

Do Spousal RRSPs Have A Role To Play?

By Jamie Golombek, Managing Director, Tax & Estate Planning, CIBC Private Wealth Management

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 an individual makes, the higher the 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. This is an option under Canadian tax law.

Pension income

Any Canadian resident who receives income that qualifies for the existing pension income tax credit, can allocate up to one-half of their qualifying pension income to their resident spouse or common-law partner. So, what is pension income? The definition mirrors the definition of pension income for purposes of the \$2,000 pension income amount. Specifically, for Canadians who are 65 years and over, eligible pension income includes 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 age 65, eligible pension income includes lifetime annuity payments under an RPP, and certain other payments received as a result of the death of the individual's spouse or partner. Old Age Security and Canada Pension Plan payments are not eligible pension income.

Pension splitting works as follows: the 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 receives 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 election to split can 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

Under pension splitting rules, pension income being transferred qualifies for the \$2,000 pension income credit in the hands of the transferee spouse. It is also included in an individual's net income for the purposes of determining any clawback of OAS benefits. The OAS clawback, which only affects about 3% of eligible Canadian seniors, kicks in at net income greater than \$67,668 in 2011 and is fully clawed back when net income reaches \$109,764. The ability to split pension income is extremely beneficial for clients who are subject to OAS clawbacks. Pension income that pushes an individual above \$67,668 (for 2011) can be transferred to a lower-income spouse or partner's return, thus preserving OAS payments.

Spousal RRSPs

So how do these rules affect spousal RRSPs? Are they still needed 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 to the plan 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 have not heralded the death of spousal RRSPs, primarily due to the definition of pension income, as described earlier.

Remember, if an individual is under 65, eligible pension income typically only includes payments from an RPP and will not generally include amounts paid from an RRSP or RRIF. 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.

The rules still 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 are 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, depending on their individual retirement incomes and tax brackets.

Contributors over 71

Spousal RRSPs may also play a critical role in financial planning for clients who are over age 71 – 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 71. 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 72. And keep in mind they don't necessarily have to be working to have earned income. They may 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 useful 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 \$25,000 to his or her own RRSP and then contribute \$25,000 to a spousal RRSP, while building up the savings for the new home. Then each could withdraw \$25,000 under the HBP – something that could not be achieved without a spousal RRSP.

Post-death RRSP contribution

Finally, the spousal RRSP still plays a role in a situation where an individual dies with unused RRSP contribution room. In that scenario, assuming the will permits it, 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.

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