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TAXSTRATEGY

Planning for your RRSPs

Take Full Advantage

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So, January 2021 has really started out with a bang (and not necessarily the good kind). "Doomscrolling" is a new word I've encountered and I have found that it is very relevant for me these days. Between the new lockdown measures in light of Covid and the unreal happenings south of the border, I'm not sure if I'm looking forward to this new year. So, thinking about RRSP planning is likely at the bottom of your list. However, I suggest that spending some time reading about how to make the most of your RRPS contributions might be just what the doctor ordered (at least to provide some semblance of normalcy in these days).

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☛ Tip #1 - Take full advantage of spousal RRSPs A spousal RRSP is simply an RRSP where you make the contributions, but the plan is in your spouse's name - i.e., owned by your spouse. It's a relatively straightforward way to split income. When you contribute to an RRSP in your spouse's name, you receive a personal tax deduction. But since the RRSP belongs to your spouse, amounts received from the plan generally will be taxable to your spouse, not you. The object of a spousal RRSP is to allocate taxable income as evenly as possible between you and your spouse, so that you will both be in a fairly modest tax bracket. So, if your spouse will be in a lower tax bracket than you when the RRSP is paid out, a spousal RRSP makes sense because withdrawals eventually will be taxed in his or her hands.

Another advantage is that the maturity deadline of a spousal-RRSP is based on the age of your spouse; so, if you're too old to contribute to your own RRSP, it may be possible to continue to contribute to a younger spouse's RRSP. Of course, you must have what's known as "earned income" to do this (which includes employment or business income, alimony received, and rental income, among other income sources. It does not include items such as investment income). A spousal plan may also be a good idea if the contributor spouse is concerned with potential creditor problems.

There are rules relating to "quick withdrawals." Amounts withdrawn from a spousal RRSP must be included in the income of the contributor spouse to the extent of tax-deductible contributions either in the year of withdrawal or in the previous two years. This includes "lump-sum" RRSP withdrawals made after the plan has matured.

Note – to the extent that you are pension splitting (i.e. where up to half of eligible pension income (including RRSPs) is allocated to a lower-income spouse or partner), the spousal RRSP may not give you any additional benefit.

☛ Tip #2 - Make "Catch-up" Contributions. If you haven't "maxed out" on your RRSP contributions in the past (going back to 1991), you're entitled to make an additional contribution over and above your normal limit for the year. That's because, (effective from 1991 onward), your "unused" RRSP contribution limit can be carried forward indefinitely to future years. Of course, one of the biggest barriers between you and your write-off could be finding the means to make a catch-up contribution. Possible sources for your catch-up contribution could include inheritances, contributions in kind, an RRSP mortgage or borrowing.

Note: If you make a very large RRSP contribution, you could be subject to the so-called "Alternative Minimum Tax." But even if this is the case, the extra tax you pay can be applied to reduce your future regular taxes. In the meantime, your RRSP nest-egg will be earning income on a tax-sheltered basis.

Another thing to bear in mind is that the higher your tax bracket, the more effective your RRSP contribution will be. So, a low-income year may not be a good time to make a catch-up contribution. If your annual income is such that you're not "too far into" a particular tax bracket, you may want to make a series of RRSP contributions which take you down to the "bottom of the bracket". Another alternative could be to make a lump-sum contribution, but defer the actual deduction until a year when you're in a higher bracket.

☛ Tip #3 - Put the high-tax stuff in your RRSP. It has been said that you should hold high-tax investments in your RRSP and low-tax investments outside your plan. But which investments are high tax? Traditionally, these have been interest-bearing investments. Stocks and equity funds, on the other hand, may qualify for capital gains treatment (50 per cent of a capital gain is tax-free), as well as the dividend tax credit if Canadian. These benefits are lost if you hold certain investments through your RRSP, since retirement and other amounts you receive from your plan are fully taxable. So, if you have investment capital both inside and outside your RRSP and you wish to invest in both equities and fixed-income investments, it is generally better to hold the former outside your RRSP and the latter inside your plan.

Can equities be high tax? A case in point arises if you're contemplating a big short-term capital gain. In this case, the equity investment could, in effect, become high tax, since you have to pay this tax for the year you sell, while the gain can be tax-deferred in your RRSP. Owning short-term-hold equities in your RRSP could defer capital gains tax for years - giving you the opportunity to take profits and reinvest on a tax-deferred basis. In some cases, this may more than make up for the tax breaks you get by holding outside your RRSP.

It may make sense to hold part of a high-appreciation equity position - the portion you may liquidate - in your RRSP. (Careful though: transferring existing investments into your RRSP triggers capital gains tax, if they've appreciated in value.)

If an equity is a long-term hold, the "outside-the-RRSP" strategy still applies.

Finally, it makes little sense to select your investment portfolio just to get the tax benefits. For example, if you like an equity investment, then by all means invest through your RRSP if that's where your capital is.

☛ Tip #4 - Building in Contribution Room for your family. If you carry on a business, it may be that you are paying your children a salary. If so, this not only creates contribution room for your kids but also results in a deduction for your company (note – make sure the salary is not unreasonably large in light of the services they are actually providing the business). Every person (including children) can receive up to $13,808 for the 2021 year without paying tax by claiming the federal basic personal tax credit. Moreover, the salary your child receives should qualify as "earned income," so that he or she will be entitled to make an RRSP contribution based on 18 per cent of the salary, something which that can be carried forward over the years.

For example, if you had two children and paid each child $13,000 a year for ten years, and this was their only income, no tax would be paid. However, each child would then be eligible for a tax write-off of $23,400 over the ten years because of the RRSP carry forwards (remember they contribute 18 per cent of their annual earned income each year), which could be used to reduce their taxes when they have higher income. So, your two kids, together over the ten years, could be in a position to claim write-offs of $46,800 - and your business would have enjoyed some write-offs in the meantime.

☛ Strategy #5 - Don't wait to contribute. Okay, this tip is pretty obvious, especially if you haven't yet contributed and we're now in the home stretch. But you'd be surprised how many people wait until the end of business day on the last day to contribute. But, if you happen to have already made your contributions for the year, this tip is still worthwhile since there's no time like the present to start contributing to your 2021 RRSP. If you have the cash available now, don't wait until February 2022 to contribute to your 2021 RRSP. Why pay tax on your interest income while it sits in your bank account when your income could be tax-sheltered in your RRSP? ❏