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Pension Income Splitting Provides Tax Planning Opportunities for Couples

The pension income-splitting rules, which became effective in 2007, 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 (hereinafter referred to as "spouse") lower marginal tax rate where retirement incomes of spouses 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. 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 the same definition used for determining eligibility for the pension income tax credit, such that individuals currently eligible for this credit will also 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), RRSP withdrawals and income from retirement compensation arrangements (RCAs).

Let's take a look at an example of how pension income splitting works. Assume that both you and your spouse are age 65 and reside in Ontario. Further assume that you earn interest and other income of $100,000 and $50,000 of (eligible) pension income, whereas your spouse earns only a total of $30,000 of interest and other income.

When preparing your 2012 tax returns, you and your spouse agree to split your pension income to allocate 50% (i.e. $25,000) of this income to your spouse which will reduce your taxable income by an equivalent $25,000. Your overall family tax savings in 2012 should be approximately $4,300 (i.e. $11,400 - $7,100) as a result of taking advantage of pension income-splitting. You would save approximately $11,400 in combined federal and provincial tax by avoiding tax on this $25,000 amount ,the majority of which is taxable at the top marginal tax rate. Your spouse's combined federal and provincial tax owing would increase by approximately $7,100 at the lower marginal tax rates (with the additional $2,000 pension tax credit offsetting much of the reduction in the age credit).

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.

Eligible Pension Income

If you receive the following type of income, it will qualify for pension income splitting purposes.

You Are 65 or Over and Receive:

1. Registered pension plan payments;
2. RRIF payments (includes LIF and LRIF payments);
3. Lifetime annuities from registered plans; or
4. Prescribed and non-prescribed annuities (interest component only)

You Are Under 65 and Receive:

1. Registered pension plan payments; or
2. Amounts (2) to (4) above only if received as a result of the death of a spouse

Some Planning Opportunities

$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, again based on the criteria described in the previous chart. 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. The extension of the RRSP maturity age from age 69 to 71 several years ago provided a longer timeframe to benefit from this strategy.

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 may increase the amount of other 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 above strategies.

[1] Income splitting already exists for CPP/QPP recipients. Spouses who are both at least 60 years old can elect to share their CPP/QPP pension benefits. 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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