PENSION SPLITTING

Do spousal RRSPs have a future now that tax rules have changed?

By Jamie Golombek

HALLOWEEN 2006 may go down as the historic day on which Federal Finance Minister Jim Flaherty decided to impose a tax on income trusts, thus finally levelling the playing field between corporations and income trusts. But the day may also be remembered for another announcement—Canadian seniors have the ability to income-split pensions, beginning in 2007.

Under Canadian tax law, each individual files his or her own tax return and is taxed on the income he or she earns on an individual basis. The United States, on the other hand, allows the filing of joint returns in which both spouses can choose to pool their incomes on the same return, with higher joint tax brackets for the couple than for a single.

Since we have a progressive tax system in Canada, the more you make, the higher your tax rate is. This has always been a source of concern for senior couples, where one spouse receives a pension while the other has very little income. The couple would be far better off and pay significantly less tax if the pension income, which is being used to support the couple jointly, could be split between both partners' tax returns.

The New Rules

According to the Department of Finance, the ability to split pension income will provide over $1 billion of new tax relief annually for Canadians. Under the new rules, any Canadian resident who receives income that qualifies for the existing pension income tax credit, will be entitled to allocate up to one-half of their qualifying pension income to their resident spouse or common-law partner. (For more on the pension income credit, see page 11 of the July issue of *Advisor's Edge*.)

So, what is pension income? The definition mirrors the definition of pension income for purposes of the newly doubled $2,000 pension income credit. Specifically, for Canadians who are 65 years and over, eligible pension income will include lifetime annuity payments under an RRSP, RPP or a deferred profit-sharing plan, as well as any payments out of a RRIF. For those under 65, eligible pension income will only include lifetime annuity payments under an RPP, and certain other payments received as a result of the death of the individual's spouse or partner.

Pension splitting will work as follows: Any pension income that one spouse chooses to allocate to his or her spouse may be simply deducted from the income of the spouse or partner who actually received the income and included on the other's tax return. Obviously, both partners must agree to the allocation in their tax returns for the particular year in question.

The new rules will likely not herald the death of spousal RRSPs.

The election to split will be made one year at a time and can be changed or modified each tax year, depending on financial circumstances and planning needs.

Let's explore a number of planning opportunities for clients.

OAS Clawback Planning

Although details of the new pension splitting regime were sparse, it is widely believed the pension income being transferred would qualify for the $2,000 pension income credit in the hands of the transferee spouse. It would also be included in an individual's net income for the purposes of determining any clawback of the OAS benefits.

The OAS clawback, which only affects about 3% of eligible Canadian seniors, kicks in at net income greater than $62,144 in 2006 and is fully clawed back when net income reaches $101,031. These amounts are fully indexed to inflation, so the 2007 amounts are at this time still unknown.

The new possibility of being able to split pension income in 2007 may be extremely beneficial for clients who are subject to the OAS clawbacks. So pension income that pushes an individual above $62,144 (indexed for 2007) could now potentially be transferred to a lower-income spouse or partner's return, thus preserving OAS payments.

Future of Spousal RRSPs

Perhaps the biggest uncertainty is what happens to spousal RRSPs. Will they still exist? Will they still be needed

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and, if so, why and in what capacity?

As a quick refresher, a spousal (or common-law partner) RRSP is an RRSP where one spouse or partner has contributed and the other spouse or partner is the annuitant or owner of the plan. It is often used by spouses to accomplish post-retirement income splitting so withdrawn funds 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.

The new rules will likely not herald the death of spousal RRSPs, primarily due to the definition of pension income, as described earlier. 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.

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So anyone who wants to retire before age 65 and does not have an RPP should still consider the use of spousal RRSP contributions which 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.

Note that the rules, as currently proposed, tend to discriminate against Canadians who save for retirement through RRSPs instead of those who save through traditional, employer-sponsored RPPs.

The reason is that RPP income recipients will be allowed to income-split at any age, whereas RRSP annuitants must wait until age 65. Unless these rules are changed, spousal RRSPs will still play an important role for those wishing to retire early (i.e. before 65), and split income.

They will also continue to play a role where an individual may wish to split more than 50% of her pension income. With a spousal RRSP, she could theoretically split up to 100% of her RRSP income with a lower-income spouse or partner. This may still be advantageous to some couples,

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depending on their individual retirement incomes and tax brackets.

Contributors Over 69

Spousal RRSPs may also play a critical role in financial planning for clients who are over age 69—the age at which they can no longer have an RRSP in their own name. That, however, doesn't mean these clients can't continue to contribute to a spousal RRSP if they continue to have RRSP contribution room beyond age 69.

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

Home Buyer's Plan Withdrawals

Spousal RRSPs can also be for younger couples looking to save up enough money for a down payment on their first home. Often, the only savings they may have are in RRSPs. Let's say one spouse is working while the other is either in school or perhaps staying at home looking after young children. 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 the savings for the new home. Then each could withdraw $20,000 under the HBP—something that could not be achieved without a spousal RRSP.

Post-Death RRSP Contribution

Finally, the spousal RRSP will still play a role in a situation where an individual dies with unused RRSP contribution room. In that scenario, the executor or estate representative can make an RRSP contribution to a surviving spouse or partner's spousal RRSP and obtain one final RRSP deduction on the deceased's terminal return.

As we can see, spousal RRSPs can still be effective notwithstanding the new pension-splitting rules. AE

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