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The Advantages of an RRSP

RRSPs offer very important tax advantages:

- Contributions made to an RRSP are tax deductible within certain contribution limits. Because of this, contributions will shelter other sources of taxable income.

- Investment earnings are not taxed while they accumulate in the RRSP. For most investments, the earnings are subject to tax as they are earned or realized. But there is no “tax drain” in an RRSP. All of the earnings will be put to work for the annuitant in the plan.

When funds are taken out of the plan, however, they are taxable. This is an important point to note. Because all funds received from the plan are potentially taxable, the real effect of an RRSP is that tax is deferred until then. In the meantime, however, the two tax advantages combine to enhance the accumulation of capital compared to funds invested in conventional investments. However, tax benefits for particular forms of investments, such as capital gains rates and the dividend tax credit, will generally be lost in an RRSP.

There could also be another form of tax savings in that, by the time an individual is taxed on RRSP payments, he or she may have retired and may therefore be in a lower tax bracket.

Spousal RRSPs

A spousal RRSP is a plan where one spouse/common-law partner makes the contributions, but the other spouse/common-law partner “owns” the plan. Contributing to a spousal RRSP allows the contributor-spouse/common-law partner to obtain a deduction from his or her) taxable income, whereas funds received out of the plan will usually be included in the spouse/common-law partner’s income. Accordingly, if it is likely that the spouse/common-law partner will have a lower marginal tax rate when funds are received by the plan, a spousal RRSP will be advantageous.

Another advantage of a spousal RRSP is that the maturity deadline is based on the age of

the spouse/common-law partner. Thus, if an individual is too old to contribute to his or her own RRSP, it may be possible to continue to contribute to a spouse/common-law partner's RRSP if the spouse/common-law partner is still eligible to contribute (contributions are not allowed after the end of the year in which the annuitant reaches age 71).

Because the RRSP is owned by the spouse/common-law partner, rather than the contributor, there is a possibility of creditor protection, i.e., if the contributor-spouse/common-law partner might be subject to adverse claims in the future. Of course, there is the possibility that the contributions could be set aside, for example, under applicable fraudulent conveyance legislation. However, depending on the circumstances, this risk could be mitigated if the contributor has historically established a consistent pattern of spousal RRSP contributions that are motivated by the tax advantages described above.

Withdrawals from a spousal RRSP are generally subject to a "three-year rule". If a taxpayer's spouse/common-law partner receives funds from an RRSP to which the taxpayer has made a contribution, the contributor-spouse/common-law partner must include an amount in income equivalent to any tax-deductible contributions to all spousal RRSPs, for the year of withdrawal as well as for the two previous years. The amount included in income will, of course, be limited to the withdrawal made by the spouse/common-law partner if this is less than the contributions made within the three-year period. The three-year rule will operate to bring into income contributions made to other spousal RRSPs within the three-year period — and not solely to the particular plan that is collapsed.

Obviously, the three-year rule may allow a degree of income splitting by staggering contributions between personal and

spousal RRSPs; after contributing to a spousal RRSP, the individual could then contribute to his or her own RRSP for the three-year period, after which he or she could then be able to withdraw from the spousal RRSP (i.e., after the three-year period).

If the contributor's spouse/common-law partner is eligible to make an RRSP contribution (i.e., she or he has earned income, etc.), contributions may be made by the spouse/common-law partner, in addition to the spousal RRSP contributions. In such situations, it may be prudent for the contributor's spouse/common-law partner to set up a separate plan, so that withdrawals can be made from the untainted plan, without regard to the three-year rule.

Contribute Early

If possible, RRSP contributions should be made early in the year. Earnings will accumulate on a tax-deferred basis sooner. In addition, an early contribution may enable an employee to apply for a reduction of source deductions due to the reduced tax as a result of the contribution. Technically speaking, the reduction in source deductions is granted when regular withholding would cause "undue hardship". However, over the years, virtually all Canadian tax offices have relaxed their procedures so that most people in this situation may be eligible for a reduction in withholding. The CRA has indicated that all deductions in calculating taxable income as well as non-refundable tax credits will be considered favourably in respect to granting a reduction in source deductions.

Contributions After Death

While no contributions can be made to a deceased individual's RRSPs, the deceased's legal representatives can make contribution to the surviving spouse/common-law

partner's RRSP either in the year of death or during the first sixty days following the end of that year. These contributions can be claimed on the deceased individual's return, up to the deceased's RRSP deduction limit for the year of death.

Deferred Contributions

It is possible to contribute to an RRSP on a current basis but not make the actual deduction claim until a later year. In spite of the fact that the deduction would be deferred, this could be advantageous if it is anticipated that the individual may be subject to a higher marginal tax rate in a future year. Notwithstanding the fact that the deduction in respect of the contribution itself would be deferred, the earnings on the contribution would, nevertheless, continue to accumulate on a tax-deferred basis.