

Pension Income Splitting—An Update

New rules were announced that will allow a recipient of eligible pension income to transfer up to one-half of their pension income to his or her spouse. Where the pension recipient is in a higher tax bracket than the transferee, this splitting of the pension income can result in a tax saving.

Note that throughout this article, we make references to a taxpayer and his or her spouse for the sake of simplicity. You should keep in mind that the new rules apply in the same manner to common-law partners.

How the New Rules Work

Essentially, the new measures provide that if you are earning pension income that qualifies for the pension income tax credit, you can transfer up to one-half of this income to your spouse, starting with the 2007 taxation year. The amount that you transfer will be taxable as pension income to your spouse for both federal and provincial/territorial purposes.

It is worth noting that the type of pension income that you can split with your spouse is based on whether you are over or under age 65:

- ◆ For taxpayers who are 65 years of age or older, eligible pension income includes annuity payments from a registered pension plan (RPP), registered retirement savings plan (RRSP) or a deferred profit-sharing plan (DPSP), and payments from a registered retirement income fund (RRIF).
- ◆ For taxpayers under 65 years of age, eligible pension income includes annuity payments from an RPP and certain other payments received as a result of the death of your spouse.

Regardless of your age, eligible pension income will not include:

- ◆ Old Age Security (OAS) benefits;
- ◆ Guaranteed Income Supplement (GIS) benefits;
- ◆ An RRSP or DPSP annuity or RRIF payment to a recipient who is under 65 years of age (unless the payment results from the death of a spouse);
- ◆ RRSP withdrawals;
- ◆ Payments from a retirement compensation arrangement; or
- ◆ Canada Pension Plan (CPP)/Québec Pension Plan (QPP) benefits. (CPP recipients can elect to combine and split CPP benefit.)

You and your spouse can take advantage of this new income splitting opportunity when you file your 2007 personal income tax returns. At that time, as part of a joint election, the higher income spouse can elect to transfer up to one-half of his or her eligible pension income to the lower income spouse. The amount transferred reduces the higher income spouse's net income, and increases the lower-income spouse's net income. A tax saving should generally arise where the lower-income spouse has a lower marginal tax rate.

It is worth noting that the draft legislation provides that where there is a change in marital status during the year, income eligible for the transfer will be pro-rated based on the number of months in the year during which the individuals were married or in a common law relationship. For example, if a couple marry during May 2007, the pension income recipient can transfer up to 8/12ths of 50% of his or her eligible pension income to their spouse. This rule will also apply in a similar manner where one spouse dies during the year.

The joint election you make only applies for that taxation year. In other words, you can determine whether a transfer is beneficial annually and make the election (or not) accordingly when you and your spouse file tax returns for that year.

Some Final Considerations

The tax savings that will result from the new measure will vary depending on your income and your spouse's income (as discussed), as well as the province where you reside. You should keep in mind that there can be negative effects that arise from increasing a lower income spouse's net income. For example, some tax credit amounts (particularly the age credit) and the OAS clawback are based on net income. So, a higher OAS clawback or a loss of tax credits may offset the tax rate saving. For 2007, if an OAS recipient's net income exceeds \$63,511, the repayment is 15% of the excess.

On a more positive note, splitting pension income can have an immediate positive effect on your cash flow if you (as a pension recipient) reduce your quarterly income tax instalments (that is, you can base instalments on estimated tax for 2007 with the pension income transfer). However, keep in mind that if you remit less than the required amount because your income is higher than expected (due to income from any source), you could be subject to interest and penalties.

Another possibility to consider if you're age 65 or over is whether you should withdraw additional amounts from your RRIF with a view to splitting some of the additional amount with your spouse. This could allow you to take further advantage of a spouse's low tax rates, or a spouse's losses carried forward (other than capital losses). However, as discussed, you can only split up to 50% of the additional amount received, so some of the extra RRIF withdrawals will be taxed in your hands—this cost would have to be compared with the tax benefit from splitting more income.

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