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FINANCIAL ADVISORY SUPPORT

The Pension Income Tax Credit

How to Receive $2,000 Tax Free . . . or Not!

If you are age 65 or over and you receive eligible pension income you may be entitled to claim a maximum pension tax credit of $2,000 on your tax return. There are many types of pension income that qualify for the credit as discussed below, but amounts received from OAS, CPP and QPP do not qualify for the credit. The tax credit on $2,000 of eligible pension income provides for a federal and provincial tax savings of between $400 and $500 depending on your province of residence. In addition to addressing when the pension credit can be claimed, this article also evaluates whether it is beneficial to structure your investments to take advantage of this credit.

Note that in this article, “spouse” includes persons who are married, as well as those who satisfy the definition of “common law partners” under federal income tax rules (including same sex couples), and who are not living separate and apart from each other as a result of a breakdown in their relationship.

What is the Pension Credit?

If you receive income from sources such as a pension plan, certain annuities, a RRIF or other locked-in registered retirement income funds, you may be eligible to claim a maximum pension tax credit of $2,000. This tax credit reduces the total amount of tax payable in the year.

As pension income generates a credit instead of a deduction, the first $2,000 of pension income is not necessarily received tax free. Only individuals in the lowest marginal tax bracket (taxable incomes below $30,000 to $40,000 depending on your province of residence) receive the first $2,000 of pension income tax free. People in higher tax brackets are taxed on the first $2,000 of pension income at a reduced rate of tax. Calculations showing the tax costs for people at different tax rates are shown on the next page.

What types of Pension Income qualify for the credit?

People who are 65 or older during the year

If you are age 65 and older at any point in the year, the definition of eligible pension income for purposes of the tax credit includes:

1. a life annuity payment out of or under a superannuation or pension plan;
2. an annuity payment received under an RRSP (i.e. reported on box 16 of your T4RSP);
3. an annuity acquired for a qualified beneficiary out of an RRSP or RRIF as a consequence of the death of the annuitant;
4. a payment out of a RRIF, LIF, RLIF, LRIF or PRIF;
5. an annuity payment received under a deferred profit sharing plan;
6. the interest element of any annuity payment that is otherwise included in your income (these amounts are usually reported in box 24 of a T4A or box 19 of a T5);
7. interest accrued on certain life insurance and annuity contracts which must be recognized for income tax purposes or generally, the income portion of an annuity payment made in the year in respect of an annuity contract subject to the interest accrual rules;
8. a payment from certain foreign pension plans; and
9. elected split pension income reported on your tax return;

People who are not yet 65 during the year

If you are not yet age 65 at any time during the year, the definition of eligible pension income for purposes of the tax credit includes only the following:

1. a life annuity payment out of or under a superannuation or pension plan;
2. all the payments described in the section above in 2. to 7. but only if such amounts are received as a consequence of the death of your spouse;
3. a payment from certain foreign pension plans; and
4. elected split pension income if it falls into any of the three categories in 1., 2. or 3. immediately above in this section.

What type of income does not qualify for the credit?

The following types of income DO NOT qualify as pension income for purposes of the pension tax credit:

- amounts or supplements received from Old Age Security or any similar amount received from a province;
- amounts received from the Canada, Quebec, or Saskatchewan Pension Plans;
- amounts received from a salary deferral arrangement, a retirement compensation arrangement, an employee benefit plan, or an employee trust;
- a death benefit;
- amounts withdrawn from an RRSP or from the deregistration of an RRSP; and
- amounts included in income and that would otherwise be “pension income” or “qualified pension income” but for which a deduction has already been taken under another section of the Income Tax Act (e.g. where the income is exempt from income tax in Canada because of a tax treaty between Canada and another country).

How much tax does the credit save?

As discussed above, people who are in the lowest marginal tax bracket pay no tax on the first $2,000 of their pension income. The table below shows the after-tax amount retained on the first $2,000 of pension income, the marginal tax rate on this pension income at various tax rates and how much tax is actually saved.

	Low	Middle	Upper Middle	High
Federal tax rate	15%	22%	26%	29%
Eligible pension income	**$2,000**	**$2,000**	**$2,000**	**$2,000**
Federal tax before credit	300	440	520	580
Pension tax credit	300	300	300	300
Net federal tax	0	140	220	280
Provincial tax (*)	0	62	102	102
Total taxes	0	202	322	382
Net amount retained after tax	**$2,000**	**$1,798**	**$1,678**	**$1,618**
Marginal tax rate on first $2,000 of eligible pension income	0%	10%	16%	19%
Approximate tax savings on $2,000 of creditable pension income	$420	$420	$420	$420

(*) Net of provincial pension tax credit

This table demonstrates that tax still has to be paid on the first $2,000 of pension income unless the person is in the lowest tax bracket.

Should you structure your investments to receive this credit?

It is often suggested that people who are 65 or older convert some of their RRSPs into a RRIF before age 71 to receive this so called "tax-free" income. The following factors should be considered before implementing this strategy:

The maximum amount of the annual tax savings is capped at $420 in our example above (this varies with each province). As such, lower income individuals will receive the first $2,000 of pension income tax free, while higher income individuals will save the same amount of money, but have to pay the incremental tax at their marginal rate of tax.

Any eligible pension income over $2,000 received in the year will be taxed at the individual's marginal tax rate.

Any benefit that results from the reduction in taxes has to be compared to the cost of the tax-deferred income foregone as a result of the early receipt of RRIF or annuity income. This means that the potential $420 in annual tax savings from the use of the credit has to be compared to the value of the foregone future tax deferred income.