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Chartered Professional Accountants

Splitting pension income with your spouse

The government generally frowns on income splitting amongst family members. The Federal government reduced income splitting in its 2018 budget even further by severely restricting when dividends can be paid to a spouse or to children over 17 years of age. However, a specific rule in the Income Tax Act allows you to split certain pension income with your spouse or common-law partner.

The rule provides that you and your spouse can make a joint election, under which you split some of your pension income with each other. You can split any amount up to 50% of the income. The split amount is reported on your spouse's tax return, while you report the other portion of the pension income. The election is annual, meaning that you can change the split amount for each taxation year, or you can choose not to split in any particular taxation year.

The split is allowed even if you do not actually transfer any of the pension income to your spouse, but it must be "eligible" pension income.

ELIGIBLE PENSION INCOME

The pension income must be "eligible pension income". In general terms, if you are **65 or older** in the year, eligible pension income includes:

- annuity income and periodic payments from a registered pension plan ("RPP");
- payments from a pooled RPP; and
- payments out of a registered retirement savings plan or registered retirement income fund.

If you are **under 65** at year-end, eligible pension income normally includes **only** "qualified pension income", which means annuity income from an RPP. However, qualified pension income will also include the other pension payments described in the preceding paragraph if they are received as a consequence of the death of a **former** spouse (i.e., not your current spouse with whom you are splitting income).

Eligible pension income does not include income from government pensions such as:

- Canada Pension Plan;
- Quebec Pension Plan; and
- Old Age Security.

SEE **SPLITTING PENSION INCOME** P. 4

There are special rules in the Income Tax Act ("ITA") that allow you to transfer property to a Canadian corporation on a tax-deferred rollover basis. These rules effectively allow you to incorporate an existing business on a tax-free basis, without paying tax on any accrued gains on your business assets. These rules can apply to most transfers of property to a private corporation, not only at the time of incorporation.

Tax-free transfers to your corporation

Section 85 rollover

THIS IS A "Section 85 rollover" (so called as the rules are found in Section 85 of the ITA), and has various conditions that must be met to be allowed:

- you and the corporation must file a joint election with the Canada Revenue Agency;
- the due date for filing the election is your tax filing date for the year of the transfer, or the corporation's tax filing date— whichever comes first; and
- in consideration for the transfer, you must receive at least one share in the corporation. You can receive other considerations as well, but you must receive at least the one share. The non-share consideration is sometimes referred to as "boot". (For instance, if you acquire the shares of the corporation, and then receive something else "to boot".) Non-share considerations can include money, a promissory note, or any property other than shares in the corporation.

Elected amount

In the joint election, you determine an "elected amount". This point is central to the transaction since the elected amount becomes:

- your proceeds of disposition of the property transferred to the corporation;
- the cost of the property for the corporation; and
- the cost of your share(s) in the corporation received on the transfer, minus the value of any "boot" that you receive. The amount is allocated first to the cost of any "preferred" shares that you receive, and then to any common shares you receive on the exchange.

As might be appreciated, in order to get a complete tax-free rollover, you need to elect an amount equal to the tax cost of the property transferred to the corporation. If you wish, you can elect at a higher amount to trigger a gain on the transfer, for instance, if you have unused losses that can offset the gain.

However, there are various limits on the elected amount which cannot be:

- greater than the fair market value of the transferred property;
- less than the fair market value of the boot you receive, if any; and
- less than the lesser of the fair market value of the property and your tax cost of the property.

Normally, you cannot trigger a loss on the transfer by electing an amount less than the tax cost of the property, e.g., if the fair market value of the property is less than your cost. In particular, you cannot trigger a loss if you and the corporation

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TAX-FREE TRANSFERS CONT'D FROM P. 2

are "affiliated". For these purposes, you and the corporation will be affiliated if you or your spouse controls the corporation—either alone or together—or if you are part of an affiliated group that controls the corporation.

Eligible property

The property you transfer to the corporation must be an "eligible property", which includes:

- depreciable capital property;
- non-depreciable capital property; and
- inventory other than land.

If you are not resident in Canada, land that is capital property used in a business conducted in Canada can qualify, if it is transferred to the corporation along with all—or substantially all—of the property used in the business.

ANTI-AVOIDANCE RULES TO CONSIDER

SUPPOSE the fair market value of the property you transfer to the corporation exceeds the value of the consideration—the shares and boot—that you get back from the corporation, and also exceeds the elected amount. In other words, you have given more to the corporation than you received back. A special rule says that if it is reasonable to regard the excess as a benefit that you wished to confer on a person related to you (e.g., a related person who owns common shares in the corporation), the elected amount will be bumped up to the fair market value of the property. This will increase your gain on the transfer because of the increase in the elected amount.

On the other hand, if the fair market value of the consideration you receive from the corporation exceeds the fair market value of the property you transfer to the corporation, the excess will normally be taxable as a shareholder benefit, and will be included in your income.

To illustrate another potential problem, the property you transfer to the corporation can include shares in another corporation. This is perfectly acceptable, and the transfer will be subject to the same rules applicable to other property.

However, if you receive back boot on the transfer and the value of the boot exceeds the "paid-up capital" of the transferred shares, the excess may be included in your income as a deemed dividend. The "paid-up capital" of shares is the income tax version of the legal stated capital of the shares and, in very general terms, reflects the value used to purchase the shares when they were originally issued.

We often have incorporated clients who are living in their principal residence and wish to purchase a new home to live in. They want to keep their original home as an investment and rent it out, but do not have the personal funds to make a down payment on the new home. If the shareholder has surplus funds in their corporation, one solution is to transfer the original home and related mortgage to the corporation. If the original home has been the principal residence for every year owned, there is no need to make the Section 85 election. It is transferred into the corporation at fair market value without tax consequences because of the principal residence exemption. The corporation issues a promissory note to the shareholder for an amount equal to fair market value of the home less the balance of the mortgage. In provinces that have property transfer tax, a trust agreement can be prepared to specify that only the beneficial ownership of the property is transferred to the corporation, while legal title remains with the shareholder.

SPLITTING PENSION INCOME CONT'D FROM P. 1

FOUR BENEFITS OF THE SPLIT

1 One benefit of the pension split occurs if you are in a higher marginal tax bracket than your spouse. The split will save you tax because the split amount will be subject to a **lower tax rate**.

2 A further benefit is the potential **doubling of the pension credit**. The federal credit is 15% of the first $2,000 of eligible pension income, while the provincial credit depends on the province of residence; the two credits together are worth up to about $450-500 depending on the province. You can claim the credit and—assuming your spouse also qualifies—your spouse can also claim the credit. In this regard, the character of the pension income in your hands flows through to your spouse.

If the pension income is **qualified pension income**, your spouse can claim the credit even if he or she is under 65. However, if the pension income is one of the **other types**, your spouse must be over 65 to claim the credit. FOR EXAMPLE:

At 68 years of age, you receive RRSP income in the year that is not qualified pension income, and elect to split up to 50% of the income with your spouse.

You can claim the pension credit, but can your spouse?	Yes… IF YOUR SPOUSE IS UNDER 65 YEARS	No… IF YOUR SPOUSE IS 65+ YEARS

3 Another possible benefit relates to the Old Age Security (**OAS**) **clawback tax**. This is a tax that effectively requires you to repay some of your OAS benefits if your income exceeds a monetary threshold ($75,910 in 2018). The clawback tax is 15% of your net income in excess of the threshold, to a maximum of your OAS income. Therefore, if you would otherwise be subject to the clawback tax, you may be able to reduce or eliminate it if you pension split with your spouse.

4 In a similar vein, the **age credit** is phased out starting at $36,976 of income (2018 amount). Depending on your income, the pension split may allow you to reinstate some of your age credit.

JOINT & SEVERAL LIABILITY

Your spouse will be liable to pay the tax on the split amount that is included in his or her income. However, you will also be jointly and severally liable for that tax. This means that if your spouse does not pay the tax, the CRA can come after you to pay it.

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