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Giving your inheritance now

Michael Nairne, Serious Money

Illustration by Chloe Cushman

Do you make an RRSP contribution or a TFSA contribution? Which is better? Every year a host of articles assist investors with this issue.

High income earners are fortunate – they don't have to make a choice. They contribute to both their RRSPs and TFSAs to the maximum extent possible. And they do so as soon as possible every year to maximize tax-deferred and tax-free growth.

However, a few of the wealthy take it one step further and turn the annual ritual of RRSP and TFSA contributions into a family affair by gifting money to their adult children and even adult grandchildren so they can contribute to their own TFSAs and RRSPs.

Most wealthy families continually face hefty tax bills. With the bulk of their assets held outside registered plans, their investment income is typically taxed at the highest marginal rate. Conservative multi-millionaires with highly taxed fixed-income portfolios really feel this pain.

Taxes are also a hurdle in inter-generational wealth transfer. Although Canada does not have an estate tax per se, there is generally a deemed disposition of capital property on death that gives rise to capital gain taxes. Transfers to a spouse or spousal testamentary trust can defer this tax but ultimately, in the typical wealthy family, the death of the second spouse triggers an avalanche of taxes. Probate taxes can take another nasty nip.

By gifting money to their adult children or grandchildren which is then used to fund TFSA and RRSP contributions, affluent parents can address both tax issues. By increasing the amount of the family's capital held in non-taxable and tax deferred environments, they reduce the family's overall income tax bill. By moving assets into the next generation's hands now, they are planning for the inevitable.

There is also a hidden benefit. Young adults often struggle to save as they face the costs of finishing their educations, launching their careers and starting their own families. If they lack the ready cash with which to make either an RRSP or TSFA contribution, their unused contribution room can simply pile up year after year. By making RRSPs and TFSAs a family affair where contributions are made earlier rather than later, the power of compounding is extended over longer time horizons. In various scenarios our firm has analyzed, this alone can add several hundred thousand dollars to a family's wealth.

TFSAs are a natural for this strategy. Unlike an RRSP, there is no need for employment and other "earned income" income to create contribution room. Any Canadian resident 18 years of age or older can contribute to a TFSA. Withdrawals are tax-free. If the money is needed in any particular year by the child, say to help out with a first home purchase, it can be withdrawn and added back in subsequent years.

RRSPs are little trickier. Since the contribution is tax deductible, its value is greater during higher income years. Hence, it often makes sense to gift money to lower earning young adults so they can make the maximum RRSP contribution permitted for the year, but defer claiming the deduction until they are in a higher tax bracket. The contribution will immediately generate tax-deferred compounding while the deduction will be used in a future year in which it is anticipated to be more valuable.

There are some caveats. Parents have to be confident their retirement years and philanthropic plans are fully funded before they start giving away their capital. Gifts should be funded out of cash and not through the sale of appreciated property that will trigger capital gains tax. Over 40% of Canadian marriages end in divorce so the family law aspects of gifting to adult children need to be considered.

Affluent families that fail to plan RRSP and TFSA contributions on a multi-generational basis are missing a valuable opportunity to maximize family wealth.

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