

FINANCIAL *Perspectives*

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Inflation or Deflation?

From Warren Jestin, Senior Vice President & Chief Economist, Scotiabank Group

Concerns about an acceleration of price pressures have blown hot and cold over the past year. Investors became worried about inflation around the beginning of 2010 when massive government stimulus and inventory rebuilding temporarily led to stronger-than-expected economic news. These fears turned to renewed concerns about a double-dip and deflation in the spring as economic momentum waned and the sovereign debt crisis in Europe escalated. By year-end, better economic news and rising commodity prices were again putting the spotlight on inflation prospects.

While inflationary hot spots have flared up in Canada, the U.S. and other developed nations, the persistence of high unemployment rates and widespread excess capacity limits the potential for a broad-based heating up of wage and price pressures. On a year-over-year basis, headline consumer price inflation was running around 2% in Canada and 1% in the U.S. at the end of 2010. If food and energy-related items are excluded, core consumer price trends were significantly lower in both countries.

In contrast, China's benchmark consumer price index was showing annual increases slightly above 5% at the close of 2010. Official concern there and in other rapidly growing emerging nations has already triggered tighter monetary and credit conditions. Much of the inflationary impetus in these nations is coming from surging prices for food – which represents a big share of household purchases- and industrial commodities. Scotiabank's Commodity Price Index has risen nearly 40% from its 2009 cyclical low. Robust performances in the BRIC nations is likely to fuel further gains in 2011, with WTI around \$100/bbl.

The inflation outlook for developed economies will be less reassuring beyond 2011 as intensifying skill shortages begin putting upward pressure on labour costs. Governments will be confronted with increased demands for health care and social support services alongside an aging population. The cost of imports from emerging markets will escalate as their income rises and currencies appreciate. The net effect – G7 central bankers will likely have a harder time achieving low inflation targets in the next 3-5 years than they have had over the past two decades.

Spousal RRSPs – Understanding How They Work

What is a spousal account?

A spousal RRSP is an account in which you make contributions however, your spouse is the annuitant or the owner of the account. This means that your spouse has control over the account in terms of investment decisions and when payments are received from the account.

Why use a spousal account?

Effective tax and retirement planning would ensure that spouses had equal income at retirement to reduce the overall tax burden that a family would have. The main advantage of a spousal RRSP therefore, is to help divide assets that will produce future income. Usually, the higher income spouse contributes to a spousal RRSP and receives a tax deduction at a higher marginal tax rate. Then in retirement, the other spouse withdraws that money to produce income and pays tax at a lower tax rate (subject to attribution rules explained below).

As an example, a family with annual income of \$70,000 earned by spouse would pay approximately \$17,000 in taxes. However, that same family with each spouse earning \$35,000 would lower the tax bill to \$11,900.

There may be situations where the lower income spouse would make contributions to a spousal account. In this case, they would likely be a member of a pension fund that is going to provide them with retirement income. Or, they have other assets that will cause them to have more retirement income than their higher income spouse.

Remember, the overall goal is to have both spouses with the same amount of retirement income.

How does a spousal account work?

When you chose to open a spousal account, your spouse's name will appear on the account. You will be the contributing spouse and you will receive a tax deduction, however the legal owner of the account is your spouse.

When they withdraw money in the future, the taxes due will be in their name, subject to attribution rules.

Attribution rules

The attribution rules in the Income Tax Act are designed to prevent abuse of spousal accounts.

If a person makes a withdrawal from a spousal account in the current calendar year and contributions have been made to any spousal account in the year of withdrawal, or in the previous two calendar years, that income will be attributed back to the contributing spouse.

The word “any” is important. A withdrawal from a spousal RRSP to which no contributions were made during the three-year period will still be attributed to the contributors income, if over that three-year period any contributions were made to any other spousal plans.

Note also the term “calendar year”. Making a spousal contribution in January 2004 would mean that the owner must wait until January 2007 before a withdrawal could be made.

Other ways to avoid attribution of income

In addition to the above, attribution of income from spousal withdrawals does not apply in the following circumstances:

- If the funds in the spousal plan are transferred to a RRIF and only minimum withdrawals are taken. If more is taken, then the excess withdrawal is subject to attribution
- If the spouse's are living apart because the relationship has ended
- If the contributing spouse died in the year the withdrawal is made
- If either spouse becomes a non-resident
- If the plan holder transfers money directly from the spousal plan to an annuity or to a locked-in RRSP that can't be cashed out for at least three years

Can I make contributions to my spouse's existing RRSP?

The short answer to that question is yes. However, as soon as you combine or co-mingle your spousal contributions with their regular contribution, the account is considered a spousal account for the purposes of the attribution rules as described above.

Depending on your circumstances, it may be appropriate to have two accounts. If you were to require funds from an RRSP before retirement, and you had two accounts, you could withdraw from the account that made the most sense from a tax perspective (i.e. the account where the contributor would have the lower tax rate).

The Role of Insurance in Tax Planning

Insurance has typically been used to protect against the risk of future financial loss. However, more and more, innovative insurance solutions are being used to safeguard the value of investors' assets in a tax-efficient manner.

- 1) *Creating a tax-free wealth transfer.* Insurance is transferred to beneficiaries outside of your estate and, as such, does not trigger taxes, probate fees, or legal costs.
- 2) *Preserving assets against taxation.* Insurance can be designed to provide beneficiaries with a lump sum of cash equal to their taxes owing on a deemed disposition value of your investments.
- 3) *Generating tax-preferred income.* Insurance strategies can be used to create tax-preferred retirement income.
- 4) *Minimizing tax on corporate assets.* Insurance can provide a means to move surplus assets out of the corporation on a tax-preferred basis while enhancing the value that will be passed to beneficiaries.
- 5) *Minimizing tax through charitable giving.* Insurance will help increase the size of your gift and in most cases provide significant tax benefits.

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