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Financial Focus

Becker Orr Wealth Management

July 2020

Income Splitting

By Clinton Orr

Reducing your tax bill in retirement can have a significant impact on your retirement budget. While minimizing tax and putting more of your retirement savings into your pocket is a worthwhile goal, it takes a proper plan to ensure that goal is achieved. One tool we often use to minimize tax in retirement is income splitting. We will look at a couple of ways retirees can split income.

In 2007 the federal government introduced pension income splitting. Since then couples have been able to pool their pension income and put half on each of their tax returns. So even if one individual earns the bulk of the pension income, from a tax perspective, they can shift up to 50% of that income to their spouse. The result is that the higher income spouse will end up in a lower income tax bracket and the couple, overall, will pay less tax.

Pension income splitting is a fantastic tax saving tool, however there are a few wrinkles. For starters it only applies to pension income. Income earned through employment, for example, does not qualify. As well, if you are drawing on your investments, the type of account makes a difference. Withdrawals from a RRSP do not count as pension income. However, if you convert that RRSP into a RRIF, withdrawals from a RRIF qualify as pension income. Income from CPP and OAS do not qualify as pension income.

There is also an age restriction. If you are fortunate enough to have a defined benefit plan through work, you can split income from that pension after the age of 55. However, if you are drawing on your RRIF, that income only qualifies as pension income if you are over the age of 65. Prior to 65, withdrawals from your RRIF cannot be split and must be listed as income on your tax return. It is worth noting that your spouse does not have to be 65, for example if you are 66 and your spouse is 64, you can pull money from your RRIF, it will count as pension income and can be split. The receiving spouse does not have to be 65 years of age or older to receive an allocation.

Clinton Orr
Vice President, Investment Advisor & Portfolio Manager
T: 204.259.2860
Beausejour: 204.205.0101
corr@cgf.com

Kevin Becker
Investment Advisor & Portfolio Manager
T: 204.259.2863
TF: 1.877.259.2888
kbecker@cgf.com

Alicia Roache
Investment Advisor Assistant (Licensed)
T: 204.259.2851
asroache@cgf.com

Maricar Irwin
Investment Associate
T: 204.259.2861
mirwin@cgf.com

Adam Buss
Wealth & Estate Planning Specialist
T: 204.259.2865
abuss@cgf.com

Canaccord Genuity Wealth Management
1010-201 Portage Avenue,
Winnipeg, MB R3B 3K6
beckerorr.com

If we don't have a defined benefit pension through work and are under 65, what can we do? There are still a few tools we can use. First, we can use spousal RRSPs. A spousal RRSP does not add a lot of value after the age of 65, however prior to 65 it can be a means of income splitting. A spousal RSRP allows one spouse to contribute to the RRSP of the other and still receive a tax deduction. The goal is that by retirement the RRSPs will be roughly the same value. That way if you and your partner retire prior to 65, you can each draw from your own RRSP and the retirement income will be divided amongst your two tax returns.

A second option for income splitting prior to 65, is sharing your CPP. You can take your CPP as early as 60. When to take your CPP is a topic for another article, for this example let's assume you and your partner decided to take it at 60. In this case the two of you can apply to share your CPP benefit. Sharing makes the most sense if one spouse receives a much larger CPP than the other. Sharing will even that out, the total CPP will be split, so each spouse receives about the same.
No one likes to pay too much tax, the key to minimizing that burden is to plan. Work with your accountant and financial professionals to see if the above tools will fit your situation.

Clinton Orr B.Comm (hons.), CIM, CFP, DMS, FMA lives in Beausejour and is a vice president and portfolio manager with Canaccord Genuity Wealth Management.