

TAX ALERT



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RRSP'S - INVEST YOUR TAX SAVINGS TO STAY AHEAD

Contributing to an RRSP for retirement has always been accepted as a financially sound proposition. Providing you follow through with all of the other necessary steps, that is true. If not, the result is not so great. The common mistake most people make is they spend their RRSP tax savings and end up being worse off than if they had not made a contribution in the first place.

To illustrate, we will go through a typical example for Pat Jones. Let's start with some basic assumptions about rates of return, time lines and tax rates so we are comparing apples and apples. We will assume a 5% interest rate on bonds 8% on stocks and tax rates of 45% and 25% respectively. Finally, let's work with an investing period of 25 years and an annual RRSP contribution of \$10,000 by Pat who is in the highest tax bracket.

Accumulated RRSP Funds

If Pat contributes \$10,000 to her RRSP every year for 25 years she will accumulate about \$500,000 in the plan if RRSP funds are invested in bonds or \$790,000 if invested in stocks. The after tax amount on withdrawal will be reduced to about \$280,000 for bonds and \$440,000 for stocks as illustrated below.

	Bonds	Stocks
RRSP deposits	\$250,000	\$250,000
RRSP earnings	<u>250,000</u>	<u>540,000</u>
Total RRSP balance	\$500,000	\$790,000
Income tax on future withdrawal	<u>220,000</u>	<u>350,000</u>
After tax accumulation	\$280,000	\$440,000

Investing Outside the RRSP

Now let's assume that Pat invests her savings in a portfolio instead of contributing to an RRSP. In that case, accumulated after tax funds in 25 years would be about \$365,000 for bonds and \$590,000 for stocks.

	Bonds	Stocks
Savings	\$250,000	\$250,000
Earnings net of tax	<u>115,000</u>	<u>330,000</u>
After tax accumulation	\$365,000	\$580,000

What happened – the accumulated after tax amount is higher by investing in a portfolio than it is by contributing to an RRSP? That seems surprising! The reason for the lower accumulated RRSP amount is because funds contributed to the RRSP are fully taxable when withdrawn – whereas taxes on portfolio capital gains and dividends are taxed at a much lower rate. You are probably starting to see the error most people make. They do not re-invest their tax savings to make up for the future tax hit on RRSP income.

To stay even, Pat should invest at least some of her annual tax refund. Let's see what happens when she does that.

	Bonds	Stocks
RRSP after tax accumulation (above)	\$280,000	\$440,000
Invested accumulation	<u>161,000</u>	<u>260,000</u>
After tax accumulation	\$441,000	\$700,000

So now the total accumulated funds are higher by using an RRSP and investing the annual tax savings than by investing. Our calculations indicate that you do not even have to invest the entire annual tax savings to break even but if you do not, you are not getting the full advantage from your RRSP. The object of an RRSP is not to stay even but to improve your net wealth in retirement so invest all of your tax refunds.

Penalties for Using RRSPs

There are penalties for RRSP investing that you should consider. When you reach retirement, tax rules make it mandatory to include a certain amount of your RRSP balance in income each year. For some individuals, their tax rate in retirement could be higher than their rate during their working years. On death of the last spouse, the full RRSP balance is taxable and a whopping tax bill usually results. Another significant penalty is that the RRSP capital and income stream cannot be well managed and estate planning options are pretty much nonexistent.

Other Choices

To be effective, RRSP investing requires a commitment to a long term saving strategies. If not, the benefit disappears or slips into negative territory. Because of the lower tax rate on capital gains and dividends, the tax advantages of RRSP contributions are diminished – especially as you get older. Perhaps you should use some of your savings to build an investment portfolio instead of contributing to an RRSP. This will also allow more flexibility to manage your finances and taxes in retirement.

At some point, individuals may actually consider reducing their RRSP balances to overcome the tax hit in retirement. They could borrow an amount equal to the tax they pay on an RRSP withdrawal to bring their total investment back to its original amount. Interest expense on the loan should be tax deductible if structured properly and families will start to build a more manageable pot of capital outside the RRSP. This is not for everyone but is an option worth looking at - certainly for high wealth individuals. The technique will also assist families with estate planning.

There is a lot to think about in RRSP planning – more than meets the eye. Contributing to an RRSP is not always the solution that it sometimes seems to be and can cost you money if not done properly. *This article appeared in the Castlemoore newsletter.*

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