Tax Talk

SCOTT TAYLOR

An RRSP is not a rainy day fund

The best advice you'll get about retirement savings is to make regular, automatic contributions to your RRSP.

The amount you contribute can be deducted from your earned income, and any income from investments in your RRSP will compound tax-free. By the time you retire, you'll probably be in a lower tax bracket than you are now, when you're working. Funds withdrawn at that time will be taxed at a lower rate.

Doesn't sound so hard.

Well, life is what happens to you while you're busy making other plans.

If you have debt or other bills, an RRSP looks like a ready pool of cash. Should you withdraw funds to pay off debt or a major expense?

Early withdrawals

When you pull funds from an RRSP, your financial institution withholds the tax immediately. The tax rate depends on where you live and the amount you withdraw.

If you're a Canadian resident, you'll pay a withholding tax of 10% (5% in Quebec) on withdrawals up to $5,000; 20% (10% in Quebec) on withdrawals of $5,001 to $15,000; and 30% (15% in Quebec) when the amount exceeds $15,000.

So let's say you want to take $20,000 out of your RRSP early. The withholding tax applied would be $6,000 (30%). That leaves $14,000.

Additionally, an early withdrawal means you lose the contribution room of those funds permanently. Also, the amount you take out will be added to your taxable income. It could bump you to a higher income tax bracket. The consequences of an early withdrawal are steep. There are a couple of special situations where the RRSP withdrawal rules differ: the Home Buyers' Plan (HBP) and Lifelong Learning Plan (LLP).

Under the HBP, you can borrow up to $25,000 from your RRSP to buy or build a home. You have to be a first-time home buyer or not have owned a home in the last five years, and you must agree to repay the funds into your RRSP within 15 years.

The LLP allows you to borrow up to $10,000 a year to a total of $20,000 when you or your spouse are enrolled full-time in a qualified program. You cannot use an LLP to finance your child's education.

Another option

An RRSP is a long-term savings plan, not a rainy day fund. For most working Canadians, it's probably the best way to reduce their tax obligation and maximize their savings over many years.

If you need more flexibility and less restriction, a tax-free savings account (TFSA) is a better option.

A TFSA is a way for adults to set money aside tax-free throughout their lifetime. Any amount you put into a TFSA as well as any income earned in the account (for example, investment income and capital gains) is generally tax-free, even when it's withdrawn.

There's a limit to how much you can contribute (the annual TFSA dollar limit for 2015 was $10,000), but you can see how much room you have by using My Account at www.cra.gc.ca/myaccount or by phoning 800-267-6999.

Since you can generally withdraw any amount from the TFSA at any time without penalties, it's a useful financial tool. Why not establish a TFSA at your bank and deposit your GST/HST refunds there? Your money can grow tax-free until you send your payment to CRA.

A TFSA can be your rainy day fund, an account for emergencies like a major repair that you'd otherwise put on a credit card. You don't want to be paying for that engine rebuild for the next 10 years.

Talk to your accountant about how to maximize the use of both programs. Better yet, your advisor can help you plan for times when cash is tight without having to deal with the consequences of tapping into your RRSP.

Scott Taylor is vice-president of TFS Group, a Waterloo, Ont., company that provides accounting, fuel tax reporting, and other business services for truck fleets and owner/operators. For more information, visit www.tfsgroup.com or call 800-461-5970.