CESTNICK

TAX MATTERS

Graduates should think about where to invest new income. Here are some things to consider

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My daughter, Sarah, is graduating from university this month. I was chatting with one of her friends, Ella, who is also graduating. "What subject did you study?" I asked. "I love history, and especially ancient civilizations, so I studied Egyptology," she replied. "What do you hope to do in the future?" I asked. "I'd like to teach the subject at a postsecondary level," she said. So, Ella studied Egyptology so she can teach Egyptology. Sounds like a pyramid scheme to me (pardon the pun).

Both of these young graduates have jobs lined up and are starting their careers now. They'll be earning more income than they ever have and were asking about saving for the future. Should they invest in an RRSP, TFSA or something else? Let me share my thinking.

First things first

Determining the best way to save money should start with a discussion about what you're saving for. Are you saving for a short-term goal such as buying a car, taking a vacation, or starting a business in the next year? Or perhaps you're following the prudent advice of many financial planners and want to create an emergency fund – typically three months of spending is a good goal. In these cases, a TFSA is a great option because you can make withdrawals tax-free when you need the funds and recontribute the amounts later.

On the other hand, if you're saving for retirement – a much longer-term goal – then an RRSP should enter the discussion. RRSPs are designed for long-term savings. Since withdrawals are taxable, and you can't recontribute withdrawn amounts (you will have permanently used up RRSP contribution room that you won't get back again), you want to avoid withdrawals until retirement if possible.

Now, if you're saving for a home purchase, you'd be wise to use a First Home Savings Account (FHSA) if you qualify. It's a new registered account; most financial institutions will offer these by October, although many offer them now.

An FHSA is a hybrid of an RRSP and a TFSA. You'll receive a deduction when you contribute (like an RRSP), but you can withdraw the funds tax-free (like a TFSA) when you buy a home. You can contribute as much as $8,000 per year, to a maximum of $40,000 in your lifetime. Even if you're not sure you'll buy a home, you can't go wrong investing in an FHSA if you would otherwise contribute to an RRSP. The reason? If you don't end up buying a home, you can transfer the funds in the FHSA to your RRSP without using up any RRSP contribution room.

Consider the math

Now that you've thought about why you're saving money, you should consider some numbers before making a final decision about an RRSP, TFSA FHSA or non-registered investment account.

If you were to earn $1,000 and invest the after-tax amount in an RRSP, TFSA or non-registered account, you'd end up with the same amount – a total of $3,004 – in your pocket after taxes at the end of 25 years with the RRSP and TFSA. This assumes a 30-per-cent tax rate both today and when you make withdrawals in 25 years with a 6-per-cent return over those years. The non-registered account would provide less after taxes – just $2,276 – owing to the impact of taxes each year over that time.

If your tax rate is higher in the future, when you make withdrawals, there would be an advantage to using a TFSA today over the RRSP, because the tax on the RRSP withdrawals in the future will hurt your wallet. On the other hand, if your tax rate is likely to be less when withdrawing funds, the RRSP is your best bet. But again, the purpose of your savings should be your first consideration when choosing the type of account.

Do the math

	RRSP	TFSA	NON-REGISTERED
Income before taxes	$1,000	$1,000	$1,000
Income taxes (30%)	–	$300	$300
Contribution to account after taxes	$1,000	$700	$700
Value after 25 years (6% return)	$4,292	$3,004	$2,428
Income tax upon withdrawal (30%)	$1,288	–	$152
Net withdrawal after taxes	$3,004	$3,004	$2,276

Note: The non-registered portfolio assumes one half interest income and one half unrealized capital gains on the portfolio annually. An FHSA has not been shown here; An FHSA can only exist for 15 years by which time the funds must be used to buy a home or could be transferred tax-free to an RRSP or RRIF.

SOURCE: OUR FAMILY OFFICE INC.

Consider your debt

Okay, after all of this, let me ask: Do you have any debt? If so, you should consider using some of your earnings to pay down your debt before other priorities. By doing this, you'll achieve a guaranteed rate of return on your money (equal to your after-tax interest costs).

Suppose, for example, that you have a car loan with an interest rate of 7 per cent and you can't deduct the interest payments. In this case, every dollar you use to pay down your car loan will provide a guaranteed 7-per-cent after-tax rate of return. That's a great return.

Student loans made under the Canada Student Loans Act, or similar legislation, do provide a tax credit for the interest paid. And federal student loans may be interest-free. So, it may make sense to pay off other debt first.

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