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TAXSTRATEGY

RRSP Tips

Lower Your Tax Bill

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The other day I was chatting with a friend about the fact that we are at the beginning of February and how both of us had a distaste for the month. "Blah" was really the first word that came to mind. Thankfully it's a short month. And another bright note: February gives you the opportunity to make those last-minute RRSP contributions for the previous year. A properly tax-planned RRSP will reap immediate benefits to you in lowering your overall tax bill, especially if you have lower bracket family members. Below are some planning tips to help you and your family make the most of RRSPs, especially if you are a businessperson or professional.

☛ Building in Contribution Room for your family.

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If you have a business, a prudent strategy could be to pay your children a salary. Again, this can be deductible from 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. So if you are thinking of paying your three year old a $50,000 salary, perhaps that might be too aggressive (unless he or she is a prodigy when it comes to bookkeeping!) However if your child is older and spends his after school or weekends helping out in the business (like I did with my father's business), then paying him (or her) a salary will reap a great benefit. In fact, if your child has no other income, it's possible to receive up to $15,000 for 2023 without your child paying any tax. That's. because he or she can shelter this income by claiming the federal basic personal tax credit.

The salary your child receives should qualify earned income, so that he or she will be entitled to make an RRSP contribution based on 18 per cent of the salary. Remember, with RRSP contribution limits eligible to be carried forward, this means that a child or other low-bracket family member may build up a "bank" of carry forwards, thus providing additional RRSP contribution room which can be drawn down 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 graduating, the salary – and therefore the RRSP contribution room - might be increased. They may pay taxes in a low bracket, but instead of sheltering this income with an RRSP contribution, they could opt to save the contribution for after graduation, when they're in higher brackets so that the deduction is more useful to them when they actually have income.

☛ Dividends versus salary. If you are a shareholder of your family company, bear in mind that dividend income received does not qualify as "earned income", even if received from a corporation carrying on an active business. Therefore, this may be a favourable factor in deciding to pay yourself a salary out of your company instead of dividends. And not only will it create a deduction for your corporation, it will increase your RRSP contribution room and create an opportunity for a personal deduction in respect of any RRSP contributions you make.

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, secretarial assistance). Besides being deductible, the salaries allow the family member/assistant to claim 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 general 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 12 per cent(for Ontario) on the first $500,000 of income. 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 (as noted above).

This strategy almost always makes sense if the distributions leave you in the bottom, "significant" 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, which usually leaves you 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 which 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 contribution for 2022 is $ 29,210. This means that, because RRSP contribution limits are based on prior- year "earned income", 2021 "earned income" of $162,278 will allow a maximum 2022 contribution.

The Dribble Effect One of the big reasons banks can rack 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 can be 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 banker's pockets.

Here are five ways to guard against the dribble effect:

☛ Shop for the best rates on RRSP and other cash balances.

☛ 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.

☛ Get into the habit of reviewing RRSP statements monthly for idle cash balances.

☛ If better rates are offered on larger balances, and you have several RRSPs, consider consolidating them in one account.

☛ Use cash balances to invest in a money market fund. There are usually no fees for these funds, which have low MERs.

Regardless, please speak to your investment advisor to ensure that you get the right advice.

Which investments should you hold 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 them 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.

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 to 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. So please speak to your investment advisor. ❏