Splitting Pension Income

...or sharing without giving

• THE BETTER WAY TO SPLIT
• SOME CASE STUDIES
• DID YOU KNOW THAT...

Under general tax rules, a tax payer must report income earned from all sources when filing a tax return.

On October 31, 2006, the Minister of Finance of Canada,1 introduced a bill2 that allows individuals to elect to split “eligible pension income” with their spouse or common-law partner, effective January 1, 2007. Quebec has harmonised its legislation to allow pension income to be split at the provincial level.

1 The Honourable Jim Flaherty
2 Adopted June 22, 2007
Under these rules, taxpayers may allocate up to 50% of their eligible pension income during a given year to their spouse. The election to allocate pension income must be made every year by filing a prescribed election form with the income tax returns of the taxpayer (“pensioner”) and the spouse (“pension transferee”). The pension transferee and the pensioner must be resident in Canada (and Québec) to split pension income on the Quebec tax return at the end of the calendar year in which the taxation year in question ends. The transferee must also be the spouse or common-law partner of the pensioner and must not be living separately at the end of the taxation year and for a period of 90 days or more starting during that year due to a breakdown in the marriage or common-law relationship. Since no money is actually transferred, this is a different way of splitting income. All other income splitting strategies required transfers of funds and any transactions considered abusive are dealt with under the “attribution rules.”

When a pensioner elects to split pension income, the split pension amount is deducted from his/her income and included in the income of the transferee.³

Tax withheld at source on the split pension amount is allocated between the transferor and transferee proportionate to the amount split. However, the spouses are jointly liable for the tax payable on the split income.

**Eligible pension income**

Only “eligible pension income” may be split, i.e. income that entitles the recipient to claim the federal non-refundable pension credit.

Generally speaking, the following income may qualify as eligible pension income:

**Individuals aged 65 and over:**

- Life annuity payments payable by registered pension plans (RPPs), usually called Supplemental Pension Plans in Québec.
- Annuity payments from a Registered Retirement Savings Plan (RRSP) or a Deferred Profit Sharing Plan (DPSP).
- Annuity payments and scheduled payments from a Registered Retirement Income Fund (RRIF), including locked-in RRIFs such as a Life Income Fund (LIF).
- The taxable portion of an annuity bought with non-registered funds.
- Income from a term deposit with an insurance company (annuity contract).
- Periodic payments stipulated in a defined contribution registered pension plan

**Individuals under 65:**

- Retirement pensions paid or payable by registered pension plans (RPPs), usually called Supplemental Pension Plans in Québec.
- All other income mentioned above for individuals 65 and over if this income is received following the death of a spouse.

Eligible pension income does not include:

- Old Age Security (OAS) pension
- Guaranteed Income Supplement (GIS)
- Québec Pension Plan (QPP) or Canada Pension Plan (CPP) benefits
- Lump-sum RRSP withdrawals
- Amounts received under a retirement compensation agreement

³ Spouse receiving the split pension amount
Tax variables

Several tax variables have an impact on the net income of each spouse who elects to split eligible pension income, mainly:

- **a) Tax rates**
- **b) Certain tax credits**
- **c) Social programs**

**a) Tax rates**

The popularity of income splitting strategies lies in the progressive nature of the tax rates. Under the Québec Taxation Act, taxpayers can make different elections than for federal tax purposes. So, greater attention must be paid to separate tax rates. As might be expected, the maximum splitting level is reached more quickly in Québec since the highest marginal rate applies at a lower income level. Income splitting beyond this level will not generate any savings.

**b) Tax credits**

The main non-refundable credits that may be affected by the pension income splitting rules are the following:

- Pension
- Age
- Spouse or common-law partner

Of the above, the federal pension credit is the only credit that is not reduced based on income level. So, taxpayers allocating eligible pension income to spouses without any pension income of their own that qualifying for this credit can double the couple’s pension credits.

Eligible pension income can be split regardless of the spouse’s age. For example, a 66-year old retiree may elect to split RRIF payments with his/her 59-year old spouse, but in this case, only the retiree will be entitled to the pension income tax credit.

There is no specific spousal tax credit in Québec, but taxpayers may transfer the basic personal amount to their spouse, if they do not use it fully. That makes the tax treatment similar to federal tax.

Québec tax credits are reduced gradually, at the rate of 15% for each dollar of net family income that exceeds a certain threshold.

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5 See Info Advice 107 for the actual amounts.
6 The spouse would have been entitled as well if the pension income arose from an RPP or if the RRIF income was paid following the death of a spouse.
Let’s take the example of a couple with a combined income of $60,000 (his income is $25,000 and she earns $35,000). Their Québec tax credits are shown below:

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<tr>
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<th>HE</th>
<th>SHE</th>
<th>TOTAL</th>
</tr>
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<tbody>
<tr>
<td>Amount for retirement income</td>
<td>$2,000</td>
<td>$2,000</td>
<td>$4,000</td>
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<tr>
<td>Age amount</td>
<td>$2,250</td>
<td>$2,250</td>
<td>$4,500</td>
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<tr>
<td>Total tax credits</td>
<td>$4,250</td>
<td>$4,250</td>
<td>$8,500</td>
</tr>
<tr>
<td>Income</td>
<td>$25,000</td>
<td>$35,000</td>
<td>$60,000</td>
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<tr>
<td>Income threshold</td>
<td></td>
<td></td>
<td>$30,345</td>
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<tr>
<td>Excess</td>
<td></td>
<td></td>
<td>$29,655</td>
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<tr>
<td>15% of excess (tax credit reduction)</td>
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<td>$4,448</td>
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<td>Adjusted tax credit amount</td>
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<td>$4,052</td>
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**Social programs**

Several programs exist but three in particular will have an impact for retirees.

1) **Health Services Fund (HSF)**

The HSF finances healthcare in Québec (RAMQ). Employers contribute between 2.70% and 4.26% of their payroll (no maximum). Individuals don’t contribute unless they have retirement, investment or business income. The maximum tax bill per individual per year is $1,000.7

Although the HSF rarely has a major impact on decisions whether to split eligible pension income or not, some situations have to be closely examined. For example, individuals with income taxed at the top provincial marginal rate must carefully decide on the amount to be split in Québec. At that rate, they would no longer realize any tax savings but might have to pay a higher HSF contribution (for example, a couple with incomes of $80,000 and $150,000).

2) **Old Age Security (OAS) pensions**8

Unlike QPP benefits, which are based on contributions made to the plan and salary history, the OAS is a universal benefit paid out to most Canadian residents. Since this program is not financed by specific contributions but rather by general income taxes, a “clawback” is applied based on net individual income.

A pensioner’s decision on whether to allocate pension income to a spouse can depend on the impact the allocation will have on the ability of the transferor and transferee to keep part or all of the OAS benefit. If the OAS is not clawed back, it can be added to the tax savings resulting from splitting pension income. Both spouses should pay less taxes since they will be taxed at lower rates.

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7 The maximum is reached when income subject to this tax (retirement, investment or business) amounts to $130,460 (2009).

8 See Info Advice 301 for benefit amounts and the clawback thresholds.
3) Guaranteed Income Supplement (GIS)

If a couple elects to split their eligible pension income and one spouse dies or they separate, voluntarily or not, a request to recalculate the GIS may be made. In such situations, the individual’s income may be used instead of family income for calculation purposes.

According to an internal federal government (Service Canada) document dated July 28, 2008, when a taxpayer is penalized with respect to the GIS and the spouse’s allowance after splitting eligible pension income for federal tax purposes, the taxpayer can request a recalculation of the GIS or spouse’s allowance, excluding the additional amount resulting from the eligible pension income split. Corrections to the GIS can be made retroactively up to a maximum of 11 months by completing form ISP-3032.

Summary

The decision to split pension income must be carefully considered as it can have an impact on social programs to varying degrees. For example:

- The pension credit might stay the same or increase;
- HSF contributions might increase or decrease, but only marginally
- The OAS might be lost or significantly clawed back;
- The spouse or common-law partner credit might stay the same or decrease (the spouse using his/her own credit) such that the tax impact is nil or marginal;
- The age credit might increase or decrease but only marginally.

Tax and financial impact

The case studies below simply aim to give an idea of potential savings and the interactions between specifically selected tax variables.

Traditional T1 preparation software can be used to calculate the actual savings from pension splitting. Although this is sometimes accomplished by trial and error, many of the more sophisticated software programs can be used to determine the optimal amount of pension to split, integrating all of the tax variables that are impacted.

Case study #1: couple aged 65 ($50,000 of RPP and $20,000 of RRIF income)

QPP benefits are already split ($6,000 each) but income is unequal ($50,000 and $20,000). Both spouses receive OAS pensions, which are not subject to a clawback. To optimize the tax savings in this example, $15,000 of RPP income should be allocated to the low income spouse so that both spouses have a pension income of $35,000. Reducing the RPP income to $25,000 each (50% of $50,000) would not have any additional positive impact. The combined tax savings work out to approximately $720. The amounts in the case study are very typical, so this situation should be fairly common.

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9 Visit Claude Laferrière’s website which publishes the effective marginal tax rates every year: http://www.er.uqam.ca/nobel/r14154/
10 Note that you can use the calculator provided by the federal government on the Internet (http://www.fin.gc.ca/pensioncalc/mm/calc_e.html) to estimate savings of federal income tax. Québec tax is not factored into the calculations, and the calculated federal income tax is that applicable outside Québec (without the abatement).
Case study # 2: couple aged 64 (one spouse has RPP income of $60,000 and $10,000 of other income; other spouse has no income other than QPP)

QPP benefits are already split ($6,000 each) but other income is unequal ($70,000 vs. nil). To equalize the incomes, $35,000 of RPP income should be allocated to the low income spouse, but the maximum allowable allocation is $30,000 (50% of $60,000). The tax savings work out to about $3,350.

Case study # 3: couple aged 65 ($60,000 of RPP and $10,000 of other income)

QPP benefits are already split ($6,000 each) but other income is unequal ($70,000 vs. nil). Both spouses receive OAS benefits with a partial clawback of around $2,400 for the higher-income spouse. The numbers are the same as for the previous example, except that the spouses are 65 years old and receive full or partial OAS benefits.

To equalize the incomes, $35,000 of RPP income should be allocated to the low income spouse, but the maximum allowable allocation is $30,000 (50% of $60,000). Since the spouse with all the income will no longer be subject to the OAS clawback, the combined savings will be around $4,780, which is $1,600 more than in Case Study #2.

Case study # 4: couple aged 65 ($140,000 and $50,000 of RRIF or RPP income)

Splitting pension income can also have a negative impact. Since QPP benefits are already split ($6,000 each), the pension incomes are unequal ($140,000 vs. $50,000) and both spouses receive OAS pensions, the full OAS amount will be clawed back from the spouse with the higher income.

To equalize the incomes, $45,000 must be allocated from the RRIF, but as a result, both spouses would lose their OAS benefits and their combined tax bill will increase by approximately $2,000. So, the income splitting strategy is counter productive.

Case study # 5: couple aged 65 ($100,000 of RRIF or RPP income each)

Since the spouses have equal incomes, it would appear that there’s no benefit to split income. However, both spouses in this example will lose almost all of their OAS entitlement. If $42,000 of eligible income from one of the spouses is allocated to the other, one spouse could avoid the OAS clawback. Since the OAS savings are greater than the increase in the tax bill resulting from the allocation of income, the net savings are approximately $2,000.

Similarly, there will be situations where it will be beneficial for a lower-income spouse to have part of his/her income taxed in the hands of the higher-income spouse’s.
Administrative aspects

Canada Revenue Agency has commented on certain aspects of splitting eligible pension income and some of these aspects have been incorporated into legislation, namely:

- The payer of the pension is not affected by splitting.
- Pensioners must elect to split income when filing their tax returns (form T1032 for federal tax and Schedule Q for the province).
- Tax withheld at source is prorated according to the allocated pension income.
- There is no impact on GST/PST credits or the CCTB (Canada Child Tax Benefit) as these amounts are calculated on the total net income of the two spouses.
- There is no reduction in tax withheld at source as income splitting is elected annually.
- Instalment payments may be calculated based on the estimated tax for the year. This should be done carefully as interest on late or deficient instalments can be significant.
- The election to split eligible pension income is made annually and can be different on each tax return (federal and provincial).
- If a person qualifies as a spouse during only part of the year, income splitting is limited to that period.

Financial planning elements

With these new rules there are more income splitting opportunities and more tax can be saved. It is essential to do the calculations every year to optimize the individual situation of both spouses. Pension splitting will also impact on two other strategies:

1) Choice between a RPP pension or commuted value
2) Contributions to spousal RRSPs

a) Pension or commuted value

When leaving their employment, members of defined benefit RPPs are generally given the choice of keeping the pension (immediate or deferred) or receiving the commuted value of the pension.

The pros and cons of the two options have been written about at length. However, members who opt for the pension can split eligible pension income with their spouse earlier if they are under 65 at the time of retirement and need the income. Those who opt to receive the commuted value will not be able to split eligible pension income until they are 65 and making withdrawals from their LIF or Locked-in RRIF, or receiving annuity payments.

b) Contributions to spousal RRSPs

Contributing to a spousal RRSP has long been a widely-used strategy to split income in retirement. For married couples who have not waived the right to a division of family patrimony, there’s no real issue because in the event of a divorce, the value of RRSPs is divided equally between the two spouses. For common-law partners, the risk of the relationship breaking down is an significant obstacle to using this strategy.

Since the new rules require only a tax election without any transfer of funds, does this mean that spousal RRSP contributions are no longer relevant?

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11 In Quebec, “retirement income” is more commonly used than “pension income.”
12 See Info Advice 307: Registered Pension Plans: Is a Transfer Always the Best Thing?
13 See Info Advice 104: RRSP Basic Rules.
There are several arguments still in favour of continuing to contribute to a spousal RRSP, mainly:

- New contributions to spousal RRSPs allow for income to be split 100%, whereas the income splitting rules limit splitting to 50%. RRSP amounts already accumulated can benefit from the income splitting rules.
- Contributions to spousal RRSPs allow for income splitting before age 65. Since the average retirement age in Québec is generally around 59\textsuperscript{15}, spousal RRSPs can be used for income splitting during the transition period.
- Contributions to younger spouses’ RRSPs can extend the tax deferral until they turn 72.
- Contributions to spousal RRSPs protect against any legislative changes that might restrict or even abolish income splitting in tax returns.
- Contributions to spousal RRSPs protect against creditor claims.
- If a spouse is required or needs to make an early RRSP withdrawal and contributions have been made to a spousal RRSP, the tax payable can be lowered by making the withdrawal from the spousal RRSP.
- With contributions to a spousal RRSP, the amounts available under a Home Buyers’ Plan can be doubled if the spouse’s RRSP does not already have a value of $25,000. Funds would also be available for Lifelong Learning Plans.

In addition, contributions to a spousal RRSP remain useful in certain circumstances where it’s the only planning strategy possible, such as the following situations:

- Persons over 71 with earned income can contribute to a spousal RRSP if the spouse is under 72. The deduction may reduce their taxable income.
- After a taxpayer dies, contributing to a spousal RRSP is the only option available for taking advantage of a final deduction and unused deductions.

Nothing is perfect, so contributing to a spousal RRSP also has some negative consequences.

- Obviously, transferring money to a spouse means a loss of control for the contributor and the money will be invested according to the spouse’s investor profile.
- Also, an owner of an incorporated business who has made significant contributions to a spousal RRSP might not be able to buy back all past service years of an Individual Pension Plan.

For many, these are minor disadvantages compared with all the benefits of contributing to a spousal RRSP.

Generally speaking, contributing to a spousal RRSP is a simple way to income split and reduce taxes.

\textsuperscript{15}QPP Transition travail – retraite, Service des statistiques et des ménages, novembre 2005.
Did you know that...

Although QPP/CPP income is not eligible for pension splitting, provisions already allow for dividing such amounts between spouses under certain criteria. However, a transfer of money is required and the election is permanent (not annual), but revocable.

In Québec, the maximum savings from income splitting for people under 65 is approximately $12,200, i.e. in the very hypothetical situation where one spouse has pension income amounting to twice the top federal marginal tax threshold (2 x $126,264 in 2009) and the other spouse has no income at all.

In the situation where both spouses receive OAS benefits, maximum savings are achieved when one of the spouses has significant eligible income (more than $120,000) and after income splitting the two spouses have incomes under the OAS clawback threshold ($66,335 in 2009). The maximum savings will top $10,200.

The annual tax election to split pension income is the right strategy for those who are not subject to family patrimony rules (e.g. common-law spouses) and are apprehensive about contributing to a spousal RRSP.

Since the rules allow the splitting of income from IPPs (a pension plan for one person) before age 65, this provides an additional incentive for setting up an IPP.
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