Pension Income-splitting Provides Tax Planning Opportunities for Couples

The pension income-splitting rules provide an effective, yet simple, strategy to lower family taxes. Being able to split pension income provides an opportunity for couples to reduce their overall family tax bill by taking advantage of a spouse's or common law partner's lower marginal tax rate where retirement incomes are disproportionate.

The rules allow a Canadian-resident individual receiving eligible pension income to allocate up to 50% of this income to his/her spouse or common law partner (hereinafter referred to as "spouse"). To make an allocation of income, each spouse must make an election on their income tax return each year. For income tax purposes, the amount allocated will be deducted from the income of the spouse who actually received the eligible pension income and added to the income of the other spouse.

The definition of eligible pension income is very similar to the definition used for determining eligibility for the pension income tax credit. As such, individuals currently eligible for this credit will generally be eligible to split pension income with their spouse. It is important to remember that it is the age of the spouse entitled to the pension income that is relevant in determining the eligibility for pension income-splitting, such that it is possible to allocate eligible pension income to a spouse who is under age 65. Ineligible income includes Old Age Security ("OAS"), Guaranteed Income Supplement ("GIS"), Canada/Quebec Pension Plan ("CPP/QPP"),[1] and RRSP withdrawals.

How pension income-splitting works

For example, assume that in 2019, both you and your spouse were age 65 and resided in Ontario. Further, assume that you earned interest and other income of $100,000, and another $50,000 of (eligible) pension income; and your spouse earned only a total of $30,000 of interest and other income.

When preparing your 2019 tax returns, you and your spouse agree to split your pension income; allocating 50% of this income to your spouse (i.e., $25,000). In doing this, you reduce your taxable income by an equivalent of $25,000; resulting in the following tax savings:

- You would save approximately $10,900 in combined federal and provincial tax by avoiding tax on the $25,000 of eligible pension income that was split with your spouse, who is taxable at a lower marginal tax rate;
- Your spouse's combined federal and provincial tax owing would increase by approximately $6,300, given his/her lower marginal tax rate (with the additional $2,000 pension tax credit offsetting much of the reduction in the age credit); and
- As a result of taking advantage of pension income-splitting, your overall family tax savings in 2019 would be approximately $4,600 (i.e., $10,900 - $6,300).

In other scenarios, the amount of Old Age Security payments clawed back may be reduced as a result of pension income-splitting allocations, creating additional tax savings. The actual results will vary by province.

Continued

Eligible Pension Income

Canadians who are 65 and over and receive:*
1. Registered pension plan payments;
2. Registered Retirement Income Fund ("RRIF") payments (includes Life Income Fund ("LIF") and Locked-in Retirement Income Fund ("LRIF") payments);
3. Lifetime annuities from registered plans; and/or
4. Prescribed and non-prescribed annuities (interest component only).
Canadians who are under 65 and receive: **
1. Registered pension plan payments; and/or
2. Items (2) to (4) above; only if received as a result of the death of a spouse

* Certain Retirement Compensation Arrangement ("RCA") payments may also qualify for individuals aged 65 or over.

** Quebec residents should note that individuals under the age of 65 (at the end of the year) are unable to split pension income for Quebec provincial tax purposes.

$2,000 pension income credit

Since the spouse receiving the transferred income (transferee) is treated for tax purposes as having received the portion of the pension income allocated to them, the transferee spouse may be eligible for the pension income tax credit; thereby possibly doubling the use of this credit for a couple. The age of the transferee spouse is relevant in determining the eligibility for this credit, which is based on the same criteria described in the chart above (except for RCA payments). Therefore, it may not always be possible to double up the use of the pension income credit. For example, consider a spouse, age 67, who receives RRIF income and allocates this income (which is eligible pension income) to his/her spouse who is only 63. While the transferee spouse would be able to claim the RRIF income on his/her tax return, the allocated income would not be eligible for the pension income tax credit since it does not represent eligible pension income to the transferee spouse due to his/her age.

The opportunity to obtain an additional pension income tax credit through pension income-splitting serves as a good reminder of other opportunities to access this tax credit. An individual 65 or over could access the benefit of the $2,000 federal pension credit (to the extent that it is otherwise unused) by converting all or a portion of his/her RRSP to a RRIF or life annuity, or by purchasing an ordinary (unregistered) life annuity with other non-registered funds. As noted in the previous definition, the RRSP annuity, RRIF payments or the interest component of an unregistered annuity would qualify as eligible pension income for an individual aged 65 or over. Depending on the individual's marginal tax rate, the pension tax credit will reduce or eliminate the incremental federal tax otherwise owing (and significantly reduce the incremental provincial tax component) on an additional $2,000 of qualifying income annually.

Reduce or avoid the OAS clawback

The decrease in the higher-income spouse's net income may reduce or eliminate the clawback of OAS benefits and can increase the amount of other income-tested tax credits, since the amount of eligible pension income allocated is deducted from the individual's income.

Spousal RRSPs still useful

The use of Spousal RRSPs as an income-splitting tool may still be recommended despite the opportunities created by pension income-splitting, since Spousal RRSPs allow for additional income-splitting prior to age 65. In addition, a Spousal RRSP provides a further opportunity to increase the amount of income-splitting beyond the 50% limitation provided by the pension income-splitting rules.

Impact on quarterly tax instalment payments

Pension income-splitting may provide additional cash flow to the extent that an individual's quarterly income tax instalments can be reduced as a result of allocating a portion of the eligible pension income to a lower-income spouse. However, care should be taken in estimating current year income tax instalments to avoid potential instalment interest charges if estimates differ from actual results.

As always, it is important to work with your tax advisor to fully understand the tax implications to your situation in determining the potential benefits of the strategies discussed in this publication.

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For more information, speak with your BMO financial professional.

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[1] A form of income-splitting already exists for CPP/QPP recipients through the CPP sharing provisions which operate independently of the pension income-splitting provisions described herein. If you are receiving your CPP/QPP retirement pension, or are eligible to receive it, you can elect to share your CPP/QPP pension benefits with your spouse. You must apply to the government requesting an equal share of the retirement benefits you both earned during the years you were together. The amount of CPP/QPP that is split depends on how long you and your spouse have lived together and your contributions made to CPP/QPP during that time. If only one spouse is a CPP/QPP contributor, you may share that one pension.

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