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## RRSP VS. TFSA – WHICH IS BETTER?

This is a question that comes up regularly in financial planning and tax planning circles. But before we attempt to answer the question, we need to know the difference in the tax treatment between these plans.

Although some commentators call the first 60 days of the year the “RRSP season”, that is not really true. As noted below, to get a tax deduction for an RRSP contribution in a year, you can make the deduction in the year or within 60 days after the year. Since an RRSP and TFSA earn tax-free income, contributing to your RRSP and TFSA should be year-round tax plans.

## RRSP basics

An RRSP (registered retirement savings plan) is essentially a personal “money-purchase” pension plan, usually set up with a trust company or an insurance company.

Your contributions to the RRSP are **deductible** in computing your income, subject to the limits described below. The RRSP can invest in various investments, including publicly traded stocks, bonds, mutual funds, GICs, and so on.

The income earned in your RRSP is completely tax free while in the plan. However, when you withdraw the funds, they are fully **included in your income** for tax purposes.

The contribution limit for 2022 is:

- Your unused contribution RRSP room from previous years, plus
- the lesser of 18% of your “earned income” for 2021 and the general dollar limit for 2022 of \$29,210 (which is indexed each year to inflation), minus your “pension adjustment”, which basically measures contributions to an employer registered pension plan, if you have one (if you don’t have one the pension adjustment should be zero).

“Earned income” is basically your employment or net business income, with some additional types of income allowed as well.

The “unused contribution room” component means that if you don’t fully contribute in a year up to your RRSP limit, you can carry that deduction room forward indefinitely.

The contribution is normally made in the relevant year, but the deduction for a given year is available for any contributions made within 60 days after the year. So for the 2022 year, you can contribute during 2022 or by March 1, 2023 and claim the deduction in 2022. (Note that for next year's deduction, the deadline will be February 29, 2024, not March 1!)

### TFSA basics

A TFSA (tax-free savings account) is normally set up with your bank or trust company.

Similar to the RRSP, it can invest in stocks, bonds, mutual funds etc.

Also similar to the RRSP, there is no tax payable on the income earned in the plan.

The difference is that there is **no tax deduction** when you contribute to the plan, and **no income inclusion** when you withdraw from the plan.

The monetary limits do not depend on earned income (as noted above, the RRSP limits do depend on this). There are flat monetary limits each year, which accumulate if you don't use them up.

In 2009, when TFSAs were introduced, the annual limit was \$5,000, and this amount has been indexed annually to inflation, but rounded to the nearest \$500 (there is one exception, in 2015 when it was bumped up to \$10,000). For 2022, the limit is \$6,000.

In addition, if you withdraw from the TFSA in one year, the amount of the withdrawal is added back to your contribution room starting with the next year.

Unlike the RRSP, you have to be 18 years or older to set up a TFSA.

Like the RRSP, any unused contribution room can be carried forward indefinitely. So if you were born before 1992, the cumulative total you can contribute as of 2022 is **\$81,500**. (See the table in our March 2022 issue for the maximum if you were born after 1991.)

### Which is better on after-tax basis?

If you are in the same tax bracket in the year of contribution and the year you withdraw the funds, the RRSP and TFSA are economically equivalent.

Although an arithmetical formula can prove this, you can think of it conceptually this way. Both plans earn tax-free income while in the plan. The TFSA provides no deduction for the contribution but no inclusion upon withdrawal, while the RRSP provides a deduction for the contribution but an inclusion upon withdrawal that effectively "offset" each other, providing the same result as the TFSA.

#### Example 1

You are in a 40% tax bracket in 2022 and the subsequent year of withdrawal, which we will assume is 2028.

You want to contribute the after-tax amount of \$10,000 of your employment income this year to one of these plans, or both. Assume the contribution doubles by 2028, and then you withdraw the entire amount.

**RRSP contribution:** If you decide to contribute \$10,000 now, you get a \$10,000 deduction so there is no tax on that amount for 2022. This means you can contribute the entire amount of \$10,000. The \$10,000 grows to \$20,000 by 2028, and when you withdraw, you pay \$8,000 in tax (40% rate), leaving you with \$12,000 after tax.

**TFSA contribution:** There is no deduction in 2022, so your after-tax amount of employment income is \$6,000 (\$10,000 net of the 40% tax in 2022). So you can contribute \$6,000. That doubles to \$12,000 by 2028 when you withdraw, with no tax, leaving you with \$12,000.

So you are left in the same after-tax position either way.

However, if you are in a different tax bracket in 2028, the two plans are not equivalent on an after-tax basis.

### Example 2

Lower tax bracket in 2028:

Assume the same facts as above.

Except assume you are in a 30% bracket in 2028. With the RRSP option, you pay \$6,000 in tax in 2028. So when you withdraw the \$20,000, you are left with \$14,000.

With the TFSA option, your tax bracket is irrelevant since the withdrawal is tax-free. So, as above, you are left with \$12,000 in 2028.

### Example 3

Higher tax bracket in 2028:

Next assume you are in a 50% bracket in 2028. With the RRSP option, you pay \$10,000 in tax in 2028. So when you withdraw the \$20,000, you are left with \$10,000.

With the TFSA option, again your tax bracket is irrelevant since the withdrawal is tax-free. So, as above, you are left with \$12,000 in 2028.

The practical problem is that we often don't know whether our tax rates will be higher or lower in the year of withdrawal.

Of course, if you are fortunate enough to be able to contribute the full limit amounts to both your RRSP and TFSA, you should do that.

Another related issue comes up if you withdraw the amounts when you are 65 years old or more. The RRSP option means you include the withdrawal in your income. So that means, depending on your income, you might be subject to the Old Age Security "clawback tax". It could also affect your age tax credit, which is phased out after a certain amount of income. (On the positive side, income from the RRSP, or from a RRIF to which it is converted, may generate the "pension credit" on your return.) With the TFSA option, these issues don't arise since the withdrawal is not included in your income. So that is another issue to consider, in addition to your tax rates in the year of contribution and the year of withdrawal. But again, this is often hard to predict.

## Potential for income-splitting with spouse or partner

One tax plan that can be considered for either an RRSP or a TFSA is the potential to split income with your spouse (or common-law partner).

Under the RRSP rules, you can contribute to either your RRSP or your spouse's RRSP (provided it is set up with the institution as a "spousal RRSP"), and you can claim the tax deduction to reduce your taxes. Your spouse will benefit from the tax-free income while it is in the RRSP. Furthermore, if your spouse is in a lower tax bracket than you when they withdraw the funds, you will obviously save tax as a couple. There is one caveat: Your spouse must wait until the third year after the year in which you make your contribution to withdraw. If the withdrawal is made earlier, there is an attribution rule that provides that it will be included in your income.

### Example

In 2022, I am in a 50% tax bracket. I contribute \$20,000 to my spouse's RRSP (which has been set up as a spousal RRSP).

I can deduct the \$20,000 from my income, which saves me \$10,000 in tax because I am in a 50% tax bracket.

The funds in my spouse's RRSP grow to \$30,000 by 2027, and they withdraw the amount. My spouse is in a 20% tax bracket, so they pay \$6,000 in tax, leaving \$24,000 after tax. Assuming I was still in a 50% tax bracket, obviously I would have paid more tax and be left with less after tax.

Because of the attribution rule, if my spouse withdrew in, say, 2024, the amount would be included in my income and the income splitting opportunity would be lost.

Under the TFSA rules, you can similarly give money to your spouse to contribute to their TFSA. Although there is no attribution of income while the funds are in the TFSA, future attribution is not prevented if funds transferred to the TFSA are withdrawn by the spouse.

## THE CAPITAL GAIN RESERVE

As readers are likely aware, if you sell a capital property like real estate or securities and your proceeds of disposition exceed your cost of the property (plus any sales costs like commissions), you will have a capital gain. Your “taxable capital gain”, included in your income for tax purposes, is one-half of the capital gain.

However, if some or all of the proceeds of disposition are due after the year of sale, you do not have to pay tax on the entire taxable capital gain in that year. In most cases, you can claim a “capital gain reserve”, as described below. Although you must still include a portion of the gain in the year of sale, you can normally spread out paying the tax on the entire gain over up to five years.

The reserve is optional. It might not be claimed if you have capital losses that could offset the capital gain, or if you expect to be in a higher tax bracket in future years.

Assuming you choose to claim it, the capital gain reserve is the lesser of two amounts:

- 1) The portion of the capital gain that can reasonably relate to the proceeds of disposition that are due after the year. This portion is determined by multiplying the amount of the capital gain by (proceeds due after year / total proceeds).

Put another way, this is the portion of the gain that isn't yet received in the year.

- 2) The second amount is a fraction multiplied by the amount of the capital gain. Basically, in the year of sale the fraction is  $4/5^{\text{th}}$  of the gain, and in the three subsequent years the fraction is  $3/5^{\text{th}}$ ,  $2/5^{\text{th}}$ , and  $1/5^{\text{th}}$ , respectively. After four years of claiming the reserve, any remaining gain after that point will not be eligible for the reserve and you will have to report the remaining gain, if any, in the fifth year.

Put another way, you must recognize at least  $1/5^{\text{th}}$  of the gain, cumulatively, each year beginning in the year of sale.

When you claim the reserve for a given year, you add the amount you claimed back into your capital gains for the next year. But you may be able to claim the reserve again for the next year, assuming some proceeds are still not due until after that year.

### Example

In 2022, I sell some land for \$600,000. My cost of the land was \$100,000. So I initially have a capital gain of \$500,000.

Under the sales agreement, the purchaser will pay me \$100,000 in 2022, and \$100,000 in each subsequent year until the full purchase is paid, which will be in 2027.

In 2022, I can claim a reserve equal to the lesser of:

1. The \$500,000 capital gain x (\$500,000 proceeds due after 2022 / \$600,000 total proceeds), which comes to \$416,666; and
2. The \$500,000 capital gain x  $4/5$ , which comes to \$400,000.

Put another way, I'm getting only  $1/6^{\text{th}}$  of the proceeds in 2022, but I have to recognize at least  $1/5^{\text{th}}$  of the gain this year.

Assuming I claim the \$400,000 reserve, I will report a capital gain of \$100,000 in 2022. One-half of that gain will be included in my income in 2022 as a taxable capital gain.

In 2023, I add back the \$400,000 reserve claimed in 2022 into my income. But then I can again claim a reserve. It will be the lesser of:

1. The \$500,000 capital gain x (\$400,000 proceeds due after 2023 / \$600,000 total proceeds), which comes to \$333,333; and
2. The \$500,000 capital gain x  $3/5$ , which comes to \$300,000.

Therefore, I will report a capital gain in 2023 of \$100,000, i.e. the \$400,000 reserve add-back minus the \$300,000 reserve.

Again, one-half of that gain, being \$50,000, is included in my income in year 2 as my taxable capital gain.

The reserve mechanism could continue through 2025, after which a reserve would be not available (since, as noted above, it is only available for four years). Therefore, the remaining capital gain would have to be reported in 2026 (the 5<sup>th</sup> year), even though some proceeds are not due until 2027.

### Other limitations on the capital gains reserve

You cannot claim the reserve if you sell property to a corporation or partnership that is controlled by you immediately after the sale. Control includes ownership of more than 50% of the voting shares of the corporation, but it also includes “*de facto*” control, which means control “in fact” even if you own less than 50% of the voting shares.

If the vendor of the property is a corporation, the reserve cannot be claimed if the purchaser of the property is a corporation controlled by the same person or group of persons that control the vendor corporation. Similarly, the reserve is not allowed if the purchaser corporation controlled the vendor corporation.

## GAINS AND LOSSES ON PERSONAL-USE PROPERTY

“Personal-use property” (**PUP**) is defined generally, for income tax purposes, as property used primarily for personal purposes. So it includes things like your car, furniture, bicycles, clothes, appliances, and so on.

If you sell PUP at a gain, one-half of the gain will be included in your income as taxable capital gain.

Unfortunately, if you sell it at a loss, you cannot normally claim a capital loss. There is an exception for “listed personal property” (**LPP**), where a loss can be claimed, but only against LPP gains.

LPP is defined as:

- Artwork;
- Rare books or manuscripts;
- Jewelry;
- Stamps; and
- Coins.

If you have a loss from the sale of LPP, it can be used to offset any gains you have from the sale of other LPP, but not against gains from the sale of other personal-use properties. If, after claiming the loss, you still have a net gain, one-half of that will be included in your income as a taxable capital gain. If your loss exceeds any gain, the excess loss can be carried back three years or forward seven years to offset LPP gains in any of those years, but not gains from other property.

For all PUP, including LPP, there is a rule that says that your *minimum* cost and proceeds of disposition for capital gains or loss purposes are both \$1,000. This is an arbitrary measure, meant to alleviate tax reporting for relatively minor dispositions and gains (or losses).

#### Example

I sell the following properties in 2022. My cost and sales proceeds are as follows:

Property 1: Cost \$300, sales proceeds \$700.

Property 2: Cost \$800, sales proceeds \$1,200.

Property 3: Cost \$1,300, sales proceeds \$900.

For property 1, since both the cost and sales proceeds are bumped up to \$1,000, I do not have a capital gain for tax purposes, even though I made net \$400 on the sale.

For property 2, my cost is bumped up to \$1,000, so I will have a gain of \$200, and half of that will be reported as a taxable capital gain.

For property 3, my sales proceeds are bumped up to \$1,000, so I will have a \$300 capital loss. However, as discussed above, I can claim this loss for tax purposes only if the property is LPP, and then only against gains from LPP.

## FLAT RATE HOME OFFICE EXPENSES EXTENDED

Normally, if you are an employee, you can deduct home office expenses only if:

- You carry on your employment duties *primarily* in your home office (basically meaning more than 50% of the time during the year); **or**
- You carry on those duties in your home office, which is used only for employment purposes during the year, *and* you regularly meet clients or customers there on a regular basis.

The home office expenses include things like supplies, minor repairs and maintenance, heat and utilities and rent (pro-rated based on the size of the home office).

Due to Covid-19, the CRA allows a “flat rate method” instead of the “regular method” described above, with no Form T2200 to be signed by the employer. Also no documents have to be kept.

The CRA flat rate method applies if you worked more than 50% of the time from home for a period of **at least four consecutive weeks** in the year due to the pandemic. In such case, you can claim \$2 for each day you worked from home during that period and the rest of the year. The maximum amount that could be claimed was \$400 in 2020. It has been increased to \$500 for 2021 and 2022.

**Marcil Lavallée**

### OTTAWA

400-1420 place Blair Towers Place  
Ottawa ON K1J 9L8  
T 613 745-8387  
F 613 745-9584

### GATINEAU

100-200 rue Montcalm St  
Gatineau QC J8Y 3B5  
T 819 778-2428  
F 613 745-9584

**Marcil-Lavallee.ca**

Marcil Lavallée, S.E.N.C. | G.P.

Société de comptables professionnels agréés  
Partnership of Chartered Professional Accountants

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