

IN THIS CHAPTER

- » Introducing the basics of RRSPs and TFSAs
- » Learning how RRSPs and TFSAs help you achieve your goals
- » Exploring the differences and similarities between both plans
- » Comparing registered and unregistered savings plans
- » Reviewing types of investment income

Chapter **1**

Introducing RRSPs and TFSAs

Canadians who are planning for their retirement and who want to finance other lifestyle needs and goals have two excellent tools at their disposal—the registered retirement savings plan (RRSP) and the tax-free savings account (TFSA). Both instruments provide tax incentives when it comes to your retirement money, and both offer the opportunity to grow your money over time through investment vehicles like stocks, bonds, exchange-traded funds (ETFs), and other financial assets.

Chapter 1 introduces these two plans at a high level and with a broad stroke. This chapter also explains some key differences between them that you need to know about. Rounding out this chapter is a discussion of the treatment of interest, dividends, and capital gains when such items are triggered outside of registered plans like the RRSP and TFSA.

Introducing the Stars of the Show: RRSPs and TFSAs

One of the most common and fundamental financial planning questions posed to Canadians is whether to invest in a registered retirement savings plan (RRSP) or a tax-free savings account (TFSA). Both options allow you to save for the future and to obtain a tax break. Both have tax advantages that can help you reach your saving and investment goals. But which plan is right for you given your financial situation and goals? One, the other, or both?

Before you can make this decision, of course, you need to understand the nuts, bolts, rules, and regulations behind each of these plans. But did you know that you additionally need to understand how saving, investing, and tax planning strategies *outside* of these plans also inform your RRSP and TFSA decisions? Understanding the broad picture is a key theme behind this book. In fact, it significantly informs how this book was structured.

This book shows you how RRSP and TFSA plans work, but that's not all. As an added bonus and valuable lesson, it also explains the basics of taxation, investment risk management, and your investing options.

So which plan is better? Spoiler alert! . . . The right plan for you is totally dependent on your personal financial circumstances and goals. This book shows you how to evaluate your decision regarding both plans in the context of personal objectives many Canadians often have, and provides a framework to help you make that decision and — even better — prepare you for your conversation with a financial planner. (Chapter 11 covers decision frameworks and the criteria you can use to help you evaluate your RRSP versus TFSA decision.)

Your personal goals, along with your tax bracket and income status, your investment time horizons, and many other factors are the focus of much discussion throughout the book to help you make the right decisions about which plan is best for you. For example, in choosing whether to put your hard-earned money into an RRSP or a TFSA, your decision may very well come down to whether you prefer to pay the tax now or to pay tax at a future date when you withdraw the funds. Or, you may find that using *both* registered plans at the same time is the best strategy for you, and the only real decision you need to make is how much you should use each plan. This book provides you with initial guidance.

Additionally, this book digs deeper into the many fundamental questions you need to address prior to your decision about RRSPs and TFSAs. For instance, what happens if you are a member of a group RRSP? What type of investments can you make within each registered plan (RRSP or TFSA)? What happens if you take out money from an RRSP or TFSA prior to your retirement? And similarly, what

happens if you withdraw that money from either plan while you are in retirement at age 65 or older? In many cases, your tax bracket will influence and inform your decision, as you will see throughout this book. The questions and considerations that require answers are many, so stay tuned and hopefully, you will be provided with the knowledge you need.

One last point I'd like to make in this broad introductory section is that there are a few common situations where neither registered plan is the right thing for you to pursue, at least for today. For instance, you may choose to pay down personal debt that is currently incurring punishing interest rates, especially if interest rates are rising in an inflationary environment. Personal debt, such as credit cards carry high interest rates. However, even in such a scenario, you may find that the tax amount you save taxes by contributing to an RRSP and obtaining immediate tax relief is a better financial decision than paying down the debt. Again, everything depends on your personal circumstances, and in this case specifically, the amount of the debt and the tax bracket you are in. Did I forget to say "everything depends?" Remember that only your qualified financial advisor will truly be in a good position to help you evaluate a given financial decision, and the reliability of the numbers that underpin a decision, financial calculation, or estimate. This book will help you set the stage for your decisions.

Considering the Broad Strokes: RRSPs

Here we go. An *RRSP* is a government-sponsored retirement plan that comes with significant tax benefits for any Canadian who chooses to participate in it. The Canadian government created this plan to motivate and inspire Canadians to save money today for their retirement tomorrow. Any money you contribute to an RRSP will be exempt from taxation in the year that you make your contribution. That's a big benefit. The idea here is that the money you have put into your RRSP (plus the money that accumulates through investment returns) will be taxed in the future at the time you withdraw funds from the plan. In other words, RRSPs are designed to effectively reduce your tax bill in your current year. Nice.

An RRSP lets you invest up to 18 percent per year of your gross income or \$29,210 (2022 amount), whichever is less, without paying income tax on that money. Because many Canadians contribute to this plan with money that has already been taxed, the very taxes associated with your contribution will therefore be refunded after you file your tax return for the contribution year.

What this all really means is that an RRSP lets you defer your taxes while at the same time allowing you to save for your retirement. Again, the key principle to remember here is that the taxes are *deferred*, and you will ultimately pay tax on the money contributed when you withdraw it. An associated concept is that because

you most likely will be in your retirement years when you come to access your money, to assume you will be in a tax bracket lower than the one you were when you made the contribution. In (for example, in your higher earning years). So, a lower tax rate will be applied when you withdraw your money, resulting in lower overall taxes, simply because you chose to invest in an RRSP. Double bonus!

Tax advantages

In summary, the essential tax advantages to RRSPs you need to remember are really threefold, as follows. (In truth, though, there are more than just three advantages because, as you will see in later chapters, there are various special aspects of RRSPs regarding homeownership, education, spousal contributions, and more.)

- » This is worth repeating: **Your contributions are tax deductible.** Now. Today. (Okay, not today, but when you file your taxes. You get my point.) In other words, you get immediate tax relief to the extent that you choose to deduct your RRSP contributions from your income in a given year. This means that your contributions are essentially made with pre-tax dollars since you are recovering taxes.
- » **Earnings within the RRSP plan are tax-sheltered.** Any investment returns you make on your RRSP investments are not taxed if the funds stay within the plan. (Permitted investments are introduced in Chapter 3 and in fact discussed in various contexts, like taxation and risk, throughout this book.)
- » **Tax deferral.** This applies to most but not all contributors. As mentioned previously, you pay tax on your RRSP savings only when you withdraw the money from the plan. When I refer to “money” I mean both your investment earnings and the amount that you contributed originally. What has really happened is that you delayed your tax liability to the future, to your retirement years, when your marginal tax rate will very likely be lower than it was when you made your contribution.

How much you can contribute and other basic rules

The amount of immediate benefit that RRSPs can give you depends on your contribution. But the amount of your contribution depends on certain rules that the federal government provides. Those rules concern RRSP contribution limits, the maximum amount a taxpayer is allowed to deposit into an RRSP on an annual basis. The contribution limit of your RRSP is a value that begins to accumulate from the time you start earning income, and the plan is attributed directly to you.

Your RRSP contribution limit is calculated by taking into account the deduction limit of the current year as well as any contributions you left unused in previous years. The detailed methodology, calculations, and ground rules over RRSPs are fully discussed in Chapter 5. My purpose here is just to give you a quick sneak preview of the most commonly applied rules around RRSPs.

Any Canadian who files an income tax return and has earned income, as defined by the Canada Revenue Agency (CRA) with reference to the Canadian Income Tax Act, can open and contribute to a registered RRSP plan. Limits exist on how much you can contribute to an RRSP annually. At the basic level, and according to existing rules at the time of this writing, you can contribute the lesser of the following two values:

- » 18 percent of your earned income in the previous year
- » The maximum contribution amount, which for the tax year 2022 is \$29,210

This maximum RRSP amount that is deductible is also referred to as the *RRSP deduction limit* or alternately *contribution room* or even *deduction room*.

You didn't think I would let you off that easy, did you? That's because no tax act would be complete without the inherent ability to complicate the formula. In Chapter 5 and other chapters, I explain all about the complexities, exceptions, and other things designed to drive you crazy! The preceding formula may undergo several additional tweaks and adjustments. It's all situational. But for now, in this introductory section, I'll keep it basic because it will apply to most Canadians.



TIP

Before you pull out your calculator and T4 slips, there is good news (incredibly) from the CRA. Your deduction limit is found on your Notice of Assessment or Notice of Reassessment from the Canada Revenue Agency (CRA). You can also access this information online as well, as I show you in Chapter 5. But essentially, your 2022 limit would be on your 2021 Notice, which you can expect to receive or have online access to after you file your 2021 income tax return.

For now, in addition to almost memorizing the above contribution formula (and where to go to simply get the number) I'd like you to remember one more thing: RRSP withdrawals do not affect the deduction limit (contribution room). This only happens with TFSAs, which you will see later in the book.

And one more thing . . .

In case you don't have the ability or funds to contribute to an RRSP in a certain year, you can carry forward your RRSP contribution room and use it in a future period. This carry-forward is subject to the limits briefly introduced in the prior section, "How much you can contribute and other basic rules."

When you do in fact have the funds, and more, the CRA's RRSP deduction limit is a mechanism that puts the brakes on your desire to back up your Brinks truck and contribute loads of money to your RRSP plan. Because contributions to an RRSP reduce the amount of income tax you pay annually to the taxman, the CRA is only playing it half-nice. After all, the CRA is the taxman. As the Beatles song goes, "that's one for you, nineteen for me." So the CRA sets the annual limit on contributions, as I described in the previous section.

Considering the Broad Strokes: TFSAs

The *Tax Free Savings Account*, or *TFSA*, was first introduced by the Canadian federal government in 2009. The nifty idea behind this plan is that every year you receive an allotment of a few thousand dollars available to contribute to your TFSA. For 2022, the annual *allotment*, or limit, is \$6,000, an amount that has not changed since 2019. In addition to this amount, you have a lifetime limit, which is influenced by how much you already contributed and your age. So, assuming you were born in 1991 or earlier, your lifetime contribution limit in 2022 would be \$81,500. You can add any rollover of unused contributions from previous years, so if you missed out, no worries!

However, a TFSA, unlike the RRSP, offers no tax break (deduction) at the time of your contribution. This is a key point to remember. A TFSA uses your after-tax net income to contribute to a TFSA, meaning that the money has already been taxed.

The good news is that any profits you earn in a TFSA, regardless of whether they come from a regular low-interest savings account, a fast-growing ETF, a stock, or any other investment, financial instrument, or product, are not subject to tax. (I discuss the three forms of investment income and the taxes you escape) later in this chapter in the section, "Understanding taxation of investment returns from non-registered financial instruments.") This good news also includes the fact that you will not owe any taxes to the Canada Revenue Agency on your earnings from this plan at the time that you choose to make a withdrawal. This is double good news.

Unlike other registered plans like the RRSP, tax-free savings accounts have relatively few withdrawal rules you have to contend with. Essentially, you can withdraw the funds from the plan at any time without penalty — although you should know that there are still exceptions to escaping penalties, as I discuss in Part 3 of this book.

So, stepping back, with these features in mind, you can see that the tax-free savings and positive investment returns in your TFSA make this plan a very powerful

incentive for saving. It helps you to maximize your total earnings by promoting the discipline of saving and leveraging your ability to invest in financial vehicles, as well.

As we all know, the gains on savings accounts are minimal at best (with the exception of recent years where the interest rates, although still low, are slowly rising). They hardly keep up with inflation. So, when you think about it for a moment, the name *tax-free savings account* is a little bit misleading. Putting your money into a savings account is — essentially equivalent to socking away your cash under a mattress. It is simply not enough to achieve a secure retirement.

However, the TFSA actually functions as an investment vehicle as well as a savings vehicle. There is a wide variety of financial instruments that you can place into a TFSA. This book contains a deeper and more detailed discussion of what those allowable investment vehicles are. Chapter 10 shows you how financial instruments are taxed outside of these plans so that, among other things, you can better appreciate the value of having them reside within a TFSA.

Savings advantages

In addition to being able to invest in a wide range of financial instruments like cash, bonds, guaranteed investment certificates (GICs), stocks, exchange-traded funds (ETFs), and mutual funds, TFSAs offer other benefits as well that help you to maximize your savings.

- » **Ease of administration:** You do not have to set up a TFSA or file a tax return in order to earn contribution room. This contribution room just appears like magic as a gift from the Canada Revenue Agency. As mentioned above, it can be found in the “My Account for Individuals” page of the CRA’s website. (Your unused contribution room is carried forward for both RRSPs and TFSAs.)
- » **The simplicity of the registered plan’s design:** An example of this simplicity is the fact that the annual contribution limit is indexed for inflation. Because inflation is rising, this is a welcome feature. Also contributing to its simplicity is the fact that you don’t need to be mindful of or worry about things like “earned income” and other calculations that determine how much you can contribute. Instead, the government simply tells you what the annual TFSA deduction will be each year. So put the calculator away. You don’t need it.
- » **Availability to young Canadians:** TFSAs are available to any Canadian over the age of 18, which means that the saving journey can start very early in life.
- » **Versatility:** You can save tax-free for any personal objective you have in mind. This includes putting money away for a car, vacation, cottage, or home.

» **Accessibility:** As mentioned before, you can withdraw money from the plan at the time that you want and for any reason at all. When you do, you will not have to pay any tax, which is a major advantage. Even after you have taken money out you can re-contribute money into the plan in the following year.

Knowing why you would use them

When comparing a tax-free savings account to a registered retirement savings plan account, consider the notion that the main use of an RRSP is to save for retirement. In contrast, TFSAs are typically used to help you save for any purpose at all — including retirement.

With an RRSP, you can contribute only after you have begun earning income from employment as well as other sources defined by the Canada Revenue Agency. (I get to these rules in Part 2 of this book). In contrast, to begin saving with a TFSA, all you need to be is the age of majority in the province or territory where you reside in Canada.

These features are the very beginning of what you need to consider, whether you are evaluating just the RRSP or just the TFSA. Things get trickier when you are comparing the merits of one plan with the merits of the other. Chapter 11 focuses on how these two investment vehicles compare and may be one of the more valuable chapters in this book.

How much you can contribute

The maximum amount that the federal government allows you to contribute to a TFSA annually is referred to as the *contribution limit*. This limit varies from year to year. In 2022, the limit was \$6,000, which it has been since 2019. Prior to that, the limit was \$5,500.

Your Notice of Assessment indicates how much TFSA contribution room you have; for RRSPs, the CRA calculates this amount for you. You can also access this information through the CRA's online portal, which is secure and has all of your pertinent tax amounts and figures. This portal, called "My Account for Individuals," is found at www.canada.ca/en/revenue-agency/services/e-services/e-services-individuals/account-individuals.html. However, it may be quicker to access it simply by asking Dr. Google using the keywords *CRA My Account*.

A quick peak at the basic differences

Contributions to your TFSA are not tax-deductible. In contrast, RRSP contributions *are* tax-deductible and may reduce the amount of tax you pay on your personal income.

You can withdraw money any time, tax-free, with a TFSA. RRSP withdrawals are taxable, subject to certain exceptions, which I discuss in Part 2. When you take out funds from your RRSP, your contribution room is lost for the amounts you withdraw. This rule is subject to certain exceptions as well. For a TFSA, on the other hand, the amounts you withdraw are added back to your contribution room in the following year. Again, this book explores the rules with a deeper dive in later chapters.

When all is said and done, an RRSP matures at the end of the calendar year in which you turn 71. However, a TFSA has no upper age limit. Also, if your spouse has a higher income, your spouse can contribute to your RRSP; a tax deduction is then available to the contributing spouse. Unfortunately, there is no equivalent TFSA plan. However, each spouse may have an individual plan and a higher-earning spouse can contribute to it. Unlike a spousal RRSP, there is no tax benefit to be realized. These are just a few of the differences at the very basic, fundamental level. As you read through, you will see how TFSAs and RRSPs differ in even more ways.

Fundamental Features of Both Plans

Although the entire book is premised upon the differences between both types of plans, some common features are worth exploring first. The first common feature, of course, is that these are excellent vehicles to promote saving, whether for retirement or any other purpose.

If you're saving for retirement, then an RRSP may be the intuitive choice, and it's a great choice. Yet both accounts — not just the RRSP — can be used for retirement savings. Although a TFSA is not geared to being a retirement savings vehicle, its flexibility can make it an excellent add-on to an RRSP. This is especially important if your RRSP contributions are already maximized.

In addition, they can both be used to purchase a home or to continue your education. It's just that the differ rules around each plan to accomplish this. Later chapters discuss how RRSPs and TFSAs can help you achieve your home ownership objectives.

Both plans have contribution limits, but the good news is that these plans exist to allow you to “contribute” in the first place, as basic as this sounds. The plans exist! Tax benefits are also generated from both plans, although the nature and timing of tax benefits differ. The key thing to remember here is that there are tax benefits to be harvested, and that is one essential thing both have in common. In addition, under both plans, contributions can be delayed, and unused contribution room can even be carried forward. You can also re-contribute amounts that you have previously taken out. This is true for both plans as well. With a TFSA, the amounts you withdraw can be contributed again in future years. With an RRSP, if you have available contribution room in the year you wish to re-contribute, you can do so. Subsequent chapters delve into the details and special rules.

A wide variety of investment vehicles and financial instruments are eligible for each plan. This book focuses on those investments from the perspective of what can be held in a plan, how each financial instrument would be taxed if it were outside the plan, and the risk profile of each type of investment. This is critical information to know when making a holistic decision about TFSAs and RRSPs.

Under both plans, from a tax perspective, your investments will not be taxed as they grow, which is another aspect common to both RRSPs and TFSAs.

Why not a GIC or Unregistered Savings Account?

This book, as the title clearly suggests, is mostly about registered plans like the RRSP and TFSA. However, you have some other investment options available to you, such as the guaranteed investment certificate, which can be held inside or outside a registered account.

Guaranteed Investment Certificates (GICs)

Guaranteed investment certificates basically operate like savings accounts. GICs help Canadians to save by allowing them to invest their money in a financial vehicle that provides not only a guarantee of the return of their original principal, but also some interest. The emphasis is on the word “some.” Although GICs are considered to be low-risk, they usually carry a low rate of return (usually less than 1.5 percent). Your savings even run the risk of not keeping up with inflation, which at the time of this writing was soaring to levels not seen for decades. So GICs are a safe investment compared to many other types of investments (which this book will also explore in subsequent chapters). As you may have guessed,

with GICs the money you essentially “lend” to your bank is invested by a bank for a certain term that you choose (as opposed to you directly investing your own money in, say, a discount brokerage trading account).

Where can you buy a GIC?

There are some general avenues you can take to buy a GIC.

The most common places that you can get GICs are banks and trust companies. A trust company is typically a subsidiary of an insurance company or one of the Canadian chartered banks. But it does not stop there. There are over 50 other Canada deposit insurance corporation member firms that compete to offer GIC products. So be sure to explore some of these other off-the-radar options for better rates. These include online-only banks.

One thing that makes GICs safe is that they are insured by the Canada Deposit Insurance Corporation up to \$100,000 when GICs have maturities of five years or less. In the case of GICs issued by a Caisse Populaire or credit unions in certain provinces, those are insured by provincial governments. Always check the rules and regulations before you transact with these issuers so that you are clear with your protections.

How do you buy a GIC?

You likely already have a bank account with money in it — I hope! With that bank account, you can purchase a GIC either by visiting a bank branch, going online over the Internet, or having a conversation with a customer service rep over the phone:

- » **Buying a GIC at a bank branch:** Buying in person means visiting your bank branch, letting them know you want to buy a GIC, figuring out the amount, the term, and the interest rate, and withdrawing the money from your account to be deposited into your new GIC. *Voilà*, you’re done.
- » **Buying a GIC at a bank online:** To buy a GIC online you need to provide your account number, branch number, and your social insurance number. There is likely a waiting period for processing this request, but it’s usually done efficiently. The bank will then email you a confirmation of the transaction.
- » **Buying over the phone:** If you want to purchase a GIC over the phone, and assuming you already have a bank account, of course, you can do so. The bank’s customer service representative will just ask you a number of security questions to make sure it’s really you. They then will guide you through the purchasing process to complete the transaction.

Non-registered accounts

A non-registered account is a taxable investment account that is available to you to enroll in. The key word and theme here is *taxable*. Non-registered taxable accounts are offered by banks and many other providers of financial services, including robo-advisors, Internet-based banks, and mutual fund companies.

In the case of interest-paying securities like GICs, the amount of periodic interest returns you can expect to obtain depends on what kind of interest-bearing investments you hold. In the case of equities like stocks, and depending on what your risk tolerance is, non-registered accounts allow you to have a wide range of flexibility.

However, non-registered accounts seldom offer the same tax advantages that RRSPs and TFSAs do. Interest income earned from these accounts is fully taxable. If you are at a high tax rate, or in fact any tax rate, the tax burden associated with interest is quite punishing when compared to the way other financial vehicles are taxed. This book covers the taxation of financial instruments held outside of non-registered accounts in Chapter 10.

Canadians who seek to get better returns on their savings and investments use RRSPs and TFSAs. When you take a long-term view of your savings and investment time window, the difference in total returns at the time of retirement can be very significant. Even if your timeline is shorter, there is no need to ignore the gifts (tax-advantaged saving and investment accounts like the TFSA and RRSP) provided to you by the Canada Revenue Agency. However, just know that you can *also* use a non-registered account for all of your other personal goals.

Understanding When You Would Open an RRSP or TFSA Plan

The question of *when* you would open an RRSP or TFSA is separate and apart from the question of *which* registered plan you would favour. In terms of opting for one registered plan over the other, that topic is discussed throughout this book. Chapter 11 is dedicated to that topic.

When should you open either of these accounts? As soon as you can! This is based entirely on the principle that savings and investment returns grow relative to the time horizon or amount of time the money in the plan is allowed to compound. *Compounding* is the ability of an investment to generate earnings, which are then reinvested or remain invested. The returns generate their own earnings. It's basic mathematics and represents a powerful force that can help you save.

Another reason to open any of these accounts as soon as possible is to take advantage of tax benefits. As you now know, by putting money into RRSPs you can get a tax deduction very quickly. This will reduce the amount of tax you would otherwise pay when you file your tax return. In the case of both registered plans, earnings within them (that is, dividends and interest) are tax-free. And paying less tax now means more money in your hands.

Both plans can help you achieve your saving and investing goals. But the answer to the question “How much of each registered plan should I get?” is rarely clear-cut. That’s the tricky part, and one of the key themes of this book is to get you as close as possible to the answer. It’s tricky because our personal circumstances differ from one Canadian to the next, and the best a book or financial planner can do is to provide you with a framework and some calculations under various scenarios. The ultimate investment decisions are up to you. Yet, you need a framework and criteria to refer to, and Chapter 11 helps you with that. These tools will help to speed your decision-making around RRSPs and TFSAs.



REMEMBER

This book can help you, but a financial planner can help you much more. A financial planner will engage in two-way conversations with you to better understand your objectives. Never ignore the advice given by a qualified financial planner or tax expert. They have a finger on your financial situation pulse. Instead use this book as preparation for your discussion with a planner. Or use it as a guide after you’ve heard your planner’s advice. This is similar to what you would do when you are planning a visit to your doctor. If you are like many people, you will likely consult Dr. Google to first see what you may be ailing from, or to compare what the doctor told you after your visit.

Revisiting my earlier comment about which registered plan you would favour, one thing to be aware of is that the answer to the RRSP versus TFSA question is not necessarily binary. In other words, you don’t have to choose one plan at the complete expense of the other. Of course, you can have both, provided you have the contribution room. For example, you may choose to place an emphasis on one over the other and still have both. Any mix or contribution can work.

Your ultimate decision, as you will see throughout this book, is that your RRSP to TFSA “mix” or “ratio” will depend on your individual financial circumstances, personal objectives, and other criteria discussed in this book. For now, as you read on, just keep in mind that with a TFSA you still have to pay tax on the money you earned from employment and other sources prior to making your contribution. On the other hand, with an RRSP you are provided with a tax refund as soon as you file your tax return after you have contributed. But, of course, later you’ll have to pay tax on the money you withdraw from the RRSP plan, which is a different outcome than the one associated with the TFSA.



REMEMBER

Your income, timelines, and many other factors that are discussed in this book will drive your decision. Chapter 11 and other chapters as well will help you to consider the criteria you need to reflect on.

Sizing Up Taxes on Non-registered Plans

In order to better appreciate registered plans like the RRSP and TFSA, it is important to understand how interest, dividends, and capital gains that are generated from or within non-registered plans are taxed — and taxed without the protections and other advantages offered by these registered plans. This distinction will help you decide or consider what type and mix of investments you should hold within your chosen plan. So even after you’ve made a decision around the plan mix (RRSP and TFSA), you still have another decision to make around the investment mix. That latter decision is informed and influenced by tax rules.

Although Chapter 10 is dedicated entirely to the tax treatment of fixed income securities as well as equities and more, the purpose of this section is to introduce you at the very high level to the fundamental types of returns you can expect to get from investments, which include interest, dividends, and capital gains.



REMEMBER

Both RRSP and TFSA plans permit investment vehicles and instruments that generate interest, dividends, and capital gains.

Before I dive into the broad explanation of the taxation of interest, dividends, and capital gains, this next small section examines the concept of tax-free versus tax-deferred, which is highly relevant to the world of RRSPs and TFSA.

Tax-free vs. tax-deferred

Tax-free savings accounts are exactly that — tax-free. When you withdraw money from a TFSA, the withdrawal does not trigger any tax. On the other hand, with RRSPs, that type of registered plan is “tax deferred” in nature. This means that you must pay tax on any money that you withdraw from your RRSP. The event in question is therefore the withdrawal.

As previously stated, if you take money out of your TFSA you can put in more money at any time, up to the TFSA permitted ceiling. However, with an RRSP, if you withdraw funds before you reach the expiration date of the RRSP, you do not in most cases have a chance to put the funds back into the account because you will have lost that contribution room.

Again, all this places in sharper focus how one plan is more tax-free in nature and the other plan is more tax-deferred in nature.

Understanding taxation of investment returns from non-registered financial instruments

How much tax does investment income draw? Yup, you guessed it — it depends. Different forms of income attract different levels of taxation. For example, relative to other types of investment income, interest income attracts the most punishing tax. Things get a bit more lenient with dividend income, where the Canada Revenue Agency (CRA) taxes you but at the same time may also give you a tax credit to cushion the blow. With capital gains, the CRA hits you with only half a blow, because only a fraction of your gains is included in your income. This chapter explores these tax matters.

By understanding how things get taxed outside of tax-sheltered registered plans like the RRSP and TFSA, you will better understand what plan to favour and what investment mix is best suited to each plan.

Interest Income

Earlier in this chapter, I discussed bank accounts and guaranteed investment certificates (GICs). These, along with term deposits, mortgages receivable, and bonds, are some of the financial instruments available out there that produce interest income. Interest income is taxable in full in the year in which it's received. No deductions or credits are associated with interest income, other than any small expenses, such as bank fees, incurred to actually earn interest.

The CRA wants your interest income so much that, for interest income on compound-interest obligations obtained in 1990 or later, for example, interest must be reported on an annual accrual basis (meaning you don't actually have to physically receive interest; instead, it is automatically calculated for you) from the investment's anniversary date. (Compound interest, by the way, is the interest you earn based on both the initial principal you put in plus the accumulated interest from prior years or periods. Think of it as "interest on top of interest.")

You will report this accrued interest as if you had actually pocketed the interest. For example, if you invested in a compound interest bearing bond on June 30, 2022 that matures in June 2023, you do not have to include in the 2022 tax year interest that accrued as of December 31, 2022. So far, so good. However, in 2023, you must report interest earned from July 1, 2022 to June 30, 2023 even though

you did not receive the interest payment in your bank account. It is therefore best to have interest-bearing bonds that mature after the year-end.

You will find a few more examples below to show you that not all interest income is administered equally!

- » **Treasury bills:** For Treasury bills (T-bills), which I discuss in more detail in Chapter 3, the difference between your acquisition cost and the selling price at maturity is calculated as interest. That is because the interest you make is simply the difference between your purchase price and the face value that you receive at maturity. A capital gain is realized only if market interest rates drop and the Treasury bills (now worth more) are sold before maturity, really meaning before their term or life essentially expires. The capital gain therefore equals the selling price, less the purchase cost plus accrued interest, up to the date of disposition. You may have to report a capital loss if the opposite happens. This is a bit of a complex area that your advisor can help you with.
- » **Indexed securities:** *Indexed securities* are financial instruments that provide interest at a rate below the current market rate. However, the amount payable upon maturity is generally adjusted based on the usually annual change in a purchasing power index, such as the Canada Consumer Price Index (CPI). In these circumstances, if there is an upward adjustment, the increase is included in the investor's income as interest. If there is a downward adjustment, the reverse occurs and the adjustment is generally deductible by the investor. Your tax slip, normally the T5 slip, provides the detailed amount that needs to be included in your tax return. *Phew!*



Providers of investment vehicles (such as banks that provide GICs) are required by law to send their clients annual information slips (a T5: Statement of Investment Income) reporting interest, dividends, and other forms of investment income. You will also likely receive a T5008 Statement of Securities Transactions from your financial institution. This slip discloses the amount paid or credited to you for securities you sold or redeemed during the year. Chapter 10 discusses in more detail these and other more complex fixed-income and other investment options.

Despite the above complexities, in summary, interest received or earned must generally be reported annually. For interest earned on bank accounts and GICs with a term of one year or less, and regular interest-bearing bonds, calculating interest earned will be easy. In fact, in these simpler cases, a T5 slip will be issued by the payor, and the interest payment for the year will be shown on your T5.

Like most tax rules, the rules around the tax treatment of interest income have changed and continue to evolve over time. The annual reporting requirement outlined here applies generally to investments made after 1989. The most current

rules can be found by googling the terms *CRA Interest Income*. If you have the time and patience, the pertinent CRA pages can be found at www.canada.ca/en/revenue-agency/services/tax/individuals/topics/about-your-tax-return/tax-return/completing-a-tax-return/personal-income/line-12100-interest-other-investment-income.html.



TIP

As you can see, some interest-bearing investments, such as T-bills and indexed instruments, have unique reporting methods. Other uniquely treated investments include annuity contracts, investments bought at a discount to face value, stripped bonds, and Canada Savings Bonds. Consider these nuances when you and your advisor are making investment and tax-planning decisions; they can have a major effect on your taxes payable. Check out these and other current tax law requirements at the CRA website (www.canada.ca/en/revenue-agency).

Canada Savings Bonds (CSBs) were no longer available for purchase as of November 2017. Any bonds you already own are guaranteed and continue to earn interest until maturity or redemption, whichever comes first.



TIP

It's a good idea to keep bonds inside a registered account such as a *registered* retirement savings plan (RRSP), registered retirement income fund (RRIF), or registered TFSA. Paying interest and having to do the bookkeeping are avoided if the bonds are held inside a registered account.

Dividend Income

Now for a breath of fresher air. Compared to interest income, any eligible dividends you receive from a Canadian corporation are subject to preferential tax rates. Eligible dividends are typically captured automatically on your T5. They are taxed at a lower rate because of the availability of a dividend tax credit. This dividend tax credit is available to you because the corporation has already paid tax on the earnings when it distributed them as dividends to you. In this way, the CRA guards you against double taxation.

Dividend income received from foreign companies — before any withholding tax is held back — is taxed at the same full tax rates as interest income. There is no gross-up and dividend tax credit treatment (see the section “Grossed out,” later in this chapter). The absence of a dividend tax credit makes sense because the CRA doesn't tax foreign corporations, so there is no double taxation issue in the first place.

Dividends included in your tax return are converted to Canadian dollars, of course. However, a foreign tax credit is available for any foreign taxes that are withheld. So foreign dividends are taxed more like interest instead of like dividends from Canadian companies.

If dividends from Canadian and foreign corporations accrue inside your RRSP, for instance, tax on this income is deferred. When you finally withdraw money from your RRSP, it will be taxed as regular income. No tax advantage such as applying the dividend or foreign tax credit is available when such dividends accrue inside an RRSP.

There are also financial animals called *capital gains dividends*, which are distributions that may come from Canadian mutual funds, exchange-traded funds (ETFs), and real estate investment trusts (REITs). For REITs, any dividend payments made by the REIT are taxed to the unitholder as ordinary income, unless they're considered qualified dividends, in which case they're taxed as capital gains. Your T5 slip sorts this out for you, so don't worry. For capital gains dividends, just realize that one-half of the capital gain distributed will be taxable on your tax return.

Distributions made by Canadian ETFs can take on many forms as well in the eyes of the CRA. They can be one or a combination of the following:

- » Canadian dividends eligible for dividend tax credit treatment
- » Capital gains (only 50 percent taxable)
- » Return of capital (not taxable, but triggers a reduction of the adjusted cost base)
- » Other income (100 percent taxable)
- » Foreign income (100 percent taxable)

Your T5 usually comes to the rescue and indicates the split.



TIP

Any distributions you receive from foreign ETFs as a Canadian are usually treated as foreign dividends, which are 100 percent taxable. When distributions from U.S. ETFs are categorized as capital gains or return of capital for U.S. taxpayers, they're still fully taxable in the hands of Canadian taxpayers.

GROSSED OUT

If you received dividends from a taxable Canadian corporation, you must gross the dividends up by 38 percent (that is, multiply them by 1.38) and then include that grossed-up amount in your taxable income. Hey, that's not fair. But wait — the federal dividend tax credit discussed previously (or 15.02 percent of the grossed-up eligible dividend) immediately comes to the rescue and instantly reduces your federal income tax payable. Provincial tax credits are available, too. Okay, that's better.



Provinces now have their own dividend tax credit, similar to the federal credit. Previously, provincial tax was calculated as a simple percentage of the federal tax after the federal dividend tax credit was applied.

STOCK DIVIDENDS AND SPLITS

A *stock dividend* is a dividend that a corporation pays by issuing shares instead of cash. Stock dividends are generally considered to be ordinary taxable dividends and are treated as such. The amount of the dividend you include in taxable income — your share of the increase in paid-up capital — also represents the cost of your new shares for future sales as well as capital gain or loss calculations.

Stock splits — where you get more shares without any change in the total dollar value of those shares — are not taxable. You gained or lost nothing from an economic or a tax standpoint.



When you get your T3 (Statement of Trust Income Allocations and Designations) or T5 tax slip showing, among other things, your annual dividend income (including any stock dividend values), you'll see that there are boxes that contain both the actual dividends and the taxable amount of dividends paid. Be careful to include only the taxable amount of dividends on your tax return.

Capital Gains and Losses

A *capital gain* occurs when you sell or otherwise dispose of a capital property for more than what you paid for it. In other words, your proceeds exceeded the cost to you. Technically, the CRA refers to this cost as the *adjusted cost base* because the CRA may sometimes require you to adjust your original cost. However, let's keep things simple and leave special rules about costs out of the picture for now. After all, this book is not just about taxes in the negative sense. It's about tax freedom and tax deferral. Hail the positives! For now, just keep in mind that capital gains are reduced by any disposition costs incurred, such as brokers' commissions. Also, continue to keep in mind that to fully appreciate RRSPs and TFSAs as valuable financial vehicles, it is critical to understand how investment income and capital gains are taxed outside such plans.

Unlike ordinary income such as salary or interest, only 50 percent of the capital gain that you make outside your RRSP is included in your taxable income. This is called a *taxable capital gain*, and this portion of the total capital gain is taxed in the year of the sale. If you suffer a *capital loss* — where your costs exceed your proceeds — the 50-percent allowable portion should first be used to offset any taxable capital gains that may exist in the same year. The allowable capital loss cannot be used to reduce other income except under special circumstances, such as death. Any unused allowable capital loss can be carried back up to three years or carried forward indefinitely, but only to reduce any future taxable capital gains.

Keep in mind that just receiving no proceeds from a sale doesn't always mean that you have no capital gain or loss to report. A special scenario can play out when you gift shares or other capital property to family members. In such cases, the CRA may deem you to have received fair-market-value consideration at the time of the gift (or a sale for less than fair market value). The amount of cash actually changing hands is irrelevant to the CRA. These sorts of situations are discussed throughout Part 2 and Part 3 of this book.



TIP

The CRA has certain rules concerning superficial losses. A *superficial loss* occurs when you execute a transaction (such as a sale or other transfer of investments) that creates a loss while you, or a related person, keep or quickly regain control of the same (or identical) property that created the loss in the first place. The CRA applies the superficial loss provision beginning 30 calendar days before and ending 30 calendar days after the disposition of a property. In other words, no fancy footwork (such as the manipulation of the timing or ownership of losses) is permitted a month before or after the sale.