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KPMG Canada

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New Tax Rules Allow Spouses to Split Pension Income

If you earn income eligible for the pension income tax credit, starting in 2007, you and your spouse or common-law partner may reduce your overall tax bill through a new pension income splitting measure announced by the Department of Finance on October 31, 2006.

Background
"Income splitting" is a term used to describe strategies to save taxes by shifting income from the hands of a family member in a higher tax bracket to the hands of a second family member in a lower tax bracket so that the same income is taxed at a lower rate — or not at all if the second family member's income is low enough. Canada's tax laws contain many measures to prevent most types of income splitting among family members, except in certain specific circumstances.

What pension income qualifies?
The type of pension income you can split with your spouse beginning in 2007 under the new rules varies depending on your age:

- If you are 65 years of age and over, eligible pension income includes lifetime annuity payments under a registered pension plan (RPP), registered retirement savings plan (RRSP) or a deferred profit-sharing plan, and payments out of or under a registered retirement income fund (RRIF).
- If you are under 65 years of age, eligible pension income includes lifetime annuity payments under an RPP and certain other payments received as a result of the death of your spouse.

New method of allocation — Joint election
To take advantage of this opportunity, you and your spouse do not need to take any action until April 2008 when it comes time to prepare your 2007 personal income tax returns. Then, the higher income-earning spouse can allocate up to 50% of his or her eligible pension income to be taxed in the hands of the lower-income spouse. The allocated amount will be deducted from income on the tax return of the higher-income spouse, and included in the income of the lower-income spouse, where it will be taxed at his or her lower marginal rate.

Since this arrangement could increase the transferee's tax payable, you and your spouse must jointly agree to the allocation by making an election in your tax returns for the year in question and on an annual basis.

Example

Assume in 2007 you earn $140,000 in taxable income: $80,000 in investment and other income and $60,000 in pension income. Assume your spouse earns $30,000 in income, including $5,000 in pension income from a spousal RRSP. On preparing your 2007 tax returns, you and your spouse jointly elect to report half of your pension income, or $30,000, on your spouse's return.

In this case, you would save about $13,600 in combined federal and provincial income tax while your spouse's tax bill would rise by about $9,600. Tax savings for you and your spouse together would be about $4,000 in total. The actual amount will vary depending on the province.

Impact on other credits and amounts

The amount of split pension income that will produce the most tax savings will vary greatly among couples, depending on the income of each spouse. You may also need to take into account the impact that the increase in your spouse's taxable income may have in reducing or eliminating the amounts of personal tax credits he or she could otherwise claim or transfer to you to claim on your tax return. These credits include the spousal credit, the age credit and medical expense credit. The income splitting may also change your or your spouse's entitlement to Old Age Security (OAS) and/or trigger a clawback of your spouse's OAS benefits.

On preparing your 2007 tax return, an analysis will need to be undertaken to determine the optimal amount of pension income to split with your spouse.

KPMG observation

If you and your spouse intend to take advantage of pension income splitting in your 2007 taxation year and you are required to pay quarterly tax instalments, you may want to estimate your 2007 taxes payable and determine what impact this may have on the amount of your 2007 tax instalment payments for you and your spouse.

For information on other family income splitting opportunities, see the 2007 edition of KPMG's *Tax Planning for You and Your Family*, available in bookstores across Canada or directly from Thomson Carswell Professional Publishing at 1-800-387-5351.

We can help

Your KPMG adviser can help you analyze whether and how much pension income should be allocated to your spouse. We can also suggest ways to help you minimize and defer your tax liabilities in the context of your overall estate planning and investment decisions. For details, contact your KPMG adviser.

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