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Spousal RRSPs are an often overlooked retirement savings tool

By Jonathan Chevreau

Spousal RRSPs work in a similar fashion to pension splitting, but have been around a lot longer

One of the three major advantages of RRSPs is the ability to withdraw money at lower tax rates than when the contributions were first made. But what if you're one half of a couple and the two partners are in different tax brackets? This is where the Spousal RRSP can aid in family income splitting.

Certified financial planner Ed Rempel provides a simple example. If one spouse earns $100,000 a year while the other earns nothing, that high-earning spouse will pay $25,200 in income tax. If instead each spouse each earned $50,000 in the eyes of the taxman, then as a couple they'd pay only $16,600 in tax. With income splitting, the higher-earning spouse has less tax taken off at the top marginal rate, and more of the income for the couple as a whole is taxed at lower rates, resulting in an annual saving of $8,600 in income tax.

Spousal RRSPs apply to legally married spouses but also to common-law partners. As explained by Adrian Mastracci, president of Vancouver-based KCM Wealth Management Inc., the contributor can deduct the amount of the spousal RRSP deposit from his/her (presumably higher) earned income, while the recipient owns the investments. The aim is to equalize retirement income of both spouses, and to have the RRSP funds withdrawn by the recipient spouse at his or her lower tax rate.

RRSP deposits can be made to your account, spousal, or a combination of both, Mastracci says. "A family can also make all deposits to one spouse and later switch to the other." If you go this route, you don't have to make spousal RRSP deposits every year. Unused RRSP room can be carried forward until funds are available.

Despite the tax advantages, spousal RRSPs are not as popular as they could or should be. It's true the need for spousal RRSPs is less apparent since Ottawa introduced pension income splitting in 2007; with pension splitting, a spouse with a substantial DB pension can "transfer" up to half the pension so it's taxed in the hands of the lower-income spouse.

Spousal RRSPs work in a similar fashion to pension splitting but have been around a lot longer. Despite the rising popularity of pension splitting, spousal RRSPs still have a role, Rempel says. If neither spouse has employer pensions and they plan to retire at the same time, income splitting can be as simple as trying to have similar amounts in their respective RRSPs, so both spouses generate similar taxable incomes in retirement. Typically one spouse earns more, has more RRSP room and is more likely to contribute to an RRSP because of the larger tax refund.

With semi-retirement being more common, Rempel says spousal RRSPs can be more helpful than pension splitting, since spousal deposits are not limited to the 50 per cent rule for pension income splitting: you can split up to 100 per cent if you wish. This income splitting also helps the couple each qualify for the $2,000 pension credit.

Matthew Ardrey, wealth advisor with Toronto-based Tridelta Financial says that once the spouse with the larger RRIF is 65 or older, the income-splitting aspect of the spousal RRSP is really no longer necessary: "Income from a RRIF may be split up to 50 per cent once the annuitant is age 65. So equalizing the RRSP accounts is not of the same value as it was before this legislation was passed."

So where the spousal RRSP really conveys an advantage is for income splitting before age 65. They also come in handy when one partner has much larger non-registered assets. If that's the case, Ardrey says it's better to have as much of the spousal RRSP in the other spouse's name: so the lower-income spouse draws income more from the spousal RRSP and the higher-income spouse from the non-registered account.

One thing to be aware of is the three-year rule for withdrawals from spousal RRSPs. If you fall afoul of this, the withdrawal amount may become taxable income for the contributor spouse. Here's how Intuit Canada explains it: "A spousal RRSP is designed for retirement. At that time, it will be converted into a RRIF or an annuity and the income will be taxed in your spouse's name at his or her tax rate. However, if your spouse withdraws funds within 3 calendar years of your contribution, that amount will be added to your taxable income in the year of the withdrawal."

Note too that a spousal RRSP contribution can be made in the year of death. For example, Ardrey cites the case of Spouse A dying: the estate of Spouse A makes a spousal RRSP contribution to Spouse B, provided that Spouse B is 71 or younger. The effect is to reduce taxes owning on Spouse A's estate. If both spouses are alive and Spouse A keeps working after 71, Spouse A can make spousal RRSP contributions to Spouse B is Spouse B is under age 71, Ardrey says.

Finally, remember that just having similar values of RRSPs is not sufficient. Rempel says couples should plan to have roughly equal taxable retirement income from all sources, including RRIFs, non-registered investments and part-time work.

Jonathan Chevreau is founder of the Financial Independence Hub[1] *and co-author of Victory Lap Retirement. He can be reached at* jonathan@findependencehub.com[2]

References

1. findependencehub.com
2. jonathan@findependencehub.com