TD Bank Financial Group

TD Economics

Special Report

December 8, 2006

THE OCTOBER 31st INCOME TRUST ANNOUCEMENT: 4 POSSIBLE WAYS TO SAVE TAX DOLLARS

On October 31, the federal government took financial markets and Canadians by surprise by announcing that a distribution tax will be levied on income trusts (see TD Economics' special report *Federal Government Takes Action on Income Trusts*, released on November 1, 2006, for more details). In the aftermath of the announcement, the loss of the tax advantage by income trusts overshadowed 2 tax measures announced to offset the potential impact on the investment income of older Canadians, namely the introduction of pension income splitting and the age tax credit enhancement. This note assesses how senior couples could potentially save money from these 2 new tax initiatives. Tax savings could come from any of the 4 following sources:

1. The $1,000 age credit enhancement
2. Pension income splitting to lessen the bite of the progressive tax rate structure
3. Pension splitting to permit fuller use of tax credits
4. Pension splitting to increase net Old Age Security payments

Combined, the pension income splitting and the age tax credit enhancement measures will cost the federal government more than $1 billion in lost revenues per year (see table 1). Some couples will capitalize on each of these 4 sources whereas other couples will benefit just from a few. As result, the tax dollars saved will vary widely. The outcome is on a "couple-to-couple" basis. The total tax savings for a couple living on a single pension of $40,000 will be about $3,000, a drop of 30% in the total tax bill and 6% of total income (see table 2 on page 2). In comparison, a couple living on a single pension of $100,000 will save about $8,700, or 37% in the total tax bill and 7% of total income. The rest of the report details how senior couples will lower their tax burden and explains why some will gain more from these tax initiatives than others.

TABLE 1: IMPACT OF AGE CREDIT ENHANCEMENT AND PENSION INCOME SPLITTING ON FEDERAL GOVERNMENT FINANCES (in millions of dollars)

Fiscal year	06-07	07-08	08-09	09-10	10-11	11-12
Increase of age credit	405	345	345	360	380	400
Pension income splitting	165	675	710	745	780	820
Total	570	1,020	1,055	1,105	1,240	1,545

Source: Department of Finance Canada

HIGHLIGHTS

- **Senior Canadian couples can save tax dollars up to 4 ways with the introduction of pension income splitting and the age tax credit enhancement.**
- **Tax savings to vary across senior couples.**
- **Tax savings to vary among provinces.**
- ***If* splitting all sources of income is introduced, younger couples would save significant tax dollars.**

1. The $1,000 age credit enhancement

The first policy aimed at limiting the fallout from the income trust changes on Canadians aged 65 years and older is the enhancement of the age credit by the federal government. This measure is relatively simple. The amount on which the age credit is computed increased from $4,066 to $5,066, effective for the 2006 tax year. In 2006, seniors will save up to $152.50 in taxes as the lowest personal marginal tax rate is 15.25%. In 2007, those eligible to receive the age tax credit will save up about $170, since the lowest personal marginal tax rate will be increased to 15.50% and the age credit will be indexed for inflation (see table 3). These are the maximum amounts that can be

TABLE 2: TAX SAVINGS AFTER INCOME SPLITTING AND AGE CREDIT ENHANCEMENT *	
Couple living with a single pension of $40,000	
Federal income tax savings	2,000
Increase in net OAS benefits	0
Total federal benefit	2,000
Total provincial benefit (median)	1,000
Total tax savings	**3,000**
as a share of income (%)	**6.0**
as a share of tax burden prior to tax relief (%)	**30.0**
Couple living with a single pension of $100,000	
Federal income tax savings	3,000
Increase in net OAS benefits	4,500
Total federal benefit	7,500
Total provincial benefit (median)	1,200
Total tax savings	**8,700**
as a share of income (%)	**7.0**
as a share of tax burden prior to tax relief (%)	**37.0**

* rounded numbers;
Source: Department of Finance Canada, TD Economics

claimed at the federal level. The age credit begins to be phased out at a rate of 15%, once net income reaches $30,270. With the $1,000 increase, the age credit will now be fully clawed back at a net income of $64,043, rather than at $57,377 prior to the announcement. This means the sweetening of the age credit by the federal government will benefit mostly low-income earners, and to a lesser extent, middle-class seniors.

Pension income splitting: a major tax relief

The second initiative introduced by the federal government is pension income-splitting, effective in the 2007 taxation year. This measure will allow any Canadian aged 65 years and older (or someone under 65 with an annuity from a RPP – see the second to last section for details on page 4) who receives pension income to allocate up to one-half of that income to their spouse. The federal government estimated that more than two million pensioners will be able to take advantage of this attractive tax measure. Even a senior couple where both people have the same pension income could still benefit from pension-income splitting, if the spouses' other source of income (employment or investment income for example) are different. However, a senior with no spouse would obviously not benefit from the possible re-allocation of pension income.

This new measure will generate overall two times more tax savings than the age credit enhancement (see table 1 on page 1). However, saving taxes by splitting pension income is not straightforward. Seniors may have to spend more time on that front while filing their tax returns in order to profit from it. We now discuss in more detail below the 3 different ways senior couples can save taxes by splitting pension income.

2. Flatten the progressive income tax rate structure

In TD Economics' special report *Federal Government Takes Action on Income Trusts*, November 1, 2006, we mentioned that pension income-splitting will save a considerable amount of money for many couples, because it dampens the bite from Canada's progressive income tax rate structure. Individuals with more income pay a higher percentage of that income in tax than do those with less income. One of the advantages of pension income splitting is that it shifts income from the spouse in a high tax bracket to the spouse in a lower tax bracket. The result is tax dollars saved as a whole for the couple.

An example will help make this clear. Consider the senior couple living on a single pension that amounts to $40,000 in 2007. The spouse with a pension income of $40,000 (spouse 1) has a taxable income of $51,034 ($40,000 pension income, $5,954 in Old Age Security (OAS) payments and $5,080 in Canadian Pension Plan (CPP) payments). Part of it is taxed at a rate of 15.50% and the remaining part above $37,178 is taxed at a 22% rate (see the estimated tax brackets for 2007 in table 4). Meanwhile, the spouse with no pension income (spouse 2) still receives OAS and CPP payments. Spouse 2's taxable income ($11,034) is taxed at a rate of 15.50%. As a result, spouse 1 pays $8,800 in federal taxes and spouse 2 pays about $1,700, for a total of $10,500. Now, if the pension income of $40,000 is evenly split at $20,000 for both

TABLE 3: FEDERAL $1,000 AGE CREDIT ENHANCEMENT

Taxable year	2006	2007
Maximum claim after enhancement (A)	5,066.00	5,167.32
Maximum claim prior to enhancement (B)	4,066.00	4,066.00
Difference (C) = (A) - (B)	1,000.00	1,101.32
Lower personal income tax rate (D)	15.25	15.50
Federal Tax Savings: (C* D)	**152.50**	**170.70**

Source: Department of Finance Canada, TD Economics

TABLE 4: ESTIMATED FEDERAL PERSONAL INCOME TAX BRACKETS FOR 2007	
Taxable Income Threshold	Tax rate (%)
$37,178 or less	15.5
more than $37,178 but not more than $74,356	22.0
more than $74,356 but not more than $120,887	26.0
more than $120,887	29.0
Source: Department of Finance Canada, TD Economics	

spouses, they would pay about $4,800 each (15.50% of $31,954) for a total of $9,600. So the federal tax savings for this couple is a significant $900.

3. Income-splitting can permit fuller use of tax credits

The example shown above reveals only the tax dollars saved by flattening the progressive tax structure. It does not take into account the tax credits, which will also lower the tax burden. Indeed, in addition to being taxed at a lower rate, pension income-splitting also allows senior couples to profit more from non-refundable tax credits (basic amount, age amount, pension income amount, etc.). In turn, these tax credits lower the couple's tax payable.

First, let's consider again the senior couple living on a single pension that amounts to $40,000. Spouse 2 cannot fully use the tax credits (basic amount, age amount) because their value exceeds the taxable income of $11,034. Since the tax credits are non-refundable, they are in part lost. Also, spouse 2 has no pension income and thus cannot claim the pension income credit of $2,000 – the increase from $1,000 to $2,000 in the pension income credit was one of the 28 tax initiatives included in the 2006 federal Budget. However, if spouse 1 transfers part of his or her pension income, spouse 2 can fully use the tax credits and also becomes eligible for the pension income credit amount of $2,000.

A couple with a single but higher pension income would profit even more from tax credits. Let's take the example of a senior couple where spouse 1 has a sizeable pension income of $100,000 and spouse 2 has no pension income. In this case, spouse 1's age credit is fully phased out because the net income is too high – $111,034 including OAS and CPP benefits. But, by transferring $50,000 of the pension income to spouse 2, spouse 1's net income comes down to $61,034, which is low enough to be eligible for the age credit amount.

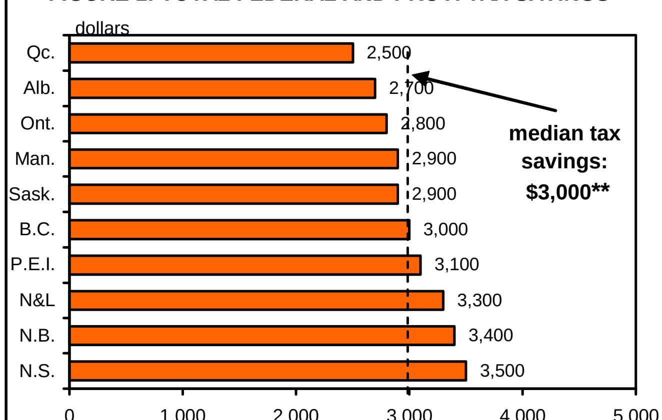
4. High income spouse could benefit from extra net Old Age Security payments

The fourth way senior couples can reduce their tax burden is by reducing the clawback of their OAS payments – a taxable monthly social security payment available to most Canadians 65 years of age or older. Before the pension income splitting was possible, a pensioner with a net income above $63,511 (2006 threshold of $62,144 indexed by inflation) would have to pay back a portion of their OAS amount at a phase-out rate of 15%. Let's consider again the senior couple living on an elevated, but single pension that amounts to $100,000. With $105,080 in net income (pension income and CPP), the OAS payments for Spouse 1 are fully claw-backed. Meanwhile, spouse 2 received the maximum OAS payments possible ($5,954). Now, with the transfer of $50,000 of the pension income to spouse 2, the net income of spouse 1 declined enough in order to claim the OAS payments of $5,954. As a result, the OAS benefits of the couple doubled to $11,908, for an after-tax savings of $4,500 (see table 2 on page 2).

Total tax savings to vary among provinces

So far, we show how older Canadians will save federal tax dollars. The sources of tax savings are similar at the provincial level, except that the total benefits will vary widely because of the wide divergence in tax structure from coast to coast. First, the tax rates are different among jurisdictions. Second, there are a different number of tax brackets – 3 in Newfoundland & Labrador and 5 in British Columbia for example. Third, the provincial tax credits differ too. Altogether, it is Canadians living in the Maritimes that will see their provincial tax burden decline

FIGURE 1: TOTAL FEDERAL AND PROV. TAX SAVINGS *



* from pension-income splitting and age credit enhancement, for a couple living on a single pension income of $40,000 a year. ** rounded number; Source: Department of Finance Canada, TD Economics

the most for a couple living on a single pension of $40,000. At the other end of the spectrum, provincial tax breaks for Quebecers will be much smaller, given that Quebec has the lowest basic amount tax credit among all provinces. Albertans would also benefit less from pension income splitting than most other provinces because of the 10% single-rate personal income tax. The median of total provincial tax savings is close to $1,000. Combined with $2,000 in federal tax savings, the median total tax relief reaches $3,000 – see figure 1.

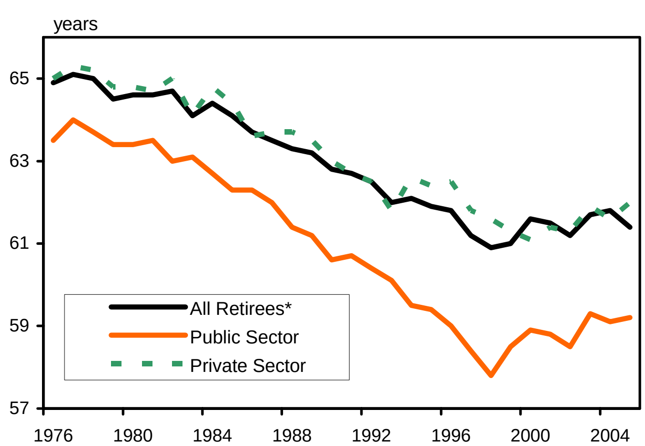
Not only older Canadians win

While other Canadians may envy the tax breaks senior couples will enjoy, there is still a lot to gain from these 2 new tax initiatives. A couple aged under 65 will be eligible to split income that is coming from annuity payments from an employer-sponsored registered pension plan (RPP). For example, someone who retires at 59 years old with an annuity from a RPP could transfer half of it to the other spouse (see average retirement age on figure 2). In 2005, about 35% of Canadian workers were members of a RPP. For younger couples, knowing that pension income splitting will be possible in the future is a big advantage today. It provides them with greater flexibility for their personal financial planning, retirement plan, and participation in the labour market.

What if income splitting is extended to all Canadians?

Since pension income splitting has been announced for 2007, there has been talk about an eventual extension to allow splitting of all other sources of incomes, including employment and investment income, for the benefit of all Canadian households. For example, let's consider a young couple living on a single employment income that amounts to $60,000 in 2007. Spouse 1's taxable employment income is $60,000 and spouse 2 has no taxable income. Prior to income splitting, the federal tax paid for the couple is about $9,400, or 15% of the employment income – see table 5. If the young couple splits the $60,000 employment income in half, the couple flattens the progressive tax structure – employment income is taxed at a rate of 15.5% rather than 22% – and spouse 2 claims the basic amount credit of $8,929 after income splitting. As a result, the federal tax paid by the couple drops by $2,900 to $6,500. The federal tax savings of $2,900 represents a drop of 31% in the total tax bill and 5%of employment income. Provincial taxes would decline as well.

FIGURE 2: AVERAGE RETIREMENT AGE IN CANADA



*Includes self-employed; Source: Statistics Canada

TABLE 5: FEDERAL TAX SAVINGS FROM SPLITTING A SINGLE EMPLOYMENT INCOME OF $60,000

Before income splitting	
Taxable income spouse 1: $60,000	
Taxable income spouse 2: $0	
Tax payable spouse 1	10,800
Tax payable spouse 2	0
Tax credit value spouse 1	1,400
Tax credits spouse 2	0
Federal tax paid spouse 1	9,400
Federal tax paid spouse 2	0
Total federal tax paid	**9,400**
as a share of employment income (%)	**16**
After income splitting	
Taxable income spouse 1: $30,000	
Taxable income spouse 2: $30,000	
Tax payable spouse 1	4,650
Tax payable spouse 2	4,650
Tax credit value spouse 1	1,400
Tax credits spouse 2	1,400
Federal tax paid spouse 1	3,250
Federal tax paid spouse 2	3,250
Total federal tax paid	**6,500**
as a share of employment income (%)	**11**
Total tax savings	**2,900**
as a share of employment income (%)	**5.0**
as a share of tax burden prior to tax relief (%)	**31.0**

Source: Department of Finance Canada, TD Economics

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