Divide and prosper

Splitting your retirement income to reduce taxes

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Are you retired? About to retire? Starting in 2007, there are a number of new ways that you can take advantage of splitting retirement income with your partner or spouse. Depending on the differences in your incomes, you may be able to increase your joint after-tax income by several thousand dollars a year.

What is income splitting and how does it work?

Income splitting is designed to take some of the sting out of Canada's progressive income tax system. Normally, the more income you make, the more tax you pay. But when you transfer some of your income to a spouse or common-law partner who makes less, your taxes can decline without adding greatly to your partner's tax bill. Overall, the two of you can end up paying much less tax.

New ways you can save

The 2007 federal Budget provides the following tax-saving opportunities to you:

- Starting this year, you can split up to 50% of your company pension (RPP) benefits with your partner – without any age restriction.
- Once you're 65 or older, you can split up to 50% of the payments from a Registered Retirement Income Fund (RRIF), Lifetime Income Fund (LIF) or Registered Retirement Savings Plan (RRSP) annuity with your lower-income partner.
- When splitting company pension benefits or payments from a RRIF, LIF or RRSP annuity, both partners can claim the pension credit. This credit has just been doubled to $2,000 a year.

In addition to these new opportunities, you can also split Canada or Quebec Pension Plan (CPP/QPP) payments once both of you are 60, to the extent that the benefits were accumulated while you and your partner were living together.

But keep your spousal RRSP

Pension income splitting doesn't mean you should forget spousal RRSPs.

In a spousal RRSP, the partner with the higher income contributes to an RRSP for the lower-income spouse. The advantage? You get the tax deduction now. After a minimum of three years, your partner is entitled to withdraw funds. Once you're retired, taking income from two RRSPs rather than one can result in a lower tax bill overall. And with a spousal RRSP, income splitting can start before 65.

By comparison, the new retirement income-splitting rules aren't as generous. There's a 50% limit on income splitting for pensions and non-spousal RRSPs – and you have to wait until you are 65 to do the latter. So it's still worthwhile to make contributions to a spousal RRSP. If you don't already have one, you may want to consider setting one up.

Are you 65 or older? Some added benefits

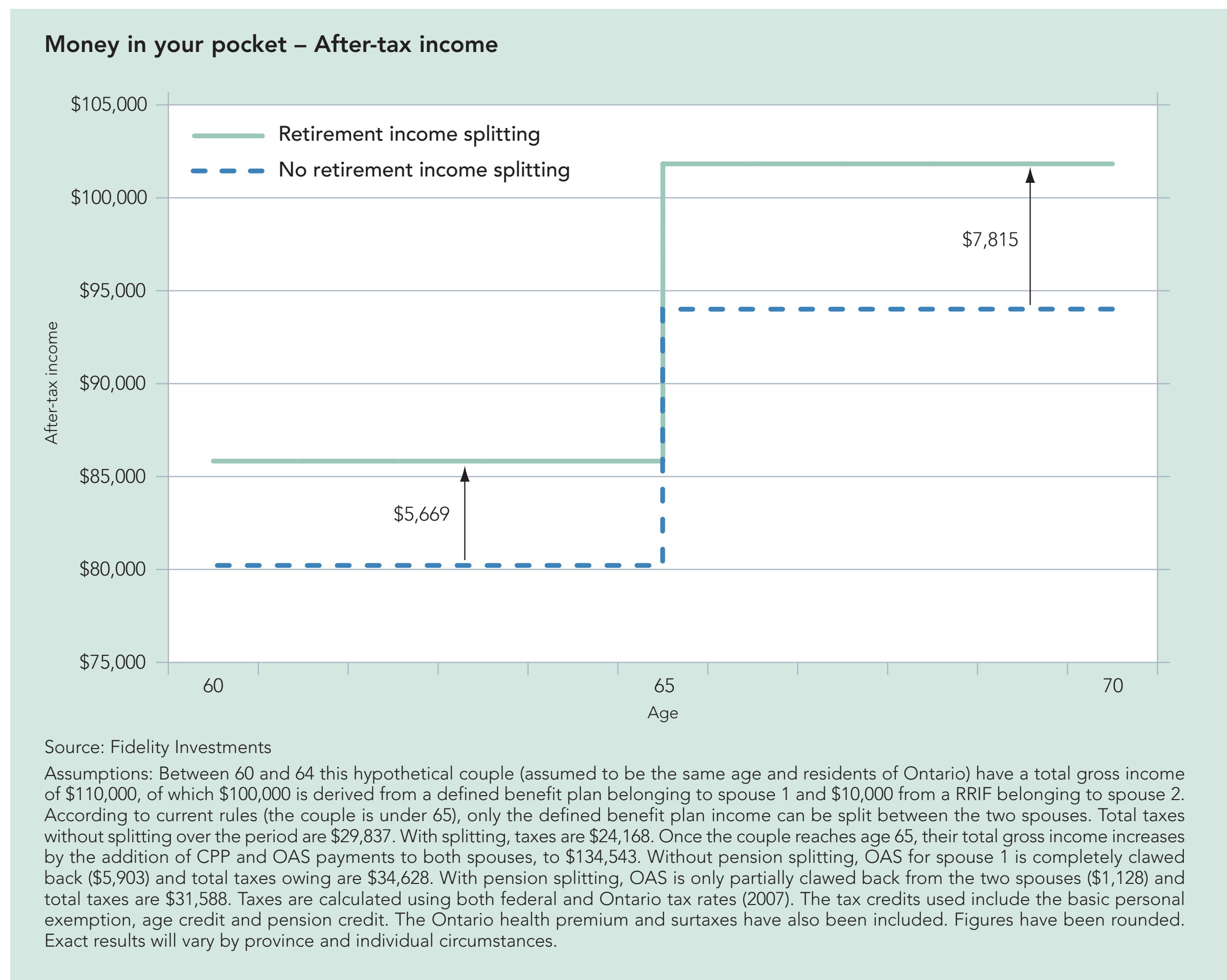
If you and your partner are 65 or older, retirement income splitting can enhance the use of the age credit. This is a special tax credit that applies to as much as $5,066 of your income. It's primarily designed to provide tax relief to low- and middle-income seniors, and once your income exceeds the $30,936 threshold, the credit starts to get clawed back. The benefit, however, is that if you don't use all of your age credit, you can transfer the remaining portion to a lower-income partner. It could mean hundreds of dollars in tax relief.

In the case of Old Age Security (OAS), income splitting can help you avoid a clawback altogether. If you can use splitting to keep you and your partner's income below the $63,511 threshold, you will receive your maximum OAS household benefit.

It makes a difference!

While every couple's circumstances are different, income splitting under the new rules, coupled with existing splitting opportunities, has the potential to give you thousands of dollars in annual tax savings through retirement.

As an example, the chart below shows how pension splitting can benefit a couple who retire at 60 but wait until 65 to begin taking CPP. They have an income of $100,000 from one partner's pension plan and $10,000 from the other partner's RRIF. By splitting the income from the pension plan, they are already saving on tax. At 65, when they begin receiving CPP and OAS, they save even more.



Source: Fidelity Investments

Assumptions: Between 60 and 64 this hypothetical couple (assumed to be the same age and residents of Ontario) have a total gross income of $110,000, of which $100,000 is derived from a defined benefit plan belonging to spouse 1 and $10,000 from a RRIF belonging to spouse 2. According to current rules (the couple is under 65), only the defined benefit plan income can be split between the two spouses. Total taxes without splitting over the period are $29,837. With splitting, taxes are $24,168. Once the couple reaches age 65, their total gross income increases by the addition of CPP and OAS payments to both spouses, to $134,543. Without pension splitting, OAS for spouse 1 is completely clawed back ($5,903) and total taxes owing are $34,628. With pension splitting, OAS is only partially clawed back from the two spouses ($1,128) and total taxes are $31,588. Taxes are calculated using both federal and Ontario tax rates (2007). The tax credits used include the basic personal exemption, age credit and pension credit. The Ontario health premium and surtaxes have also been included. Figures have been rounded. Exact results will vary by province and individual circumstances.

The next steps

Talk to your financial advisor for more details and to determine which of your sources of income are eligible for retirement income splitting. Then you will need to make a request on your income tax return, specifying the portion of pension income that you wish to split. (You can change this arrangement each year to suit your needs.) Remember that to get the best possible tax savings from the new income-splitting opportunities, it's best to plan in advance. Spousal RRSPs should also be set up many years before you retire.

If you intend to split public pension benefits, you'll have to contact the Department of Human Resources and Social Development (*www.sdc.gc.ca*) for the CPP and the Régie des rentes du Québec (*www.rrq.gouv.qc.ca*) for the QPP.

It's part of your plan

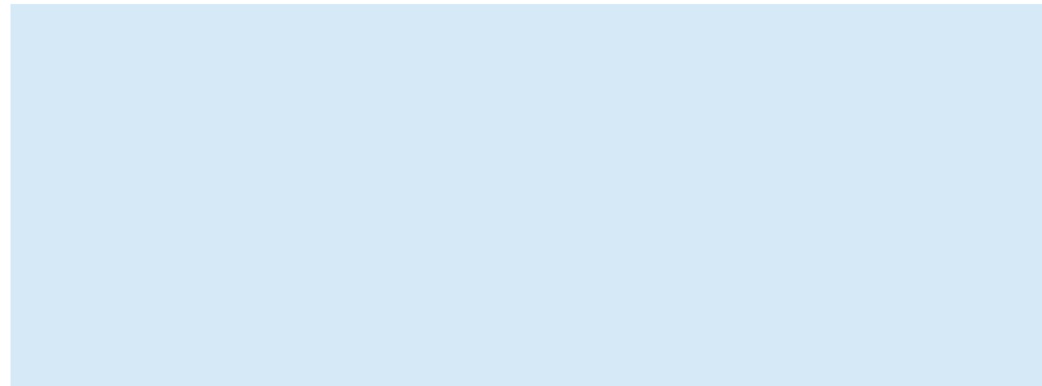
Retirement income splitting is just one of the ways you can reduce taxes. It can be an effective part of your lifetime retirement income strategy, but it's only one part.

These new measures must be balanced against several other important decisions, such as when to take benefits and how fast you should draw down savings.

By looking at all these issues and the ways they interact, you, your financial advisor and your tax advisor can create a complete retirement income plan.

The sooner you get started the better. After all, you have nothing to lose but taxes owing.

Talk to your advisor.



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