

Reduce taxes with income-splitting

Many couples are not aware of the full range of options when it comes to splitting income, both before and after retirement. Good planning can significantly increase their combined income

BY WENDY CUTHBERT



LIVING WELL IN RETIREMENT CAN often be a matter of making full use of strategies that reduce taxes for those clients on fixed incomes. Splitting income with a spouse who is in a lower tax bracket remains a key strategy for accomplishing this goal. The ways to do so include splitting pension income, spousal RRSPs, investment loans and tax-free savings accounts. Such strategies can greatly reduce a couple's overall tax bill.

Pension income-splitting, introduced in 2007, is popular. Under this strategy, a pensioner receives his or her pension as usual but, at tax time, the couple can choose how much of that pension income — up to half is permitted — to transfer to the low- or no-income spouse. The result reduces the total taxes the couple pays on the income.

In addition, according to Carol Bezaire, vice president, tax and estate planning, at Toronto-based **Mackenzie Financial Corp.**, depending on individual tax brackets, this strategy may allow the couple to avoid the clawback on old-age security. This year, the clawback, which gradually reduces the OAS payment as income increases, starts to kick in at income above \$66,733, with full clawback at \$108,090.

Pension income-splitting is also useful to maximize the use of federal and provincial pension income tax credits, which are non-refundable tax credits used to offset taxes paid. Before 2007, only the pensioner could receive these credits. Now that pension income can be split, both spouses can claim each credit, potentially doubling the tax savings. For instance, in 2010, the federal pension credit is \$2,000. That can be doubled to \$4,000 for pension-splitters over age 65, meaning they would each save \$300 in taxes based on a 15% tax rate.

Bezaire says the choice of whether to split pension income, and by how much, can be revisited every year, depending on the circumstances facing each couple. However, clients with defined-contribution pension plans must wait until age 65 to use this strategy. Beneficiaries of defined-benefit pension plans can split their pension income whenever they begin to receive it. CPP income can also be split, but spouses must make this election when they begin receiving CPP and it is permanent.

In addition, spousal RRSPs are a choice for couples in which one spouse earns less than the other, says Bezaire. Spousal RRSPs allow the higher-earning spouse to

contribute to an RRSP in the lower-income spouse's name so that, when withdrawals begin, the person in the lower tax bracket pays the taxes on the withdrawals.

Spousal RRSPs also offer more flexibility when it comes to income-splitting. RRSPs are accessible even before the official retirement age of 65, so they can be used by couples to fill income gaps created if the higher-income earner stops working, by choice or otherwise, before age 65, according to Tina Di Vito, head of Toronto-based **Bank of Montreal's** Retirement Institute.

Spousal RRSPs can also be useful if the partners are different ages. If one spouse is 71, he or she has no choice but to collapse his or her RRSP. Those assets can be rolled into a RRIIF to reduce taxes no later than age 71, but minimum withdrawals must begin at age 72. Having a spousal RRSP in the younger spouse's name means the RRSP's assets can grow for a longer period, deferring withdrawals and conversion to a RRIIF as long as possible. (See story on page B13.)

Another, increasingly popular way to split income is to use a spousal loan. With interest rates at historical lows, the timing for this vehicle could not be better. Using this method, the higher-income spouse loans

money to the lower-income spouse to purchase assets that generate investment income; these can include stocks, bonds, property or a private business. To avoid the attribution rules, interest on the loan must be deductible as a business expense. To establish the "business" relationship, careful records of documents showing that the loan is formally structured, such as annual payment of the interest, must be kept. Income from the purchased assets accrues to the purchaser/lower-income spouse, reducing the couple's overall taxes. The lower-income spouse can also deduct the interest paid. And although the lender/higher-income spouse must include the interest received in his or her taxable income, at rates like 1%, such amounts will be relatively low.

Couples can also use TFSAs to split income. The higher-income earner can fund a spouse's TFSAs. There are no attribution rules and each spouse may contribute up to \$5,000 each year, with all growth of assets remaining tax-free. As of Jan. 1, 2011, a couple who has put nothing into TFSAs can deposit \$15,000 each, Bezaire says. "If you invest that in dividend-paying stocks and securities or holdings you like, you can make that thing sing for you."