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TAX MATTERS

Four more RRSP-related tax mistakes you should avoid

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We all make mistakes. Like the time I bought Carolyn a treadmill for our first anniversary. I was young and naive at the time. Last year I bought her a $100 gift card for a local hardware store. She was not a happy camper about that, either. I guess I should have made it $200.

I continue to make mistakes. Last week, I spoke about three mistakes many people make with their registered retirement savings plans (RRSPs). Today, I want to continue that conversation with more RRSP mistakes to avoid.

MISTAKE 4: TAKING RRSP DEDUCTIONS IN THE WRONG YEAR

Grace just made a contribution to her RRSP last week. Since she contributed within her contribution limit, and before the March 1, 2021 deadline, she can claim her RRSP deduction on her 2020 tax return, or she can save the deduction for a future year. You don't have to claim your RRSP deduction in the year you make the contribution. It's possible that she might just claim this deduction in the wrong year.

Grace was affected by the pandemic and expects her income to be meaningfully higher in 2021 than it was in 2020, so she'll be in a higher tax bracket in 2021. As a result, she'll save more tax by deferring her deduction and claiming it on her 2021 tax return. She'll still report the contribution on Schedule 7 of her tax return for 2020, but she can choose to carry forward the amount and deduct it next year when she files her 2021 tax return. It could make sense to postpone the deduction for even a couple of years if she expects her income to be that much higher in the future.

MISTAKE 5: WITHDRAWING TO PAY DEBTS

Martin has $10,000 of debt he'd like to pay off. His loan is at 5 per cent, and he has five years left on the loan. By paying off his debt today, he'll effectively earn a guaranteed 5 per cent after-tax return on the amount he pays off today. He was planning to make a withdrawal from his RRSP and then pay off the debt.

In most cases, this won't make sense, especially in the case of short-term debt or where your rate of interest is low – as with most home mortgages, for example. In Martin's case, he'll pay more in tax on his withdrawal than he'll save in interest costs. He will also have wasted valuable RRSP contribution room since he won't get that room back again when he makes the withdrawal. Martin would have to use up new contribution room to replace those RRSP dollars. He'd be better off using tax-free savings account assets, if he has any, to pay down the debt.

MISTAKE 6: GIVING YOUR SPOUSE FUNDS TO CONTRIBUTE

Warren and his wife, Janine, are saving for retirement. Janine has plenty of unused RRSP contribution room but lacks the funds to make a contribution. Warren, on the other hand, does have some cash, so he plans to give Janine $50,000 so that she can contribute to her RRSP before the March 1, 2021, deadline.

The problem? The attribution rules in our tax law could apply to withdrawals from Janine's RRSP later. Specifically, Warren could face tax on all or part of the withdrawals that Janine makes from her RRSP then. How so? The Canada Revenue Agency has said that an RRSP is considered to be "property" under our tax law. Therefore, any withdrawals from an RRSP are considered to be "income from property."

The attribution rules in our tax law apply to income from property and will attribute that income back to the spouse who gave the cash to acquire the property. Warren would be better to contribute to a spousal plan for Janine or lend her the money at the prescribed rate (currently 1 per cent) to avoid this attribution. A spousal RRSP is a plan to which one spouse contributes and receives the deduction, but from which the other spouse will make the withdrawals and pay the corresponding tax.

MISTAKE 7: COMBINING CERTAIN RRSPS

Sarah's husband has contributed $30,000 to a spousal RRSP for her over the past two years. To simplify her life, Sarah has decided to combine this RRSP account with her other RRSP that she had set up for herself a few years ago. The problem? When you combine spousal RRSP dollars with regular RRSP dollars, the entire plan becomes a spousal RRSP subject to the rules that apply to spousal RRSPs. So, if Sarah wanted to make any withdrawals from the combined plan, it's possible that some or all of those withdrawals could be taxed in her husband's hands, depending on when he last made contributions. The rules around spousal RRSPs are a topic for another day.

Tim Cestnick, FCPA, FCA, CPA(IL), CFP, TEP, is an author, and co-founder and CEO of Our Family Office Inc. He can be reached at tim@ourfamilyoffice.ca