



Income Splitting in Retirement



Wolters Kluwer

INCOME SPLITTING IN RETIREMENT

[Please note that any reference to the term “spouse” in this article includes a reference to the term “common-law partner”.]

Couples planning for or approaching retirement worry about whether they will have enough saved to ensure a comfortable lifestyle during those retirement years. Most focus on the total savings which they need to accumulate, while others look more at the amount of income those savings can generate on an annual basis.

Both those numbers are important, but at the end of the day, it is the amount of income left after taxes are paid which will determine one’s lifestyle in retirement. And for many retirees who have paid off the mortgage and who no longer have financial responsibility for their children, income taxes can be



the single largest annual expenditure in their budget. That being the case, it makes sense to consider every means by which the annual tax bill can be reduced.

For retired Canadians who are married or living in a common-law relationship, arranging their affairs in a way which allows them to split income and share tax credits is likely to have more impact on their total after-tax income than any other step which they can take. This article reviews the income splitting and credit-sharing strategies available to most Canadian couples in retirement.

What is income splitting and why does it work?

Income splitting is simply the allocation of total family income between two spouses in a way that ensures the best possible tax result. Income splitting works because Canada has what is termed a “progressive” tax system, meaning that the rate of tax imposed increases as income rises.

Our federal income tax system, to which every individual resident in Canada is subject, imposes the following tax rates and brackets for 2016.

| Income Amount | Tax Rate |
|---------------------|----------|
| \$0–45,282 | 15.0% |
| \$45,283–\$90,563 | 20.5% |
| \$90,564–\$140,388 | 26.0% |
| \$140,389–\$200,000 | 29.0% |
| Over \$200,000 | 33.0% |

Canadian residents must also pay income tax to the province or territory in which they live. Like the federal system, tax rates imposed by provincial and territorial tax systems increase as income rises, and each province sets its own rates and income brackets.

Looking at the figures, it’s not hard to see how splitting income between spouses can significantly reduce the overall income tax payable on total family income received. However, whenever Canadians reduce the amount of income tax they must pay, it means less revenue for the federal and provincial governments. For that reason, most income splitting strategies are blocked by a set of tax provisions known as the attribution rules. Essentially, income splitting is possible only where exceptions to those rules are provided for in our tax laws. Fortunately for Canadian retirees, most of those exceptions are made available specifically to Canadians over the age of 60 or 65, depending on the particular strategy involved.

While splitting or sharing of income is the strategy which can make the most difference to total tax payable, it’s also possible to reduce that number through the transfer of tax credits between spouses. For everyone, calculating the amount of tax payable for the year is, basically, a two-step process. An individual first determines his or her taxable income and calculates the amount of tax payable on that income by multiplying the income amount by the tax rate applied to each bracket of income, as outlined above. In the second step, the taxpayer determines the total amount of non-refundable tax credits available to him or her, and then subtracts that total credit amount from tax payable to arrive at net tax payable for the year, as in the following example.

2016 total income—\$35,000

Federal tax payable (at 15%)—\$5,250

Federal tax credits claimable—(\$1,721)

Net federal tax payable—\$3,529

For some taxpayers, the amount of non-refundable federal tax credits claimable can actually exceed the amount of federal tax (i.e., the credits reduce federal tax payable to zero, with credit amounts left over).

In such cases, taxpayers can sometimes transfer the

leftover or unused credit amounts to a spouse, who can then use them to reduce his or her tax payable. While such credit transfers are available to all Canadian couples regardless of age, many of the credits which may be transferred—like the age credit or the pension credit—are those which are, in most cases, claimed only by retirees. Like the strategic allocation of income, sharing of credits in this way can serve to further reduce total tax payable on overall income of retired couples.

Finally, eligibility for some federal tax credits or benefit programs frequently claimed or received by older Canadians are reduced as an individual's income increases, and eligibility for benefits can be lost entirely where an individual's income exceeds a prescribed threshold. Reducing income through the use of income splitting strategies can ensure that eligibility for such credits or benefits is maximized for both spouses.

Who can use and benefit from income splitting?

Most of the income splitting strategies allowed by our tax system make it possible to split income (or transfer unused tax credits) only between legally married spouses,

and they must be living together in order to qualify. Income splitting with other family members (e.g., a retired parent and an adult child) is not generally permitted, even where the parent lives in the same household with that adult child.

There are also instances in which the ability to split income, while available, doesn't

actually provide any benefit. The goal of income splitting is to ensure as much income as possible is taxed at the lowest possible tax rate—where possible, the one applied to income amounts under about \$45,000 a year. The greatest benefit from income splitting and credit transfers is realized by couples in which one spouse's income is greater than that of the other, and therefore taxed at a higher rate. Generally, the wider the income gap between spouses, the greater the benefits which can be realized.

Take, for example, spouses who have incomes of \$58,000 and \$30,000, respectively, and who would benefit from the re-allocation of as much as \$14,000 in income from the higher income spouse to the lower income one, who would then pay tax on that income at the lowest federal rate of 15%. In the hands of the higher income spouse, most of that \$14,000 in income would have been taxed at a federal rate of 20.5%. However, once the \$14,000 in income is re-allocated to the lower income spouse, all of the couples' total income of \$88,000 is taxed at the lowest federal tax rate of 15%.

Income splitting doesn't produce significant benefits where the income of both spouses are already taxed at the lowest rate. In other words, since all income under \$45,000 a year is taxed at the lowest federal rate of 15%, splitting of income between spouses who each have an income of less than \$45,000 cannot produce real tax savings.

It is, however, often the case that there is a significant difference between income amounts received by each spouse in retirement. One spouse may have an employer pension while the other does not, or the bulk of funds held in a registered retirement savings plan may be held by only one spouse, or one spouse may have chosen to receive Canada Pension Plan benefits earlier than the other spouse. In those situations, re-allocating income and/or sharing credits can produce some significant tax savings.

Income splitting strategies

Retired Canadians usually receive income from one or more of the three major sources. The first is the government benefits available to most retirees—the Canada Pension Plan and the Old Age Security benefit. The second such source, received by a minority of Canadian retirees, is the monthly payment from an employer-sponsored pension plan. Finally, most Canadian retirees have private savings, usually accumulated through a registered retirement savings plan (RRSP), which they draw on for income in retirement. Income splitting strategies are available for each of these sources of retirement income, with the sole exception of Old Age Security benefits.

Pension income splitting

The ability to split private pension income is likely the single biggest tax "break" available to retired Canadians, and can be used by virtually all couples in which one person is over the age of 65 and is receiving non-government source retirement income. The general rule with respect to pension income splitting is that taxpayers who receive private pension income during the year are entitled to allocate up to half that income to a spouse for tax purposes.





In this context, private pension income means a pension received (at any age) from a registered pension plan and, where the income recipient is over the age of 65, periodic (monthly, quarterly, or annual) payments from a registered retirement income fund (RRIF), or from an annuity purchased with funds from an RRSP. Government source pensions, like payments from the Canada Pension Plan, Quebec Pension Plan or Old Age Security payments do not qualify for pension income splitting under any circumstances.

The mechanics of pension income splitting are quite simple. There is no need to transfer funds between spouses or to make any change in the actual payment or receipt of qualifying pension amounts, and no need to notify a pension plan or RRSP or RRIF administrator. Instead, taxpayers who wish to split eligible pension income received by either of them must each file Form T1032(E)15, *Joint Election to Split Pension Income*, with their annual tax returns. That form, which is not included in the general tax return package issued by the CRA, can be found on the CRA website at www.cra-arc.gc.ca/E/pbg/tf/t1032/t1032-15e.pdf.

On the T1032, the taxpayer receiving the private pension income and the spouse with whom that income is to be split must make a joint election to be filed with their respective tax returns for the particular tax year. Since the splitting of pension income affects both the income and the tax liability of both spouses, the election must be made and the form filed by both spouses—an election filed by only one spouse or the other won't suffice. In addition to filing the T1032, the spouse whose pension income is to be split must deduct from income the pension income amount allocated to his or her spouse. That deduction is taken on line 210 of his or her return for the year. And, conversely, the spouse to whom the pension income is being allocated is required to add that amount to his or her income on the return, this time on line 116. Essentially, to benefit from pension income splitting, all that's needed is to file a single form with the CRA and for each spouse to make a single entry on his or her tax return for the year. And, unlike some other forms of pension sharing, when it comes to pension income splitting, couples are able to specify how much income is to be allocated to each spouse (to a maximum of 50% of eligible pension income), in order to obtain the best possible tax result.

The benefits of making that minimal effort can be significant. Take, for example, a retired couple over the age of 65 who have a combined income of \$80,000, with the husband receiving \$55,000 and the wife \$25,000. Where, as part of his income, the husband receives \$30,000 in eligible pension

income (which could be income from a registered pension plan or periodic receipt from a RRIF or annuity), he can allocate up to \$15,000 of that eligible pension income to his wife. At his income level, the husband would pay about \$3,075 in federal income tax on that \$15,000 of pension income. When that income is taxed instead on his wife's return, the tax payable (since her total income, even after pension income splitting, is within the first, lowest tax bracket) will be about \$2,250.

An additional benefit can arise from pension income splitting where it allows the recipient spouse to claim a pension income credit. That federal credit, which reduces federal tax by as much as \$300 per year, is available to any taxpayer who reports eligible pension income. In the above example, once the \$15,000 in pension income is allocated to the wife, both she and her husband will have sufficient eligible pension income to claim a full pension income credit for the year, reducing their combined federal taxes by \$600.

In most cases, being able to claim a tax deduction or credit for a tax year requires the taxpayer to take any necessary actions before December 31st of that year. One of the best attributes of income splitting as a tax planning strategy is that it doesn't have to be addressed until it's time to file the return for the year at the end of April. By the end of February or early March, taxpayers will have received the information slips which summarize their income for the previous year from various sources. At that time, couples who might benefit from pension income splitting can review those information slips and determine the allocation of income between them which will provide the best possible tax result.

While the annual tax guide issued by the Canada Revenue Agency (CRA) outlines the mechanics of pension income splitting, there is no information provided on the circumstances in when the option of splitting pension income is available, or the benefits which can be obtained. The CRA does, however, provide that information on its website, at www.cra-arc.gc.ca/pensionsplitting/menu-eng.html.

Sharing of Canada Pension Plan benefits

Anyone over the age of 18 who has worked in Canada has made contributions to the Canada Pension Plan and is entitled to receive benefits from that plan in retirement, and individuals can choose to begin receiving those benefits anytime between ages 60 and 70. The amount of CPP retirement benefit to which an individual is entitled depends on the amount of contributions made throughout his or her working life, which in turn depends on the person's income level and number of years

in the workforce. Consequently, there is a great deal of variation in the amount of benefit payable. For 2016, while the maximum monthly benefit is \$1,093. All Canada Pension Plan retirement benefits received are fully taxable.

In most cases, where both spouses are receiving CPP benefits, there will be a difference in the amount of benefit which each receives. It is, however, possible to equalize those amounts, and to gain a tax benefit by doing so, through the sharing of CPP benefits between spouses. Such benefit sharing can also take place even where only one spouse is receiving CPP retirement benefits because the other spouse does not qualify for such benefits.

In either case, in order to share CPP benefits the spouses must file an application to do so, on Form ISP1002 (available on the Service Canada website at [www.servicecanada.gc.ca/eforms/forms/sc-isp-1002\(2015-02-23\)e.pdf](http://www.servicecanada.gc.ca/eforms/forms/sc-isp-1002(2015-02-23)e.pdf)).

The rules allowing sharing of CPP benefits are not, unfortunately, as flexible as those which govern the splitting of private pension income between spouses. When it comes to sharing of CPP benefits, the percentage of benefits which can be allocated to a spouse is determined by a set formula, and cannot be specified by the individuals who are sharing the benefits. Under that formula, the portion of CPP

which both spouses could have contributed to the CPP. Using that formula, a spouse can receive a maximum of 50% of the other spouse's CPP retirement benefit. As well, unlike pension income splitting, which is a "notional" transfer of income between spouses which happens only on paper, CPP pension sharing actually changes the monthly amount received by each spouse from the Canada Pension Plan.

Take, for example, two spouses, one of whom receives \$700 per month in CPP retirement benefits and the other who receives \$300. The couple is entitled to share the maximum of 50% of benefits received. Consequently, once their application for CPP benefit sharing is approved, each spouse will begin to receive \$500 per month in CPP retirement benefits, and each will be taxed on that \$500 amount. If the joint contributory period for the spouses was shorter, the sharing of benefits between them would be less, such that one might receive \$600 and the other \$400.

Credit transfers between spouses

Every Canadian who files a tax return can claim certain tax credits which reduce the amount of tax he or she must pay. Those credits are known as non-refundable tax credits, meaning that they can reduce or eliminate an amount of tax owing, but any excess of credits left over after tax is reduced to zero, and is not refunded to the taxpayer.

Some such excess credits can, however, be transferred to a spouse, and used to reduce that spouse's tax payable for the year. Generally, such a transfer can take place where the spouse who is entitled to the credits has claimed them to the extent required to reduce his or her federal tax to zero (in other words, no federal tax is payable for the year) and there are unused credit amounts remaining.

There are several federal non-refundable credits which are eligible for transfer in this way, and three of them—the age credit, the pension income credit, and the disability credit—are those most likely to be available to, and claimed by, retirees.

Age credit

Canadian taxpayers who are over the age of 65 are entitled to a federal age credit of \$1,069. Where the taxpayer's income for the year is more than \$35,927, the available credit is reduced, and eligibility for the credit is lost where an individual's income for the year is more than \$83,427.

Where both spouses are 65 or older, and each has an income of less than \$83,427, it is possible to transfer any excess age credit claimable by one spouse to the other.



pension that can be shared is based on the number of months the individual and his or her spouse lived together during the joint contributory period. That joint contributory period is the time period during

Disability credit

Illness or just advanced age can diminish an individual's ability to function, and, where the ability to carry out ordinary functions of daily life is severely compromised, the individual affected may be entitled to claim the disability tax credit. That credit, which is not affected by income, reduces the disabled individual's federal tax payable for the year by \$1,200.

As with the age credit, one spouse can transfer any unused disability tax credit to his or her spouse. However, unlike the age credit, the ability to transfer a disability tax credit is not affected by the age of either spouse—such a transfer can take place at any age.

Pension income credit

As outlined in the example above, individuals who receive private pension income (registered pension plan benefits or periodic amounts from a RRIF or an annuity) can claim a pension income credit on up to \$2,000 of that income, which reduces federal tax payable by \$300. A taxpayer who has a remaining pension credit amount available after federal tax is reduced to zero can transfer some or all of that amount to a spouse. Once again, there is no age restriction on such transfers.

All of these transferable non-refundable tax credits are first claimed by the individual who is entitled to them. Where there are credits leftover after that individual's income has been reduced to zero, the amount which may be transferred to a spouse is calculated on the Federal Worksheet, which is provided as part of the annual tax return package.

Looking to the future

Most retired Canadians receive income from multiple sources, and those sources usually change over time. One spouse might elect to begin receiving his or her CPP retirement benefit, or might become eligible for payments from the Old Age Security program. Later, when one spouse turns 71, he or she will be required to begin receiving annual payments out of RRSP savings. It's important, therefore, to remember that any change in income of either spouse requires a reassessment, and possibly a change, in income splitting strategies currently in place.

Since the percentage of CPP benefits which can be shared between spouses is determined by a specific formula, spouses who have applied for and received CPP pension sharing can't alter the allocation of such benefits as between them. However, if those spouses decide that such pension sharing is no longer a good income splitting strategy for them, they can, at any time, cancel a CPP pension sharing arrangement, by filing Form ISP 1014, *Cancellation of Pension Sharing for Canada Pension Plan Retirement Pension(s)*, available on the Service Canada website at [www.service-canada.gc.ca/eforms/forms/sc-isp-1014\(2014-08-01\)e_cpp.pdf](http://www.service-canada.gc.ca/eforms/forms/sc-isp-1014(2014-08-01)e_cpp.pdf).

Where spouses have taken advantage of pension income splitting, it's easier to make a change in the amount of income currently allocated to one spouse or the other. Practically speaking, decisions on pension income splitting are made each year when preparing the tax returns for both spouses, and so there is no need (or opportunity) to take action before that time. Where, however, there is a change in income during the year—for instance, one spouse begins receiving Old Age Security payments during 2016—that change will almost certainly alter the optimal allocation of pension income as between the spouses, and the determination of that allocation will have to be made when the 2016 tax return is prepared in the spring of 2017.

Conclusion

Sharing or splitting of income or credits between spouses is the best tax “break” available to Canadian retirees. While the strategies outlined above should be considered as soon as retirement income begins, and are generally available to taxpayers aged 65 and older, they become especially useful once an individual is over the age of 71. By that time, most Canadians will be receiving retirement income from all of the most common sources—Canada Pension Plan and Old Age Security benefits, as well as payments from private retirement savings and, perhaps, from an employer pension plan. All that is really required to put income or credit splitting and sharing strategies in place is some basic tax calculations and some paperwork, and the results, in terms of potential tax savings, will more than justify that investment of time and effort.