Are spousal RRSP contributions still useful?

Sylvain Chartier

Contributing to a spousal RRSP is a widely used income splitting technique. Although it's simple and without any tax risks after the three-year holding period[1], this strategy involves transferring funds to the spouse. For married couples who have not waived family patrimony partitioning, this problem does not really arise since, in the event of a divorce, the property is divided up in equal shares between the spouses. However, for common-law spouses, the risk of a relationship breakdown is a significant obstacle to the implementation of this strategy.

On October 31, 2006, Canada's Minister of Finance, Jim Flaherty, introduced a bill on pension income splitting to take effect on January 1, 2007. Under these new rules, up to 50% of pension income received may be split with the spouse. RRIF and LIF income may be split after age 65.

Since these new income splitting rules require a simple tax election and no transfer of money, are spousal RRSP contributions out of date?

For people not subject to family patrimony rules (e.g. common-law spouses) and who were already apprehensive about contributing to a spousal RRSP, the new annual tax election for splitting pension income is definitely the strategy to adopt.

However, for married couples, numerous arguments can be made in favour of spousal RRSP contributions:

- With a spousal RRSP, 100% of new contributions can be split, while the income splitting rules are limited to 50% of income. Past contributions can benefit from the income splitting rules
- With spousal RRSP contributions, income can be split before age 65. Since the average retirement age in Québec is around 59[2], spousal RRSP contributions can be used for this purpose during the transition period
- If the spouse is younger, spousal RRSP contributions can extend tax-deferral until he or she turns 72
- Spousal RRSP contributions protect taxpayers against changes in legislation that could limit or even abolish tax income splitting
- In the event of a requirement or a need to make an early RRSP withdrawal, spousal RRSP contributions ensure that withdrawals are taxed less heavily
- Spousal RRSP contributions can double the amounts that can be used under the Home Buyers' Plan (HBP) if the spouse does not already have $20,000 in his/her RRSP. Funds would also become available for Lifelong Learning Plans (LLPs)

In addition, spousal RRSP contributions will remain useful in certain circumstances where it is the sole planning strategy possible:

- Anyone over age 71 with earned income can contribute to a spousal RRSP is the spouse is under age 72. The deduction could reduce the contributor's taxable income
- If a contributor dies, spousal RRSP contributions are the sole option possible for benefiting from a final deduction and utilizing unused contribution room

But no solution is perfect, and spousal RRSP contributions have a few unfavourable consequences. Clearly, contributors lose control over the money they transfer to their spouse. As a result, investments are made according to the spouse's investor profile.

Also, taxpayers at the helm of an incorporated business who have made significant contributions to a spousal RRSP may be unable to buy back all the past service years to top up an Individual Pension Plan (IPP).

However, these disadvantages are insignficant compared with the benefits of contributing to a spousal RRSP.

Generally speaking, spousal RRSP contributions can simplify any strategy for splitting income and reducing taxes without the higher-income spouse being taxed on withdrawals.

To sum up, we believe that spousal RRSP contributions still remain a key financial planning strategy.

Sylvain Chartier

Sylvain Chartier is Manager, Fiscal Planification, National Bank Financial Planning, a wholly owned subsidiary of National Bank.

1- To prevent the application of attribution rules, funds must remain in the spousal RRSP at least three calendar years after the last contribution.

2- RRQ Transition travail – retraite, Service des statistiques et des ménages, November 2005

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