RBC Dominion Securities

THE ADVISOR

May 14, 2009

Pension Income Splitting

How you and your spouse may be able to benefit

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Since the introduction of the pension income splitting rules in 2007, many families have significantly reduced their total tax bill by allocating certain types of retirement income to a lower income spouse who is taxed at a lower rate. This article summarizes these rules, as well as some of the key opportunities that you and your spouse may wish to consider as part of your overall plan to draw upon your retirement income.

Pension Income Splitting — The Basics

The following is a summary of some of the basic rules around pension income splitting:

INCOME SPLITTING

Qualifying income received during the year is eligible to be split with a spouse.

In order to achieve the desired result for the couple, any amount between 0% and 50% of the qualifying income may be allocated to a spouse for income tax purposes.

WHO CAN BENEFIT FROM PENSION INCOME SPLITTING

These rules are particularly good news for couples where the primary recipient of the qualifying income is subject to a tax rate that is significantly higher than that of their spouse.

Note that “spouses” 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.

TYPES OF INCOME THAT QUALIFY FOR SPLITTING

Only certain types of income may be split under the pension income splitting rules. The types of income that qualify depend on the age of the person who is the **primary recipient** of the income.

Note that the age of the spouse to whom the income is to be allocated (generally the lower income spouse) is not relevant for the purposes of the pension income splitting rules.

In most cases, a primary recipient who is under 65 years of age during the entire tax year will be able to split only the income that is paid to them directly from a defined benefit pension plan.

A primary recipient who is at least 65 years of age during the tax year will have more types of income that are eligible to be split with their spouse.

The following summarizes the main types of income that may be split with a spouse, depending on the age of the primary recipient:

FOR PRIMARY RECIPIENTS WHO ARE UNDER 65 DURING THE TAX YEAR:

- Periodic payments received directly from a defined benefit pension plan
- Certain types of annuity income received as a consequence of the death of a previous spouse or common law partner

FOR PRIMARY RECIPIENTS WHO ARE 65 AND OLDER DURING THE TAX YEAR:

- Periodic payments received directly from a defined benefit pension plan
- Payments received from an RIF, LIF, RLIF, LRIF or PRIF
- Payments received from annuities purchased with the proceeds of an RSP, RIF, LIF, LRIF or PRIF
- The taxable portion of payments received under certain types of annuity contracts purchased with non-registered funds (typically prescribed annuity contracts)
- Periodic payments received from a money purchase (defined contribution) pension plan in the same manner as permitted under a LIF — note that only some money purchase pension plans are designed to allow these types of payments

SOME TYPES OF INCOME THAT DO NOT QUALIFY

The following summarizes some of the more notable types of income that do not qualify for pension income splitting. Note that this list is not exhaustive:

- Lump sum payments from an RSP
- Canada Pension Plan (CPP) and Quebec Pension Plan (QPP) payments (CPP/QPP payments may be split using a different set of rules)
- Old Age Security (OAS) benefits
- Payments received from a Retirement Compensation Arrangement (RCA) and several other types of supplementary retirement plans

HOW TO MAKE THE ELECTION TO SPLIT PENSION INCOME

To split the qualifying income, there is nothing in particular that needs to be done at the time that it is received. In fact, the decision about how much income to reallocate can be delayed until it is time to prepare your income tax returns for the year in which the income was received.

Spouses who wish to split qualifying income must file a joint election form together with their income tax returns on or before the filing due date (generally April 30 of the year following the tax year or June 15 for self-employed taxpayers).

CRA form T1032 — "Joint Election to Split Pension Income" is available on the Canada Revenue Agency (CRA) public website.

HOW MUCH WILL THE TAX SAVINGS BE?

The amount of tax savings will depend on a number of factors including the amount of qualifying income, the difference between the spouses' marginal tax rates and the impact that the reallocation could have on certain government benefits and tax credits. The appendix at the end of this article provides a few examples.

Planning strategies and other considerations

SPOUSAL RSPS STILL HAVE THEIR USES

Saving through a spousal RSP has been one of the most popular strategies available for couples to use in an attempt to equalize the amount of their expected retirement incomes. Since the introduction of the pension income splitting rules, there has been some discussion as to whether or not using a spousal RSP still makes sense.

The following are some of the key reasons why using a spousal RSP may still be a useful strategy for you and your spouse:

Enhanced income splitting: Under the pension income splitting rules, a couple can only reallocate a maximum of 50% of qualifying income to a spouse. There will be many cases where a couple will not be able to achieve the optimal extent of income splitting through these provisions alone (for example, when the qualifying income received in the current year represents only a small fraction of the family's total retirement income). In such cases, having funds in a spousal RSP will enable certain couples to further reduce their overall tax bill.

Income splitting prior to age 65: If *both* spouses retire prior to age 65 and the couple requires income above and beyond whatever fixed sources are available (such as government income sources and a company pension), it may be beneficial for the couple to be able to draw on a spousal RSP or spousal RIF owned by the lower income spouse to fund the shortfall, and keep the family's tax bill at a minimum (assuming that non-registered assets are not available, or that they need to be preserved for use at a later date). RIF income from the higher income spouse cannot be split prior to age 65 under the rules.

Use of the Home Buyers Plan and Life Long Learning Plan: Having a spousal RSP enables both spouses to potentially make use of these government programs, rather than just one of the spouses.

Planned leaves of absence, low income years: Spousal RSPs do not necessarily have to be used for retirement. With proper advance planning to avoid income attribution, it may be possible to use a spousal RSP to pay expenses during a period of low earnings prior to retirement such as a sabbatical, a period of unemployment or even a parental leave.

Possible changes in tax legislation: There is no guarantee that any piece of tax legislation will remain in its current form indefinitely going forward. While it is unlikely that it would disappear, there is nevertheless the possibility that changes could be introduced at a later date to reduce the tax benefits that have been created under the pension income splitting rules. While legislative changes are also possible for spousal RSPs, it may make sense to continue to save using spousal RSPs to provide an alternate means of reducing your family's tax bill during retirement, should it ever be needed.

INDIVIDUAL PENSION PLANS (IPPS) MAY NOW BE MORE ATTRACTIVE

Business owners may wish to take another look at using an IPP if they previously chose not to use one because of the impact of the IPP on being able to make spousal RSP contributions to take advantage of income splitting during retirement.

One potential drawback of using an IPP has been that it typically results in the plan member receiving a maximum pension adjustment (PA) and, therefore, generally eliminates the possibility of making any further contributions to an RSP, including a spousal RSP.

While the resulting inability to make RSP contributions has not changed, the pension income splitting rules now allow business owners to split the income stream paid from an IPP with a spouse at any age, or in the event that the IPP member chooses to receive the commuted value, the income received from the locked-in plan to which it is transferred, beginning at age 65.

SPOUSES WHO ALREADY HAVE SIMILAR AMOUNTS OF INCOME

There are a few instances where you may still be able to benefit from the reallocation of income which is done through the pension income splitting rules, even though there may be little or no difference between the amounts of your taxable incomes. For example:

Reallocating income to enable both spouses to receive the pension income tax credit: If one spouse is currently receiving qualifying pension income but the other is not, it may be worthwhile to reallocate up to $2,000 of this income to enable both spouses to benefit from this tax credit. This credit is typically worth between $400 and $500 per year for each taxpayer.

While the age of the spouse receiving the reallocated income is not relevant **for the purposes of pension income splitting**, it is relevant under this strategy as explained below:

- If the spouse receiving the reallocated pension income is **at least 65 years of age** during the tax year, they will be able to claim the pension income tax credit as a result of receiving any type of reallocated income that qualifies for pension income splitting.

- However, if the spouse receiving the reallocated pension income is **less than 65 years of age** during the entire tax year, the original source of the reallocated income that will enable them to claim the pension income tax credit is generally limited to periodic payments that were received directly from a defined benefit pension plan.

Reallocating income to reduce or eliminate the clawback of OAS benefits: The pension income splitting rules provide an opportunity to reallocate income from one spouse to another in order to reduce or eliminate the impact of the OAS clawback for the higher income spouse.

People receiving OAS benefits whose net income exceeds the OAS clawback threshold are required to repay their benefits at the rate of 15 cents per dollar of net income that exceeds this amount until the OAS benefits are completely "clawed back".

For example, suppose a couple living in Ontario is receiving total income as outlined below, and spouse "A" is receiving sufficient qualifying income to enable the couple to equalize their incomes under the pension income splitting rules.

Also, assume that spouse "A" is currently receiving OAS benefits, some of which would be clawed back since their net income exceeds the OAS claw back threshold.

	Net income and taxable income	**Marginal tax rate excluding the effect of OAS clawback**
Spouse "A"	$70,000	33.0 %
Spouse "B"	$60,000	31.2 %

While the **income tax savings** for the couple will be nominal (under $100), the reallocation of $5,000 under the pension income splitting rules will also result in a **reduction of OAS clawback** and, therefore, additional savings of $750 (or about $500 after tax) for the current year.

Reallocating income to maximize the use of cash flow: At the time of filing your tax return, you may decide not to reallocate any income to your spouse since you are both in the same tax bracket. However, you may consider reviewing the amount of taxes owing or the amount of tax refund each of you may have at the time of filing your tax returns. If one spouse is entitled to a tax refund while the other spouse has an amount owing, then you may consider reallocating some qualifying income in order to reduce the refund for one of you and reduce the amount of taxes that have to be paid at the time of filing for the other spouse. The income splitting would allow you to better manage your cash flow so that you make use of a refund immediately to reduce the amount that would have to be paid at the time of filing.

When reallocating the income to make use of a refund, you should ensure you both continue to be in the same tax bracket and the overall tax liability is not increased.

Summary

The pension income splitting rules will undoubtedly affect both the retirement savings and retirement income planning strategies of many Canadians. In many cases, the opportunity to reduce your family's tax bill during retirement may be significant.

For the most part, your tax savings will be calculated at the time that you prepare your income tax return; and it will become apparent at that time how much qualifying income, if any, should be reallocated.

However, there will be cases where you may need to decide from which plan to withdraw funds needed to cover a shortfall, and how much to withdraw. Everyone's circumstances will be different. Whatever your situation is, it will be important to discuss your needs with your advisor and together, with input from your own professional tax advisor, make the best decision possible for you and your family.

Appendix: Tax savings — a few numerical examples

The following provides an illustration of how much tax it may be possible for a couple residing in Ontario during the 2009 tax year to save as a result of applying the pension income splitting rules.

In the examples that follow, it is assumed that both spouses benefit from only the basic personal amount. The impact of the reallocation of split pension income on any other personal tax credits, deductions or government benefit payments will be ignored in these examples.

Note that the potential savings resulting from a reduction of the clawback of Old Age Security (OAS) benefits and the ability to claim certain tax credits can be significant. This is discussed in greater detail on the final page of the main article.

In the following three examples, it is assumed that the spouse with the higher income has a sufficient amount of qualifying pension income to be able to reallocate the amount needed to equalize the couple's taxable incomes.

		Taxable Income		Tax Payable		Tax
		Before	**After**	**Before**	**After**	**Savings**
Example #1	High spouse	$75,000	$50,000	$17,862	$9,722	$8,140
	Low spouse	$25,000	$50,000	$3,102	$9,722	-$6,620
	Total:	**$100,000**	**$100,000**	**$20,964**	**$19,444**	**$1,520**
Example #2	High spouse	$90,000	$50,000	$23,311	$9,722	$13,589
	Low spouse	$10,000	$50,000	$0	$9,722	-$9,722
	Total:	**$100,000**	**$100,000**	**$22,302**	**$19,444**	**$3,867**
Example #3	High spouse	$250,000	$125,000	$96,939	$39,224	$57,715
	Low spouse	$0	$125,000	$0	$39,224	-$39,224
	Total:	**$250,000**	**$250,000**	**$95,977**	**$78,448**	**$18,491**

Note that there is a limit to the amount of income tax that a family can save in any given year as a result of reallocating qualifying pension income. Example #3 provides a rough example of this.

Also, note that the *Income Tax Act* limits the amount of income that may be paid directly from a registered pension plan. In Example #3, it is assumed that some or all of the qualifying income was received from sources other than a registered pension plan, such as a RIF or a prescribed annuity.

Once the lower income spouse's taxable income reaches the level at which the highest marginal tax rate applies, no further tax savings will result from additional income splitting strategies, including pension income splitting.