



ARTICLE REPRINT

# Don't Leave Retirement to Chance

Understanding tax savings for TFSA and RRSP

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KPMG ENTERPRISE

# Don't Leave Retirement to Chance

## Understanding tax savings for TFSE and RRSP



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Entrepreneurs don't have company pension plans or benefits. They must rely on themselves to save for retirement, their children's education or a rainy day. That's why it's important small business owners remember that the potential tax savings from making use of the tax-assisted savings plans available can go a long way toward helping them achieve their financial goals.

Most self-employed individuals, are probably familiar with registered retirement savings plans, but not as many may know all the benefits of the tax-free savings account, or TFSA.

Although the contributions are initially limited, as room increases, a TFSA can become a significant supplement to an RRSP.

Starting in 2009, individuals could contribute up to \$5,000 a year to a TFSA, if they are 18 or older and resident in Canada. This means a \$10,000 contribution can be made to a TFSA opened in 2010.

Although contributions are not tax-deductible, the investment income and capital gains earned on investments in the account are tax-free and tax-free withdrawals can be made at any time. The amount of the withdrawal will be added to the contribution room in the following year.

As well, funds can be given to a spouse to establish a TFSA, and the attribution rules that would normally tax the investment income in the individuals hands will not apply.

With careful planning, using TFSAs should allow a family to avoid paying tax on the income earned on the first \$10,000 of savings each year.

While the TFSA should be a key part of an entrepreneur's investment and retirement planning, it is necessary to weigh these advantages against the benefits of other tax-assisted savings plans such as RRSPs and registered education savings plans, or RESPs, and other financial priorities such as paying down the mortgage.

Generally, if the resources are available, the self-employed should invest in all relevant plans.

The key factor to consider is that RRSP contributions are tax-deductible but the contributions and investment earnings are taxed at the time of withdrawal. TFSA contributions are not tax-deductible but withdrawals of contributions and investment income are tax-free.

As such, the best tax strategy for dividing investments between TFSAs and RRSPs may depend on any differences between an individual's current tax bracket and the bracket he or she expects to be in when the individual begins to withdraw funds from an RRSP.

For individuals who expect their future income to fall into the same tax bracket as their current income, the tax benefits of a TFSA and an RRSP will be similar. That is, the value of the tax deduction for an RRSP contribution will generally equal the value of withdrawing funds tax-free from a TFSA.

For individuals who expect future income to fall into a lower tax bracket than their current income, an RRSP investment can provide a tax advantage because the deduction they get today will be more than the tax they will eventually pay when the money from an RRSP is withdrawn.

On the other hand, if income falls into a lower tax bracket now but there is an expectation it will be higher in the future, a TFSA offers a greater tax benefit because those individuals would pay a higher tax rate on future RRSP withdrawals than they would pay today on the income contributed to the TFSA.

Unlike an RRSP, which must be wound up at age 71, TFSAs can be maintained for an individual's lifetime.

Individuals, who are saving for a child's education, should also keep in mind that, unlike a TFSA, an RESP offers an annual guaranteed rate of return of \$500 (20 percent on \$2,500 annual contributions) via the federal Canada Education Savings Grant.

Once children turn 18, it is a good idea for them to open their own TFSAs with funds from the parent to help finance their postsecondary education and other expenses.

Investors also need to consider which investments to hold in their registered accounts.

TFSAs and RRSPs are generally allowed to hold the same qualified investments, such as cash, guaranteed investment certificates (GICs), term deposits, mutual funds, government and corporate bonds, publicly traded securities, and in certain cases, shares of small business corporations.

One exception is that shares of an investor's own company probably won't qualify for a TFSA. These accounts cannot hold investments in "non-arm's length entities," which generally means companies in which the investor, his or her spouse and other related persons, either individually or collectively, own 10 percent or more of the shares.

Investments that are expected to increase significantly in value during a short time are best put in a TFSA, because the income and capital gains earned can be withdrawn tax-free at any time and any withdrawals the holder makes will create additional contribution room.

Sorting out all the options and choosing the most tax-effective savings and retirement strategy can take some time and effort, especially for busy entrepreneurs. But, the tax savings he or she can realize over time definitely make the effort worthwhile.

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