MONTHLY NEWSLETTER

RRSPs: Food for Thought

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Our goal is to provide updates on topical tax issues. Information contained in the newsletters is not meant to be a comprehensive summary of the issues raised. Rather, we wish to bring what we believe to be important issues to the attention of our valued clients. We would be pleased to discuss any questions that you, the reader, might have in greater detail.

SUMMARY OF RRSPS

Registered Retirement Savings Plans ("RRSPs") are often top of mind to taxpayers in February as they look to minimize their taxes and the contribution deadline approaches. Most people are familiar with the general rules related to RRSPs, namely:

- taxpayers accumulate contribution room based on 18% of their earned income in a given year. The room can be carried forward and used in the future if not used in the year it is earned
- contributions are tax deductible to the extent of the contributor's RRSP room and can be deducted when the contribution is made in the calendar year or the first 60 days of the following taxation year
- if someone contributes more than their RRSP contribution limit permits, they are subject to a tax equal to 1% of the over-contribution amount per month
- income earned within an RRSP can be earned free of tax as long as the funds remain in the RRSP
- withdrawals from RRSPs are taxable in the year they are withdrawn

With these basics in mind, the remainder of this discussion will provide food for thought and will focus on a number of factors to consider when determining how much, if any, to contribute to an RRSP.

TAX DEFERRAL YES, BUT NOT NECESSARILY AN ABSOLUTE SAVINGS

The principal benefit offered by RRSPs stems from the graduated tax rate system in Canada. The effective tax rate can range from as low as 0% for those with limited income to as high as 49.53% with the recent introduction of the "super tax" in Ontario. The higher the taxpayer's marginal tax rate, the greater the tax deferral offered by RRSP contributions.

For example, assume a taxpayer subject to the super tax contributes $10,000 to their RRSP. The deduction would shelter $10,000 of income from tax and would reduce taxes payable in the current year by $4,953. In the future when the $10,000 is ultimately withdrawn from the RRSP, if income levels remain unchanged, the withdrawal will be taxed at the 49.53% rate, resulting in additional tax in the year of the withdrawal of $4,953. In this simple example, the RRSP provides a deferral of tax, but not an absolute savings.

Comparatively, assume that the income level drops considerably in retirement such that the marginal tax rate in the year of the withdrawal is reduced to 20%. In the year of the contribution, taxes will still be reduced by $4,953. However, in the year of the withdrawal when the taxpayer is in retirement, taxes will be $2,000. In this instance, the RRSP provides a deferral of tax as well an absolute savings of tax of $2,953.

These simple examples are meant to highlight an important characteristic of RRSPs: contributing when your tax rate is high and withdrawing when your tax rate is low offers the best overall tax result. Although this may seem like an obvious conclusion, taxpayer's often focus on minimizing tax in a given year and often lose sight of this.

RRSPs offer a deferral benefit and also an absolute tax savings where income levels are lower in the year the funds are withdrawn. RRSP contributions are generally less attractive to lower income taxpayers.

Investment Considerations

The current capital gains inclusion rate in Canada is 50%, meaning that half of a capital gain realized in a non-registered account can be received tax free. Other types of investment income such as interest income are fully taxable. RRSPs shelter capital gains and other investment income from tax while the funds are retained in the plan. However, when the funds are ultimately withdrawn, the income inclusion rate is 100% of the withdrawn amount. There is no mechanism to credit for 50% of realized capital gains.

Where possible, it generally makes sense to hold growth stocks in unregistered accounts and interest or dividend paying investments in your RRSP.

Are Spousal RRSPs a Thing of the Past?

Spousal RRSPs offer a mechanism for couples to split income and reduce their overall income tax burden when funds are withdrawn from an RRSP. The contributor is permitted a deduction from their income and withdrawals from the RRSP are taxed in the hands of the taxpayer's spouse provided the attribution rules do not apply. Where spouses are in different income tax brackets, spousal RRSPs can provide substantial income tax savings. The disadvantage is that a spousal contribution becomes the property of your spouse.

The 2007 federal budget introduced pension splitting, which allows couples to split up to 50% of their eligible pension income. With pension income splitting, no assets are transferred. You and your spouse simply file a joint election each year as part of your income tax filings. This also means that you can choose on a yearly basis whether or not income splitting makes sense.

So the question becomes, are spousal RRSPs now a thing of the past? We would argue not, for the following reasons:

1) Income can be split at any age - under the pension income splitting rules, you must be at least age 65 to split income and you must convert your RRSP into a RRIF. Regular RRSP withdrawals do not qualify for pension income splitting. However, with spousal RRSPs, you can split income anytime that the attribution rules don't apply. If a spousal contribution hasn't been made in the current year or the two previous calendar years, any withdrawals from the RRSP will be taxable to your spouse.
2) 50% limitation on pension splitting - After age 65, you can split up to 50% of your pension income with your spouse. With spousal RRSPs, you determine the amount of income to split by deciding how much to contribute to the spousal RRSP, subject to your contribution room.
3) A younger spouse allows for continued RRSP contributions - If you have a younger spouse, you can continue to contribute to the spousal RRSP until the end of the year your spouse turns 71, provided that you still have RRSP contribution room.
4) Legislation is subject to change – pension income splitting is currently permitted. There is no guarantee of what tax changes will come in the future. Therefore, taking advantage of spousal RRSPs provides additional assurance that income splitting will be possible in retirement.

Although pension splitting has reduced the benefit of spousal RRSPs, spousal plans are still an important planning tool that should be considered.

Implications of Death

When a taxpayer passes away, the fair market value of their RRSP at the time of their death must be included in their income on their final personal income tax return. Certain exceptions exist. For instance, if the designated beneficiary of the RRSP is the taxpayer's spouse, a rollover is permitted for income tax purposes such that there is no immediate income tax implication. Only on the death of the surviving spouse would the RRSP become taxable.

When estate planning, it is important to remember that the value of your RRSP is not its true value. For example, take someone who has diligently saved and invested for many years, growing their RRSP to $1,000,000. If this investor were to suddenly pass away, their estate owe tax of close to $500,000 with the remaining $500,000 available to satisfy the bequests of their will. Clearly this is not a desirable outcome. When deciding whether or not to contribute to your

RRSP, consider the current balance in the plan, your age, your health, your retirement needs, and your current marginal tax rate. The expected tax on the RRSP should also be factored into planning related to one's will.

RRSPs may not always make sense, especially given the income tax implications on death.

RRSPs vs TFSAs

Tax Free Savings Accounts ("TFSAs") were first introduced in 2009. TFSAs differ from RRSPs in that the contributions are not tax deductible and withdrawals are not taxable. TFSAs offer the same benefit of sheltering investment income earned from income tax while the funds remain in the account. TFSA contribution room now sits at $36,500 for every Canadian who was at least 18 in 2009, or $73,000 per couple. Many Canadian families cannot afford to maximize their RRSP and TFSA contributions, and so the question becomes which is best?

There is no right or wrong answer. Both plans have unique advantages and disadvantages. RRSPs are better suited to long term retirement savings while TFSAs are best suited for personal savings to be used for a trip, car, etc. One should also consider the factors outlined above to determine if an RRSP makes sense.

It is important to note that when you withdraw funds from a TFSA, the contribution room is replenished by the amount of the withdrawal on January 1 of the following year. For example, if you contributed $30,000 to your TFSA in 2014 and then withdrew the $30,000 in the same year, $30,000 would be added to your TFSA contribution room on January 1, 2015. RRSP contribution room is not replenished when funds are withdrawn. TFSAs are therefore more flexible in terms of making contributions and withdrawals than RRSPs.

A planning opportunity for someone who is unsure whether a TFSA or RRSP contribution is best is to contribute to the TFSA to allow income to be earned tax-free. Later in the year, once income levels and cash flow concerns are known with better certainty, the amounts can be withdrawn from the TFSA and contributed to the RRSP. The taxpayer benefits from tax free income earned while deciding how much to contribute to their RRSP and also from the deduction provided by the RRSP contribution.

TFSAs and RRSPs each offer significant income tax benefits. The decision of which is best is usually dictated by the taxpayer's motivation for saving.

CONCLUSION

RRSPs appear quite simple on the surface. However, there are many nuances that taxpayers should consider in their planning. We suggest you contact a professional advisor if you have any uncertainties about your RRSPs.

About the Authors:

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