Pension income splitting versus spousal RRSPs

Determining when each tax strategy works best.

PENSION INCOME SPLITTING CAN BE A GREAT WAY to reduce taxes. Couples can split their income once their Registered Retirement Savings Plans (RRSPs) become Registered Retirement Income Funds (RRIFs). The rules allow a pensioner to transfer up to one half of his or her eligible pension income to a spouse.[1] Sounds great, right? So why keep that spousal RRSP? Spousal RRSPs may still offer some advantages, particularly if one spouse earns significantly more income than the other.

Income splitting with a RRIF

Under the pension income splitting rules, you must be at least age 65 and convert your RRSP into a RRIF in order to split income. Regular RRSP withdrawals do not qualify for pension income splitting. For people who retire early, a spousal RRSP provides more flexibility. This is because you choose how much to contribute to the spousal RRSP, which has the potential to equalize retirement income and save taxes.

Contribution strategies

It's important to remember that spousal RRSPs have a three-year rule: if funds are withdrawn from a spousal RRSP within three calendar years of a contribution (the income attribution period), all or part of the income could be taxed to the contributor spouse. It is usually best to make spousal contributions within the calendar year, instead of during the first 60 days of the following year. For example, if a spousal contribution is made in February 2018 for the 2017 tax year, the contributor spouse would be taxed, all or in part, on withdrawals made before January 1, 2021 (provided no further spousal contributions are made). However, if the contribution were made before December 31, 2017, the contributor spouse would be taxed, all or in part, only on withdrawals made before January 1, 2020.

If you are making contributions regularly, another strategy is to wait until you have three years' worth of RRSP room, then make the full contribution all at once and deduct it over the next three years. At the end of the three-year income attribution period, your spouse could make a withdrawal and you, as the contributor spouse, would not be taxed. The following year, you could make another lump-sum deposit that maximizes all your unused RRSP room. Because the attribution rules are applied based

[1] The terms "spouse" and "spousal" include a spouse or common-law partner as defined by the the Income Tax Act (Canada).

on when the contribution was made, not deducted, this plan provides you with a decision window every three years – to withdraw or to contribute. This strategy does have a couple of downsides: lost investment gains because of the delayed contributions, and lost RRSP contribution room, since RRSP/RRIF withdrawals cannot be recontributed like TFSA withdrawals can.

Not restricted to 50 per cent

After age 65, you can split up to 50 per cent of your RRIF income with your spouse. With spousal RRSPs, in contrast, you determine the amount of income to split by deciding how much to contribute to the spousal RRSP.[2] This is helpful if your goal is to have equal incomes in retirement and keep your tax bill as low as possible.

Another plus

Although you can't contribute to your own RRSP after age 71, you can make contributions to your younger spouse's RRSP until the end of the year your spouse turns 71, provided you still have RRSP room. The income from those RRSP contributions can also be delayed until the year after your spouse's 71st birthday.

Take advantage of unused room at death

If you have unused RRSP room at the time of your death and your spouse didn't turn 71 the previous year, your executor could reduce the taxes paid by your estate by contributing to a spousal RRSP.

Take action

The disadvantage of a spousal RRSP, of course, is that a spousal contribution goes into an account held by your spouse and not your own personal RRSP. However, if the values of each spouse's account are roughly equal, income taken from those accounts can also be nearly equal, achieving some income splitting. With pension income splitting, no assets are transferred. You and your spouse just file a joint tax election each year. This also means that you can choose on a yearly basis whether or not income splitting makes sense. The best course of action? Consult with your tax advisor. ■

[2] When a spousal RRSP is converted to a RRIF, the minimum withdrawal is taxed in the annuitant's (account holder's) hands, regardless of the three-year attribution rule. If RRIF withdrawals are greater than the minimum and the three-year rule applies, then the excess withdrawal above the minimum is taxed in the contributor spouse's hands.