Federal Finance Minister Jim Flaherty’s surprise announcement on October 31, 2006, shutting down income trusts was front page news across Canada. It even garnered major stories in the business pages of the international press. The Finance department’s press release, titled “Canada’s New Government Announces Tax Fairness Plan”, declared that the Harper government’s four-part plan, which consists of the changes affecting income trusts and three other measures, “will restore balance and fairness to the federal tax system …” [Department of Finance Canada 2006a].

Closing the income trust loophole through which a growing number of companies were trying to avoid corporate tax was a long overdue move. The Conservative government did what the previous government had failed to do.

But what about the other three parts of the ‘Tax Fairness Plan’?

One of these – a reduction of half a percentage point in the federal corporate income tax rate, starting in 2011 – continues in a vein that Liberal Finance Minister Ralph Goodale began in his February 2005 budget when he announced that the corporate tax rate will fall in gradual steps between 2007 and 2010, from 21 percent to 19 percent. Under the Conservative government’s ‘Tax Fairness Plan’, the rate is scheduled to go down even more, to 18.5 percent in 2011. The Finance department estimates the cost of the half percentage point reduction in the corporate tax rate at $725 million in fiscal year 2011-12 (the first full year in which the reduction will be in effect). This is a large amount of money, and it is far from clear why further corporate tax reductions should be a higher priority than, say, reducing child poverty or creating a more skilled and educated workforce. However, this is a debate for another day.

In this commentary, Caledon focuses on the remaining two parts of the ‘Tax Fairness Plan’ which are important measures that, to the present time, have almost entirely avoided scrutiny in the media – even though Minister Flaherty went to some lengths to trumpet them in his Economic Update of November 21. These measures are a proposal to allow spouses and common-law partners to split pension income between them when calculating the income tax...
owed by each, and an increase in the age credit for taxpayers 65 years and over.

According to estimates from the Finance department, these two measures, if implemented, will cost Ottawa more than $6 billion cumulatively over the next six years in foregone tax revenues. Not one cent of this $6 billion will go to the 1.7 million seniors with incomes so low that they already do not pay any income tax. Other seniors will see some gains as a result of these measures, in the form of lower income tax. But for most, the tax reduction will be modest – only up to $158 a year for seniors living alone, and less than $600 a year at best for the majority of senior couples with modest or no income from private pensions or RRSPs.

But there are a fortunate few who will see very substantial tax savings from Ottawa’s ‘Tax Fairness Plan’. In some instances, their tax cut will amount to several thousand dollars a year. These lucky winners are high-income couples in which one spouse or partner is receiving large amounts of income from private pensions and RRSPs while the other spouse or partner receives little or no such income. As the analysis in this commentary will show, the tax liability of these well-to-do senior couples will be significantly reduced if the federal government’s proposals are implemented.

There is some irony, therefore, in the wording of the Ways and Means Motion the government tabled in the House of Commons regarding its ‘Tax Fairness Plan’ – wording that refers to “targeted assistance … to pensioners and seniors” [Department of Finance Canada 2006b]. The assistance will, indeed, be targeted, but not to those who really need assistance.

Caledon has always been in favour of strengthening the income security of Canada’s seniors, who have made enormous contributions to building our country and who, in many instances, live on modest incomes. Thanks to improvements in public pension programs over the years, the maturing of employer-sponsored pension plans, and the historic rise in the labour force participation of women, who thereby become eligible for pensions in their own right from the Canada and Quebec Pension Plans and employer-sponsored plans, Canada has made substantial strides in reducing poverty among the elderly: The incidence of low income among Canadians 65 and older fell from 21.3 percent in 1980 to 5.6 percent in 2004 [Statistics Canada 2006a]. However the work is not finished: some seniors remain in poverty (notably 17.0 percent of single elderly women and 11.6 percent of single elderly men), and many more live just over the poverty line.

It is hard to understand how the goal of better income security for seniors is furthered by showering scarce public money on lucrative tax breaks for a small minority at the top that are living comfortably, while ignoring entirely those at the bottom who barely have enough to get by.

There is a better way – a way that would deliver real tax fairness to all seniors and that would cost the same or a bit less than the $6 billion over the next six years which Ottawa is ready to spend on its ‘Tax Fairness Plan’. This commentary describes such an alternative. However, before doing so, it is necessary to look at the government’s proposals in more detail.

The proposal to allow couples to split pension income

In Canada, every person, whether living alone or with a spouse or partner, files his or her own tax return. Unlike the United States (and a
number of other countries), Canada’s tax system does not provide for joint returns in which couples report their combined income. Joint returns have been considered several times in the past in Canada, but they have always been rejected because of their undesirable consequences. For example, in a joint-return system, a mother who goes back to the labour force when her children reach school age would have her income added to that of her husband for tax purposes, and her income would be taxed at the husband’s highest marginal tax rate. This approach would usually result in a much higher effective rate of tax on the wife’s income than in a system, like Canada’s, of individual returns. In other words, it would impose an economic penalty on mothers for returning to the paid labour market.

Under the current provisions of the Income Tax Act, a taxfiler with dependants, which can include a dependant spouse, is allowed a non-refundable tax credit for each eligible dependant. A tax credit is a reduction in the amount of tax that a taxfiler would otherwise have to pay. However, the Act does not allow a person to reduce the amount of tax which he or she must pay by transferring some of his or her income to a dependant with less income and, as a result, whose marginal tax rate may be lower.1

The Harper government’s ‘Tax Fairness Plan’ would introduce an unprecedented deviation from the fundamental principles of Canada’s income tax system – principles which have served that system and Canadians well over many decades and through several changes in governments. If the government’s proposals are implemented, couples – whether married or common-law – will be allowed to split pension income between them when calculating their income subject to tax, and each will pay tax on half that income.2 According to information from the Finance department, eligible pension income for seniors3 will include payments from a registered pension plan (more usually referred to as a private, employer-sponsored or workplace pension plan), a registered retirement savings plan (RRSP), a deferred profit-sharing plan and payments out of or under a registered retirement savings fund (RRIF). It will not include benefits under public pension programs such as Old Age Security and the Canada/Quebec Pension Plans, nor payments from ‘top-up’ schemes such as retirement compensation arrangements. The proposed splitting of pension income will start in 2007 [Department of Finance Canada 2006c].

A major deviation from the fundamental principles underlying Canada’s tax system might be justified if it resulted in a fairer tax system or an equitable distribution of the savings among seniors in general. However, the ‘Tax Fairness Plan’ fails this test entirely.

Seniors living alone – who make up 30 percent of all Canadians aged 65 and over – will, obviously, get nothing out of the proposed splitting of pension income between spouses or partners. Nor will elderly couples whose income is so low that they already pay no income tax. Notable among the excluded are the poorest of Canada’s seniors – the 165,000 who have no income other than their Old Age Security pension and the maximum amount of the income-tested Guaranteed Income Supplement.

Many senior couples will see a reduction in their income tax if the plan is implemented. But the size of the reduction will depend on the total amount of their income. Those who are the best off – the relatively small percentage of seniors who are truly affluent – will get the largest tax savings, while the majority in the middle will see only a modest tax break.

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Figure 1 shows the federal tax that senior couples with various amounts of income from private pensions and RRSPs will save if the government’s proposal for income splitting is implemented. The data in the table comes from the Finance department [Department of Finance Canada 2006c]. The assumptions underlying the data in Figure 1 are that, at present, all the income from private pensions and RRSPs is received by one spouse or partner, that both qualify for a full Old Age Security pension, and that the spouses or partners already split their Canada Pension Plan retirement benefits between them (discussed below).

As Figure 1 shows, a senior couple with a modest private pension of $20,000 a year will realize a grand total of $310 in federal income tax savings as a result of income splitting. For a couple with $30,000 in pension income, the savings increases to $802. However, a well-to-do senior couple with $100,000 in pension income will see a tax reduction of $7,280 – more than nine times that of a couple with $30,000 in pension income, and more than 23 times that of a couple with $20,000 in private pension income.

To put these numbers into perspective, in 2004 the average amount of pension income of senior couples with any income at all from private pensions and RRSPs was $22,900 [Statistics Canada 2006a]. The average is probably somewhat higher today, but not by much. The great majority of senior couples would see,
at best, only modest tax savings of $600 or less as a result of the government’s proposed income splitting.

There is an important factor that should be kept in mind when considering the numbers in Figure 1. The different incomes given at the bottom of Figure 1 (and the other charts in this commentary), ranging from $0 to $100,000, show only income from private pensions and RRSPs. They do not include income from other sources. In particular, they do not include the Old Age Security (OAS) pensions that both spouses or partners receive, nor do they include the couple’s Canada Pension Plan (CPP) retirement pension. On an annual basis, two OAS pensions and one maximum CPP retirement pension total more than $22,000. So, for example, a couple with $20,000 in income from private pensions and RRSPs actually has at least $42,000 in total income, counting their OAS and CPP pensions. And this is almost exactly the median total income of elderly families in 2004 according to Statistics Canada [Statistics Canada 2006a].

Some might argue that the proposal to split income from private pensions and RRSPs is no different than the provision of the Canada Pension Plan (CPP) allowing pensioner couples to divide their CPP retirement benefits between them. Known technically as an ‘assignment of retirement pension’, this feature of the CPP has been in effect since 1987. It is a recognition of the contribution that both spouses or partners have made to the well-being of the household, and it provides spouses and partners who worked in the home – usually women – a share of the CPP pension of the spouse or partner who worked in the paid labour market.

While the assignment of CPP retirement pensions and the government’s proposal to allow couples to split income from private pensions and RRSPs might seem similar, they are, in fact, very different. Under the CPP provision, each spouse or partner actually receives half of the combined retirement pensions of the couple in the form of a monthly cheque. Under the government’s proposal, on the other hand, there is no actual transfer of pension income, only a deeming of income for purposes of reducing the amount of tax that would otherwise be paid by the higher income spouse or partner. If the spouse or partner who worked in the home (most likely the wife) does not get any share of the other spouse or partner’s private pension or RRSP today, she will not get any if the government’s proposal is enacted. All she will get is a tax liability.

The proposal to increase the age credit

A tax break for seniors has been a longstanding part of Canada’s personal income tax system. Until 1987, this tax relief was delivered by allowing seniors (persons aged 65 and over) to deduct a prescribed amount – called the ‘age amount’ – from their total income when determining income subject to tax. Because deductions in a progressive tax system provide greater savings to persons with high incomes than to those with low and modest incomes (tax savings increase with the taxfiler’s highest marginal tax rate), the ‘age amount’ and most other deductions and exemptions were converted to tax credits in 1988. The amount of the age credit was determined by multiplying the previous ‘age amount’ by the lowest marginal tax rate. In this way, all taxpaying seniors received the same tax break. In 1994, the system was modified further by targeting the age credit to seniors with low and middle incomes. This change was done by reducing the ‘age amount’ used in calculating a senior’s age credit by 15 percent of his/her net income, if any, over a prescribed threshold. Note that the age credit is non-refundable, which
means that it does not benefit seniors whose incomes are so low that they do not owe income tax.

For the 2006 tax year, before Ottawa’s proposed increase, the maximum age credit was worth $620.07. This amount is the product of multiplying $4,066 (what the previous ‘age amount’ would have been if the old deduction had been continued) by 15.25 percent (the lowest marginal tax rate for 2006). The net income threshold in 2006 at which the age credit starts to be reduced is $30,270. Taxpaying seniors with net incomes below this threshold are entitled to the full age credit. For all other seniors, the age credit is reduced. Seniors with net incomes above $57,377 – less than 10 percent of all seniors in Canada – do not receive any age credit. If a senior with a spouse or partner who is also a senior does not use all of her/his age credit (because her/his tax due is less than the credit to which she/he is entitled), the unused portion can be transferred to the spouse or partner. According to estimates from the Finance department, the existing age credit will cost Ottawa $1.56 billion in foregone tax revenues in 2006 and a forecast $1.62 billion in 2007.

The federal government has proposed that the ‘age amount’ used to calculate the age credit be increased by $1,000, from $4,066 to $5,066, with effect retroactively to January 1, 2006. This change would increase the maximum age credit for 2006 by $152.50, to $772.57. It would also raise the income level at which no age credit is available to $64,043. Figure 2 shows the federal income tax savings from the proposed increase to the age credit for seniors with various amounts.
of income from private pensions and RRSPs [Department of Finance Canada 2006c]. The same assumptions underlie the data in Figure 2 as those used in Figure 1.

**The combined impact of income splitting and increasing the age credit**

Figure 3 shows the combined federal income tax savings that single seniors and senior couples would realize through the implementation of the two measures in the ‘Tax Fairness Plan’ directed primarily to Canadians age 65 and over – splitting of pension income and increasing the age credit.

Figure 3 makes several facts very clear:

- Seniors with the lowest incomes will realize no benefit at all from the ‘Tax Fairness Plan’ because they do not pay any income tax. These are the poorest of Canada’s elderly, those most in need. But they will get nothing under the ‘Tax Fairness Plan’.

- The government’s plan treats senior couples much more generously than single seniors. The tax savings that single seniors will realize are small compared to those of senior couples. Women are disproportionately represented among single seniors because, on average, they live longer than men. In fact, 72 percent of all single elderly Canadians are women.

- The big winners from the government’s ‘Tax Fairness Plan’ will be high-income couples with substantial amounts of income from private pensions and RRSPs. Single seniors and senior couples in the middle-income range will see some tax
savings from the plan, but these pale in comparison to the tax cuts bestowed on senior couples at the top of the income scale. And it warrants repeating that the different incomes shown at the bottom of Figure 3 only consist of income from private pensions and RRSPs. They don’t include income from other sources, in particular Old Age Security and the Canada Pension Plan. A single senior with, say, $20,000 in income from a private pension or RRSP has a total income of about $36,000 when OAS and CPP are taken into account. For a senior couple with $20,000 in income from pensions and RRSPs, total income is around $42,000.

Figure 4 gives another perspective on the unfair distribution of benefits from the so-called ‘Tax Fairness Plan’. It shows tax savings from the plan as a percentage of a senior couple’s total income.

For a couple with a modest $20,000 in income from a private pension or RRSP, federal income tax savings would be just 1.6 percent of their total income (income from private pensions and RRSPs plus income from OAS and CPP). For a couple at the top end of the scale, with $100,000 in pension and RRSP income, the tax savings comes to 6.4 percent.
These very unfair results come at a high price to the federal government – more than $6 billion in total over the next six years. Table 1 gives the Finance department’s estimates of the federal taxes that will be foregone each year as a result of the two measures, as well as the cumulative total [Department of Finance Canada 2006c].

As large as these numbers are, the total foregone tax will be even higher. Barring a major change in the way in which provincial and territorial income tax is calculated and collected, senior couples residing in all provinces except Quebec will receive an additional tax reduction in their provincial or territorial income tax as a result of pension income splitting. This will happen because the Canada Revenue Agency collects income tax on behalf of all the provinces and territories except Quebec, and a key condition for doing so is that the province or territory use the same definition of taxable income as in the federal income tax system. The amount of the foregone provincial/territorial tax will depend on the applicable income tax rates in each province or territory. In Ontario, for example, it will be about half the foregone federal tax revenue from residents of that province.

Unlike changes in the way taxable income is calculated, changes to non-refundable tax credits in the federal income tax system do not automatically result in corresponding changes in the way provincial and territorial non-refundable tax credits are calculated. The provinces and territories are free to provide and design tax credits in their own tax systems. It remains to be seen whether provinces and territories would follow Ottawa’s lead and increase their age credit (which would further reduce their income tax revenues).

**A fair alternative**

There is a better way – a *truly* fair way – to distribute the $6 billion among Canada’s seniors. Caledon’s alternative consists of three elements:

- Scrap the proposed splitting of pension income entirely. No amount of tinkering...
will make such a measure fair. It will always give windfalls to those with the highest incomes and ignore those with the lowest.

- Implement the proposed increase in the age credit. At the same time, convert the increased portion of the age credit into a refundable tax credit so that even the poorest of seniors – those with incomes too low to pay tax – will receive the same financial benefits as other low- and modest-income seniors. Under Caledon’s proposal, seniors who owe income tax would use both parts of the age credit – the existing non-refundable portion and the new refundable portion – to reduce the amount of that tax, as is the case with the existing non-refundable age credit. However, if the amount of the refundable portion of the age credit exceeds the amount of the tax owed, or if no tax is owed at all because a senior’s income is too low to put him/her into the taxpaying range, the senior would receive a cheque from the government for the difference.

- Double the pension income tax credit from $2,000 to $4,000, but make the increased portion of the pension income credit subject to the same income test as now applies to the age credit so that benefits are targeted to lower and middle-income seniors. (Note that the pension income credit would remain non-refundable.) Since 1975, the income tax system has provided a tax break for persons receiving income from a private pension or an RRSP. Since 1987 this tax break has taken the form of a non-refundable tax credit. Until the 2006 federal Budget, the amount of the pension income credit was determined by multiplying a taxfiler’s income from private pensions and RRSPs, up to a maximum of $1,000 a year, by the lowest marginal tax rate. The 2006 Budget raised the maximum to $2,000. The Finance department estimates that the cost of increasing the maximum pension income amount from $1,000 to $2,000 would be $409 million in the current fiscal year (2006-07) [Department of Finance Canada 2006d].

Figures 5 and 6 compare the benefits that single seniors and senior couples respectively would receive under the government’s ‘Tax Fairness Plan’ and Caledon’s alternative.

As Figure 5 shows, all single seniors will either come out ahead or the same from Caledon’s alternative compared with Ottawa’s ‘Tax Fairness Plan’. The single seniors who will benefit the most from Caledon’s alternative are those with modest amounts of income from private pensions and RRSPs in the range of $10,000 to $20,000. A single senior with $20,000 of private pension income will see a tax savings of $468 under Caledon’s alternative, compared with only $158 under Ottawa’s proposals. According to Statistics Canada, the average amount of private pension and RRSP income for single seniors in 2004 was $14,300. Single seniors with no private pension income, who are among the poorest among Canada’s elderly and who will be shut out from any benefits under Ottawa’s proposals, will get $158 under Caledon’s alternative.

Low- and middle-income senior couples will also come out ahead under Caledon’s alternative compared with Ottawa’s proposals, as shown by Figure 6. Once again it is important to remember that the different incomes given at the bottom of Figures 5 and 6 consist only of income from private pensions and RRSPs and do not include income from other sources, in particular Old Age Security and the Canada
Figure 5
Change in net tax savings from Ottawa's proposals and Caledon's alternative, single seniors, 2007

Figure 6
Change in net tax savings from Ottawa's proposals and Caledon's alternative, senior couples, 2007
Pension Plan. A senior couple with $30,000 in private pension and RRSP income has a total income of about $52,000 when OAS and CPP are included. This amount is considerably above the median income of $41,900 for all senior families in 2004.

As for the cost of Caledon’s alternative, it will be the same as or a bit less than the cost of the Harper government’s proposals. Caledon’s alternative would result in far greater fairness for the same or even a lower cost: a real win-win for Canada.

**Conclusion**

The Conservative government has opted for tax breaks that will provide windfall benefits to some of the wealthiest seniors, only modest benefits to middle-income seniors, and nothing at all to the poorest of Canada’s elderly who are most in need of assistance. As this commentary has shown, using data from the Finance department, a well-to-do couple with $100,000 in income from private pensions and RRSPs would get a tax break of as much as $7,280 from the proposed splitting of pension income. This is 23 times more than the tax break of $310 for a couple with a modest pension income of $20,000 – which is close to the average pension income of all senior couples in Canada with such income.

The federal government has characterized its proposed changes as ‘tax fairness’. Tax unfairness is the real result.

The cost of this manifest unfairness is very high – by the Finance department’s own estimates, $6 billion over the next six years. Not one cent of this $6 billion will go to seniors with the lowest incomes – those who already do not pay income tax because their income is so low. In addition, there will be significant costs for the provinces and territories.

There is an alternative which would cost the same or a bit less than the government’s proposals and which we believe would be truly fair. That alternative, which Caledon has described in this commentary, would provide tax relief to middle-income seniors and allow them to keep a little more of their retirement savings for themselves. At the same time, it would give much-needed additional financial assistance to the poorest of seniors who are, at best, just getting by and who need all the help they can get.

Canadians need to have a discussion about what tax fairness really means. Caledon has prepared this commentary as part of its contribution to that vital discussion.

_Ed Tamagno and Ken Battle_

**Endnotes**

1. The closest thing is a spousal Registered Retirement Savings Plan (RRSP). This is an arrangement under which one spouse or common-law partner contributes to the RRSP of the other spouse or common-law and counts the contribution as a deduction in determining his/her (the first spouse or partner’s) income subject to income tax. Unless the funds in a spousal RRSP are withdrawn within two years of the contribution, they become the property of the spouse or partner in whose name the RRSP is registered. Spousal RRSPs are a means for splitting future, but not current, retirement income between spouses or partners.

2. Under the government’s proposals, couples could split pension income between them in any proportion they choose. In most instances, a 50-50 split would probably have the greatest advantages in terms of tax savings. However, depending on other factors, a different split could be more advantageous to some couples.
3. The government’s proposal for income splitting is not limited to seniors. Persons aged under 65 would also be able to split their pension income with their spouses or partners, just like seniors aged 65 or more. Moreover, the age of the spouse or partner would not be a factor. The only difference in the government’s proposal between persons aged under 65 and those aged 65 or over is the types of pension income eligible for splitting. According to the Finance department, “for individuals aged 65 years and over, eligible pension income includes lifetime annuity payments [pensions] under a registered pension plan, a registered retirement savings plan or a deferred-profit sharing plan and payments out of or under a registered retirement income fund. For individuals under 65 years of age, eligible pension income includes lifetime annuity payments [pensions] under a registered pension plan and certain other payments received as a result of the death of the individual’s spouse or common-law partner” [Department of Finance Canada 2006c]. The only persons aged under 65 who would qualify for pension income splitting under the government’s proposal would be retired persons who belonged to an employer-sponsored pension plan when they were in the paid labour force, and the surviving spouses and partners of deceased members of employer-sponsored pension plans. Data from Statistics Canada shows that only 27 percent of persons employed in the private sector – about one in four private-sector workers – belong to an employer-sponsored pension plan. In the public sector, on the other hand, 86 percent of employed persons – more than five out of six workers in the public sector – belong to such plans [Statistics Canada 2006b].

4. From January 1 to June 30, 2006, the lowest marginal tax rate was 15 percent. Under Minister Flaherty’s budget of February 2006, the rate increased to 15.5 percent on July 1. The lowest effective marginal tax rate for 2006, therefore, was 15.25 percent.

References


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