Planning for Retirement? Beware of CPP & OAS Taxes

Description

If you're planning for retirement, you're probably eagerly anticipating getting CPP and OAS. These benefits are crucial lifelines for Canadian retirees, providing income for those who are no longer working. Individually, CPP and OAS don't pay much. CPP averages about $640 a month, while OAS maxes out at $613. However, the two together can be pretty valuable, typically paying about $1,250 a month.

There's a catch though: both CPP and OAS are fully taxable as ordinary income. And if you're still working part time or drawing a generous employer-sponsored pension, the taxes can be significant. Not only that, but a really well-off retiree could lose *all* of their OAS to taxes. I'll explore that in just a minute. First, let's look at how regular income tax applies to CPP and OAS.

Regular income tax

The first pension tax you need to be aware of is one that applies to *both* CPP and OAS: income tax.

CPP and OAS are considered ordinary income, so you'll pay taxes on them just as you'd pay tax on employment income. If you're receiving nothing but CPP and OAS, the taxes should be fairly low: the two together are unlikely to add up to more than $20,000 a year. However, if you're still working or getting considerable pension benefits, the taxes could be fairly high.

Your marginal tax rate is determined by *all* of your taxable income taken together. If, with work, CPP, OAS and an employer pension together, you're earning over $80,000 a year, you could easily have a marginal (federal/provincial combined) rate of 40%. In that case, expect to pay the CRA back $500 on every $1,250 a month you get in CPP/OAS benefits.

OAS recovery tax

A second tax you need to be aware of is the OAS recovery tax. This is a 15% tax you have to pay on income above a certain threshold, up to the point where your OAS is entirely eaten up. For 2019, the threshold was $75,910; for 2020, it's $77,580. If you make $126,058 this year, you'll have to pay back all of your OAS money.

The OAS recovery tax is a real doozy because it can eat up the entire benefit. Regular income tax can only go so far; the OAS recovery tax can eventually cancel out every penny of OAS you receive.

Fortunately, there are ways to combat it. One of the best is to hold your investments in a Tax-Free Savings Account (TFSA). Investments are considered taxable income, and the TFSA shelters them from taxes. Thus, holding your investments in a TFSA can spare you the OAS recovery tax.

Consider the case of an investor holding $50,000 worth of the **iShares S&P/TSX 60 Index Fund** (TSX:XIU) in a TFSA. With a 3.4% trailing yield, that investment would yield about $1,700 a year in dividend income. Under normal circumstances, that income could put the investor past the OAS recovery tax threshold.

But because they were wise enough to hold the fund in a TFSA, they won't pay a penny in tax on any of it. Not only would they avoid the dividend taxes–which themselves could be substantial–they'd also stay below the OAS recovery tax threshold.

That would be a huge win. And it goes to show that, if you're holding investments, it pays to hold them in a TFSA.

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