



Pension Income Splitting – The Gory Details

Patrick Longhurst

I have recently received a number of questions about pension income splitting and thought this was a good opportunity to address the whole issue in my column. Pension income splitting (Splitting) was first introduced in Federal Finance Minister Jim Flaherty's Tax Fairness Plan of October 2006, and was passed into law in 2007. Parallel rules have also been adopted by most provinces.

As you know, the basic principle behind any form of income splitting is to move taxable income from the higher income spouse or common-law partner (Higher) to the lower income spouse or common-law partner (Lower) with a view to reducing the overall tax payable. The savings typically arise from Canada's "progressive" tax system, under which we pay a higher rate of tax as our taxable income increases. So, in theory, the closer that the two incomes are, the less tax the couple pays in combination. Pension income splitting applies only to eligible pension income and, unlike some other forms of income splitting, no money changes hands. When completing the tax return, Higher elects to transfer up to 50% of eligible pension income to Lower, but this is purely a paper transaction.

As stated on the CRA website - "Eligible income for splitting purposes includes:

- The taxable part of annuity payments from a superannuation or pension fund or plan; and
- If received as a result of the death of a spouse or common-law partner, or if the pensioner is age 65 or older at the end of the year: annuity and RRIF payments, and RRSP annuity payments."

So, in most cases, you would be able to split pension income from a defined benefit pension plan at any age, and RRIF or annuity income from an RRSP after age 65. Income from a Locked-in Retirement Account (LIRA) would be treated the same as an RRSP.

Income that is not eligible for this type of splitting includes:

- Old Age Security,
- Canada / Quebec Pension Plan benefits (although they can still be split in the traditional way), and
- Income from Supplemental Pension Plans, whether

funded through a Retirement Compensation Agreement (RCA) or unfunded.

From a technical point of view, in addition to filing their regular tax returns, a couple that wants to split their pension income must file an additional Form T1032 to provide the amount they wish to split and to confirm that they are both aware of what is happening. From Lower's perspective this looks a bit like a "lose/lose" proposition. Lower gets no additional cash and has to pay more tax. It is only when you look from the perspective of the couple as a whole that the advantages become apparent.

Given everything I have said up to now, you might think that Higher should always split eligible pension income with Lower, and that the full 50% splitting would normally give the largest overall tax reduction. However, after receiving your letters, I wanted to test this out for myself. What I discovered was very different.

For my analysis I looked at a couple living in Ontario, both aged over 65. I believe that similar results would apply in other provinces, although the details would be slightly different. While the impact of shifting federal and provincial tax brackets was important, other items also had an influence on the impact of pension income splitting. These included:

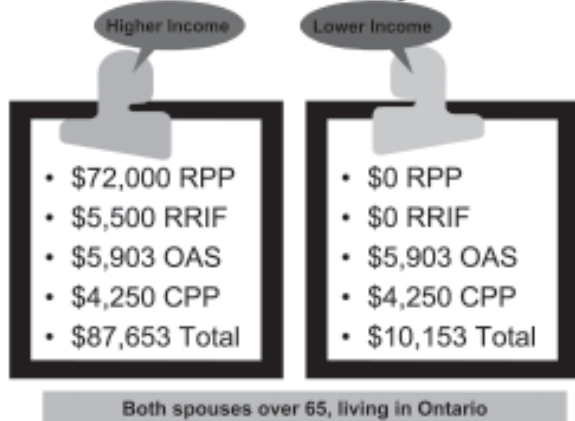
- The federal and provincial tax credits,
- The OAS clawback,
- Provincial surtax rates, and
- Provincial health premiums.

In many cases, these different factors work in opposite directions, with some increasing the total tax payable and some decreasing it. Maybe the best way to illustrate this is through a couple of examples, using 2007 tax rates and credits.

Case Study 1

In case study 1, Higher has some Registered Pension Plan (RPP) and Registered Retirement Income Fund (RRIF) incomes. Higher and Lower are already splitting their CPP. If Higher and Lower do no Splitting; their net incomes are

Case Study 1



\$87,653 and \$10,153 respectively. Their total tax payable is \$27,128.

If they do maximum Splitting, by transferring \$38,750 of eligible pension income from Higher to Lower, their net incomes become \$52,903 and \$48,903 and their total taxes decrease by \$7,078. Although their combined federal and provincial taxes both decrease, the biggest single component of the tax reduction is the fact that Higher is no longer affected by the OAS clawback.

In 2007 the OAS clawback was equal to 15% of net income before adjustment: \$63,511. By reducing Higher's net income, we have eliminated a clawback of \$4,221. This looks impressive, but we can do slightly better. If they do a 36.3% split, their net incomes become \$63,511 and \$38,295. Their total tax payable is reduced by a further \$200. By finessing the Split, so as to place Higher right on the threshold for the OAS clawback, we have created an optimum position by slightly increasing the combined provincial age amount and also decreasing the combined Ontario Health Premium. If the split were any less, then Higher would start to be affected by the clawback and total taxes would start to increase again.

Case Study 2

In case study 2, Higher has RPP and RRIF income. Higher was also a member of a Supplemental Executive Retirement Plan and is receiving an additional pension from a Retirement Compensation Agreement (RCA), which is not eligible for splitting. Lower was a member of an RPP. If Higher and Lower do no Splitting, their net incomes are \$176,268 and \$51,268 respectively. Their total tax payable is \$77,383.

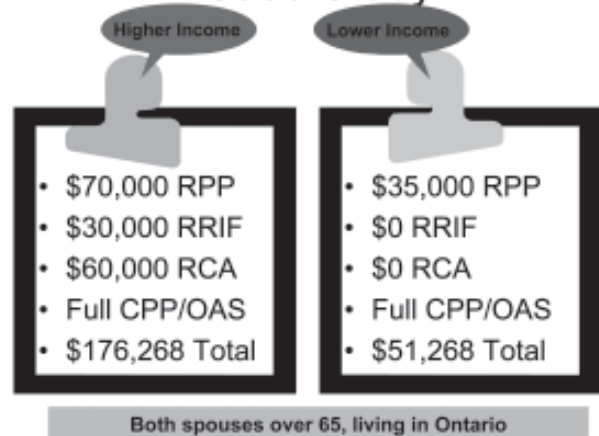
If they do maximum Splitting, by transferring \$50,000 of eligible pension income from Higher to Lower, their net incomes become \$120,365 and \$95,604 and their total taxes decrease by \$284. Once again, there are basic savings in

federal and provincial taxes, but this time the OAS clawback is the spoiler. By significantly increasing Lower's net income, we have made him / her subject to nearly a complete OAS clawback, which was not there before the Splitting.

Can we do better? Yes, by only Splitting 22.2% of the eligible pension income. In that case, the net incomes become \$148,165 and \$71,974 and the total tax saving has jumped to \$1,788. The reduction in federal and provincial taxes is less than with 50% splitting, but the clawback has been reduced by \$4,170.

For those of you who are wondering why the combined net incomes in these two examples don't always add up to a consistent total, the answer is that the OAS clawback affects the amount of the individual's net income, and this varies from situation to situation.

Case Study 2



Summary

So, my message is: Don't jump to conclusions about the best way to split your pension income. Sometimes even the optimizers built into the tax software are incorrect. Take the time to try a few different splits and understand the dynamics of your situation.

One last point. In one letter I was sent, the writer indicated that his parents were separated and assumed that they were not eligible for Splitting. In fact, his father was in hospital, while his mother was living in the family home. Separations like this, whether for medical, educational or business reasons, do not take away the ability to split eligible pension income.

Looking forward to seeing some of you on the October cruise!

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