Splitting pension income is no cure-all:

There is still a place for spousal RRSPs

by Jamie Golombek, November 4, 2006

With the financial community's attention and energy this week spent mourning the fate of income trusts, the government's announcement it would allow pension income-splitting, beginning in 2007, took a back seat in the headlines.

Under Canadian tax law, each individual files his or her own tax return and is taxed on the income they earn on an individual basis. The United States, on the other hand, allows the filing of joint returns in which both spouses can pool their income 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 concern for senior couples when one of them is receiving a pension and the other has little income. The couple would be better off, and pay significantly less tax, if the pension income, which is being used to jointly support the couple, could be split between partners on their tax returns.

On Tuesday, as a possible conciliatory gesture to income trust-reliant seniors, the government announced that such pension-income splitting will be permitted next year, prompting much debate on the future of spousal RRSPs.

A spousal or common-law partner RRSP is any RRSP to which 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 It is often used by spouses to accomplish post-retirement income-splitting: Funds withdrawn from a spousal RRSP are taxed in the hands of the annuitant spouse instead of the contributor spouse.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 substantial tax savings.

So, do the new rules herald the death of spousal RRSPs? Likely not, primarily due to the government's definition of qualifying "pension income" that can be split.

The rules depend not only on the type of pension income, but also on your age.

For example, if you are 65 or older, eligible pension income basically includes any payments from a registered pension plan (RPP), annuity payments out of an RRSP or deferred profit-sharing plan, as well as RRIF withdrawals.

However, if you are under age 65, eligible pension income typically only includes payments from an RPP – not amounts paid from an RRSP or RRIF.

Thus, as financial writer and author Bruce Cohen points out, "those intending to retire before 65 should still consider spousal RRSP contributions," which would ultimately allow RRSP withdrawals to be taxed in a lower-income spouse's hands without having to wait until age 65.

"This is poor public policy," says Malcolm Hamilton of Mercer Human Resource Consulting, explaining that it treats those who receive a pension from an RPP more favourably than those who save for themselves through an RRSP. In other words, RPP-income recipients will be allowed to income split at any age versus RRSP annuitants, who must wait until age 65.

Instead, Hamilton would like to see a common age, say 55, at which time participants in either an RPP or RRSP would be entitled to split their pensions. Unless the rules are changed, however, spousal RRSPs will still play an important role for those wishing to retire early. As always, careful financial planning is necessary.

Since we have a progressive tax system in Canada, the more you make, the higher your tax rate is.