

Making the Most of Pension Income Splitting

Unlike contributing to a registered retirement savings plan (RRSP) or claiming the new home renovation tax credit, the idea of splitting pension income to reduce taxes doesn't get a lot of attention in the media. That's unfortunate for a couple of reasons. First, the splitting of pension income can provide significant tax savings to those able to utilize it, and those are generally older taxpayers, who in many cases are living on a fixed income and can really benefit from the tax savings received. Second, unless you're receiving good tax planning advice, it's very easy to overlook pension income splitting as a way of reducing your tax burden. The only references to pension income splitting on the annual return are two entries, one on line 116 and the other on line 210, and unless you are already aware of the significance of those entries, there's really nothing to alert you to it. In addition, the form that must be filed to effect a pension income-splitting strategy isn't part of the standard tax return package provided to taxpayers by the CRA – taxpayers must obtain it separately.

The ability to split pension income has been available for a few years now, having first been announced by the Department of Finance in the fall of 2006. The general rule is that taxpayers receiving private pension income (including a pension received from a former employer and, where the recipient taxpayer is over the age of 65, payments from a registered retirement savings plan or a registered retirement income fund) are entitled, beginning with the 2007 tax year, to split up to half that income with a spouse for tax purposes. (Government-source pension income, like payments from the Canada Pension Plan or Old Age Security payments, do not qualify for pension income splitting). Since then, a number of provinces have indicated that they will adopt the federal proposals for provincial tax purposes.

While the concept and general rules governing pension income splitting aren't particularly complex, the splitting of pension income has some fairly wide-ranging, beneficial tax consequences for the taxpayer and his or her spouse.

How to elect to split pension income

The mechanics of pension income splitting are relatively simple. There is no need to make any change in the actual payment or receipt of qualifying pension amounts, and no need to notify the pension plan administrator. In addition, the decision of whether and to what extent to split pension income for tax purposes does not have to be made until the return for the year is filed (for 2009 returns, the spring of 2010). Taxpayers who wish to split eligible pension income received by either of them must file Form T1032, Joint Election to Split Pension Income, with their annual tax return, and the form is available on the CRA Web site at <http://www.cra-arc.gc.ca/E/pgb/ff/t1032/t1032-08e.pdf>. On the T1032, the taxpayer receiving the private pension income and the spouse with whom part of 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 do.

In addition to filing the T1032, the spouse who actually receives the pension income must deduct from income the pension income amount allocated to his or her spouse, 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.

As well as reporting the pension income "received" and claiming the corollary deduction on lines 116 and 210, there's a requirement that, where tax has been withheld from the income to be split, that tax must be allocated on the return for the year in the same proportion as the pension income is allocated. The formula for doing so is outlined in Part 5 of Form 1213.

Effect of pension income splitting on eligibility for other federal credits and benefits

Eligibility for a number of federal tax credits and benefits is based, in whole or in part, on a taxpayer's net income or on family net income. Once pension income is split, the net income of the pension recipient spouse will be reduced while the net income of the spouse with whom the income is split increases. Consequently, where eligibility for a particular federal tax credit (the GST/HST, for example) is based on family net income, splitting of pension income will have no impact on either eligibility or amount received, since overall family net income is unchanged. Where, however, a tax credit or benefit is calculated based on one individual's net income, the splitting of pension income can create real benefits.

For couples over the age of 65, the ability to minimize or eliminate any clawback of Old Age Security Benefits through pension income splitting can be significant. Most Canadians are eligible to receive such benefits, which can reach about \$500 per month, after they turn 65 years of age. However, taxpayers who have net income of more than about \$66,000 (for 2009, with the amount indexed annually) have their benefits reduced, or "clawed back". The clawback rate is 15 per cent of net income over the threshold amount of \$66,000. Taxpayers having income of more than about \$105,000 receive no benefits at all.

As an example of the benefits that can be realized, take the situation of the couple where one spouse has annual retirement income of \$85,000, from various sources, including eligible pension income, and the other has no private retirement income at all, only Canada Pension Plan and Old Age Security benefits. At those income levels, the lower income spouse would have full OAS entitlement, but the spouse with the higher income would lose just under half of OAS benefits. If eligible pension income is split such that both spouses have income below \$66,000, both would enjoy full OAS entitlement, amounting to about \$12,000 for the year. Absent pension income splitting, the couples' total OAS entitlement for year would have been just over \$9,000.

Finally, taxpayers receiving private pension income can claim a non-refundable federal tax credit of up to \$2,000 on their returns for the year. The actual credit claimable is equal to the amount of qualifying pension income earned or \$2,000, whichever is less. The CRA has confirmed that where pension income is split, the amount of such income reported for tax purposes by each spouse will be used to determine eligibility for and the amount of any pension income credit. For example, where a taxpayer who receives \$10,000 in eligible pension income for the year allocates 50 per cent of that amount, or \$5,000, to a spouse, both spouses will be able to claim the full \$2,000 pension tax credit on their return for the year the income is reported.

The ability to split pension income between spouses has the potential to achieve real and permanent tax savings and to enhance eligibility for certain federal tax credits and benefits. And as long as the administrative requirements outlined above are followed, pension income splitting is a win-win opportunity for eligible taxpayers.

The CRA has made an effort to provide information to taxpayers who might qualify for such pension income splitting, as well as tax information of interest to taxpayers over the age of 65 generally, through its Web site. That information, which includes links to relevant government forms and publications, can be found on the Web site at <http://www.cra-arc.gc.ca/tx/ndvdl/tpcs/pnsn-splt/menu-eng.html>.