TAX LETTER

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SPLITTING PENSION INCOME WITH YOUR SPOUSE

Overview of rules

The Income Tax Act has several rules that combat the splitting of income among family members. However, an important exception applies to certain types of pension income. Back in 2007, the government enacted specific rules to allow spouses and common-law partners to split "eligible pension income". Under these rules, you can split up to 50% of your eligible pension income with your spouse or common-law partner for income tax purposes.

The pension split is made by "joint election", by filing Form T1032 with your tax return for the relevant taxation year. Each year, you can elect to split anywhere between 0% and 50% of your eligible pension income for the year with your spouse, or not elect at all.

In other words, you decide each year whether you want to do the split, and you have the flexibility to change the elected amount each year.

The eligible pension income that is eligible for the split includes:

If you are 65 or over in the year

- Pension annuity income (for example, from a defined benefit pension plan);
- Registered retirement savings plan (RRSP) annuity payments;
- Payments out of a registered retirement income fund (RRIF);
- Periodic payments from a money purchase (defined contribution) pension plan;
- Pension payments from a pooled registered pension plan;
- Annuity payments from a deferred profit sharing plan; and
- Retirement payments out of a retirement compensation arrangement.

If you are under 65 throughout the year, eligible pension income is normally limited to "qualified pension income", which includes the first item above – pension plan annuity income. However, the other amounts also qualify as qualified pension income if you are receiving them as a consequence of the death of a **former** spouse or common-law partner.

Benefits of the split

Making the pension income split is obviously beneficial for you if your spouse is in a lower tax bracket. That is, by shifting the split amount into your spouse's hands at a lower tax rate, you will save overall tax as a couple.

Another benefit of pension income splitting, even if your spouse is not in a lower bracket, is the doubling of the pension tax credit. The federal credit is 15% of up to $2,000 of your eligible pension income (the provincial credit rates vary). As discussed in the section below, your spouse can also qualify for the credit if you make pension income split, which again will result in overall tax savings because you can both claim the credit.

Shifting your pension income can also help if you are subject to the Old Age Security (OAS) "clawback tax". Under that clawback tax, the OAS benefits you receive are clawed back at a rate of 15% of your income over $79,054 (2020 figure, indexed for inflation). If your income is higher than that amount, the pension income split may benefit you since it can reduce the OAS clawback. However, if the split puts your spouse over the threshold OAS amount, you will have to take that into account in determining whether there is an overall tax savings. Fortunately, most tax return software programs do the calculation for you.

Similarly, the age credit, which is available to anyone who is 65 years of age or older, is phased out if your income is over $38,508 and is eliminated entirely when your income reaches $89,421 (2020 figures). The age credit is therefore another factor to take into account, but again, most tax return software will do the math for you.

Doubling up the pension credit

The eligible pension rules apply in terms of your eligibility for the pension credit. If you are 65 years or older, the eligible pension amounts described earlier all qualify for the credit. If you are under 65, only qualified pension income amounts qualify for the credit. The federal credit is 15% of up to $2,000 of the pension income. Provincial credits vary from province to province.

The rules also apply to your spouse if you make the pension income split. The split pension amount is treated as the type of pension income that it would have been in your hands, and then the credit for your spouse may apply depending on their age.

Example

You are 68 years old and receive $60,000 in RRSP annuity payments. You make an election to split 50% of this amount with your spouse. As a result, you include $30,000 in your income and your spouse includes $30,000 in their income.

For reasons noted above, you qualify for the pension credit in respect of $2,000 of this amount because you are over 65.

If your spouse is 65 or over in the year, they will also qualify for the pension credit. However, if they are under 65, they will not get the credit.

Joint liability for tax

Your spouse includes the split pension amount in income, even if they do not actually receive any of it. They also get credit for a proportional amount of any tax withheld from your pension payments. Your spouse is then liable to pay the tax applicable to that amount.

However, you are not off the hook entirely. You are jointly and severally liable with your spouse to pay that tax (for example, if your spouse cannot or does not pay the tax).

Government pensions

The pension income splitting rules in the Income Tax Act do not apply to government pension payments such as the Canada Pension Plan (CPP), Quebec Pension Plan (QPP) or the OAS.

However, under the CPP legislation, you and your spouse can elect to pool your CPP payments and share in the pooled amount equally. In contrast to the pension income splitting rules discussed above, you and your spouse each receive your share of the pooled amount. Each of you reports the amount you receive on your income tax return. As with the pension income split, this can result in overall tax savings for most of the same reasons. Similarly, the QPP in Quebec allows sharing between couples.

LIFE INSURANCE AS COLLATERAL – PREMIUMS MAY BE DEDUCTIBLE

Life insurance premiums are normally not deductible in computing income because they are considered personal expenses.

However, there is an exception, where you (or your corporation) may deduct life insurance premiums. Typically, this will apply when you run a business and go to a bank or other financial institution for a loan. If your business does not have "hard" collateral, the institution may ask for collateral in the form of life insurance on your life (or that of another key employee in the business). Basically, you would assign the insurance policy to the institution as collateral on your loan.

Generally, the premiums will be deductible if the loan is used for the purpose of earning income from a business or property.

However, the deduction for a taxation year is limited to the "net cost of pure insurance in respect of the year". Furthermore, the deduction is limited to the amount "that can reasonably be considered to relate to the

amount owing from time to time during the year… to the institution under the borrowing".

The "net cost of pure insurance" is determined using actuarial principles as described in the Income Tax Act Regulations (your insurance company should be able to provide you with this figure).

In terms of the amount "that can reasonably be considered to relate to the amount owing from time to time during the year" under the loan, the Canada Revenue Agency provides the following example:

Example

You have life insurance coverage under a policy where the death benefit is $500,000. You assign the policy as collateral to a bank for a loan to be used in your business.

The amount owing under the loan throughout the taxation year is $200,000. As such, the deductible amount is equivalent to 40% (200,000 / 500,000) of the lesser of the premiums payable for the year and the net cost of pure insurance under the policy for the year.

CHARITABLE DONATIONS ON DEATH

General rules

The charitable donations tax credit applies to your gifts made to a "qualified donee", which includes registered charities, universities and colleges, and federal, provincial and municipal governments (as well as certain other donees, including registered journalism organizations as of this year). The federal credit equals the total of:

- 15% of the first $200 of donations made in the year;
- 33% of additional donations, to the extent you are in the top tax bracket by having taxable income exceeding $214,368, and
- 29% on donations over $200 that don't qualify for the 33% rate above.

Example

In 2020, you make $20,000 of charitable donations. Your taxable income for the year is $224,368.

Your federal credit is:

- 15% x $200; plus
- 33% x $10,000 (the excess of your taxable income over $214,368); plus
- 29% x the remaining $9,800 of donations.

In addition, you will receive a provincial tax credit. The amount of the provincial credit will vary, depending on your province of residence.

The donation can be claimed in 2020 or carried forward and claimed for any of the next five years.

Rules upon death: Donations by deceased

When a person dies, donations made in the year of death qualify for the credit for the year of death or the immediately preceding year. The deceased person can also claim the credit for the year of death for donations made by the person's spouse or common-law partner in the person's year of death, or for donations made in the previous five years by the person or the spouse or common-law

partner to the extent they have not been otherwise claimed.

However, a donation made by the person's spouse or common-law partner in the year of death cannot be claimed for the taxation year immediately preceding death.

Rules upon death: Donations by will or estate of deceased

A donation made by a deceased person's will or estate, or by a designation under the person's life insurance policy, RRSP, RRIF or TFSA, is deemed to be a donation made by the person's estate at the time the donated property is transferred to the qualified donee.

However, the donation can generally qualify for the donations tax credit for either the deceased person or their estate (which files a separate return as a trust for years after death, until the estate is wound up).

If the donation is made while the estate is a graduated rate estate ("GRE"), the deceased person can claim the credit for the year of death or the immediately preceding year. In most cases, the deceased's estate can qualify as a GRE for up to 36 months after the person's death.

Furthermore, donations made by the estate within 60 months after the death qualify for the deceased's credit for the year of death or the immediately preceding year, if the estate would qualify as a GRE but for the fact that more than 36 months have passed since the individual's death (certain conditions apply). If the donation is made after the 60-month period, the deceased cannot claim the credit.

Alternatively, the GRE can claim the credit for the year that the donation is made or a preceding year of the estate. Additionally, the estate, whether it is a GRE or not, can claim the credit for the year of the donation or any of the five following years.

The credit can be shared or allocated between the deceased person and the GRE for these purposes, but the credit cannot be doubled up. The person's surviving spouse or common-law partner cannot claim the credit for a gift made through the deceased's will or otherwise by the GRE.

Example

John dies in 2020. John's estate qualifies as a GRE. In 2022, the GRE makes a $50,000 donation to a charity.

Options:

The credit for $50,000 of donations can be claimed for John's year of death (i.e. on his terminal return) or the immediately preceding year, or can be split between the two years.

Or the credit can be claimed by the John's estate on its estate (trust) tax return for 2020, 2021, or 2022, or in any of the following five years.

Alternatively, the credit can be split amongst the various options, but the total donations claimed cannot exceed $50,000.

CHARITABLE DONATIONS ON DEATH FOR PUBLICLY-TRADED SECURITIES

When a person makes a gift or donation of property other than cash, the person is normally deemed to receive proceeds of disposition equal to the fair market value of the property. This deeming rule can trigger a taxable capital gain or allowable capital loss, depending on whether the property is worth more or less than its cost.

However, taxable capital gains from the donation of most publicly-traded securities are deemed to be nil and therefore are not included in income. (Similarly, gains from donations of certified ecological property or cultural property are not included in income.)

When you die, there is a rule that provides that your property is deemed to be disposed of for fair market value proceeds (unless it is left to a spouse or common-law partner).

However, if the property is donated, generally within 60 months of death, and qualifies for the donations credit (as described in the preceding article), no taxable capital gain results on death or from the donation. This rule results in a complete tax-free “rollover” both upon your death and on the donation.

DONATIONS MADE BY SPOUSAL TRUSTS AFTER DEATH OF BENEFICIARY SPOUSE

A qualifying spousal trust can be used to defer tax when transferring property from one spouse to the trust in which the other spouse (or common-law partner) is a beneficiary. Normally, you can transfer property into the spousal trust on a tax-free rollover basis. That is, the transfer takes place for proceeds equal to your tax cost of the property, and the trust takes over that same tax cost.

However, when your spouse, the beneficiary of the trust, dies, there is a deemed disposition of the trust properties at their fair market values. Also, the trust is deemed to have a taxation year-end on their death, with a new taxation year beginning immediately thereafter.

Where a charitable donation of this type of spousal trust is made after the taxation year that is deemed to end upon the spouse’s death ("Year X") and by the trust’s filing-due date for Year X, the donations credit can be claimed by the trust in Year X. The filing due-date for Year X is 90 days after the end of the calendar year in which Year X ends. The trust can claim the donations tax credit for Year X for the donation, or alternatively for the year of the donation or the following five years.

FEDERAL BUDGET DELAYED

The Minister of Finance was scheduled to deliver the 2020 Federal Budget on March 30, 2020. However, due to concerns surrounding the COVID-19 virus, the House of Commons has been adjourned to at least April 20, 2020. As a result, the Budget will be delayed. As of the time of writing, a new Budget date had not been announced.

CARRYBACK OF ESTATE CAPITAL LOSSES

When you die, you are deemed to dispose of most of your properties for fair market value

proceeds. The deemed disposition can generate capital gains or losses. The transferee who acquires the property as a consequence of your death gets the property with a deemed cost equal to that fair market value.

Although the transferee will typically be one of your heirs, in some cases it will simply be your estate. Thus, for example, if your property goes into your estate and the estate then sells the property, the estate may have a gain or loss, depending on its actual proceeds of disposition on the sale relative to its deemed cost on acquiring the property from you. The estate is a person (a trust) and a taxpayer for income tax purposes, and therefore must file a tax return if it owes tax.

If the estate has a gain or loss on the disposition of the property, it can simply report that amount on its tax return.

However, if it has a capital loss in its first taxation year, it can elect that the capital loss be carried back to your return for the year of death and used for that year. This may be beneficial if the estate has no capital gains so that it cannot use the capital loss.

Example

John dies in 2020. One of his properties had a cost of $100,000 and a fair market value of $150,000 at the time of his death. The property goes to his estate. As such, he reports a capital gain of $50,000 and taxable capital gain of $25,000 in the year of death.

His estate acquires the property at a cost of $150,000. It sells the property in its first taxation year for $120,000, thus incurring a $30,000 capital loss. If the estate elects, the $30,000 capital loss is deemed to be John’s in his year of death. Half of that, or a $15,000 allowable capital loss, can reduce John's terminal year taxable capital gain of $25,000 to $10,000 for the 2020 year.

Alternatively, the estate can keep the $30,000 capital loss and use it to offset its own capital gains in its first taxation year or future years (as long as the estate remains in place).

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This letter summarizes recent tax developments and tax planning opportunities; however, we recommend that you consult with an expert before embarking on any of the suggestions contained in this letter, which are appropriate to your own specific requirements.