BUCHANAN BARRY LLP
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TAX NEWSLETTER

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SPLIT PENSION INCOME WITH YOUR SPOUSE

For the past 10 years, you have been able to "split" up to 50% of your eligible pension income with your spouse or common-law partner for income tax purposes. The amount that you split with your spouse for a particular year is called the "split pension amount". The mechanics of the pension split are described below.

Benefits of the split

Pension income splitting is advantageous where you are in a higher tax bracket than your spouse in a particular year. That is, your spouse will include the split pension amount in his or her income and you will not include that amount in income. By shifting that amount into your spouse's lower tax bracket, you will save tax overall as a couple.

Another significant benefit of pension income splitting relates to 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 below, your spouse may also qualify for the credit if you do the pension income split, which again will result in overall tax savings because you could both claim the credit.

Furthermore, it can be beneficial if you are otherwise subject to the Old Age Security (OAS) clawback tax. Basically, your OAS is clawed back at a rate of 15% of your income over $73,756 (2016 amount). So if your income exceeds that amount, the pension income split will save you some of the OAS clawback. Conversely, if the split puts your spouse over that threshold OAS amount, you will have to take that into account in determining whether there is an overall tax savings.

In a similar vein, the age credit, which is available to anyone who is 65 years of age or older, is reduced once your income is over $35,927 and eliminated when your income reaches $83,427 (2016 amounts). So that is another income threshold to take into account in determining your and your spouse's tax savings with the pension income split.

Although the above calculations and thresholds may be difficult to work through, pension income split software programs and calculators make the work relatively easy. Most accounting firms have access to these.

Mechanics of the split

The pension income split is done on an annual basis, with the joint election form T1032 filed by you and your spouse in your tax returns for the relevant year. You can elect to split anywhere from 0% to 50% of your eligible pension income each year. But the amount can vary from year to year. For example, you might elect 40% this year, 50% next year, have no election for the following year, and so on.

The eligible pension income that qualifies for the split includes the following:

If you are 65 or over, it includes:

1. Pension income from a pension plan annuity;
2. Registered retirement savings plan (RRSP) annuity payments;
3. Payments from a registered retirement income fund (RRIF);
4. Periodic payments from a “money purchase” registered pension plan;
5. Pension payments from a pooled registered pension plan;
6. Annuity payments out of a deferred profit sharing plan; and
7. Certain payments out of retirement compensation arrangement.

If you are under 65, eligible pension income normally only includes item 1) above, i.e. pension plan annuity income. (However, the next five payments also qualify if you are receiving them as a consequence of the death of a **former** spouse or common-law partner.)

Similar rules apply in terms of your eligibility for the pension credit – that is, the eligibility depends on whether you are at least 65 years old. They also apply to your spouse if you do the pension income split. Effectively, 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 his or her age.

Example:

*This year, you are 67 years old and receive $60,000 in RRSP annuity payments (**not** as a consequence of a former spouse's death). You elect to do a 50% pension income split with your spouse. As a result, your spouse includes $30,000 of that split pension amount in her income and you include the other $30,000.*

You will qualify for the pension credit on $2,000 of your remaining pension income because you are over 65.

If your spouse is 65 or over in the year, she will also qualify for the pension credit on $2,000 of the pension income you have transferred to her. However, if she is under 65, she will not get the credit.

Draft legislation released on September 16, 2016 proposes to expand the definition of eligible pension income to include certain retirement benefits received by former members of the armed forces. Specifically, it will include amounts received, subject to a monetary limit determined under defined pension benefit rules, on account of a retirement income security benefit under the *Canadian Forces Members and Veterans Re-establishment and Compensation Act*. This change, once enacted, will apply to 2015 and subsequent years.

Joint Liability for Tax

The pension income “split” is somewhat of a misnomer, because the income tax rules do not require that you actually give any of the income to your spouse. In other words, your spouse includes the split pension amount in income, even if he or she does not actually receive any of it.

Your spouse will be liable to pay the tax applicable to that amount. Your spouse can pay the tax out of his or her own resources, or you can pay it. Also, the Income Tax Act provides that you will be jointly and severally liable with your spouse to pay that tax (e.g. in the event that your spouse does not pay the

tax). So either way, you and/or your spouse will have to pay any resulting tax.

Government pension

On a final note, 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 (not the Income Tax Act), 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 will each actually receive your respective shares 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 outlined earlier. Similarly, the QPP in Quebec allows sharing between couples.

CONTRIBUTE TO YOUR SPOUSE'S RRSP FOR MORE INCOME SPLITTING

How it works

In addition to splitting pension income as discussed above (which can include splitting your RRSP annuity income), there is another method of effectively splitting income using your RRSP. This requires some long-term planning.

This method is different from that outlined above, in that it involves you contributing to your spouse's (or common-law partner's) RRSP, rather than splitting the income once it is received by you out of your RRSP.

For this to be possible, your spouse's RRSP has to be set up as a "spousal plan", so that you are allowed to contribute to it. This is trivial to do; you simply ask your financial institution to have the plan designated as such.

Each year you contribute up to your RRSP contribution room for the year. For 2016 this includes:
The lesser of
- $25,730, and
- 18% of your "earned income" for 2015.

(If you are a member of an employer-sponsored registered pension plan, your contribution room will be reduced to the extent of your "pension adjustment" for 2015.)

Furthermore, your unused RRSP room from previous years can be carried forward in this year, and if still unused, it can be carried further indefinitely.

In any particular taxation year, you can use your contribution room to contribute to either your RRSP or your spouse's RRSP, or a combination of both. For example, if in 2016 your RRSP contribution room is $20,000, you can contribute any amounts to both RRSPs as long as the total does not exceed $20,000. The amount that you contribute is deductible in computing your income, not your spouse's income.

To the extent that you contribute to your spouse's RRSP, there eventually will be some income splitting. That is, when your spouse withdraws from his or her RRSP, it will be included in your spouse's income rather than yours. But as noted, in the year of contribution, the RRSP deduction is from your income. If your spouse is in a lower tax bracket than you, there will be an overall savings in tax.

Beware of attribution rule

The only catch with RRSP contribution splitting is an income attribution rule. Basically, the

rule says that if you contribute to your spouse's RRSP during one year and he or she withdraws that amount in the same year or during the next two years, the withdrawn amount will be included in your income.

> <u>*Example:*</u>
>
> *In February of Year 1, you contribute $10,000 to your spouse' RRSP (claiming a deduction for the previous year, Year 0). By year 3, this amount grows to $13,000, and your spouse withdraws the entire $13,000 amount.*
>
> *In Year 3, you will have to include $10,000 in your income. Your spouse will include $3,000.*

The obvious way to avoid this rule is to ensure that your spouse waits until Year 4 (or later) to withdraw the amount, because there will be no attribution.

Note that you cannot avoid this rule by contributing to different plans. If your spouse has multiple RRSPs and you contribute to plan A in Year 1 and plan B in Year 2, your spouse would have to wait until Year 5 to withdraw funds from *either* plan to avoid having the attribution rule apply.

NON-ARM'S LENGTH TRANSFERS

There are special rules that apply under the Income Act if you dispose of, or acquire property from, a non-arm's length person.

In general terms, a non-arm's length person includes a person you are related to (for income tax purposes). So for individuals, this includes your lineal ascendants and descendants such as children, grandchildren, parents and grandparents. It also includes your spouse, siblings, and most in-laws such as siblings-in-law and parents-in-law. Interestingly, it does not include aunts, uncles, nieces and nephews, and cousins. Also, as discussed below, there are special rules that apply to spouses and common-law partners.
In terms of corporations, a non-arm's length corporation includes a corporation that you control, and a corporation controlled by a person that is non-arm's length with you. But the corporate non-arm's length rules are quite complex and can include corporations in a myriad of corporate structures. Professional advice should be obtained.

<u>*Disposition for less than fair market value*</u>

If you give or dispose of property to a non-arm's length person for proceeds less than the fair market value of the property, you will be deemed to dispose of the property for fair market value proceeds. Unfortunately, this rule is one-sided, and does not affect the acquiror's cost of the property.

> <u>*Example:*</u>
>
> *You sell property to your brother Jack for $15,000. Your cost of the property is $10,000 and the fair market value of the property at the time of sale is $18,000.*
>
> *You will have proceeds of $18,000, resulting in a capital gain of $8,000, and a taxable capital gain of $4,000 included in your income. However, Jack's cost of the property will be the $15,000 that he paid for it. So if he turns around and sells it to a third party for $18,000, he will have a capital gain of $3,000 and taxable capital gain of $1,500, resulting in double taxation.*

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Acquisition at more than fair market value

Conversely, if you acquire a property from a non-arm's length person for more than its fair market value, your deemed cost of the property will be the fair market value. But again, this a one-sided rule, and the person disposing of the property will have proceeds equal to the actual amount paid for the property.

Example:

You acquire property from your brother Jack for $15,000. The fair market value of the property at the time of purchase is $12,000.

Your cost of the property will be $12,000. However, Jack's proceeds of disposition of the property will be $15,000.

Rollover for transfers to spouse

If you give or dispose of property to your spouse or common-law partner, the above rule does not normally apply. Instead, your proceeds and your spouse's cost will equal your tax cost of the property, resulting in a tax-free rollover.

However, you and your spouse can elect out of the rollover, in which case the above non-arm's length rules apply. The election may result in gains or income for you, but a bumped-up cost for your spouse. The election may be beneficial if you have losses that can offset the gains or income resulting from the deemed disposition, or if you are able to claim the capital gains exemption on the disposition.

Example:

You have a property with a cost of $10,000 and fair market value of $15,000, so the property has an accrued gain of $5,000.

If you give the property to your spouse and do not make the election, you will have proceeds of $10,000 and no capital gain. Your spouse's cost of the property will be $10,000.

Assume instead that you have capital losses (in the current year or losses from previous years) that can offset the accrued gain. If you make the election, you will have deemed proceeds of $15,000. You will have a $5,000 gain, and $2,500 taxable capital gain included in your income, which will not be taxed because of the offset from your losses. The upside is that your spouse will have a bumped-up cost of the property of $15,000, and thus a lower eventual capital gain on sale of the property.

TRANSFERS IN AND OUT OF PERSONAL TRUSTS

Personal trusts are set up for various purposes. Often, they are set up by a "settlor" who puts property in trust for an individual or individuals, known as the "beneficiaries" of the trust. For income tax purposes, a trust is considered a separate person, and is a "taxpayer" that may be subject to tax, tax return filing obligations, and other requirements under the Income Tax Act.

Transfers of property into a trust

Unless one of the exceptions discussed below applies, if you transfer property into a trust, you will normally have deemed proceeds of

disposition equal to the fair market value of the property. As such, you may realize a capital gain or income if there is an accrued gain in respect of the property. (If there is an accrued loss, you will sometimes be denied the loss under the "superficial loss" rules in the Income Tax Act.)

Tax-free Rollovers into Trusts

On the other hand, if you transfer property to the following types of trusts, there will be a tax-free rollover, meaning that you will have deemed proceeds of disposition equal to your tax cost of the property and therefore no capital gain or income. The trust will inherit your tax cost of property. The trusts that qualify are:

- A spousal trust. Basically, this is a trust under which your spouse (or common-law partner) is a beneficiary who is entitled to all of the income of the trust during his or her lifetime, and no one else may obtain any of the capital of the trust during the spouse's lifetime.

- A joint spousal trust. You must be at least 65 years old to set up this trust. This is a trust under which you and your spouse (common-law partner) are beneficiaries who are entitled to all of the income of the trust until the later of your deaths, and no one except you and your spouse can obtain any of the capital of the trust until the later of your deaths.

- An *alter ego* trust. You must be at least 65 years old to set up this trust. You as a beneficiary must be entitled to all of the income of the trust during your lifetime and no one else can obtain any of the capital during your lifetime.

- A "protective" trust. Basically, this is a trust where the transfer of the property does not result in change in beneficiary ownership of the property – meaning that you retain all beneficial aspects of ownership and no other beneficiary does.

Although there is an automatic tax-free rollover for transfers to these trusts, you can elect out of the rollover, in which case the fair market proceeds rule normally applies. The election out of the rollover may be beneficial if you have tax losses that can offset any accrued gains from the fair market disposition of the property, since the trust will have a bumped-up cost equal to the fair market value.

Distributions of property out of a trust

Most distributions of property out of a personal trust take place on a tax-free rollover basis. Most family and private trusts are set up as personal trusts. However, the technical requirement for personal trust status is that no beneficial interest in the trust can be acquired for consideration payable either to the trust or to a person who contributed to the trust.

There are some situations where the rollover does not apply, including:

- Where the property is distributed to a beneficiary who is not resident in Canada;
- Where the trust was a "revocable" or "reversionary" trust under which the settlor could obtain back the property he or she transferred to the trust;
- Where the trust elects out of the rollover; and
- Where the trust is a spousal trust, joint spousal trust or *alter ego* trust (see above), and the property is distributed to a person other than life beneficiary under the trust (e.g. you, your spouse, etc.).

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Where the rollover does not apply, the distribution of the property will give rise to proceeds of disposition of the property equal to its fair market value. This may result in a capital gain or other income.

AROUND THE COURTS

Supreme Court of Canada rules on rectification

A taxpayer can apply to rectify a transaction that occurred pursuant to a legal agreement or document, but that does not reflect the actual intended transaction. Typically, the application will be made where the transaction that occurred resulted in adverse consequences relative to what the taxpayer intended. For example, in the 2000 *Juliar* case, the Ontario Court of Appeal allowed rectification of the taxpayers' transactions because the taxpayers had a common and continuing intention to transfer certain shares on a tax-free basis, contrary to the actual transfer of shares that would have resulted in tax payable.

In the recent decision of *Fairmont Hotels*, the Supreme Court of Canada narrowed the scope of the *Juliar* decision. Without getting into complex details, the main issue in the Fairmont case was whether the court would rectify an agreement that provided a redemption of shares by a corporation into one that provided a loan from the corporation. The taxpayers argued that the share redemption frustrated their intent that the transaction takes place on a tax-neutral basis, and as such asked for the rectification order. However, the Supreme Court held that a general ongoing intention to avoid or reduce tax was not enough to grant rectification.

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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.