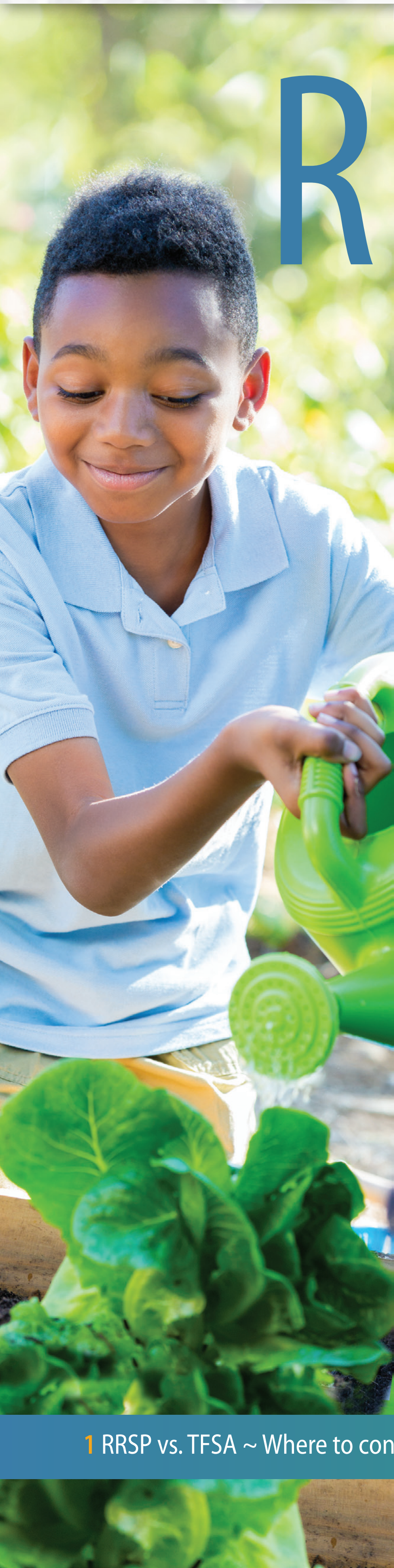
the abacus

ISSUE 80

GALLOWAY BOTTESELLE & COMPANY
Chartered Professional Accountants



RRSP vs. TFSA

Where to contribute?

FUNDS INVESTED in either a registered retirement savings plan (RRSP) or a tax-free savings account (TFSA) both grow tax-free while in the account. However, there is a difference between the accounts in terms of contributions and withdrawals.

Assuming you have sufficient contribution room, contributions to an RRSP are deducted from your income and therefore save you tax in the current year. Contributions to a TFSA are not deducted and therefore come out of your after-tax income.

Conversely, withdrawals from an RRSP are included in your income, whereas withdrawals from a TFSA are not included in your income.

So which account is more advantageous in terms of tax savings?

That depends. You'll need to look at your marginal tax rate ("rate") in the year of contribution relative to your rate in the year of withdrawal. There are three possibilities:

Your rates in both the years of contribution and withdrawal are EQUAL:

Here, the two accounts are essentially equivalent in terms of tax savings, although – due to the deduction – the **RRSP** will allow you to have more money grow tax-free.

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Your rate in the year of contribution is GREATER than your rate in the year of withdrawal:

If so, you are likely better off making an **RRSP** contribution.

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Your rate in the year of contribution is LESS than your rate in the year of the withdrawal:

In this case, a **TFSA** contribution may be more advantageous for you.

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SEE **RRSP vs. TFSA** P. 4

Child care expenses

IF YOU INCUR child care expenses because you are employed, carrying on a business, or attending school, you will normally be allowed to deduct some – or maybe all – of those expenses in computing your income.

If you are **married** (or in a common-law partner relationship), the **lower income spouse** (or partner) is normally the only one who can claim the deduction. Thus, for example, if the lower income spouse has no earned income *(per number 3, below)*, then no deduction will be allowed.

In certain cases, the higher income spouse (or partner) may claim a limited deduction in a taxation year. Basically, this occurs if the lower income spouse (or partner) is in school during the year; is physically or mentally infirm and incapable of caring for the children; or is in prison for at least two weeks in the year.

If you are **single**, you can claim the entire deduction.

The deduction for a taxation year is the lowest of the three following amounts **for the year**:

1 Actual child care expenses

Total amount paid for baby-sitting, nanny services and day care; and

A limited amount for boarding camps and schools, *e.g., summer overnight camp*

- $200/wk/child under age 7 at year-end;
- $125/wk/child age 7-16 at year-end; and
- $275/wk/child eligible for disability tax credit.

2 Total annual child care limit

This limit is not per child, but for the total of expenses. So, if you spend $13,000 on your baby and $0 on your 12-year-old, the $13,000 can be deductible. Amounts for expenses at year-end:

- $8,000/child under age 7 at year-end;
- $5,000/child age 7-16 at year-end; and
- $11,000/child eligible for disability tax credit.

3 Two-thirds earned income

- Gross income from employment;
- Business income *(after expenses)*; and
- Disability pension under the Canada Pension Plan or Quebec Pension Plan.

EXAMPLE

JOHN AND ISABEL are married and have two children, aged five and 12, neither of whom is eligible for the disability tax credit.

The couple incurred $15,000 of child care expenses in the year. They also sent their 12-year-old to summer camp for three weeks during the year, and spent $1,000 on that.

John is the lower income spouse, with earned income for the year of $30,000. His child care expense deduction will equal the lowest of these three amounts for the year:

1 Actual child care expenses

Child care	15,000	
Camp ($125 x 3 wks)	375	
AMOUNT		$15,375

2 Total annual child care limit

5-year-old	8,000	
12-year-old	5,000	
AMOUNT		$13,000

3 Two-thirds earned income

John's $30,000 income	x 2/3	
AMOUNT		$20,000

John can deduct **$13,000** based on the *Total annual child care limits*.

Spousal support payments *were* "periodic" ...and therefore deductible

Spousal support payments are deductible for the payer of the support if certain conditions are met. For example, the payments must be made pursuant to a court order or written agreement, and normally they must be made "on a periodic basis."

THE **CASE**

In the recent *Ross* case, the taxpayer made payments to his former spouse. Although most of the conditions for deductibility were met, the Canada Revenue Agency ("CRA") denied the deduction on the grounds that the taxpayer's payments were not made on a periodic basis.

THE **BACKGROUND**

The taxpayer made five instalments payments to his former spouse:

- a lump sum of $20,000 on the signing of their separation agreement in November 2015;
- the transfer of a car *(a payment-in-kind)* worth $20,000 in December 2015; and
- three further payments in December 2016 of $4,000, $3,000 and $3,000.

THE **JUSTIFICATION**

Apparently, the reason the payments were all made near the end of the years – rather than throughout the years – was because Mr Ross did seasonal work as a lobster fisherman. His income generally peaked in the fall and early winter.

THE **APPEAL**

On appeal to the Tax Court of Canada, the judge held that the CRA misapplied the meaning of "periodic basis" to the facts. There was a series of payments made over two years as set out in the separation agreement, and therefore could qualify as being periodic.

RRSP vs. TFSA CONT'D FROM P. 1

EXAMPLE

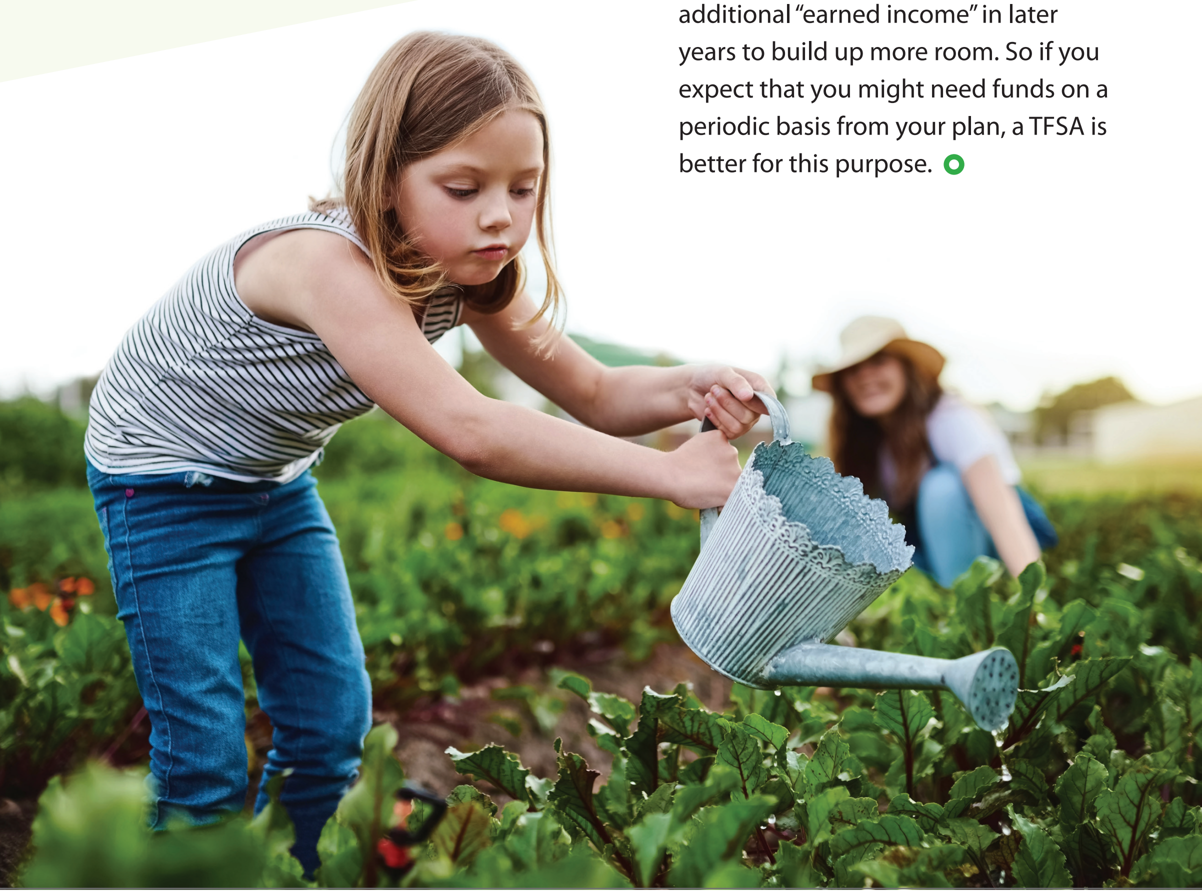
THIS YEAR, you are in a 50% tax bracket. You contribute $2,000 to your RRSP, which saves you $1,000. Therefore, your net investment is $1,000 after tax.

You also contribute $1,000 to your TFSA. Since this amount is not deductible, your net investment is also $1,000 after tax.

Both amounts double in value by a future taxation year. Therefore, your RRSP investment grows to $4,000 and your TFSA investment grows to $2,000. You withdraw both amounts and are again in the 50% tax bracket. Your RRSP withdrawal is subject to 50% tax and nets you $2,000. Your TFSA withdrawal is not included in your income and therefore nets you $2,000.

On the other hand, if your future tax rate is **less than 50%,** your RRSP withdrawal would net you more than $2,000.

If your future tax rate is **greater than 50%,** your RRSP withdrawal would net you less than $2,000.



Your effective tax rate

Lastly, it is important to use your "effective" tax rate for the above purposes. For example, if your "regular" tax rate remains the same, but your RRSP withdrawal in the future year would subject you to the Old Age Security clawback tax, or reduce your age credit, your effective tax rate in the future year would be higher than the earlier effective rate. In such case, your TFSA investment would come out ahead.

Contribution room

Note also that TFSA contribution room can be used over and over. If you withdraw funds from your TFSA, your contribution room is increased by a matching amount the next January 1.

With an RRSP, the contribution room that you have built up each year is lost once you have used it, and you need additional "earned income" in later years to build up more room. So if you expect that you might need funds on a periodic basis from your plan, a TFSA is better for this purpose.

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Accounting for what **matters**™

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Published by

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