, you can manage – to a certain extent – how much you pay. But it requires smart saving, wise investing, careful planning... and a touch of ingenuity.

## Understand the fine print

The income splitting strategies described in this article are simplified to provide you with a quick overview of the basic ideas. As with most tax strategies, you should make sure you are familiar with the law and fine print that apply before you put these strategies into action. For more information, contact a professional or the Canada Revenue Agency (CRA).