Wealth Management

the Navigator

INVESTMENT, TAX AND LIFESTYLE PERSPECTIVES FROM RBC FAMILY OFFICE SERVICES

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To invest in an RRSP or not

The registered retirement savings plan (RRSP) has long been recognized as an essential retirement savings vehicle. Some investors often ask whether it's better to contribute to an RRSP or to a non-registered account. This article outlines some considerations when deciding whether to contribute to your RRSP. The considerations involved in deciding whether to invest in an RRSP are also applicable to a spousal RRSP. Any reference to a spouse in this article also refers to a common-law partner.

This article doesn't address the decision about where to save, for example whether to allocate excess funds to an RRSP, tax-free savings account (TFSA) or outstanding debt. If you are interested in learning about these considerations, please ask your RBC advisor for our article on comparing saving options.

What are your saving goals and objectives?

It's important to think about your personal goals and objectives when saving, in conjunction with your current circumstances. What are you saving for? When do you expect to use your savings? What are your priorities? Do the attributes of an RRSP align with your objectives?

RRSPs are designed to encourage individuals to save for retirement. If you're saving for the short term for expenses such as a car purchase, a wedding, a home renovation or your child's education, an RRSP may not be the best savings vehicle for you. Common goals that align with investing in an RRSP include:

- Saving for retirement or the future – An RRSP maximizes compound tax-deferred growth within the plan until the funds are withdrawn for retirement lifestyle expenses.
- Saving for a home – the Home Buyers' Plan program allows you to borrow up to $60,000 from your RRSP without immediate tax consequences to buy or build a qualifying home.
- Saving for future education – the Lifelong Learning Plan program allows you to borrow up to $20,000 from your RRSP without immediate tax consequences to finance post-secondary education or training for you or your spouse.

Benefits and potential drawbacks of an RRSP

In order to make an educated decision about contributing to your RRSP, it's important to understand both the benefits and potential drawbacks of the account.

Benefits of an RRSP

Contributions are made with before-tax dollars: Unlike saving in your non-registered account, where contributions are made with after-tax dollars, RRSP contributions are effectively made with before-tax dollars. This is because contributions you make to an RRSP are tax-deductible against all sources of taxable income. Since you essentially don't pay tax on the income you contribute to an RRSP, you are left with more money to invest.

RRSP contributions and contribution room can be carried forward: If you don't contribute your maximum annual RRSP limit, you can carry forward the unused portion and contribute in a future year when the deduction may serve you better or when have more cash flow to contribute. Similarly, if you have already made an RRSP contribution, there's no requirement to claim it as a deduction in the year you made it. RRSP contributions you've already made can be carried forward indefinitely and claimed as a deduction in a future year.

Tax-deferred compounding growth: Another significant benefit of investing in an RRSP is that income and capital gains earned in the plan compound on a tax-deferred basis and are only taxable when you withdraw funds from the plan. For example, if you earned $1 of income within your RRSP, you have the ability to re-invest the full $1. If instead you earned that income in a non-registered account, you would need to earn $1.66 pre-tax, assuming a 40% marginal tax rate, in order to re-invest a full $1. This tax-deferred compounding allows your investments to grow faster so that you can save more for retirement.

Income splitting opportunities: In retirement, an RRSP may provide income splitting opportunities for you and your spouse, which can result in significant tax savings for your family. One of the most simplistic, yet effective, methods of income splitting between spouses is contributing to a spousal RRSP for the future benefit of your spouse, who may be in a lower tax bracket in retirement. Withdrawals from a spousal RRSP or spousal registered retirement income fund (RRIF) will be taxable to your spouse (provided you didn't make a contribution in the year of withdrawal or in the two previous tax years).

As well, once you're age 65 or over, up to 50% of the income you receive from your RRIF can be split with your spouse. The portion allocated to your spouse is taxed in their hands at their potentially lower marginal tax rate.

If you don't contribute your maximum annual RRSP limit, you can carry forward the unused portion and contribute in a future year when the deduction may serve you better or when have more cash flow to contribute.

Creditor protection: For federal purposes, RRSPs and RRIFs are generally creditor protected from seizure in the case of bankruptcy. There's no cap on the amount of assets that are protected, with the exception of any RRSP contributions made in the 12 months before the date of bankruptcy. Some provinces or territories may extend the protection outside of bankruptcy, for example, to a professional liability lawsuit or at death.

Potential drawbacks of an RRSP

Not ideal for short-term savings: Since the RRSP is intended to promote saving for retirement, the characteristics of the plan discourage early withdrawals. For example, if you withdraw from your RRSP, the amount withdrawn is taxable and you can't reclaim your contribution room. As such, the RRSP may not be the best savings vehicle for you if you potentially need to draw on the funds in the short term.

Mandatory withdrawals at age 72: RRSPs mature by December 31 of the year you turn 71. On or before that date, you have to either transfer your RRSP to a RRIF, use the funds to purchase an eligible annuity, or collapse the plan and withdraw your RRSP funds (less withholding tax) in cash or in-kind. Both RRIFs and annuities have an annual minimum withdrawal requirement. Even if you don't need the money for your living expenses, by age 72 you're required to receive taxable income.

Withdrawals are fully taxable: Any amount you withdraw from your RRSP or RRIF, as well as any annuity payments you receive, are fully taxable as regular income at your marginal rate, regardless of the type of income that was earned in your RRSP. If you had generated mainly tax-preferred income such as dividends or capital gains inside your RRSP, the preferential tax treatment of this type of income is lost.

Capital losses reduce the value of your RRSP: An RRSP may also not be the ideal savings vehicle if you have a high-risk investment profile. If you incur any capital losses within your RRSP, you can't claim them against capital gains realized in the RRSP. The losses will simply reduce the value of your RRSP that will be available for you in retirement.

Withdrawals may impact income-tested benefits: Since RRSP and RRIF withdrawals are considered fully taxable income, they may impact your income-tested benefits such as Old Age Security (OAS), the Guaranteed Income Supplement (GIS) and provincial drug benefits available in some provinces. If you're planning to rely on these benefits in retirement, you will have to factor this into your decision of whether or not to contribute to an RRSP. The larger your RRSP becomes, the more retirement income you will typically have, and this could cause a claw back of certain income-tested benefits.

Fully taxable at death: The fair market value (FMV) of your RRSP or RRIF on the date of death is fully taxable as income on your final tax return, unless you leave it to a spouse or, in some instances, a financially dependent child or grandchild. If you had instead invested in a non-registered account, the difference between the FMV of the securities at the date of death and their adjusted cost base (ACB) would be taxable as a capital gain, which is only 50% taxable.

Key variables to consider

Contributing to your RRSP makes more sense in some situations than it does in others. In order to be strategic and effective in maximizing the benefits of the RRSP, you'll want to understand some of the key variables in determining whether investing in an RRSP may be the right approach.

Your marginal tax rates

Your marginal tax rates throughout the RRSP lifecycle may impact your decision to contribute. Generally, it makes sense to contribute to an RRSP if you expect to be in a lower marginal tax bracket in retirement than in your working years when you are contributing. By making an RRSP contribution and getting a deduction when you're in a higher marginal tax bracket and withdrawing the funds when you're in a lower marginal tax bracket, you pay less tax overall on the principal amount.

For example, let's assume you're currently in a 40% marginal tax bracket, and you'll be in a 30% marginal tax bracket during retirement due to a decrease in income. If you were to earn $10,000 of income today, you'll pay 40% or $4,000 in taxes. However, you can defer paying tax on this amount by making an RRSP contribution of $10,000. If you make the contribution and then withdraw the $10,000 from your RRSP or RRIF during retirement, you'll only pay $3,000 in taxes at that time. By making the RRSP contribution, you'll not only benefit from the tax-deferred growth inside your RRSP, but also pay less tax on the principal amount of $10,000.

Your marginal tax rates throughout the RRSP lifecycle may impact your decision to contribute. Generally, it makes sense to contribute to an RRSP if you expect to be in a lower marginal tax bracket in retirement than in your working years when you are contributing.

Your marginal tax rate throughout the period when you're investing in an RRSP can also influence your decision to contribute. In general, the higher your marginal tax rate during this period, the more you may benefit from investing in an RRSP. This is because the benefit of tax-sheltered growth on your investment income earned inside your RRSP increases as your marginal tax rate increases.

As mentioned earlier, a complete analysis of whether to invest in your RRSP includes an estimate of taxes on your RRSP withdrawals (i.e. your after-tax rate of return). Depending on the circumstances, it may be difficult to predict your future marginal tax rate, so it's important to do a thorough review of your retirement plans in order to gain a good estimate of your income level in retirement.

Considerations at the time of contribution

In deciding whether or not to contribute to an RRSP, you may want to consider the following guiding principles with respect to your marginal tax rates:

- The higher your marginal tax rate is at the time of your RRSP contribution, the larger your tax savings will be. The additional capital generated from the tax savings generally makes investing in an RRSP a good choice if you're currently in a high marginal tax bracket.
- An effective way of using your RRSP deduction is to claim just enough to reduce your income to just above the next lowest tax bracket. Doing so maximizes the value of your RRSP deduction. For example, let's assume your taxable income for the year is $130,000 and the marginal tax rate at that level of income is 44%. Let's also assume the marginal tax rate drops to 38% when taxable income reaches $96,000. Even if you had large unused RRSP contribution room and can contribute upwards of $50,000, you'll optimize your tax savings if you contribute $33,000 to your RRSP in order to bring your taxable income down to $97,000. If you contribute more than $33,000, you'll be saving tax at progressively lower rates — you'll be getting a tax savings of 38% or lower instead of 44% on any RRSP contribution over $33,000.
- If you have relatively low income now but expect your income to be higher in the next few years, you may want to wait before contributing. This may be the case

if you're just starting out in your career. Since RRSP room can be carried forward indefinitely, you can save your contribution for a year when your tax rate is higher and your contribution will result in a bigger deduction. Another option may be to contribute to your RRSP this year, but not claim the tax deduction until the year you have higher income.

- Everyone in Canada is allowed a basic personal amount where they don't have to pay taxes on approximately the first $16,000 of taxable income. If you're making less than the basic personal amount, you will not benefit from making an RRSP contribution. This is, of course, unless you plan on contributing and carrying the contribution forward to use in a future year where you expect more significant income.

With these principles in mind, your marginal tax rate is a key consideration in deciding whether to invest in an RRSP. However, you may also want to look at other factors such as your investment time horizon, your rate of return on an investment and also the type of investment you choose.

Your investment time horizon

A particular advantage 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 each year your investments are held and re-invested in your RRSP. Therefore, the longer you have to save, the larger the possible tax benefit an RRSP can provide. To illustrate the benefits of tax-deferred compounding growth, please refer to the numerical comparison in the next section.

A numerical comparison

This illustration compares an investment held in your RRSP to an investment held outside your RRSP, in a non-registered account. The illustration assumes the investment has a 6% annual return of interest income and that you have a marginal tax rate of 40% each year. Since contributions to your RRSP are effectively made with before-tax dollars and contributions to your non-registered account are made with after-tax dollars, the illustration assumes you have $10,000 to invest in your RRSP and $6,000 ($10,000 x 60%) after-tax funds to invest within your non-registered account. Lastly, for a simplified but complete net after-tax rate comparison, the illustration assumes you withdraw the entire amount from your RRSP and pay tax at your marginal tax rate of 40% at the 10-, 20- and 30-year marks.

Years	Value within an RRSP (A)	Net after-tax value of investing in an RRSP (A) x 60% = (B)	Net after-tax value of investing in a non-registered account (C)	Difference (B–C), showing the benefit of investing in an RRSP over time
0	$10,000	$6,000	$6,000	$0
10	$17,908	$10,745	$8,546	$2,199
20	$32,071	$19,243	$12,172	$7,071
30	$57,435	$34,461	$17,336	$17,125

The results show that investing in an RRSP will provide a higher after-tax return than investing in a non-registered account and that the benefits of investing in an RRSP increase over time. In addition, in order to illustrate the impact of using an RRSP, this comparison assumed that your marginal tax rate in the year of contribution was the same as in the year of withdrawal. However, if you expect to be in a lower marginal tax bracket in retirement than in your working years, the benefits of investing in an RRSP may be even greater.

Other considerations

Your investment strategy and asset allocation

Your investment strategy may help determine if an RRSP is the right savings vehicle for you. First and foremost, you will want to ensure your asset allocation conforms to your personal investment goals, risk tolerance and diversification needs. That said, asset location — how assets are distributed between all of your accounts, such as non-registered and registered — is important because holding your investments in the appropriate accounts may have a significant effect on your after-tax return.

As an example, you may benefit from holding securities that pay Canadian and U.S. interest income as well as U.S. dividends inside your RRSP or RRIF. This is because you can defer the tax on the interest and U.S. dividend income, which would otherwise be fully taxable outside of a registered account. On the flip side, if your investment strategy dictates holding securities with long-term growth, the RRSP or RRIF may not be the ideal savings vehicle for you. The preferential tax treatment of capital gains is lost inside these accounts. In fact, holding growth investments inside your RRSP or RRIF may result in more tax overall as the entire value is fully taxable when withdrawn from the registered account as opposed

to being 50% taxable as a capital gain if the investment was held in a non-registered account.

Your employer matching programs

If your employer offers a matching program when you contribute to your RRSP, then it will typically make sense contribute up to the employer match. This will increase your overall compensation and help to maximize tax-deferred compounding growth with the added benefit of your employer's contribution.

Your savings discipline

If you have a difficult time saving for your retirement, contributing to an RRSP may be a good solution for you. You can set up automatic deposits to your RRSP. This will ensure a portion of your pay is immediately and regularly contributed to your RRSP, which can help you gradually build up your RRSP over time. In addition, the punitive consequences of early withdrawal (i.e. fully taxable at your marginal rate and loss of contribution room) may work to curb spending behaviour and stop you from spending your savings.

Your other sources of retirement income

If you have other sources of retirement income, contributing to your RRSP may be less critical to your retirement needs. In fact, if you have a defined benefit (DB) pension plan through your employer, you may not even have a significant amount of RRSP room to contribute. This is because your annual RRSP contribution limit is reduced when you have an employer sponsored pension plan.

Further, an employer pension plan will offer a guaranteed payout upon retirement, whether you need the money or not. If you happen to have a decent-sized RRSP as well as a DB pension plan, you will be required to withdraw a certain amount annually, on top of your pension once your RRSP becomes a RRIF. This combined retirement income may impact your access to income-tested government benefits such as OAS and GIS.

If you want more income flexibility in retirement, you can consider directing your funds to other savings vehicles such as a TFSA. With a TFSA, you can choose the amount to withdraw at any time, and the amount withdrawn may not impact your income-tested benefits, as it's tax-free.

The value of your RRSP or RRIF on death

As a general rule, on your death, the FMV of your RRSP or RRIF is included as income on your final tax return and taxed at your marginal rate. There are exceptions to this rule when you designate qualified beneficiaries, such as your spouse or a financially dependent child or grandchild, as the beneficiary of your plan. In these circumstances, the tax on your RRSP or RRIF proceeds

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may be deferred and/or taxed in your beneficiary's hands. However, unless these exceptions apply, if you have a large RRSP or RRIF when you pass away, you could be taxed on these proceeds at the highest marginal rate. For this reason, if you're approaching retirement and have already accumulated a large RRSP portfolio and have no qualified beneficiaries, you might be discouraged from investing additional funds into your RRSP.

Moving from Canada

If you have an RRSP but are planning to leave Canada and become a non-resident, consider whether it makes sense to continue contributing to your RRSP. You will not be able to directly transfer your RRSP or RRIF to a retirement plan in another country. Instead, you will have the option to either leave the RRSP or RRIF intact or take the money out and pay non-resident withholding tax.

To assist you in determining the best course of action, you will want to understand how the RRSP or RRIF will be treated in the foreign country you're moving to. For more information on the options available for your RRSP or RRIF once you become a non-resident of Canada, please ask your RBC advisor for the articles on moving from Canada to the U.S. or to another country. If you have plans to move from Canada, talk to a qualified cross-border tax advisor as to whether it makes sense to continue contributing to your RRSP.

Conclusion

Choosing to invest in your RRSP is a personal decision and one which is based on numerous factors. An RRSP is a great way to save for the future and provides meaningful tax deductions and tax deferral until you start to withdraw from it. RRSPs are not as flexible as other savings vehicles, which is why it's important to determine what you'll ultimately use the funds for prior to contributing.

This article may contain strategies, not all of which will apply to your particular financial circumstances. The information in this article is not intended to provide legal, tax or insurance advice. To ensure that your own circumstances have been properly considered and that action is taken based on the latest information available, you should obtain professional advice from a qualified tax, legal and/or insurance advisor before acting on any of the information in this article.



Wealth Management

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