Understanding the OAS “Recovery Tax” (November 2010)

Mention the words “OAS recovery tax” to most Canadians and you’ll likely get a blank look in return – even from those who actually pay the tax. Talk about the OAS “clawback”, however, and you’ll probably get a much stronger reaction, especially from those whose retirement income is reduced each month by that clawback.

Old Age Security (or OAS) is one the two main components of Canada’s government-sponsored retirement income system – the other being the Canada Pension Plan (CPP). (There are also federal and provincial supplements which are available to lower-income seniors.) While many Canadians over the age of 65 receive both OAS and CPP benefits every month, the two plans are quite different. In order to receive CPP benefits, it is necessary to have paid into the CPP during one’s working life, as virtually all employees (as well as the self-employed) do. It is possible to begin collecting CPP benefits as early as age 60 (OAS benefits begin, in all cases, at age 65), and the amount of monthly CPP benefit received is based on a complex formula which measures the amount of contributions made over the taxpayer’s working life, with some adjustments. For 2010, the maximum monthly benefit payable is $934.17. The only determinants of the amount of benefits receivable are one’s contribution amount and the age at which one elects to begin receiving benefits – other sources of available income or one’s overall income level are not considered.

Eligibility for OAS, on the other hand, is based on Canadian residency. Essentially, a person aged 65 and older who has lived in Canada for at least forty years after the age of 18 is eligible for full OAS benefits. Where the length of Canadian residency after age 18 is less than forty years, a partial pension is earned at the rate of 1/40th of the full monthly pension for each full year lived in Canada. OAS benefits are fully indexed to inflation, and the maximum monthly benefit payable in the last quarter of 2010 is $521.62.

The differences between the CPP and OAS extend to how each program is financed. The CPP, like all contributory pension plans, is financed out of contributions made and income earned from the investment of those contributions. OAS, on the other hand, is paid from general federal government tax revenues. And, as the Canadian population ages, the cost of OAS to the federal government has continued to increase.

Several years ago, the federal government determined that it was no longer willing to maintain OAS as a program of universal entitlement. The conclusion reached was that the priority for benefits would be Canadian seniors whose income from all sources fell below a government-determined ceiling. And the result of that determination was the OAS “recovery tax”, or clawback.

The clawback, as it known to virtually everyone but the federal government, is simple in concept. Where a person receiving OAS benefits has income for the year over the prescribed ceiling, 15% of that excess is deducted from the amount of OAS to which he or she would otherwise be entitled, up to the full amount of any OAS benefit otherwise
payable. For 2010, that income ceiling is $66,733, and the clawback is calculated as shown in the following example.

If the OAS recipient's income in 2010 was $80,000, then the repayment would be 15 percent of the difference between $80,000 and $66,733:

\[
\begin{align*}
\text{Repayment} &= \text{Income} - \text{Ceiling} \\
\text{Income} - \text{Ceiling} &= \$80,000 - \$66,733 = \$13,267 \\
\text{Repayment} &= \$13,267 \times 0.15 = \$1990.05
\end{align*}
\]

In this case, the OAS recipient would have to repay $1990.05 of benefits received for 2010. In all cases, the amount of any required repayment is capped by the amount of OAS actually paid to the taxpayer during the year – one cannot be asked to repay benefits which were never received.

In the year that a taxpayer turns 65 and begins to receive OAS, even if his or her income for the year will be greater than the allowable ceiling, the full amount of OAS benefits, without taking into account any clawback, will be paid. However, when that taxpayer files a tax return for the year during tax filing season the following spring, the bottom line will likely be an unpleasant surprise. When completing the return, the taxpayer must declare all OAS benefits received on line 113. The calculation of any required repayment is done on the federal worksheet which accompanies the return and it essentially determines 15% of the taxpayer's income over the income ceiling. That figure is carried over to lines 235 and 422 of the return as a required social benefits repayment amount. In the very worst case scenario, where a taxpayer had received the maximum OAS benefit for a full twelve months and was subject to a full clawback, the repayment amount could be as much as just over $6,000.

Of course, the federal government generally prefers to collect any tax owing from taxpayers throughout the year rather than at tax filing time. Each year, the federal government will estimate, based on prior year income amounts, the amount of any clawback which may be payable for the current year, and will deduct an amount from the OAS monthly benefit otherwise payable, such that the amount of the clawback is paid on an ongoing basis. Of course, it's also possible that a taxpayer's income can fluctuate from year to year. That's unlikely to be the case for a taxpayer whose income is derived from a private pension plan or an annuity, but where a taxpayer is living on investment returns from a registered retirement income fund, or wages from part-time employment, fluctuations in income are quite possible. In such circumstances, and especially where the taxpayer's income is reduced to the point that any clawback amount is significantly reduced or even eliminated, the Canada Revenue Agency (CRA) should be notified and a request made to reduce or eliminate the tax deduction being made. The means for doing so is a prescribed form, the Request to Reduce Old Age Security Recovery Tax at Source for Year ____, which is available on the CRA Web site at http://www.cra-arc.gc.ca/E/pbg/tf/t1213_oas/t1213oas-10e.pdf. That form, once completed, is sent to the CRA and the taxpayer is notified, in four to eight weeks, of whether the Agency has approved the request.