

# The TaxLetter®

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Your Guide to Tax-Saving Strategies

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## RRSP PLANNING

*Optimize your RRSP contribution  
by combining these...*

# Six steps

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RRSP season has almost come to a close, and you may be wondering how much you should contribute this year.

The best way to figure this out is to identify your “optimal RRSP/TFSA contribution.” This is an important factor in every retirement plan.

Most Canadians base their contribution amount on the extra cash they have on hand, their RRSP and TFSA contribution room, or sometimes the amount needed to avoid paying tax when they file their return.

However, the optimal contribution is based on integrating these six key factors:

### **Step 1: Contribution needed in order to have**

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### **the retirement you want**

Your retirement plan should specify how much you need to invest each year in order to achieve the retirement you want.

This is a key starting point. It should provide a balance between your lifestyle today and your lifestyle after you retire. It is a critical factor, since the entire purpose of long-term investing in your RRSP or TFSA is to save for your retirement.

For example, if your retirement plan says that you and your spouse need to invest \$23,000 per year, then your total contributions to your RRSPs and TFSAs should probably be \$23,000.

Very few Canadians actually have a detailed plan. They have not planned when to retire or what exact lifestyle they want, and how much they need to invest to achieve it. There is a

classic saying: “By failing to plan, they are planning to fail.”

### **Step 2: Optimize your RRSP contribution based on your tax bracket**

To get the largest possible tax refund, you need to know your current tax bracket. The optimal RRSP contribution amount based on your tax bracket is the amount you can contribute without going into the next lower bracket.

For example, if your income is \$100,000 a year, you will get a refund of about 43 per cent on the first \$19,000 you contribute, but then a smaller refund of only 33 per cent on contributions above \$19,000.

If you want to contribute \$23,000 this year, you would get a larger refund by claiming \$19,000 this year and \$4,000 next year.

There are quite a few small tax brackets, but in Ontario the main ones for 2012 are roughly:

Taxable income and approximate marginal tax rate:

Less than \$43,000	20%
\$43,000 - \$81,000	33%
\$81,000 - \$132,000	43%
More than \$132,000	46%

### **Step 3: Choose between a RRSP or TFSA**

Is a RRSP or TFSA a better place for your retirement savings?

The main issue here is your marginal tax rate today (tax rate on the amount you will contribute) versus your marginal tax rate when you withdraw the money, presumably after you retire (including the clawbacks on various government programs). The other issue is how effectively you will use your tax refund.

In general, if your taxable income is below \$43,000 per year today a TFSA is probably the better choice since you are in the lowest tax bracket. Your retirement tax bracket will be the same or higher.

If you expect your taxable income after you retire to be very low (below \$23,000 a year) or relatively high (above \$70,000 a year), then choosing the TFSA is also better because you will be affected by the clawbacks of various government programs in addition to income tax.

To determine which is better (RRSP or TFSA) you first need a retirement plan so that you know what tax bracket you will be in after you retire.

For a more in depth discussion on RRSPs vs. TFSAs, and the importance of considering the various clawbacks of government programs, see the September and October 2012 issues of *The TaxLetter*.

#### **Step 4: Maximize your contributions**

It is generally a good idea to maximize all your RRSP and TFSA contribution room over your working life, since both can provide significant benefits from tax deferral and many years of

tax-deferred or tax-free investment growth.

Your RRSP lifetime contribution room is your current room plus all the room you expect to get before you retire. Your new contribution room each year is 18 per cent of your earned income for the previous year to an annual maximum (\$22,970 for 2012), less an adjustment if you are in a pension plan.

For example, if you have \$50,000 RRSP contribution room today and earn \$100,000 per year with no pension plan, then you will get \$18,000 additional contribution room each year.

If you plan to retire in 25 years, your additional future RRSP contribution room will be \$450,000. Your lifetime RRSP contribution room is therefore \$50,000 plus \$450,000, or \$500,000. To maximize your RRSP contributions by the time you retire, you should contribute \$500,000 over 25 years, or \$20,000 per year.

Remember: allow for your expected salary increases. To simplify this calculation, we usually ignore inflation. If you expect your salary to just rise by inflation, then your RRSP contribution room would also rise and your contribution would be \$20,000 per year plus inflation. TFSA contribution room is also expected to rise by inflation, but in \$500 increments.

TFSA room is \$5,000 per year per person starting in 2009, increasing to \$5,500 for 2013. It is not related to your income, so your lifetime contribution room continues even after you retire.

However, we are trying to work out the best contribution for your working years, as you will also have working-lifetime TFSA contribution room.

If you have not contributed to a TFSA yet, your limit this year is \$25,500. If you plan to retire in 25 years, then your additional future TFSA contribution room will be \$5,500 per year, or \$137,500.

Therefore, your lifetime TFSA contribution room is \$25,500 plus \$137,500, or \$163,000. To maximize your TFSA contributions by the time you retire, you should contribute \$163,000 over 25 years, or \$6,520 per year.

#### **Step 5: Adjust your contribution based on the tax refund you want**

If you have a specific plan for your refund, such as paying off a debt or making an RESP contribution for your child's education, you may want to contribute enough to your RRSP to get the refund you want.

A common and effective strategy for parents trying to maximize their cash flow is to contribute monthly to their RRSP and then use the tax refund to contribute to their child's RESP.

For example, if you want a \$5,000 refund so that you can contribute \$2,500 to a family RESP for both of your children and you are in a 43 per cent marginal tax bracket, you would need to contribute \$5,000 divided by 43 per cent (or at least \$11,600) to your RRSP.

#### **Step 6: Use cash or borrowed funds to contribute**

## John and Mary: One couple's strategy

Combining all of the above six factors into one strategy is both an art and science. You need to look at each factor individually and decide what makes the most sense. It would be nice if they all pointed to the same number, but that rarely happens. Consider this example:

	John	Mary
Income	\$100,000	\$60,000
Marginal tax bracket	43%	33%
RRSP contribution room	\$ 50,000	\$50,000
TFSA contribution room	\$ 25,500	\$25,500
Existing RRSPs	\$100,000	\$100,000

John and Mary have \$15,000 cash on hand. Neither has opened a TFSA yet. Based on their retirement plan, they need to invest \$23,000 per year to have the retirement they want.

They plan to retire in 25 years and have worked out a specific retirement lifestyle, for which they will need \$56,000 per year each (in today's dollars). That means John and Mary will probably be in the 33 per cent tax bracket when they retire (at today's tax rates).

Neither spouse has a pension. Their tax refund is normally \$1,500, excluding the RRSP portion of their refund. In addition, they have a line of credit with an available limit of \$30,000.

Now let's look at the six factors individually and work out John and Mary's optimal RRSP/TFSA contribution:

- ✎ To achieve the retirement they want: John and Mary need to contribute a combined total of \$23,000 to their RRSPs and/or TFSAs.

- ✎ Optimal contribution in their tax brackets: John can contribute up to \$19,000 in the 43 per cent tax bracket; Mary can contribute up to \$17,000 in the 33 per cent tax bracket.

- ✎ RRSP or TFSA: Based on their retirement plan, we expect this couple will retire in the 33 per cent tax bracket. John should contribute the first \$19,000 to his RRSP because he is now in the higher 43 per cent tax bracket. After that, he will be in the 33 per cent tax bracket, which is the same as in retirement.

Mary is in the 33 per cent tax bracket both now and in retirement, so the benefits of RRSP and TFSA are about the same for her. When this situation occurs we usually give a slight edge to the TFSA because of flexibility, unless the tax refund is specifically needed for something.

- ✎ Maximum contribution room: John has \$50,000 of room and gains \$18,000 additional room each year. That is a total of \$500,000 over 25 years. To maximize it, he would need to contribute \$20,000 per year.

Mary has \$50,000 of room and gains \$10,800 additional room each year, for a total of \$320,000 over 25 years. To maximize it, she would need to contribute \$12,800 per year.

Maximizing is a very good idea for John. He will have a 10 per cent tax gain by receiving refunds of 43 per cent of his contributions, but will only have to pay 33 per cent tax when he withdraws from his RRSP after retiring. Maximizing RRSP contributions is less critical for Mary. Both have \$25,500 of TFSA contribution room and gain \$5,500 additional room each year. That is a total of \$137,500 over 25 years. To maximize it, they would each need to contribute \$6,520 per year to their TFSAs.

- ✎ The refund they want: John and Mary have no specific use for their tax refund.

- ✎ Cash or borrowed funds to contribute: This couple has \$15,000 in cash. Contributing \$19,000 to John's RRSP would give them a tax refund of about \$9,500, including their other tax deductions and credits. If Mary's contribution is to an RRSP, then the tax refund will be about \$11,000. They also have \$1,000 per month available cash flow after all expenses, which could be used to make payments on an RRSP loan or for next year's RRSP contribution.

Where can you find the money to make a contribution? The amount you could contribute includes:

- ✓ Cash on hand
- ✓ Your expected tax refund after making your contribution
- ✓ The amount you can afford to borrow from a credit line or RRSP loan

If you do not have the cash on hand, there are many possible strategies here. But the most effective are usually the “top-up” 2-year loan strategy and RRSP catch-up loan.

These RRSP refund strategies were discussed in more detail in the July 2012 issue of *The TaxLetter*, but here are a couple ideas to give you a sense of what can be accomplished with a bit of creativity:

☛ If you have \$10,000 cash, the “top-up” strategy allows you to borrow \$7,000 from your credit line and contribute a total of \$17,000 to your RRSP.

If you are in a 43 per cent tax bracket, you would get a tax refund of about \$7,000, which you can use to pay off your credit line. The result: you get an extra \$7,000 invested without impacting your cash flow.

☛ You can effectively contribute \$23,000 per year with only \$1,000 per month using the “2-year RRSP loan strategy.”

If you have no cash available to contribute, but have \$1,000 per month available cash flow, you can take a 2-year RRSP loan of \$23,000 every year. If you are in a 43 per cent tax bracket, your tax refund would be almost \$10,000, which

can be applied to the loan. Your monthly payments would pay off the loan in time to do it again next year.

Once you have worked out your optimal RRSP/TFSA contribution for each factor, you can then put the pieces together and determine your optimal strategy.

### Consider a spousal RRSP

You should also consider how much of any RRSP contribution to apply to a spousal RRSP. In general, it is a good idea to plan for you and your spouse to have similar taxable incomes after you retire.

Some types of retirement income can be split, but not all, and the rules may change in the future. A spousal RRSP is a good tool for saving tax in the future through income splitting.

Your final decision should determine the specific RRSP, spousal RRSP and/or TFSA contribution for both you and your spouse.

### Putting it all together

John and Mary need to invest \$23,000 per year to have the retirement they want.

Adjusting for their tax brackets, contributing to a RRSP is the most beneficial option for John for

the first \$19,000. Mary can contribute the remaining \$4,000 in a RRSP or a TFSA, since they will be in the same tax bracket after John’s contribution.

John needs to contribute \$20,000 a year to maximize his lifetime room. His optimal contribution based on his tax bracket is only \$19,000 – not quite his maximum.

Any additional contributions would be in the lower 33 per cent tax bracket. Since this difference is small, it is best to keep the additional \$1,000 in case John’s income is higher in a future year.

They have \$15,000 cash, so John and Mary are \$8,000 away from their \$23,000 goal. If they use the “top-up” strategy and contribute \$15,000 from cash and \$8,000 from their credit line, they will be able to pay off the credit line with their tax refund.

Their tax refund will be \$9,500 if Mary’s contribution is to a TFSA and \$11,000 if it is to her RRSP. They can use \$8,000 to pay off their credit line from the RRSP top-up and have either \$1,500 or \$3,000 cash left over.

Next year the numbers will be similar and they should contribute another \$23,000. If they start contributing their extra

#### Optimal contributions for John and Mary

	This year	Future years
John’s RRSP	\$9,500	\$11,500
John’s contribution to Mary’s RRSP	\$9,500	\$7,500
Mary’s RRSP	-	\$4,000
TFSA contribution (for either)	\$4,000	
<u>Total contributions</u>	<u>\$23,000</u>	<u>\$23,000</u>

\$1,000 per month, they will have contributed \$12,000 and be \$11,000 short.

They could do the top-up strategy again, and all \$23,000 next year is to their RRSPs.

While the plan is very precise, in reality they would need to leave some room for error to ensure their cash flow is not too tight. And although it works for John and Mary, this plan leaves them with hardly any

extra cash.

I generally prefer the TFSA for Mary's contribution, but might recommend a RRSP just to get a bit more of a refund to increase their cash flow.

Note that John's \$19,000 contribution should be \$9,500 to John's RRSP and \$9,500 to Mary's spousal RRSP. This will keep their retirement incomes about the same.

This example gives you a

sense of how to integrate the six key factors to determine your optimal strategy. So, what is your optimal RRSP/TFSA contribution strategy?

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