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What to do with your tax refund

Strategies to optimize the use of your income tax refund

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Financial Advisory Support

As a result of RSP contributions, interest expenses, tax shelter deductions or various other tax deductions and credits, you may be expecting or have recently received a 2008 income tax refund from the Canada Revenue Agency (CRA). According to the CRA, the average 2007 income tax refund cheque issued to individual tax filers was $1,440.

If you receive a tax refund, it may be a good opportunity to determine if you can use some or all of it to improve your financial well-being. This article discusses some strategies that may help you use your income tax refund wisely and assist you in meeting your financial goals…every little bit helps!

Unique spending ideas

If you are expecting to receive a 2008 income tax refund from the CRA or have recently received it, then you may be tempted to spend your refund. In some cases this is an appropriate use of the money, depending on your need at the time.

Here are some ideas you may not have thought of for spending your refund:

- Take a self-improvement course (new language, cooking, presentation course).
- Join a health club.
- Hire a tutor for your children to help them in school.
- Make your house more energy efficient (new furnace, new windows, etc.); this may result in tax credits on your 2009 tax return.
- Service your car (preventative maintenance increases the life of a car).
- Donate to a charity and get a tax deduction on this year’s tax return.
- Go on a much needed vacation.

Improve your financial well-being

Has your advisor recently prepared a financial plan for you? If so, a good first step in determining the best use for your refund is to review the recommendations in your financial plan. You can then review the areas needing improvement and prioritize in terms of what is most important to you. The receipt of an income tax refund can be a great catalyst for you to implement some of the strategies in your financial plan.

Preparing your Will or Power of Attorney, setting up your emergency fund or putting adequate disability or life insurance in place can be easily done with the average tax refund. Of course saving the refund in an RSP, RESP, TFSA or paying down debt are all financially wise saving strategies for the funds.

Speak to your advisor if you require assistance in reviewing the recommendations in your existing financial plan, or if you would like a new financial plan prepared for you.

The following are some common financial planning recommendations that you may want to address with your tax refund.

ADDRESS RISK MANAGEMENT STRATEGIES

When it comes to managing your finances, many people understand the benefits of saving on a regular basis; but what is equally important, but sometimes forgotten, is ensuring that you and your family are taken care of in the event of your death or disability. The receipt of your income tax refund can be a catalyst to address the following three common risk management strategies:

i) Meet a lawyer to have a Will and Power of Attorney prepared.
ii) Ensure you have adequate disability and critical illness insurance.
iii) Ensure you have adequate life insurance.

EDUCATION SAVINGS

If you plan to help your children with their education costs, you may wish to use your income tax refund to contribute to a Registered Education Savings Plan (RESP). The first $2,500 of RESP contributions attracts a government grant of $500 to $600 depending on your family income. If you have not opened an RESP for your children, the receipt of the CRA refund cheque can be a great way to start making contributions.

REDUCE NON-DEDUCTIBLE DEBT

You generally can’t go wrong by paying down an outstanding non-deductible debt subject to a high interest rate. Non-deductible debt includes credit card debt, a personal-use car loan, a line of credit used for personal purposes or the mortgage on your home. As the interest on a loan used for personal purposes is not deductible for income tax purposes, you are paying the interest on the loan with after-tax monies. The higher the interest rate on the loan or the higher your marginal tax rate, the more income you have to earn to pay the interest on this loan, so the more beneficial it is to pay down this debt.

RSP OR NON-REGISTERED SAVINGS

If you do not have high-interest, non-deductible debt, then another option for your income tax refund is to save your refund in an RSP or a non-RSP account. Whether you should save your refund in an RSP or non-RSP account depends on your specific circumstances and several financial assumptions. However, the following general observations can be noted:

i) If your marginal tax rate in retirement is expected to be the same as or lower than your marginal tax rate today, then consider contributing to your RSP.

ii) If you are seeking to invest in securities that produce Canadian source dividends and capital gains and are in a low tax bracket today but expect to be in a higher tax bracket in retirement, you are generally better off to save outside of an RSP.

Speak to your advisor about whether you should contribute your tax refund to a registered or non-registered account. Your advisor has access to tools that can help you decide which option is best for you.

CONTRIBUTE TO A TAX-FREE SAVINGS ACCOUNT (TFSA)

Beginning in 2009, the TFSA became available as a new investment vehicle for Canadian resident taxpayers. The TFSA provides a further option for investing your tax refund. The new TFSA allows you to make a $5,000 annual maximum contribution. All growth, income and withdrawals are tax-free. You are also able to gift money to your spouse to invest in a TFSA without being caught by the income attribution rules.

You may be wondering if it is better to invest your tax refund in an RSP or a TFSA if you are unable to do both. The following general guidelines can help you make this decision:

i) Choose the TFSA if your expected marginal tax rate at retirement is going to be higher than your marginal tax rate today.

ii) Choose the RSP if your expected marginal tax rate at retirement is going to be lower than your marginal tax rate today.

EMERGENCY FUND

A fundamental financial planning strategy is to have some money set aside for unexpected expenses or a job loss. In general, consider keeping approximately three to six months of living expenses within a liquid emergency fund. If you do not have an adequate emergency fund, you may want to direct some or all of your tax-refund towards its creation.

As an alternative to directing your income tax refund to a savings vehicle that may earn little interest, consider obtaining or increasing your line of credit for emergency purposes only.

Receive your tax refund earlier

You should ensure the information you provide to your employer on your TD1 form — Personal Tax Credits Return is up to date every year. You may have had a change in your personal or family situation since last year that allows you to claim credits for items like pension income, spouse or common-law partner amount, caregiver amount, disability amount and others. Letting your employer know of these additional credits will allow your employer to lower your income tax deductions at source instead of waiting until your tax return is assessed within about six months of year-end to receive your refund.

If you do not want to wait until after you file your income tax return to receive your tax refund, you can also complete CRA's T1213 form if you have regular tax deductions such as RSP, child care expenses, alimony, etc. This form is used to ask for reduced tax deductions at source for any deductions or non-refundable tax credits that are not contained on the TD1 form. If this form is accepted by CRA, they will authorize your employer to reduce the income tax withheld from your paycheque during the year, thereby increasing your net pay. In essence, this will enable you to receive your tax refund periodically throughout the year rather than waiting for a lump sum tax refund after you file your income tax return.