INFO ADVICE

Splitting Pension Income

... or sharing without giving

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

Since January 1, 2007, it is possible to split a taxpayer's pension income with his or her spouse. In 2014*, the Quebec government changed the age of eligibility for income splitting to 65 years for all eligible pension income.

** June 4, 2014 Quebec budget*

NATIONAL BANK

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 a "split income amount" to their spouse 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 to split pension income on their tax returns 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 they 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. No money is actually transferred (this is a different way of splitting income). All other income splitting strategies requiring 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 included in the income of the transferee (the spouse receiving the split pension amount) and deducted from the pensioner's income.

Tax withheld at source on the split pension amount is considered to be that of the transferee rather than the pensioner. However, the spouses are jointly liable for the tax payable on the split income.

Eligible Pension Income

Only "eligible pension income" may be split. Income that is included in this definition is 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);
- 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[1]:

- retirement pensions paid or payable by registered pension plans (RPPs);
- 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);
- Canada Pension Plan (CPP) or Quebec Pension Plan (QPP) benefits;
- lump-sum RRSP withdrawals;
- amounts received under a retirement compensation agreement;2
- amounts received from a "top-hat" supplementary retirement plan;
- retiring allowances;
- death benefits.

[1] Since 2014, pension income splitting before the age of 65 years is only possible at the federal level for residents of Quebec.
[2] Except in certain circumstances.

Tax Variables

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

1. tax rates

The popularity of income splitting strategies lies in the progressive nature of the tax rates. Under the *Loi de l'impôt sur le revenu (QC)*, Quebec taxpayers can make different elections than for federal tax purposes. Greater attention must therefore be paid to separate tax rates.

2. certain tax credits

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

- Pension income amount
- Age amount
- Spouse or common-law partner amount

Of the above, the federal pension income amount credit is the only credit that is not reduced based on income level. As such, taxpayers allocating eligible pension income to spouses without any pension income of their own that would qualify them 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. In this case, only the retiree will be entitled to the pension income tax credit.[3]

There is not specific spousal tax credit in Quebec, but taxpayers may transfer the basic personal amount to their spouse, if they do not use it fully in their own tax return. This makes the tax treatment similar to federal tax.

Quebec tax credits are reduced gradually when net family revenue exceeds $34,030 (in 2018). The rate of reduction is 15% for each dollar of net family income that exceed this threshold.

3. social programs

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

1) Health Services Funding

Each province or territory finances health services according to their health insurance plan. For example, in Quebec, the HSF (RAMQ) finances healthcare. Employers contribute between 2.50% and 4.26% of the payroll (no maximum). Individuals do not contribute unless they have retirement, investment or business income. The maximum tax bill per individual per year is $1,000.[4] Other provinces have different programs, such as the Ontario Health Premium (a component of Ontario's personal income tax system), or British Columbia's annual fee.

[3] 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 his or her spouse.
[4] The maximum is reached when income subject to this tax (retirement, investment or business) reaches $135,985 (in 2018).

Health services funding contributions rarely have a major impact on decisions of whether to split eligible pension income or not. However, some situations should be closely examined. For example, individuals with income taxed at the top provincial marginal rate must decide carefully on the amount of pension income to split, since at this tax rate, they would no longer realize any tax savings, but might have to pay a higher health services funding contribution.

2) Old Age Security (OAS)[5]

Unlike CPP/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.

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, individual income may be used instead of family income for calculation purposes.

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;
- Health premiums or health tax contributions might increase or decrease;
- the OAS might increase or decrease, partially or in total; amounts may be significant;
- 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.

Tax and Financial Impact

The role of the advisor is not to produce income tax returns, but rather to understand the different variables and situations that my influence the decision to split pension income. The case studies below simply aim to give an idea of potential savings and the interactions between specifically selected tax variables.

Traditional individual income tax preparation software can be used to calculate the actual savings from pension splitting. An accountant can determine the optimal amount of pension to split, by investigating the various tax variables.[6]

[5] See InfoAdvice 7.2.1.IC1 : Government Benefits

[6] We encourage you to visit Claude Laferrière's website which publishes the effective marginal tax rates every year: https://www.cqff.com/claude_laferriere/accueil_courbe.htm.

Case study #1: Couple aged 65 ($50,000 of RPP for the client and $20,000 for the spouse)

CPP/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 $1,000.

Case study #2: Couple aged 64 (one spouse has RPP income of $60,000 and $10,000 of other income)

CPP/QPP benefits are already split ($6,000 each) but other income is unequal ($70,000 vs. nil). If the couple lives in Quebec, and as the pensioner is not 65 years old, the RPP income can only be split at the federal level. To equalize the incomes, $35,000 of RPP income should be allocated to the low income spouse, but the maximum allowable allocation is only $30,000 (50% of $60,000). The tax savings work out to approximately $1,600 in Quebec and could be between $2,000 and $3,800 for the other provinces.

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

CPP/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 $1,000 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 between $4,000 and $4,800 depending on the province of residence. This strategy will allow the recovery of approximately $1,000 in OAS.

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

Splitting pension income can also have a negative impact. CPP/QPP benefits are already split ($6,000 each), and the pension incomes are unequal ($140,000 vs. $50,000). In this case, 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 a significant portion (70%) of their OAS benefits. In this case, even if the tax bill is reduced, the loss of some of the OAS income would, in certain cases, be larger than the savings, and therefore income splitting 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 is no benefit to splitting income. However, both spouses in this example will lose almost all of their OAS entitlement. If approximately $40,000 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 would be between $700 and $1,500, depending on the province of residence. The savings would be even greater if the income splitting is elected only at the federal level (a choice available only in Quebec).

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

The Canada Revenue Agency has confirmed certain aspects of splitting eligible pension income and some of these aspects have been incorporated into legislation:

- 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 Quebec).
- Tax withheld at source is prorated according to the allocated pension income.
- There is no impact on GST/PST or HST credits 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 due to errors can be significant.
- The election to split eligible pension income[7] 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 rules, income splitting can be more significant and easier to implement. It is essential to complete the calculations every year to optimize the individual situation of both spouses. Pension splitting will also impact two other strategies:

1) 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 its 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 (only at the federal level for Quebec residents). Those who opt to receive the commuted value will not be able to split eligible pension income until they are 65 when making withdrawals from their LIF or Locked-in RRIF, or receiving annuity payments.

2) Contributions to a spousal RRSP[8]

Contributing to a spousal RRSP has long been a widely-used strategy to split income in retirement. 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?

[7] In Quebec, "retirement income" is more commonly used than "pension income".
[8] See InfoAdvice 7.1.1.IC1: RRSP Basic Rules.

For married couples, there are several arguments still in favour of continuing to contribute to a spousal RRSP:

- 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 is generally around 62[9], 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 the Lifelong Learning Plan.

In addition, contributions to a spousal RRSP remain useful in certain circumstances where it is 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 remains a simple and effective way to income split and reduce taxes.

[9] Données Québec – Institut de la statistique du Québec, 2014 data (2016-02-23).

Did you know that…

Although CPP/QPP 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), although revocable.

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 ($75,910 in 2018). The maximum savings will vary between $8,000 and $10,000 depending on the province of residence.

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.