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TFSAs, RRSPs, Death and Taxes

There are certain tax benefits to the Tax-Free Savings Account (TFSA) when assessing future taxation. Let's compare RRSPs and TFSAs.

RRSPs miss any capital gains taxation benefits. Equity funds earning capital gains in a non-registered account get a benefit of being only 50% exposed to taxation. In non-registered equity investments, any gains can be offset by capital losses. Not so with RRSPs. All capital gains— in fact all income earned in an RRSP and RRIF are taxed at your marginal tax rate when taken out. And bear in mind that capital losses cannot be claimed with an RRSP.

What capital gains advantage does the TFSA offer? Rather than paying tax on up to half of your initial principal investments plus any profit, when withdrawing from an an RRSP, the entire amount is yours to keep in a TFSA—including any capital gains, minus capital losses. This is of particular interest to those who invest in stocks and/or equity funds. As an investor, imagine being able to take all of your money out as you please from a TFSA, now or in retirement. One might agree that, "Insufficient facts always invite danger, Captain." *(Spock, Star Trek)*

How does a TFSA contribution affect my RRSP? Your TFSA contribution does not affect your annual RRSP contribution limit. The difference between the TFSA and the RRSP is that TFSA contributions

Continued on page 2...

Continued from page 1...

are not tax-deductible and income earned in your TFSA whether compound interest, other investment income or gains, is tax-free when withdrawn.

Estate planning and the TFSA Individuals can name surviving spouses and partners as successor account holders, ensuring the tax-free status of a TFSA will continue after death. *Note:* The TFSA allows funds to be rolled over to the successor annuitant, up to Dec. 31 of the year following the year of an annuitant's death. Form RC240 must be completed for this to happen.

Small fortunes and the RRSP The following amounts could accrue to a person who invests a small amount of money over time. One person alone, could accumulate a whopping $301,478—the amount in an RRSP at age 65 if a person started contributing $2,000 every year from age 25 (assuming five per cent compound annual growth and 1.5 per cent inflation).

The total amount of wealth held in RRSP/RRIF vehicles amounted to $775 billion—this is the amount assessed in 2011 according to Investor Economics as noted in a CBC article. Add to this $36 billion contributed in 2012, plus $38 billion in 2013 and you have approximately $850 billion. Adjustments would need to be made for new incoming contributions, growth on investments, and withdrawals from the total RRSP/RIFFs. This growing base of registered monies will soon exceed $1 trillion dollars.

Death and RRSP Taxes When you die (with no remaining spousal rollover) your RRSP wealth is considered “cashed out” placing you up to a near-50% tax bracket, reducing this portion of your nest egg to about 50% of your RRSP.

Essentially your tax deduction over the years is really only a "deferred tax deduction" if the government gets to take a portion of your contributions back with all the accrued growth of your investments also. This is still the case when people do not outlive their RRSP wealth.

True, the government pays you a tax refund every year that you contribute your hard-earned money. In effect, you have agreed to allow Canada Revenue Agency (CRA) to swap your RRSP/RRIF wealth—including any capital gains on stocks or equity funds—as a form of reimbursement for your annual tax refund over the years. So for some the RRSP may not be the preferred route of investing.

How can a good financial plan help? To minimise the government take-back of taxes on money left in your RRSP/RRIFs in your estate after your death, there are some important planning tactics that you can use:

- Consider balancing your RRSP contributions with TFSA contributions in the future. TFSAs are not taxed when money is withdrawn or in the estate
- Consider mixing TFSAs and perhaps non-registered investments, into your retirement savings mix.
- If you have substantial wealth held in RRSPs there is an estate planning tactic that uses a permanent life insurance plan to mitigate the taxes payable to the government. From a small percentage of the RRSP holdings per annum you pay premiums on a life insurance policy with an equivalent face value of up to half of the value of your RRSP/RRIF holdings. When you die the insurer pays a tax-free benefit to your estate or your beneficiaries free of government probate or estate administration tax.
- You may also consider purchasing a joint last-to-die life insurance policy to compensate for the taxation in your final estate. This works well for married partners. When both spouses die the insurer pays a tax-free benefit to your estate or your beneficiaries.

Talk to your advisor about combining RRSPs, TFSAs and life insurance to maximize your tax planning.

Source: Adviceon | CBC | *Source:* Statcan