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TAX*STRATEGY*

Tips to help you and your family make the most of your RRSPs

RRSP tax plan

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Putting money into your Registered Retirement Savings Plan, or RRSP, is a great way to start planning for your retirement. And there's no better time to start thinking about your economic future than at the beginning of a new year. But let's not forget that a properly tax-planned RRSP will reap immediate benefits to you—lowering your overall tax bill, especially if you have lower-tax-bracket family members.

Here are some planning tips to help you and your family make the most of your RRSPs, especially if you are a businessperson or professional.

Dividends versus salary

If you have a company, bear in mind that dividend income does not qualify as "earned income," even if received from a corporation carrying on an active business. Only income that qualifies as earned is considered in calculating the amount you can contribute to your RRSP. The upshot of this is that many business owners choose to pay themselves a company salary rather than dividends.

Building in contribution room for your family

If you have a business, a prudent strategy could be to pay your children salaries. This can be deductible to your company as long as the wages are not unreasonably large, in view of the business-related services your children actually perform for the company. If your child has no other income, it's possible for him or her to receive up to $11,327 for 2015 without paying any tax because he or she can shelter this income by claiming the basic personal tax credit.

The salary your child receives should qualify as earned income such that he or she shall be entitled to make an RRSP contribution based on 18 per cent of that salary (up to a prescribed limit). And remember: RRSP contribution limits are eligible to be carried forward. This means that a child or other low-tax-bracket family member may build up a "bank" of "carry-forwards." This, in turn, provides additional RRSP contribution room that can be used up when the individual reaches a higher tax bracket; e.g., when they get a job after graduating from university.

If your kids are close to graduation, their salary—and therefore their RRSP contribution room—might be increased. Your children may pay taxes in a low bracket, but instead of sheltering this income with an RRSP contribution, they could opt to save these RRSP contributions for after graduation. Embarked on their own careers—one hopes!—they will be in higher brackets. If so, the deductions they qualify for will be more useful to them at that time.

By the way, these strategies are not limited to businesspeople. An employee can claim a deduction for salaries paid to an assistant (which may include, for example, stenographic and secretarial assistance). Besides being deductible, the salaries allow the family member/assistant to claim

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an RRSP contribution.

Note: To claim these write-offs, you must complete Form T2200, which must be signed by your employer, but does not have to be submitted with your tax return. The form certifies that you are required to defray these expenses as part of your employment arrangement.

Distributions from corporations

Perhaps the single biggest tax break is the ability to earn business income in a corporation. Lucrative small-business tax rates mean that, depending on the province, your company can pay tax at about 15.5 per cent or even less.

However, corporations cannot make RRSP contributions. And owner-managers cannot make such contributions—unless they have earned income. So if you have no other sources of earned income, it generally makes sense to distribute funds in the form of a salary from the company in order to fund RRSP contributions.

This strategy almost always makes sense if the distributions still leave you in the bottom tax bracket.

Here's why. Although the applicable personal tax rate near this level may be a bit higher than the company's, by making an RRSP contribution, you are effectively cutting your taxes by 18 per cent. This usually leaves you at close to the same rate as your company would pay if it did not distribute the income. You will also have taken the remainder of the money out of your company, so that you may now use it as you wish. Finally, the investment income from your RRSP will compound tax-free in your RRSP instead of being earned by your company and subject to ongoing taxes.

Strictly speaking, distributions that take you out of the lowest tax bracket may be less "tax-efficient." But in most cases, the owner-manager will need the extra dough—i.e., to live on—so distributions will be necessary in any event. If so, such distributions should usually be made in the form of salary (rather than dividends, which do not qualify as earned income) until your earned income is enough to allow for a maximum RRSP contribution.

Note: The maximum RRSP limit for 2014 is $24,270. This means that, because RRSP contribution limits are based on prior-year earned income, 2013 earned income of $134,833 will allow a maximum 2014 contribution.

The Dribble Effect

One of the big reasons banks are racking up big profits is that they pay you very little interest on cash balances in bank accounts, especially when it comes to your RRSP.

The effect of low deposit rates is insidious. At any given time, there isn't much money at stake. But slowly and surely, the lost interest dribbles away—after a while, those dollars can really mount up—and they go right into the bankers' pockets.

Here are five ways to guard against the "dribble effect."

1) Shop for the best rates on RRSP and other cash balances.
2) Put your RRSP into strip coupons. These financial instruments lock in the interest until maturity. In the meantime, there are no cash payments dribbling into your RRSP.
3) Get into the habit of reviewing RRSP statements monthly for idle cash balances.
4) If better rates are offered on larger balances, and you have several RRSPs, consider consolidating them into one account.
5) Use cash balances to invest in a money market fund. There are usually no fees for these funds, with low management expense ratios (or "MERs"). Most Canadian money market funds are designed to maintain a fixed net asset value per unit at $10.

Which investments should be held 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 the source is Canadian.

These benefits are lost if you hold stocks and equity funds in your RRSP, as all amounts you withdraw from your RRSP are fully taxable; i.e., with RRSPs, income from capital gains and dividends is, ultimately, taxed at the same rate as interest income.

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 equities for the short-term 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 would get by holding them outside your RRSP.

Tax tips

- 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. ❐