



Just do it: The case for tax-free investing

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Whether you choose an RRSP or TFSA, most Canadians would be well served by simply making a contribution to either plan. That's because, no matter which plan you choose, you have the ability to earn tax-free investment income for life, which is an opportunity that no one should pass up.

While Canadians often ponder whether it would be better, given limited resources, to contribute to a Tax Free Savings Account (TFSA) or a Registered Retirement Savings Plan (RRSP), it's important not to lose track of the major benefit of each plan – the tax-free growth.

Tax-free growth

While all investors will openly acknowledge the fact that investment income, be it interest, dividends or capital gains, is 100% tax-free when earned inside a TFSA, only a handful will assert the same assumption when it comes to income earned inside an RRSP. In fact, many individuals consider investment income earned within an RRSP to be merely “tax deferred.” This is simply incorrect.

To prove that income and growth inside an RRSP (or its successor, a RRIF) is indeed completely tax free,¹ let's take a look at an example.

On January 1st, Dan, whose marginal effective tax rate (METR)² is 33.33%, can afford to invest \$2,000 of his net after-tax cash flow in an RRSP. If Dan contributes \$3,000³ to his RRSP, he will get a tax refund of \$1,000 (\$3,000 times 33.33%), netting him the \$2,000 he has budgeted for retirement savings.

But if Dan can only afford to invest \$2,000, where does he get that extra \$1,000 to fund the \$3,000 RRSP contribution? He either takes it temporarily from other non-registered funds, or he borrows it at a favourable rate under an RRSP Loan Program, and pays it back as soon as he gets his tax refund.⁴ While the interest on such a loan is not tax deductible, if timed properly, the duration of such a loan can be as short as nine days – the time it can take to file your tax return electronically and have your refund directly deposited into your account. This minimizes the amount of non-deductible interest paid.

Now, let's assume Dan invests the funds on January 1st and earns a 5% return this year so that by December 31st, his RRSP has grown in value to \$3,150 from his initial \$3,000 RRSP contribution. If Dan pulls out the \$3,150 from his RRSP at the end of the year and he's still in a 33.33% tax bracket, he would pay \$1,050 of tax on his RRSP withdrawal and net \$2,100.

As Figure 1 shows, when you compare the \$100 he has netted with the \$2,000 it cost him to contribute, Dan has realized a 5% tax-free rate of return. In other words, the income he earned was not simply tax-deferred, but it was indeed completely tax-free.

¹ The equivalent of a tax-free rate of return is earned in an RRSP when tax rates are the same constant at the time of contribution and withdrawal.

² The marginal effective tax rate (METR) takes into account not only an individual's statutory income tax brackets but also considers the impact of the loss of various income-tested benefits, such as Old Age Security or the Age Credit, which are “clawed back” once income reaches various annually-indexed, preset thresholds.

³ The simple formula used to optimize the ideal RRSP contribution given an individual's cash contribution = Cash on hand divided by (1 minus METR).

⁴ Following from the formula above, the additional amount an individual needs to borrow to optimize the RRSP contribution = Cash on hand times [1 divided by (1 minus METR) minus 1].

Figure 1: Tax-free growth in an RRSP

Description	Cash flow	RRSP account
RRSP Contribution - January 1st	\$3,000	\$3,000
Tax Refund (33.33%)	(1,000)	n/a
Net cost of RRSP contribution (A)	\$2,000	n/a
Growth (5%)	100	150
Value of RRSP - December 31st	n/a	\$3,150
Tax (33.33%)	n/a	(1,050)
Net after-tax proceeds of RRSP (B)	\$2,100	\$2,100

In Figure 1, the after-tax growth is \$100 (calculated as the \$2,100 value at December 31st minus the \$2000 net cost of the RRSP contribution) and the tax-free rate of return is 5.00% (calculated as the growth of \$100 divided by \$2,000 net cost of the RRSP contribution).

Effect of changing tax rates

Of course the above example assumed that Dan's initial METR at the time of contribution was identical to his METR at the time of ultimate withdrawal. This is the easiest to model in that there is no additional tax rate benefit (disadvantage) associated with contributing to an RRSP. The sole benefit of RRSP investing is the ability to earn tax-free investment income over time.

Figure 2: RRSP vs. non-registered, same rate

Description	Cash flow	RRSP account	Non-registered account
RRSP Contribution	\$3,000	\$3,000	n/a
Tax Refund (33.33%)	(1,000)	n/a	n/a
Net after-tax savings	\$2,000	n/a	\$2,000
Total amount contributed	n/a	\$3,000	\$2,000
Ending Value	n/a	21,120	14,080
Tax (33.33% on RRSP / 16.67% on capital gain)	n/a	(7,040)	(2,013)
Net after-tax proceeds	n/a	\$14,080	\$12,067

Figure 2 shows the after-tax value of Dan's RRSP, invested over 40 years at 5%, as compared to the after-tax value of an equivalent investment had Dan gone the non-registered route. The non-registered investment assumes no income or gains are realized during the accumulation period and, when the entire amount is cashed in at the end of 40 years, a capital gain is realized, taxed at 50% of Dan's METR, assumed to be constant.

Clearly, the RRSP beats the non-registered account when Dan's METR stays the same upon ultimate withdrawal, due to the tax-free investment income earned in the RRSP. The RRSP account would show an even greater advantage over the non-registered account if the non-registered account assumption was more realistic in that annual interest or dividend income was earned and taxed annually or gains were realized occasionally during the accumulation phase and taxed throughout the period rather than merely at the end.

It goes without saying that if Dan's METR was lower upon retirement than it was upon contribution, the relative advantage of the RRSP over non-registered savings would be that much greater.

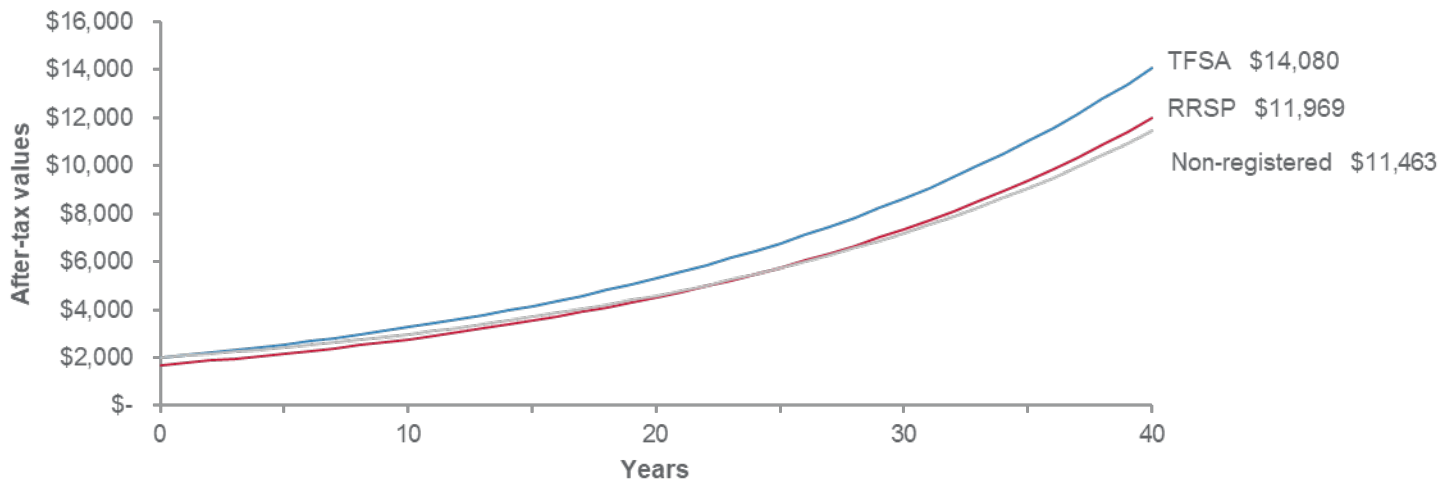
But what if your METR actually increases between now and retirement?

Some commentators⁵ have suggested that building up too much money in an RRSP or its successor, a RRIF, could very well be a bad thing because of the potentially high METR associated with RRIF withdrawals.⁶

But depending on the rate of return assumption, the number of years of tax-free compounding available, as well as the types of investment income you might otherwise earn by saving an equivalent amount in a non-registered account, the benefits of the tax-free compounding can actually outweigh the additional tax cost of a higher withdrawal METR.

Let's model this by using the same assumptions as above but this time we'll assume that Dan's METR increases by a full 10% from 33.33% to 43.33% upon retirement. After 40 years, there would be \$14,080 in the TFSA, \$11,969 in the RRSP and \$11,463 in non-registered savings.

Figure 3: After-tax values of RRSP, TFSA and non-registered account; 5% return; METR 33.33% at contribution, 43.33% at withdrawal



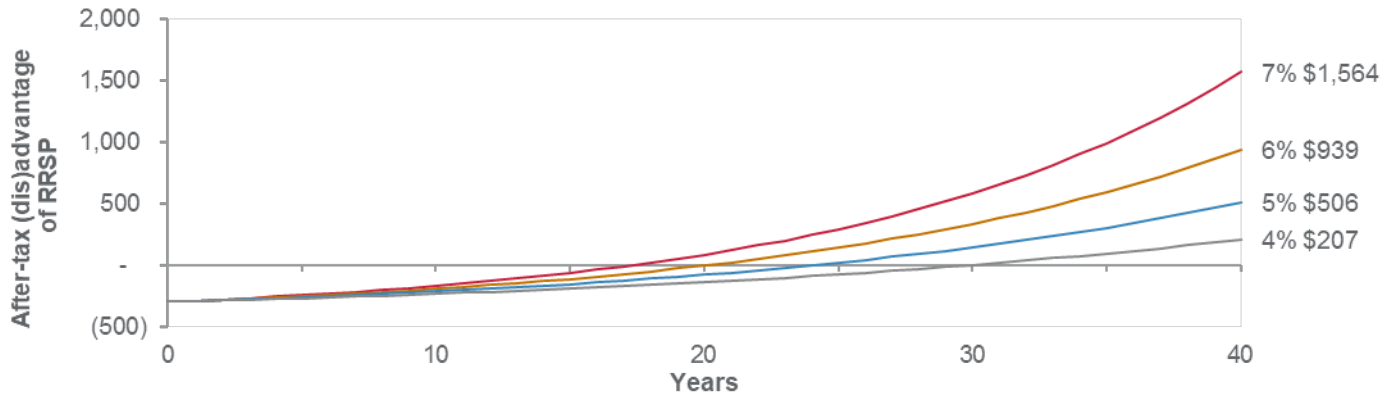
In Figure 3, with a 5% rate of return, contributing to a TFSA provides higher after-tax values throughout the entire period; however, it would take some time for the after-tax value of the RRSP to beat out the after-tax non-registered investments. The point at which RRSP savings start to exceed non-registered savings (the "breakeven point") is 25 years.

In Figure 4, the RRSP value is higher than the non-registered investments (and the RRSP has an advantage over non-registered investments) where there is a positive value. The RRSP value is lower than the non-registered investments (and the RRSP has a disadvantage compared to non-registered investments) where there is a negative value. The breakeven point occurs when the value is zero (where the line crosses the x-axis) and there is neither an advantage nor disadvantage from investing in an RRSP compared to non-registered investments. The number of years to the breakeven point decreases as the rate of return increases.

⁵ See, for example, Michael Nairne, "The dark side of RRSPs," Financial Post, January 19, 2011 available online at financialpost.com/personal-finance/dark+side+rrsps/4131635/story.html and John Newell, "Were RRSPs a major mistake?" Financial Post, January 19, 2011 available online at financialpost.com/opinion/counterpoint-were-rrsps-a-major-mistake.

⁶ Of particular concern to some higher income seniors is the potential recovery ("claw back") of Old Age Security (OAS) benefits, which can effectively add 15% to some retirees' METR.

Figure 4: Relative (dis)advantage of RRSP vs. non-registered investing; METR 33.33% at contribution, 43.33% at withdrawal



To reiterate, both Figures 3 and 4 paint an extreme picture whereby the non-registered account grows free of any tax during the accumulation period and is fully taxed as capital gains at the end of 40 years. In a more realistic world, the breakeven points illustrated in Figure 4 would come much sooner if the non-registered savings were taxed throughout the accumulation period and at rates less favourable than that of capital gains.

The role of TFSAs

Finally, a quick word about TFSA investing is warranted. The TFSA can also play an important role in retirement savings accumulation in that all investment income earned inside a TFSA is never taxed, provided the rules are followed. For taxpayers nearing retirement whose time horizons are shorter and whose METRs upon ultimate retirement savings withdrawal are expected to be higher than they were during the period of contribution, saving within a TFSA may provide additional tax savings beyond the tax-free investment accumulation.

TFSAs also play an important role in retirement savings for low-income Canadians. A low income earner would be best advised to maximize his or her TFSA to the extent possible. Any additional savings, however, should be directed to non-registered savings instead of RRSPs due to the potential loss of the Guaranteed Income Supplement (GIS) upon retirement. In this case, even a full and immediate taxation of investment income annually in a non-registered account is preferable to an RRSP because those in the lowest tax bracket are facing a 20% or so METR when they contribute but a 50% to 70% estimated METR when they withdraw.⁷

In a nutshell, if you think that your post-retirement METR will be materially larger than your pre-retirement METR (as would happen if you were expecting to be subject to the GIS or OAS recovery tax, TFSAs are the best choice. If you think that your post-retirement METR will be materially smaller than your pre-retirement METR (as might happen if you plan to split pension income with a lower-income spouse or partner) then RRSPs work best. If you are not expecting your post-retirement METR to differ materially from your preretirement METR, then it doesn't really matter which plan you choose. This is discussed in detail in our report titled Blinded by the Refund: Why TFSAs may beat RRSPs as better retirement savings vehicle for some Canadians.⁸

⁷ As Richard Shillington wrote in his 2003 Report, "(F)or many lower-income Canadians RRSPs are a terrible investment." See: "New Poverty Traps: Means-Testing and Modest-Income Seniors" – C.D. Howe Institute Backgrounder No. 65, April 2003, which is available online at cdhowe.org/public-policy-research/new-poverty-traps-means-testing-and-modest-income-seniors.

⁸ The report Blinded by the Refund: Why TFSAs may beat RRSPs as better retirement savings vehicle for some Canadians is available online at cibc.com/ca/pdf/rrsp-versus-tfisa-report-en.pdf.

Conclusion

For Canadians expecting to have a similar or lower METR upon retirement, there is no doubt that RRSP investing beats non-registered investing, no matter the type of income earned and the rate of return assumption. For those saving for retirement who expect to face a higher retirement METR, depending on the time horizon, rate of return assumption and investment mix (i.e. interest, dividends or capital gains), the benefit of tax-free accumulation of investment income inside an RRSP can still outweigh non-registered investing, once the TFSA is maximized.

In other words, in nearly all cases, no matter your tax rate now or in the future, RRSP or TFSA investing should be an integral part of your retirement plan.

So, what are you waiting for? Just do it!

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