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## Splitting Pension Income: Enhanced Savings for Senior Citizens

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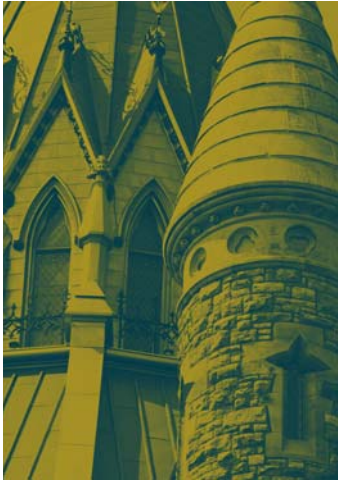
On October 31, 2006, federal Finance Minister Jim Flaherty caught the investment community off guard with his announcement that distributions from most publicly traded flow-through entities, including income trusts, would soon be taxed. This well-publicized proposal spooked many people in the country, especially senior citizens, given that income trusts have been a popular investment vehicle due to their regular distributions of income and attractive rates. However, the Minister tempered his news by announcing on the same day that the government would significantly increase the extent to which pension income can be split between spouses and between common-law couples.

Under the current tax system, each taxpayer is required to report the income that he or she earns every calendar year and to pay tax on it at graduated tax rates. This means that the lowest federal tax rate of 15.25% applies to the first approximately \$36,000 of income earned, a higher rate applies to the next \$36,000 of income earned, and the highest rate of 29% applies to income earned in excess of approximately \$118,000.<sup>1</sup> If one spouse earns enough income so that much of it is taxed at the highest or higher rates, and the other spouse earns little or no income, income splitting would clearly be beneficial: more income could be taxed at the lower rates, thereby achieving overall tax savings for a couple. Currently, income splitting for seniors is generally limited to Canada Pension Plan income and to withdrawals made under a spousal registered retirement savings plan ("RRSP").<sup>2</sup>

The Minister announced proposals that, beginning in 2007, any Canadian resident who receives income that qualifies for the

pension income tax credit can allocate a maximum of 50% of that income to his or her spouse or common-law partner, provided the spouse or common-law partner is also a Canadian resident.<sup>3</sup> Income that will be eligible for splitting for individuals aged 65 and older will include lifetime annuity payments under a registered pension plan, an RRSP plan, or a deferred profit-sharing plan, and payments out of a registered retirement income fund ("RRIF"). For individuals under the age of 65, eligible income will include lifetime annuity payments under a registered pension plan and certain other payments received as a result of the death of the individual's spouse or common-law partner. In addition, the Minister announced that the age tax credit, which is a direct reduction to the amount of income tax payable and is applicable to Canadian residents age 65 and older, will be increased retroactive to January 1, 2006. For 2006, this means additional federal tax savings of approximately \$152.50 for those Canadians eligible to receive the credit.<sup>4</sup>

As an example, consider Mr. and Mrs. Jones. Mr. Jones is 72 years old and is expected to earn about \$200,000 in income in 2007, of which \$120,000 is attributable to RRIF income. Mrs. Jones, age 68, is only expected to earn \$10,000 of pension income.<sup>5</sup> The following table illustrates the benefit of the enhanced pension income splitting proposal if Mr. Jones allocates \$60,000, or 50% of his RRIF income, to his wife. (Note that only federal rates are used in the example below. The applicable provincial rates would also need to be considered in addition to the federal rates of tax. As of November 10, 2006, none of the provinces have commented on whether they will adopt a similar proposal.)



## Benefits of Proposed Changes to Income Splitting

### No Pension Income Splitting

	<u>Mr. Jones</u>	<u>Mrs. Jones</u>
Net Income	\$200,000	\$10,000
Tax, at graduated rates <sup>6</sup>	49,176	1,550
Less: applicable tax credits <sup>7</sup>	(1,696)	(1,550)
Net tax payable	47,480	0

Total estimated federal tax payable for Mr. and Mrs. Jones: \$47,480

### Pension Income Splitting

	<u>Mr. Jones</u>	<u>Mrs. Jones</u>
Net Income	\$140,000	\$70,000
Tax, at graduated rates	31,776	13,036
Less: applicable tax credits	(1,696)	(1,696)
Net tax payable	30,080	11,340

Total estimated federal tax payable for Mr. and Mrs. Jones: \$41,420

Estimated tax savings achieved through pension income splitting: \$6,060

- <sup>1</sup> Rates apply to the 2006 tax year. The tax rates are lower on dividend income earned from taxable Canadian corporations and for capital gains realized on the disposition of capital property such as shares and bonds.
- <sup>2</sup> Spousal RRSP plans, though, must be collapsed by the end of the year in which the annuitant (recipient) reaches the age of 69.
- <sup>3</sup> Spousal RRSPs would still be useful under the new pension income-splitting rules, as the 50% limit does not apply to income withdrawn under this plan and taxed in the hands of the annuitant.
- <sup>4</sup> The age tax credit will increase from \$620 (\$4,066 x 15.25% tax rate) to \$772.50 in 2006. The age tax credit begins to be 'clawed' back for net income in excess of \$30,270 in 2006 and is phased out completely when net income reaches \$64,043.
- <sup>5</sup> For simplicity, assume no CPP or OAS income.
- <sup>6</sup> Incorporates increase in 2007 of lowest federal tax rate to 15.5%. Tax brackets based on 2006 figures. Brackets are indexed to inflation and, therefore, actual brackets for 2007 will consist of slightly higher amounts, once determined.
- <sup>7</sup> Basic Credit of \$8,939 for 2007 plus pension credit of \$2,000, both tax effected at 15.5%. Age credit is clawed back to nil for Mr. Jones, and is utilized for Mrs. Jones to eliminate any remaining tax payable balance. Under the pension income splitting example, age credit is clawed back to nil for both Mr. and Mrs. Jones.

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