Wealth
Management

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC WEALTH MANAGEMENT SERVICES

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Create RRSP contribution room for a minor

If your minor children have earned income, consider filing tax returns for them. This will enable them to generate Registered Retirement Savings Plan (RRSP) contribution room and open RRSPs. Opening and contributing to an RRSP may help your child learn the benefits of saving and may also reduce their taxes.

File a tax return

Many teenagers start working part-time after school or on weekends to earn pocket money. It gives them some freedom, a sense of purpose and duty, and an appreciation for the value of money.

If your child earns an annual income below the basic personal exemption, they may not need to file a tax return but there may be benefits to doing so. Filing a tax return allows them to accumulate RRSP contribution room by having "earned income" documented with the Canada Revenue Agency. Some examples of earned income include salary, wages or tips from employment or net income from a business carried on by a self-employed individual.

By filing a return, your minor child will accumulate RRSP contribution room at the rate of 18% of earned income subject to the annual maximum.

Contributing to an RRSP and earning room at an early age

The following example illustrates how contributing early to an RRSP may increase the tax-deferred growth that occurs over the lifetime of the RRSP.

Assume two Ontario schoolmates, Bob and Joe, each get summer jobs at age 13. They continue working and each earns $4,000 every summer. At age 22, they both get full-time jobs after graduating from university.

Bob's parents file a tax return each year on Bob's behalf, while Joe's parents do not. This extra effort made by Bob's parents generates $6,480 [($4,000 x 18%) x 9 years = $6,480] of RRSP contribution room for Bob by the time he graduates from university. The tax rules allow for an indefinite carry-forward of unused RRSP contribution room, so this RRSP contribution room accumulates for Bob from age 13.

If Bob's marginal tax rate is 29.7%* when he starts working full-time, Bob will be able to reduce his tax liability by approximately $1,925 ($6,480 x 29.7%) if he contributes the full amount of his carry-forward room to his RRSP in his first year of employment. Bob could invest these additional funds or use them to supplement his cash flow. If Bob is age 22 when he makes this contribution, and he leaves the funds in his RRSP until age 60, that extra $6,480 in his RRSP will grow to nearly $60,000 (assuming a growth rate of 6% per year).

By filing a tax return at a younger age, Bob will be able to build savings earlier, and the savings will compound on a tax-deferred basis for a longer period of time. This will potentially provide a larger nest egg at retirement.

When Bob eventually makes withdrawals from the RRSP, they will be taxable at his marginal tax rate for the year in which he makes the withdrawal. Bob may be able to time his withdrawals so that the RRSP income is taxed at a lower rate. This may be possible during retirement when he may be earning less income and be in a lower marginal tax bracket.

Other benefits

- **Educational:** Consider getting your children involved in preparing their tax returns. This may help them develop an understanding of Canada's tax system and may be useful in teaching them sound financial management habits.
- **Income splitting:** If you own a business, there may be benefits to hiring your children and paying them a salary. There is no attribution if your child earns employment income from your business. Keep in mind that the salary you pay them must be "reasonable" for the services they provide. Generally, if you're trying to determine what's considered reasonable, ask yourself what you would pay an unrelated individual to do the same work.
- **Tax-deferred compounding:** Referring to the earlier example, to take advantage of additional years of tax-deferred compounding, Bob could make the contributions to his RRSP annually ($4,000 x 18% = $720 per year), as he earns RRSP contribution room, so the funds are invested as soon as possible in his RRSP. By getting the funds into the account sooner, the value at age 60 could be even higher than the $60,000 noted in the example.

* The 29.7% tax rate is an estimate of the marginal tax rate for those with taxable income of approximately $70,000 in Ontario. The exact rate of tax savings will depend on the individual's actual income for the year and their province or territory of residence.

> If your minor child or children have earned income, consider helping them file a tax return, even if they do not have to pay any taxes and are not required to file a tax return. This will allow them to create RRSP contribution room and is also a great way to help them get into the habit of saving and learning about the benefits of compound growth.

Bob can claim the deduction when his income increases and he's subject to tax at higher rates in order to maximize the value of the RRSP deduction. The tax rules allow you to carry forward your undeducted RRSP contributions indefinitely.

- **Home Buyers' Plan:** If your children build up their RRSPs early, they could use the funds to take advantage of the Home Buyers' Plan (HBP). The HBP allows your child to borrow up to $35,000 from their RRSP with no immediate tax consequences to purchase their first home.

Other considerations

- **Additional costs:** You may incur additional tax advisor fees or have to dedicate additional time and resources in order to file a tax return for your child. Keep this cost in mind when determining whether it makes sense to use this strategy.
- **Ability to work:** Refer to federal and provincial/territorial laws for information on the type of part-time employment available to minors. This particularly relates to industrial settings. You should keep this in mind if you plan to employ your minor child in your business.
- **Ability to open account:** Although the tax rules allow minors to open and contribute to their RRSP, as long as they have the contribution room, not all financial institutions may accommodate opening RRSPs for minors. Speak with your financial institution to ensure they can open an RRSP for your minor child.
- **$2,000 over-contribution:** Generally an individual can over-contribute a cumulative lifetime total of $2,000 to their RRSP without incurring a penalty. Minors do not qualify for the lifetime over-contribution. The additional $2,000 over-contribution amount is available to them only when they are 18 years old or over at any time in the taxation year.

- **Social Insurance Number (SIN):** Your minor child must have a SIN to file their tax return and open an RRSP account. You may apply for their SIN at any time after birth.
- **When your child will need access to their funds:** If your child will need access to their earnings in the short term (for example, to pay for post-secondary education), then an RRSP may not be the best savings vehicle. Funds withdrawn from an RRSP are fully taxable to your child and they will not regain their RRSP contribution room. It may make more sense to invest their earnings in a non-registered account.

Summary

If your minor child or children have earned income, consider helping them file a tax return, even if they do not have to pay any taxes and are not required to file a tax return. This will allow them to create RRSP contribution room and is also a great way to help them get into the habit of saving and learning about the benefits of compound growth.

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