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Spread the wealth

Income planning isn't just for retirees

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When people think of income planning, they usually think of retirement. Prior to retirement, Canadians are mainly concerned with paying debt and accumulating retirement assets, so they ignore income-planning opportunities.

Many options before retirement

There are, however, a number of situations before retirement where income planning can play a role within a broader wealth plan. In these situations, it may be appropriate, and even tax-efficient, for clients to take income from their portfolios before they retire.

These often-overlooked opportunities range from utilizing low tax rates for family members to maximizing the benefits of professional corporations.

As part of managing a full and balanced portfolio, pre-retirement income planning involves looking at all the different "buckets" available — RRSPs, TFSAs, insurance products, non-registered portfolios, and other products — and making use of them in ways that are creative and hopefully more tax-efficient.

Scenario #1: Generating income for the professional practitioner

Low tax rates are currently in effect for professionals and small business owners who earn active business income inside a corporation. Allowing business income to accumulate within a corporation is an excellent way to reduce overall taxes. The downside, of course, is that this money must remain within the corporation.

This is the first scenario where it is appropriate to create and draw income from a personal investment portfolio before retirement. This personal portfolio must generate sufficient income to fund the owner and his or her family's lifestyle until it is time to pull money out of the company. This may be at retirement, or, in certain situations, upon an owner's death.

By creating an income stream from existing funds, the low tax on corporate earnings can be deferred until the funds are eventually pulled out. This tax deferral is as high as 35% in certain provinces. With such a large discrepancy, corporate portfolios can accumulate substantially and create a much larger retirement portfolio.

Scenario #2: Taking RRSP income before age 71

At age 71, Canadians must convert their RRSP to a RRIF and begin drawing income. What was once a vehicle used to accumulate assets has now become a vehicle from which to take income. Some retirees are advised to keep their RRSP intact until age 71 and live off their non-RRSP investments, because income earned within an RRSP is not taxable until it is pulled out. This tax deferral allows investments to grow faster. While general financial planning recommends this strategy, in some cases it makes sense to take income from your RRSP prior to age 71 and forgo this tax deferral. This is often referred to as an RRSP meltdown strategy.

One strategy involves taking money from your RRSP if you have little or no other taxable income. If structured properly, you may also receive up to $2,000 with few or no tax consequences by gaining access to the $2,000 pension credit. These benefits may outweigh the lost tax deferral opportunity.

A second strategy consists of melting down your RRSP to avoid the Old Age Security clawback. This involves taking income out of an RRSP in low-income years to reduce the value of the RRIF created at age 71. This lowers minimum payments — which are based on the value of the RRIF — and minimizes the Old Age Security clawback. In 2011, the Old Age Security clawback begins when net income exceeds $67,688. For each additional dollar of net income, $0.15 is clawed back to repay the Old Age Security benefits received.

Scenario #3: Creating income for children

Splitting income with children can be tricky. There are various attribution rules within the Income Tax Act that mean a parent still has to pay tax on dividends and income generated by assets given to their underage children. That said, if the money is invested inside a properly set-up trust, capital gains can be taxed in the child's hands at lower tax rates.

In most instances, the capital gains can be sheltered using the child's basic personal exemption and other personal tax credits. Since a capital gain is usually the only type of continued on page 16

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income a minor can earn without it being attributed back to the parent, properly structuring a portfolio to create primarily capital gains income (as opposed to interest, foreign income and Canadian dividends) is important.

Luckily, there are a number of investment products structured primarily for this purpose. Creating a portfolio that generates annual capital gains income can be more efficient than investing purely in growth-oriented (tax-deferred) investments.

Second-generation income, or income earned on income, is taxed in the child's hands. To make things easier, families often create an additional investment account to track second-generation income. Once the child turns 18, attribution ceases and all income is taxed in the child's hands. In these cases, creating income to make use of lower tax rates and personal credits such as tuition and education credits can go a long way to enhancing the family's overall wealth.

When using a trust, you must ensure it is set up properly, or the parents could find themselves on the hook to pay the capital gains taxes as well.

Creating income for a disabled child is also an important consideration for some families. In this case, you could create an investment portfolio that generates income sufficient to meet the disabled child's needs. Alternatively, you may want to consider purchasing an annuity from an insurance company to ensure there is a guaranteed income stream for life.

Scenario #4:
Spousal loans

Shifting income from one spouse to another is a particularly appealing strategy, especially in the current low interest rate environment. Although the Canada Revenue Agency prescribed rate could increase in the future, it is currently set at 1%, the lowest rate in over 25 years.

By implementing a spousal loan, a low-income-earning spouse can borrow from the higher-income spouse to invest in an income-generating portfolio and make use of that spouse's basic personal credits and lower tax bracket.

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It's generally a good idea to ensure that the income generated by the investment will also cover the 1% interest rate payable to the lender. This amount must be paid by January 30 of each year for the loan to be valid.

Scenario #5:
Using TFSAs

Currently, there isn't much contribution room in Tax-Free Savings Accounts, but when the ceiling rises, TFSAs will become a more important part of income and portfolio planning. Today, many use the TFSA to shelter capital gains made from active trading or on shares that have drastically increased in value.

As interest rates rise and as TFSA contribution room grows, however, the accounts will become equally valuable to conservative investors. Unlike dividends and capital gains, interest income is fully taxable, which means almost 50% of income goes to tax. Keeping interest-bearing investments inside a TFSA can eliminate this.

Final thoughts

Cash flow planning can make a big difference in the tax paid on income-generating assets. It's a simple concept: the higher-income-earning spouse pays the family's daily living expenses while the lower-income earner accumulates capital for investing can result in significant tax savings. It is also possible to pay taxes on behalf of other family members since the payments are not subject to attribution rules. AER

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