



Investing with the OAS Clawback in Mind

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Many investors seek guidance about which types of investment income are the most tax efficient for their portfolio. This decision is complicated by the fact that various types of investment income have different impacts on income-sensitive benefits such as the OAS clawback.

Many factors go into determining an investor's optimal asset mix (the proportions of the portfolio invested in cash, fixed income and equities). Some of these factors are the rate of return required to achieve an investor's goals, risk tolerance, time horizon and tax situation. Once the optimal asset mix is established, an asset location strategy is then formulated to determine the account(s) in which the interest, dividend and capital gain-producing investments should be contained. An investor may have several accounts such as: a registered account in the form of an RRSP/RRIF/LIRA/LIF account, a non-registered account, a Tax-Free Savings Account and possibly a corporate (business) account. If all of these "pots of money" are for the purpose of funding a retirement goal then they should not be managed in isolation but should work together as part of the overall strategy.

Before we go any further, let's do a quick refresher of some of the basics:

- Interest, dividend and capital gain income are all taxed in the same manner when held inside an RRSP. That is, the different types of income lose their identity. Tax on investment income is deferred until a withdrawal is made at which time tax is paid based on the investor's marginal tax rate.
- Dividends from Canadian companies and capital gains from Canadian and foreign companies receive preferential tax treatment if held in a non-registered (open) or corporate account rather than in an RRSP.
- In Ontario, at the highest marginal personal tax bracket, interest is taxed at 46.41%, eligible dividends from Canadian companies at 26.57%, and capital gains at 23.20%.
- Because of the integration rules, eligible dividends from Canadian public companies are "grossed up" (inflated) by 45% when computing net income and the OAS clawback.
- The maximum OAS benefit is approximately \$518 per month or \$6,200 per year in 2010.

- When an investor's adjusted net income exceeds \$66,733, the OAS clawback kicks in and 15% of amounts over and above this threshold must be paid back as a social benefit repayment. When net income reaches approximately \$108,090, the OAS benefit is fully repaid.

While it is tax beneficial to invest in Canadian dividend-producing stocks as opposed to interest-bearing investments in a non-registered account, seniors need to be aware that this tax saving is eroded for them because of the negative impact the gross-up has on net income and hence the clawback. However, it is important to note that an investor is still ahead even after repaying some of the OAS benefit.

The following illustration is based on an investor who is over 65, with pension income of \$60,533 and investment income of \$5,000. Tax results are approximate.

	Interest Income	Eligible Dividends
Pension income	\$60,533	\$60,533
OAS	6,200	6,200
Interest income	5,000	0
Eligible dividends	0	5,000*
Total	\$71,733	\$71,733
Taxes payable	\$15,941	\$14,903
OAS repayment	750	1,080
Total tax and repayment	\$16,691	\$15,983*
In investor's pocket	\$55,042	\$55,750

* Note that the \$5,000 dividend was grossed up to \$7,250 for the purpose of the tax and OAS clawback calculation.

Although the investor pays back an additional \$330 in OAS, his/her tax bill is \$1,038 less due to the preferential tax treatment of the dividend. The net result is a \$708 net tax and OAS repayment savings by opting for Canadian dividend income rather than interest income.

This example illustrates the importance of making decisions that optimize an investor's overall tax situation.

Additional Strategies for Minimizing the Clawback

- If your portfolio holds both Canadian and foreign dividend-producing stocks, you should consciously decide on where to locate these investments. In cases where the OAS clawback is an issue, Canadian dividend stocks are best held in a corporate account and foreign dividend stocks are best held in a non-registered account. If foreign dividends are earned in the non-registered account, the foreign dividend is treated as other income for tax purposes and is not grossed up, which mitigates the OAS clawback. If using a corporate account is not an option, then the investor is still ahead by holding the Canadian dividend inside the non-registered account as opposed to an RRSP.
- Transfer a portion of a non-registered account to a qualifying permanent insurance product as a means of sheltering investment income and lowering personal income.
- Consider rolling a portion of a non-registered account to an existing holding company to reduce personal income. Of course, there are a variety of factors to consider with this strategy including the costs associated with involving accountants and lawyers to file the rollover. These costs should be compared to the incremental benefit to determine if it is worthwhile.
- Increase the emphasis on capital gain-producing investments such as growth stocks that do not pay a dividend. Representation in this area should be part of the overall investment strategy that would consider the asset mix, cap size (i.e. large vs. small), and style of investing (i.e. growth vs. value). Many investors are currently favoring investments that pay cash in the form of dividends as opposed to relying strictly on the capital gains potential.
- Consider loaning funds to a spouse to lower taxable income. Interest must be repaid and reported as taxable income by the lender at the prescribed rate in effect when the loan is made. At the time of writing the rate was 1%. Of course, a couple's combined tax bill and social benefits repayment must be examined to determine if it is advantageous or not and worth the added complexity.
- Consider capital class mutual funds with the potential to defer investment income. Keep in mind, however, that the trade-off is typically a higher cost of investing through higher management expense ratios that are not tax deductible.
- Do yearend tax-loss selling to apply capital losses against capital gains that have been realized during the year. A portfolio with individual securities allows for maximum flexibility when realizing tax losses. As always, be aware of the superficial loss rules.

- Conversely, an investor might want to top up their income to the OAS threshold level of \$66,733 and trigger capital gains now instead of later when it would impact the OAS. A comparison between the lost tax deferral and potential OAS savings later on must be made.

As always, try to seek the advice of an advisory team that preferably includes your accountant, financial planner and portfolio manager working together in an integrated fashion.

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