

# Pension income splitting

On October 31, 2006 the federal government introduced a new planning opportunity for Canadian seniors: the ability to split pension income beginning in 2007. This InfoPage explains what pension income splitting is and how it can help to lessen your tax burden.

Under Canadian tax law, everyone files their own tax return and is taxed on the income they earn on an individual basis. Since we have a progressive tax system, the more you make, the higher your tax rate. This has always been a source of concern for senior couples, where one of them is receiving a pension and the other has very little income. The couple would pay significantly less tax if the pension income, which is being used to support the couple jointly, could be split between both partners.

## Qualifying pension income

According to the Department of Finance, the ability to split pension income will provide nearly 700 million in new tax relief annually for Canadians. Under the new rules, any Canadian resident who receives income that qualifies for the existing \$2,000 pension income tax credit (see page 4, "Pension Income Credit") will be entitled to allocate to their resident spouse or common-law partner up to one-half of their qualifying "pension income."

What is pension income? The definition mirrors the definition of pension income for the purposes of the federal pension credit.

Income that qualifies for pension splitting may depend on the recipient's age, as follows:

### Recipients under age 65:

- Pension income from a registered pension plan (RPP), i.e., a pension from an employer-sponsored defined benefit or defined contribution plan

### Recipients age 65 or over:

- Pension income from a registered pension plan (RPP), i.e., a pension from an employer-sponsored defined benefit or defined contribution plan
- Income from an annuitized registered retirement savings plan (RRSP)
- Registered retirement income fund (RRIF) withdrawals or withdrawals from RRIFs subject to federal or provincial locked-in legislation, such as LIFs and LRIFs
- Income from an annuitized deferred profit sharing plan (DPSP)

Why the age 65 requirement for RRSP annuity, RRIF and LIF income? The government has stated that the purpose of this age requirement is to target the pension income credit to retired individuals.

Since individuals have much greater personal control over the timing of withdrawals under RRSPs, RRIFs and LIFs compared to RPPs, without the age 65 rule, individuals who aren't retired could gain tax advantages through income splitting well before age 65, for example, by withdrawing RRIF income annually while still saving for retirement.

On the other hand, pensioners who receive RPP income generally have little control over the timing of their pension payments, since they usually (although not always) only receive such payments when they're retired.

### **Ineligible income**

The following types of income are *not* eligible:

- Old Age Security (OAS)
- Guaranteed Income Supplement (GIS)
- Canada Pension Plan (CPP)/Quebec Pension Plan (QPP)
- RRSP annuities, RRIFs, and DPSP annuities (if recipient is under age 65)
- RRSP withdrawals
- Income from retirement compensation arrangements (RCAs)

Note that while CPP income doesn't qualify as eligible pension income for either the pension income credit or pension splitting, existing rules do permit CPP recipients to split their CPP retirement benefit. Under these rules, spouses and common-law partners who are both at least 60 years of age can share up to half of

their CPP retirement benefit, with the split between the partners determined by the number of years they lived together during the period they were required to contribute to CPP.

### **How will it work?**

Mechanically, any pension income that's split can be simply deducted from the income of one spouse or partner and included as income on the other spouse's or partner's tax return.

The election to split pension income will be made one year at a time and can be changed or modified each tax year, depending on financial circumstances and planning needs. The ability to split (or not to split) any amount up to half of one's pension income presents a huge opportunity to maximize tax planning for seniors. One such area of planning involves the Old Age Security clawbacks.

### **OAS clawback planning**

Although the technical information surrounding the details of the new pension splitting regime is sparse, it's widely believed that the pension income being transferred will not only qualify for the \$2,000 pension income credit in the hands of the transferee spouse but will also be included in an individual's net income for the purposes of determining any clawback of OAS benefits.

The OAS clawback, which affects a mere 3% of eligible Canadian seniors, only kicks in at net income greater than \$63,511 in 2007 and is fully clawed back when net income reaches approximately \$102,865.

The new possibility of being able to split pension income may be extremely beneficial for individuals subject to the OAS clawback. Why? Pension income

that pushes an individual above \$63,511 could now potentially be transferred to a lower-income spouse or partner's return, thus preserving OAS payments.

### **Future of spousal RRSPs**

In light of these new rules, will spousal RRSPs become a thing of the past? Will they still be needed and, if so, in what capacity?

As a quick refresher, a spousal (or common-law partner) RRSP is a plan in which one spouse or partner has contributed, and the other spouse or partner is the annuitant or owner. It's often used by couples to accomplish post-retirement income splitting, as funds withdrawn from a spousal RRSP are taxed in the hands of the annuitant spouse instead of the contributor spouse. If the annuitant spouse is in a lower tax bracket than the contributor spouse in the year of withdrawal, there may be an absolute and permanent tax savings.

It's likely the new rules won't herald the death of spousal RRSPs, primarily due to the definition of pension income that qualifies to be split, as discussed earlier.

### **Splitting under age 65**

Remember, if you're under 65, eligible pension income typically only includes payments from an RPP and will not generally include amounts paid from an RRSP or RRIF. Thus, anyone who wants to retire before age 65 and doesn't have an RPP should still consider the use of spousal RRSP contributions that would allow the ultimate withdrawals to be taxed in a lower-income spouse's or partner's hands without having to wait until age 65.

### **Splitting more than 50%**

Spousal RRSPs will also continue to play a role for individuals who may wish to split more than 50% of their pension income. With a spousal RRSP, one could transfer up to 100% of their RRSP income to a lower-income spouse or partner. This may be advantageous to some couples, depending on their individual retirement incomes and tax brackets.

### **Contributors over age 69**

Spousal RRSPs may also play a critical role if you're over age 69 – the age when you can no longer have an RRSP in your own name. You can, however, continue to contribute to a spousal RRSP if you have RRSP contribution room beyond age 69.

In fact, with many seniors working well into their seventies, you may still be generating “earned income” and thus be able to contribute to a spousal RRSP as long as your spouse or partner is under age 70. And keep in mind, you don't necessarily have to be working to have earned income – you might simply own a rental property that generates net rental income, which is specifically included in the definition of earned income for the purposes of calculating eligible RRSP contribution room.

### **Home Buyers' Plan (HBP) withdrawals**

Another continuing advantage of spousal RRSPs can be for younger couples looking to save enough money for a down payment on a first home. Often, the only savings they may have are in an RRSP. If one spouse is working and the other isn't, the working spouse, over the years of accumulation, could contribute a total of \$20,000 to his or her own RRSP and then contribute \$20,000 to a spousal RRSP while building-up savings for the new home. Then each could withdraw

\$20,000 under the HBP – something that can't be achieved without the spousal RRSP.

### Post-death RRSP contribution

Finally, the spousal RRSP will still play a role in situations where individuals die with unused RRSP contribution room. In this scenario, the executor or estate representative can make an RRSP contribution to a surviving spouse's or partner's spousal RRSP and obtain one final RRSP deduction on the deceased's terminal return; planning that isn't possible without the spousal RRSP.

### Pension income credit

The pension income credit provides a non-refundable reduction in taxes payable on qualified pension income. Effective for the 2006 tax year, the maximum amount of pension income eligible for the credit is \$2,000.

### Planning opportunity

How can you take advantage of this credit without actually receiving any pension income in the traditional sense? If you're 65 or over, ensure you receive at least \$2,000 a year from a RRIF. If you're aged 65 to 68, consider transferring some of your RRSP money to a RRIF so you'll be in a position to claim this credit.

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