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To Invest in an RRSP or Not

The RRSP Conundrum

The registered retirement savings plan (RRSP) has long been recognized as an essential retirement planning vehicle. However, the value of this retirement planning vehicle is sometimes questioned by investors. Is it better to invest outside an RRSP? This article examines the various factors to consider when deciding whether to invest inside or outside an RRSP.

The Canadian government introduced the registered retirement savings plan (RRSP) in 1957 to encourage individuals to save for retirement. By investing in an RRSP, you can deduct the amount of your RRSP contribution from your taxable income, up to your annual RRSP deduction limit, thereby lowering the taxes you must pay. In addition, funds in an RRSP can grow on a tax-deferred basis. The investment income and capital gains generated in the plan are not subject to tax until you withdraw them from the RRSP, or from a registered retirement income fund (RRIF) if you have converted your RRSP to a RRIF. Alternatively, RRSP funds can be used to purchase an annuity. With an annuity, payments are taxed in the year received.

Since funds within an RRSP have never been subject to income tax, any amount you withdraw or receive from an RRSP/RRIF/annuity is fully taxable as part of your income in the year you make the withdrawal or receive a payment. One concern, especially if you have accumulated significant sums in your RRSP, is that the entire amount of the RRSP/RRIF/annuity will be included as income in the year of your death unless you can transfer the RRSP/RRIF/annuity to your surviving spouse or a financially dependent child or grandchild. This means that a significant portion of your RRSP/RRIF/annuity could be taxed at the highest marginal tax rate, which would not be the case if the investments were held outside an RRSP.

Many individuals have reconsidered investing in an RRSP due to the fact that they could lose a significant portion of their RRSP/RRIF to taxes when they withdraw funds as income. In addition, when funds are withdrawn, capital gains that have accumulated inside the RRSP will be fully taxable as part of the plan holder's income for the year, whereas only 50% of capital gains accruing outside an RRSP are taxable as income. Many people wonder if they would be better off investing outside an RRSP, especially if they intend to invest in equities.

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When you evaluate your own situation, consider the following factors:

Your marginal tax rate

Your marginal tax rate at the time of your RRSP contribution

Your marginal tax rate at the time of your RRSP contribution may be the most important factor in determining whether or not to invest in an RRSP. The tax savings from your RRSP deduction can provide you with more capital up front on which you can earn additional income.

If you are in a 40% marginal tax bracket and invest \$1,000 outside an RRSP, you will have only \$1,000 on which to earn income. If you invest the \$1,000 in an RRSP, you could receive up to \$400 in tax savings to add to your investment. You could invest this \$400 outside an RRSP or you could use it to make another RRSP contribution. You could have up to \$1,400 available on which to earn income.

The higher your marginal tax rate is at the time of your RRSP contribution, the larger your tax savings will be and the more capital you will have with which to earn income. The additional capital generated by the tax savings generally makes investing in an RRSP a better choice if you are currently at the highest marginal tax rate.

Your marginal tax rate during the RRSP investment period

Your marginal tax rate throughout the period when you are investing in RRSPs can also influence your decision to contribute to an RRSP. In general, the higher your marginal tax rate during this period, the more you may benefit from making an RRSP contribution. This is because the benefit of sheltering your income from tax inside your RRSP increases as your marginal tax rate increases.

Your marginal tax rate at withdrawal

Your marginal tax rate at the time you withdraw funds from your RRSP/RRIF can also affect your decision to contribute to an RRSP. This is due to the fact that the amounts you withdraw from an RRSP/RRIF are included in your income in the year you withdraw them. For most people it makes sense to contribute to an RRSP since they will likely be in a lower marginal tax bracket when they retire. By making RRSP contributions now, they will not only benefit from the ability to defer tax on the income they earn inside the RRSP, but they will also pay less tax on the principal amount.

For example, let's assume you are currently in a 40% marginal tax bracket, and you will be in a 30% marginal tax bracket during retirement due to a decrease in income. On \$1,000 of income, you will pay 40% or \$400 in taxes today; however, you can defer paying taxes on this amount by making an RRSP contribution of \$1,000 today. If you withdraw the \$1,000 from the RRSP/RRIF during retirement, then you will only pay \$300 in taxes. By making the RRSP contribution, you will not only benefit from the tax-deferred growth inside the RRSP, but also pay less tax on the \$1,000.

If you are currently in a lower marginal tax bracket, the advantage of investing in an RRSP may be less obvious, particularly if you will be in a higher marginal tax bracket at the time the investment is withdrawn from the RRSP/RRIF. In this case, whether you will be better off investing in an RRSP will depend on other factors such as your investment time horizon, your rate of return on investment and also the type of investment you choose.

Your investment time horizon

One of the advantages of contributing to an RRSP is the ability to earn tax-deferred income. The benefits of tax-deferred compounding growth within an RRSP increase considerably the longer the investment is held in the RRSP.

Table 1, illustrates the net after-tax value of a \$1,000 investment in an RRSP compared to investing the same amount outside an RRSP. The example assumes, an annual 6% return (fully taxable in the non-registered account each year) and a marginal tax rate of 40% every year. This example also assumes that the tax saving created by making an RRSP contribution is reinvested into a non-registered portfolio. It illustrates that the overall difference in the net after-tax growth of the investment inside an RRSP (along with the reinvestment outside of an RRSP) versus just investing outside an RRSP increases dramatically with time.

Table 1

Years	Net after-tax value of investing in an RRSP plus investing the tax-savings in a non-registered account (A)	Net after-tax value of investing just in a non-registered account (B)	Difference (A – B), showing the benefit of an RRSP
10	\$1,644	\$1,424	\$220
20	\$2,736	\$2,029	\$707
30	\$4,602	\$2,889	\$1,713

Your rate of return

Your rate of return can also influence your decision to contribute to an RRSP. In general, the higher your rate of return, the more you will benefit from investing in an RRSP.

To illustrate this point, compare the example in Table 1 using an annual rate of return of 6% to the results in Table 2 using an 8% rate of return. The results are shown in Table 2 below.

Table 2

Years	Net after-tax value of investing in an RRSP and investing the tax-savings in a non-registered account (A)	Net after-tax value of investing just in a non-registered account (B)	Difference (A – B), showing the benefit of an RRSP
10	\$1,935	\$1,598	\$337
20	\$3,818	\$2,554	\$1,264
30	\$7,670	\$4,082	\$3,588

By increasing the annual rate of return by 2%, the difference in the net after-tax growth of a \$1,000 RRSP (along with the reinvestment outside of an RRSP) investment compared to \$1,000 invested only in a non-registered account also increases over the 10-, 20- and 30-year periods.

The type of investment you choose

The various types of investment income are taxed in different ways. All your interest income is taxed at your full marginal tax rate, while only 50% of capital gains are taxable at your marginal tax rate. Dividend income from Canadian corporations also receives more favourable tax treatment than interest income.

Since interest income is taxed at a higher rate than capital gains or dividends from Canadian corporations, it is a good idea to purchase investments that generate interest income (such as GICs and bonds) inside an RRSP whenever possible. This way, you can shelter the interest income that you earn from tax.

Some advisors recommend purchasing common shares outside of an RRSP as an alternative to investing in an RRSP. As common shares often provide little, if any, dividend distributions, they can provide tax-deferral benefits similar to an RRSP because you only pay tax on the shares when they are sold. As previously mentioned, unlike RRSP income, which is fully taxable, only 50% of the gains from the sale of common shares is subject to tax outside of an RRSP. Additionally, losses from the sale of common shares can be used to offset capital gains, while capital losses realized inside an RRSP cannot be used to offset capital gains generated inside or outside an RRSP.

This investment strategy may make sense if investing in common shares is consistent with your investment objectives and your risk tolerance. To benefit from this strategy, you will need to be in a low marginal tax bracket and expect to be in a significantly higher marginal tax bracket in the future or have already accumulated a large RRSP portfolio.

Another RRSP alternative is to invest in a universal life insurance policy. Investment earnings within the policy can accrue on a tax-deferred basis, and earnings paid out as death benefits can be received tax-free by the beneficiary. Comparison of the merits of investing in an RRSP versus investing in a universal life policy is beyond the scope of this article, but investing in a universal life policy can be beneficial if you require insurance coverage and wish to leave a larger estate to your beneficiaries.

The value of your existing RRSP portfolio

RRSP investors are often concerned that their estate may have to pay almost half the value of their RRSP/RRIF portfolio in taxes in the year they die. According to current Canadian tax rules, the value of your RRSP/RRIF portfolio will be included in your income in the year of your death. This is because you have never paid tax on the funds in your RRSP. This rule will apply unless it is possible to transfer your RRSP/RRIF to your spouse or your financially dependent child or grandchild on your death. Including your RRSP/RRIF in your income in the year of death could mean that someone in the lowest tax bracket could be taxed at the highest marginal rate in the year they die.

This may discourage low-income individuals who have large RRSP portfolios and no qualified beneficiaries from investing additional funds into an RRSP. However, if you have significant unrealized capital gains in your non-registered portfolio, it could also have an impact on you since the capital gains could be deemed to be realized and taxable at death.

Life insurance may be used to meet this potential tax liability. The death benefit could pay the tax bill while the value of your RRSP/RRIF remains intact at the time of death to leave to your beneficiaries.

RRSP vs. non-RRSP investment calculations

Your advisor can help you calculate, based on given assumptions, the net after-tax values of a \$1,000 investment in an RRSP versus \$1,000 invested outside an RRSP. Ask your advisor for assistance in determining what's right for you.

RRSP vs. Tax-Free Savings Account (TFSA)

The TFSA was introduced by the federal government in the 2008 budget. Starting in 2009, all Canadian residents aged 18 and older can contribute to a TFSA. All Canadian residents aged 18 and older who have a social insurance number will be able to open a TFSA starting in 2009. If 18 is not the age of majority in the province where you live (currently 19 is the age of majority in Newfoundland and Labrador, New Brunswick, Nova Scotia, British Columbia, Northwest Territories, Yukon and Nunavut), you will be able to open a TFSA when you reach the age of majority in your province of residence. However, TFSA contribution room will still start to accumulate from age 18. Unlike an RRSP, contributions to a TFSA are not tax-deductible; however, income and capital gains earned inside a TFSA grow on a tax-free basis.

If you are deciding whether to contribute to an RRSP or a TFSA, consider some of the factors discussed in this article. In particular, consider your marginal tax rate at the time you make a contribution and your marginal tax rate when you make a withdrawal. Also take into account your investment time horizon as a withdrawal from an RRSP is taxable, but you will not pay tax when you withdraw funds from a TFSA. The amount withdrawn is added to your TFSA contribution room for the following calendar year to allow you to re-contribute the amount withdrawn.

Your advisor can help you calculate, based on given assumptions, the net after-tax value of investing \$5,000 in an RRSP compared with investing the same amount in a TFSA or a combination of both. Ask your advisor for assistance in determining what's right for you.

Conclusion

The decision to invest in your RRSP or outside it depends on your specific situation and a number of financial assumptions. However, the following general observations can be noted:

- You will generally be better off investing in an RRSP, regardless of the type of investment you choose or the rate of return, if your current marginal tax rate remains the same (or decreases) during the time you are investing in the RRSP.
- You may be better off investing outside your RRSP if you are seeking to invest in common shares and are currently in the lowest marginal tax bracket, but are expecting to be in a higher marginal tax bracket in the future.
- For all other situations, the decision to invest inside or outside an RRSP will depend on your current and future marginal tax rates, your investment horizon and the types of investments you choose.



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