PERSONAL Newsletter

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An Overview of the Taxation of Pension Income

During retirement, the income from your pensions likely represents the majority of your income upon which you depend. Therefore, it can be important to understand precisely how your pension income is taxed and how you can reduce that tax burden if at all possible. This article discusses the taxation of pension income, including Old Age Security and Canada Pension Plan payments.

Old Age Security Pensions

Old Age Security ("OAS") pensions are payable to Canadians who have attained age 65. In addition, some persons receive additional payments as a Guaranteed Income Supplement ("GIS") or Spouse's Allowance ("SA"), either from the federal government or from a provincial government. If your net income exceeds a threshold amount, you will be required to repay part or all of the OAS through a special clawback tax. If you have received the OAS pension, you must include it in your income and pay income tax on it. The OAS is the basic amount which is paid to Canadians 65 or over.

If your tax return indicates that you are 65 or older, but shows no social security income, the CRA's computers will likely flag the return for a manual check. You will speed up the processing of your return if you attach a letter stating that you are not receiving the OAS pension for whatever reason.

If you receive the GIS or SA you must also include it in income for tax purposes, but an equal amount may be claimed as a deduction from "net income" to arrive at "taxable income" after the deduction. The effect of this rule is that the GIS or SA is not taxed in your hands, but it must be included in your income for purposes of determining whether certain income-tested credits or other benefits may be claimed by you or by other taxpayers on whom you are dependent.

GIS and SA are collectively referred to as "net federal supplements" on the T1 return; they are reported separately from basic OAS payments.

You do not automatically receive the OAS or GIS; you must apply to receive them. You can apply

online through My Service Canada Account or using the Application Form ISP-3550. You do not have to renew your application each year--if you are eligible, you will receive the payments as long as you file your income tax and benefit return annually.

The inclusion of your GIS or SA in your income can affect your claim for the age credit amount (reduced by net income over a threshold amount), medical expenses (amount of expenses less 3% of net income), or, although less likely, your credit for donations (maximum 75% of net income), and might have some effect on other tax calculations, especially provincial tax credits which refer to your net income. It also enters into the calculation of family income for determining the GST credit and Canada Child Benefit.

Though it is rare, you may have received OAS payments in error in the year or earlier years. Where you have repaid OAS amounts in the year for which your tax return is filed, you may claim a deduction for the amounts repaid to the extent they were included in your income on that return or returns for earlier years.

OAS "Clawback"

There is a special tax on OAS pension amounts received by a taxpayer with net income for the year in excess of a threshold amount as indexed annually; for 2022 the threshold is $81,761. The special tax is 15% of your net income in excess of the threshold for the year up to the amount of your OAS pension. OAS payments are subject to withholding on the potential clawback where net income has in prior years exceeded the threshold as indexed for the current year. Withholding for the January–June period of any year will be based on income calculated on second prior year returns; withholding for July–December will be based on prior year returns. The clawback system applies to non-residents, and may result in 100% withholding where the non-resident files no base year tax return, subject to any treaty protection which may be available.

Pension Tax Credit

Individuals calculate their basic federal tax by multiplying their taxable income brackets by the appropriate marginal tax rates and then subtracting from the result their credits, including the pension credit. The pension tax credit is a non-refundable credit, which means the credit cannot be claimed if an individual does not have income tax payable before claiming the credit. If the individual does not have enough income tax payable to cover the full amount of the pension credit available, the unused portion of the pension amount may be transferred to the individual's spouse or common-law partner.

Anyone having received "eligible pension income" during a particular calendar year can claim the pension tax credit for that year. "Eligible pension income" includes the "pension income" of an individual 65 or older at year-end and the "qualified pension income" for an individual under 65 at year-end.

The pension tax credit that may be claimed for a particular year is calculated at the rate of 15% of the lesser of two amounts: (1) $2,000; and (2) the "eligible pension income" received by the individual during the year, which is the "pension income" for an individual over 64 at year-end and the "qualified pension income" for an individual under 65 at year-end. Thus, the credit only applies to up to $2,000 of income. The pension income amount used to calculate the pension tax credit may be reduced if a portion is deducted elsewhere in the individual's return. Canadian Forces members and veterans must use a different calculation taking into consideration certain retirement income security benefits and income replacement benefits to calculate their "eligible pension income".

The most common income items included in an individual's "pension income" are:

- Life annuity payments from a superannuation plan, pension plan other than pooled registered pension plan ("PRPP"), or specified pension plan ("SPP");
- Annuity payments from a registered retirement savings plan ("RRSP") or amended RRSP;
- Payments from a registered retirement income fund ("RRIF") or amended RRIF;

- Payments or withdrawals from a PRPP;
- Periodic payments from a money purchase registered pension plan ("RPP");
- Annuity payments from a deferred profit sharing plan ("DPSP") or revoked DPSP; and
- Annuity payments from an advanced life deferred annuity ("ALDA") made after the individual turned 65.

The most common income items included in an individual's "qualified pension income" are:

- Life annuity payments from a superannuation plan, pension plan (other than PRPP), or SPP; and
- Any of the following income items, provided they are received as a result of the death of the individual's spouse or common-law partner,
  - Annuity payments from an RRSP or amended RRSP;
  - Payments from an RRIF or amended RRIF;
  - Payments or withdrawals from a PRPP;
  - Periodic payments from a money purchase RPP;
  - Annuity payments from a DPSP or revoked DPSP; and
  - Annuity payments from an ALDA.

Payments of OAS, GIS, Canada Pension Plan pension payments, and Québec Pension Plan pension payments do not quality for the credit.

Pension Income Splitting

If a pensioner and their spouse or common-law partner sign a joint election, the pensioner can transfer to the spouse or common-law partner up to 50% of the pensioner's "eligible pension income". If the pensioner is 65 years of age at the end of the taxation year, all their pension income is "eligible pension income" and up to 50% of it can be transferred to their spouse or common-law partner. If the pensioner is not 65 at the end of the year, only their pension income eligible for the $2,000 pension income amount is eligible income for this income splitting election. The pensioner must deduct the transferred pension income on their return and the pension transferee must report it on their return.

There are two possible benefits to splitting income.

First, if the transferee is in a lower tax bracket than their spouse or common-law partner (the transferor), the couple's tax will be lower overall. That is, the spouse or common-law partner's income taxed at the higher rate will be reduced and the transferee's income taxed at the lower rate will be increased. Provincial tax will also be reduced, but generally speaking the federal tax rate brackets will determine whether the election is beneficial in terms of tax rates.

Second, if the transferee is 65 or over at the end of the taxation year in which they are splitting pension income, the transferee can use the transferred income along with their own pension income to determine the $2,000 pension income amount used to claim the pension tax credit. Therefore, to the extent that the person does not already have $2,000 of pension income of your own before the transfer, they can increase this credit. If a spouse or common-law partner has more than $2,000 of "eligible pension income", this will increase the credit available to them as a couple. If a person is not 65 at the end of the relevant taxation year, they may still claim the credit in respect of "qualified pension income" transferred from their spouse or common-law partner. Essentially, "qualified pension income" will include a spouse or common-law partner's private pension or annuity income (not including RRSP, RRIF, or DPSP income) plus certain amounts received as a consequence of the death of a spouse or common-law partner.

To qualify for pension income splitting, the following conditions must be met:

- You and your spouse or common-law partner must have been resident in Canada at

the end of the calendar year or at the time of death if this occurred during the year.

- You must be living together at the end of the year. If at year-end you are living separate and apart by reason of a breakdown of the relationship which proves to have lasted for at least 90 days, no transfer is permitted.
- If you have more than one partner at the end of the year, only one transfer is permitted.
- If you were married or commenced living in a common-law partnership during the year, or your spouse or common-law partner died during the year, you must prorate the amount eligible for transfer by the number of months during which your relationship existed. The month in which your relationship began or your spouse or common-law partner died counts as a full month, and the number of months during which the relationship existed is divided by 12 to determine the amount you are allowed to transfer.

Remember that a lower-income spouse or common-law partner may transfer certain amounts not needed to reduce his or her income to a higher-income spouse or common-law partner. Such amounts would include the pension, age, and child amounts. Because those income transfers only grind amounts that would otherwise be transferred, the result is neutral (i.e., there is no cost or benefit to the couple as a whole). However, to the extent the lower-income spouse has other unused non-refundable and non-transferable amounts eligible for tax credit to soak up transferred pension income, there is a benefit. The transferor may be able to increase non-refundable credits like the age amount which would otherwise be reduced by the transferred income.

Canada Pension Plan Splitting

The Canada Pension Plan ("CPP") contains rules which allow spouses or common-law partners who are living together (not separated or divorced) to assign retirement pensions to each other. With assignment, each spouse can receive a portion of the other's CPP pension. The amount depends on how long the taxpayers lived together and on their contributory periods. For example, if you lived together for 20% of both your contributory periods, you keep 80% of your pension and the remaining 20% is divided equally between you and your spouse. It appears that where both spouses are receiving CPP pensions (or one CPP and one QPP pension), the pension sharing must apply to both. Pension sharing commences the month following approval of an application by either spouse to Employment and Social Development Canada, and can be terminated by joint application or on certain contingencies such as divorce or death.