Kids and RRSPs

The two don’t often go hand-in-hand. But perhaps they should.

Most advisors overlook that it may make sense for minors to begin thinking about RRSPs. It may also make good business sense for advisors to get into the practice of planning RRSPs for children, as it could give advisors an edge in retaining assets when a multi-trillion-dollar intergenerational transfer of wealth begins later this century.

To determine whether an RRSP for a child makes sense, inquire whether your client’s children have any “earned income.” While the Income Tax Act’s definition of “earned income” includes several types of income, such as rental income, royalty income and business income, most children are likely only to have employment income, either from a part-time job after school or on weekends and/or a full-time job during the summer months.

Pay kids a “reasonable” salary to generate earned income.
Recommend that small business-owning clients consider employing their teenage children where feasible. This can be an effective income-splitting strategy for the owner-manager. It also provides a way for a child to “earn” his or her weekly allowance that will qualify as earned income if paid as salary but not if merely given as a weekly spending stipend.

A word of caution: Ensure any salaries paid to children are reasonable and can be justified. Several recent tax cases have found the payment of salaries to children was merely an income-splitting scheme and have disallowed those deductions. For example, in the September 2004 decision of Hampson v. The Queen (2004 TCC 623), a self-employed psychologist who earned just over $60,000 attempted to deduct $12,500 in salaries he paid to his two children, aged 14 and 9, for their services. Hampson claimed he paid $7,000 of the $12,500 to his son for computer

Tax-sheltered plans can be a good option for children’s long-term savings goals.

By Jamie Golombek
programming and software services. The judge denied the deduction, saying while ... “there were probably lots of things about the operation of computers that [the son] understood and could perform better than his father ... to justify expenditure of $7,000 for his services requires a good deal more evidence than there is before me today.”

**Kids should file returns.**

Ensure your client’s child files a tax return with the CRA to report any income earned. If less than the basic personal amount ($8,012 in 2004), he or she need not worry about paying any income tax since the income will be fully offset by the basic personal credit. The child should still file the return, however, in order to inform the CRA of his or her earned income for the purpose of building up RRSP contribution room.

**To contribute or not to contribute?**

Consider whether or not children, who are filing tax returns today in respect of earned income so as to build up RRSP contribution room, should even bother making an RRSP contribution. Since RRSP contribution room is cumulative, and there is an unlimited carry-forward period in which to make the contribution, there really is no rush to contribute immediately. You, however, may be able to provide some helpful advice to guide your client’s children towards an optimal RRSP solution.

If the teen is saving her earned money, inquire as to the timeframe for which she’s saving. If it is short term, say, to buy a car, it’s probably not worth contributing to an RRSP only to pull the money out and pay tax on it, permanently losing her RRSP contribution room. If, however, it’s a longer-term goal, such as for post-secondary education, or for a down payment on a home, then an RRSP contribution may make sense. Money can be withdrawn, tax-free, for either of these purposes under the federal government’s Lifelong Learning Plan or Home Buyers’ Plan.

The advantage of investing the child’s savings in an RRSP as opposed to in a non-registered account is the tax-deferred compounding available inside a registered plan. However, this is really only a concern if the child has enough income, either now or in the foreseeable future, to put him or her above the basic personal amount annually and thus faces tax on what would otherwise be non-registered investment earnings.

**To deduct or not to deduct?**

Consider whether or not, after making the RRSP contribution, the deduction should be claimed. In most cases it should not, particularly if the child’s income is below the basic personal amount. Even at incomes above the personal amount but below $35,000 (the first federal tax bracket for 2004), the child may be advised to wait until he or she begins working full-time and is in a higher tax bracket where the RRSP deduction will be worth more. Even this benefit, however, could be offset by the advantage of investing the tax refund received years earlier. Finally, recall that just like with RRSP contributions, there also is an unlimited carry-forward period for RRSP deductions.

**Opening up the Account**

Most financial institutions are reluctant to open up a non-registered investment account for minor children. Although one can legally enter into a contract with a minor, the problem is that the contract may be unenforceable should the minor one day wish to get out of it.

That said, most financial institutions are willing to open up an RRSP account for a minor child since it cannot be opened “in-trust.” The institution will require a completed RRSP application form and a letter of consent signed by the child’s parent or guardian. That document gives the parent or guardian full signing authority over all transactions in the account until the minor becomes of age.

**Practice Management**

Consider establishing an early, meaningful relationship with your clients’ children through an RRSP strategy. Remember, these children may one day turn out to be some of your best clients—and one day they may also inherit their parents’ assets—money that may otherwise leave your practice.

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